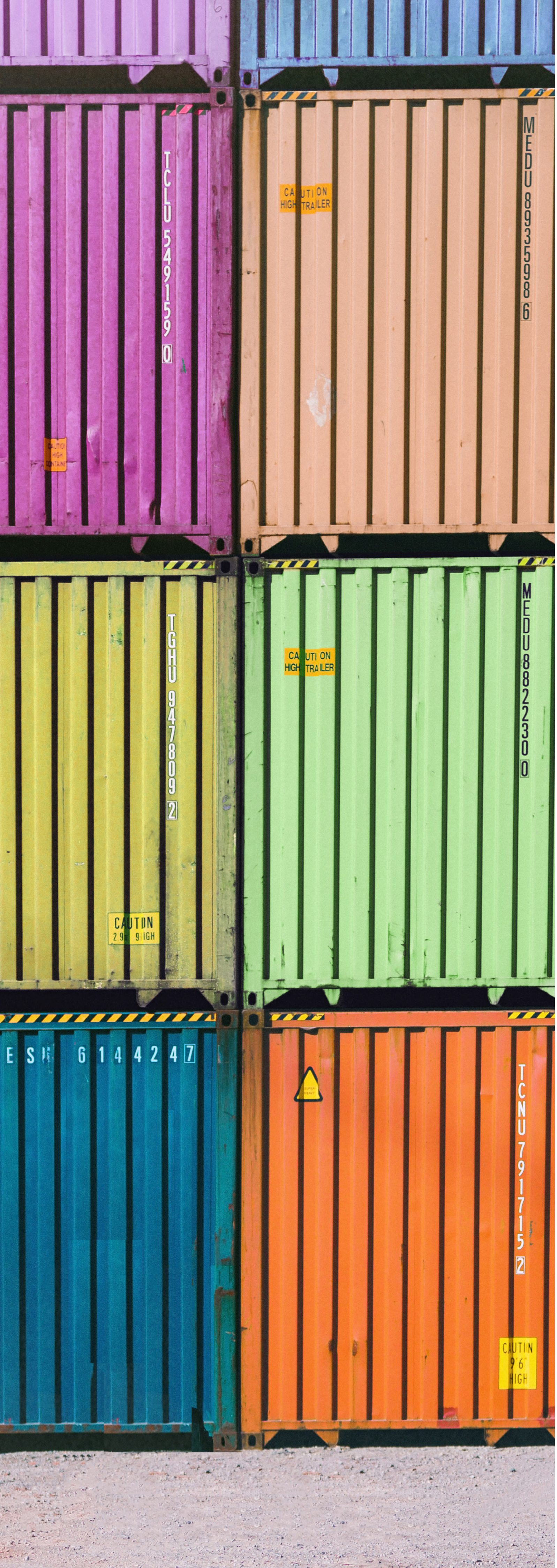

Expert Insights

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Tariff response strategies for the US-China trade war

Easing the impact of geopolitical upheaval on retail and consumer products

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Companies need to rethink their supply chains with consideration for the range of consequences should their expectations for the future of global trade prove overly optimistic or pessimistic.

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Talking points

Tariffs on China-made goods are high and potentially going higher
Retailers and consumer products companies have been finding ways to protect the US consumer from significant price increases.

Companies should use smart pricing strategies to protect and grow share in categories most central to their value propositions
"Smart price changes" mean increasing margin on items with less price sensitivity while leaving others untouched, and lowering prices to take share from competitors where it matters most to customers.

To protect the business, nurture and safeguard supplier relationships
In these times of uncertainty, it's vital to upgrade supplier relationships through close communication, and joint mitigation and contingency planning.

Adjusting to the new reality of tariffs

Chatter about US tariffs on China-made goods grew to fever pitch in early 2018, leaving retailers and consumer products companies wondering if the talk was more a bluff than reality. Turns out it wasn't a bluff. Initial tariffs have already increased dramatically, and more are scheduled to go into effect this year.

The state of affairs as of September 12, 2019 is that the US government has placed USD 250 billion of China-made goods under a 25 percent tariff and has announced an increase to 30 percent to begin on October 15, 2019.[1] The remainder of China-made imports—worth USD 300 billion—partially went under a 15 percent tariff on September 1 with the rest announced to go under the same tariff on December 15.[2] Conjecture abounds as to what happens next.

Astute US retailers and consumer products companies are finding ways to mitigate the impact of tariff hikes. Negotiating with suppliers has shown that China-based manufacturers are willing to bear much of the tariff costs. By executing smart price changes—increasing prices on items less central to their value proposition—US companies are investing in keeping customer prices low. US companies and their suppliers are also accelerating contingency planning should US-China trade become untenable.

How much cost will consumers absorb?

The US economy is doing well, with steady growth, low unemployment, and little consumer price inflation above normal.[3] The lack of inflation is so acute that the US Federal Reserve lowered interest rates this year, a move that tends to inflate the economy.[4] Gross domestic product (GDP) growth is healthy.[5] The US Consumer Price Index (CPI) is low compared to the last 20 years, and could conceivably drop even lower (see Figure 1). After an initial decline driven by trade tensions, US consumer confidence rebounded in July 2019.[6]

It’s a mistake to pass a tariff directly on to the consumer without consideration for competitors who may face less tariff exposure, or are more willing to invest in their customers.

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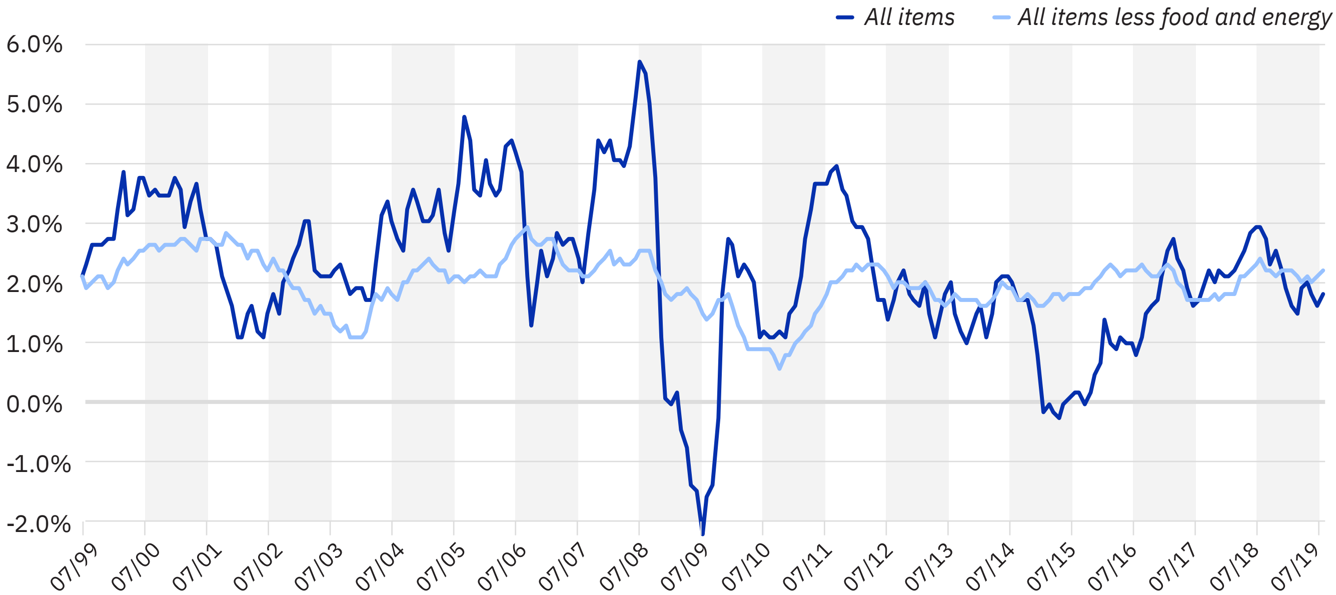
Figure 1

US Consumer Price Index, 12-month percentage change over a 20-year period



Source: US Bureau of Labor Statistics.

While the US economy overall appears to be suffering little from the tariffs, some economic indicators are signaling trouble on the horizon.[7]

But suppliers—on average—have been over-estimating the effects of tariffs on their costs by nearly twofold.[8] In extreme cases, some suppliers expect retailers to raise their prices by the same percent as the tariff. But a 25 percent tariff doesn’t translate to a 25 percent consumer price increase, not even close: if a retailer buys from a US supplier that buys and imports from a China-based manufacturer, the 25 percent tariff increases the cost of goods to the supplier, not the retail sale price. The weakening of the Chinese currency, along with subsidy and rebate programs, results in an even lower effect on the consumer price.

For example, for an item with a consumer price of USD 10, where the retailer’s gross margin is 30 percent and the supplier’s 40 percent, a 25 percent import tariff falls to what the supplier paid the China-based manufacturer, in this case USD 4.20. Passed to the consumer, it raises the shelf price of the 10-dollar item by USD 1.05, or 10.5 percent, as illustrated below.

	No tariff	25% tariff	
Consumer price	**$10.00**	**$11.05**	←
Retailer gross margin (30%)	$3.00		
Retailer cost	**$7.00**		
Supplier margin (40%)	$2.80		
Supplier cost	**$4.20**	**$5.25**	→ +$1.05

And that’s only the beginning.

Customer-driven tariff strategy

In March 2018, soon after the first official salvo of the ongoing US and China trade war, China's currency was trading at 6.30 yuan to 1 dollar. Less than four months later, the yuan had breached 6.70, a 6 percent devaluation. The timing of Goldman Sachs' 12-month outlook for China's yuan at 7.05, a level the currency hasn't breached in more than a decade, is already surpassing predictions and may need to be re-evaluated.[11]

An exchange rate today of 7 yuan to 1 dollar, versus 6.30 yuan to 1 dollar means that goods purchased today from China priced in yuan are exactly 10 percent cheaper when purchased in dollars. In other words, a product that previously cost USD 10 now costs USD 9.

Applied to the example of an item with a USD 10 price tag on the shelf, and the USD 4.20 cost from the China-based manufacturer, the currency devaluation lowers the cost to USD 3.78 and the 25 percent tariff raises it to USD 4.73. Passed to the US consumer, the price is now USD 10.53. The 10.5 percent increase from the 25 percent tariff is now only a 5.3 percent increase versus 10.5 percent thanks to currency devaluation, as illustrated below. It's not far-fetched to assume that further tariffs may bring further devaluation.

	No tariff	With 10% yuan devaluation	With 10% yuan devaluation and 25% tariff	
Consumer price	**$10.00**		**$10.53**	←
Retailer gross margin (30%)	$3.00			
Retailer cost	**$7.00**			
Supplier margin (40%)	$2.80			
Supplier cost	**$4.20**	**$3.78**	**$4.73**	→ **+$.53**

Beijing unveils a new round of retaliatory tariffs

On August 23, 2019, China announced new tariffs on US imports totaling USD 75 billion would start September 1, and range from 5- to 10-percent.[9] The tariffs target 5,078 products, including soybeans, coffee, whiskey, seafood, and crude oil. China's Finance Ministry also plans to resume tariffs of 25 percent on US imports of automobiles and 5 percent on automobile parts beginning December 15.[10]

How retailers and brands can thrive in the face of tariffs

- Improve price perception by becoming more competitive on items central to their value propositions
- Take share from competitors who are more exposed to tariffs
- Limit price increases to areas less central to the value proposition
- Take costs out of other areas of the business to fund tariff mitigation item pricing

Beyond devaluation, the cost of China made goods to US buyers is being lowered by programs to reduce manufacturing costs and lessen the tax burden on producers. This and other government programs are helping to shield China-based manufacturers, US importers, and consumers from the tariffs. While retailers may be able to negotiate away some of the tariff costs depending on product mix, those without the resources and flexibility to leverage suppliers or quickly shift product sourcing may have to pass extra costs to customers.

Whatever part of the tariff can't be mitigated through negotiation can be made up for by increasing price, increasing sales volume, or finding a cost-competitive supplier in a non-tariffed country. Large retail chains need to do all three, but thoughtfully. Where tariff-induced price optimization is utilized, we've seen individual item price increases fall in the 1- to 8-percent range.[12] A US retailer that has 20 percent of its items coming from China may need price increases averaging around 4 percent for about 30 percent of its portfolio.

Tariffs underscore the need for resiliency

The customer comes first, and US retailers and consumer products companies need to exercise all means to reduce the effects of a tariff. The possibility and threat of tariffs are likely to remain a significant feature of the global economic and geopolitical landscapes for the foreseeable future. Uncertainty in the current US-China trade war highlights the need for resilient and agile supply chain and pricing strategies, and the preparation that's necessary.

Both the US and China can brace for the unknown with:

- *Heightened awareness.* Monitor and anticipate government announcements and media reports.
- *Preemptive actions.* Continue to lobby both governments to de-escalate conflict, diversify countries of product origin, and increase domestic supplies.
- *Supplier housekeeping.* Maintain close supplier relationships, track their efforts to mitigate tariff exposure, and form contingency plans in order to react quickly to change.

Now more than ever, companies need to keep a close watch on the geopolitical situation, plan for a range of possible scenarios, and be ready to act both defensively and offensively. The modern company must study not only the latest consumer and market trends, but also stay abreast of trade skirmishes and new agreements between governments playing out globally in real-time.

In the current back-and-forth between the US and China, competitors face more or less exposure to geopolitical risk, depending on their share of business, including imported and exported goods, from China-based sources. What's more, companies need to clearly understand the strengths and weaknesses within their competitors' supply chains, and to map them against their own.

Companies should also think through the range of consequences should their predictions about the future prove overly optimistic or pessimistic, and choose an informed and deliberate course of action (see Figure 2). Much like military planning, retailers and consumer products companies need to understand what their "no-regrets moves" are under all possible scenarios, and how they'll react should each scenario come to pass. They also must prepare to execute their plans boldly and quickly.

In cases of uncertainty, one such no-regrets move is to designate the person or office responsible for watching the situation, preparing plans, and coordinating any necessary response. Preparation of plans includes modeling problematic scenarios and establishing and testing contingencies before they are needed. Once activated, any response should be managed centrally, with a clear mandate from the top.

Competitors face more or less exposure to geopolitical risk, depending on their share of business outside of their home country.

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Figure 2

Retailers future tariff beliefs, rational actions, and possible outcomes

		Your consequence depending on what happens		
Your belief about future tariffs	**Your rational actions**	**Increase**	**Stay the same**	**Decrease**
Increase	– Stockpile inventory ahead of the tariff hike – Shift supply chain away from China – Raise prices where possible to gain margin early – Postpone supplier cost increases	Achieved cost savings through forward buying	Stocked excess inventory at same cost	Stocked excess inventory at higher tariff levels and disrupted supply chain
Stay the same	– Keep order size constant – Continue to raise prices where possible – Continue to negotiate with suppliers based on current tariff levels	Missed opportunity to save cost through forward buying at lower tariff	Adequately stocked at same cost	Incurred higher cost on BAU order size
Decrease	– Pause orders until tariffs are lifted, letting inventory dwindle – Allow temporary cost increases until tariff lift – Hold prices low to take market share	Under-stocked and will incur higher cost at increased tariff levels	Under-stocked, but did not incur additional cost	Under-stocked, but saved cost by avoiding tariffs

Source: IBM analysis.

Surviving the trade war

By definition, and traditionally, tariffs have been used by governments to protect weaker sectors of an economy from better-developed foreign competitors.[13] However, tariff policy is being linked to issues related more to the geopolitical balance of power than to simple economic protectionism. US companies that don't see the bigger geopolitical picture may not sufficiently rethink the way they manage risk across borders.

Currency risk has long been a topic to which global companies have paid close attention. Risk of trade barriers being used as a tool to address geopolitical issues that go beyond economic imbalances is the new risk that the industry must learn to manage in an ongoing manner.

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Are you ready to respond purposefully to tariffs?

- What is your total cost of goods from China-based sources, both directly and indirectly, by supplier and item?
- What is your strategy to manage price perception on items that are most central to your customer value proposition, but facing tariff pressures?
- How successful have you been relative to your competitors in pushing back on tariff-related cost increase requests from your supplier base? What program do you have in place to manage these requests and pro-actively manage the risk of future tariff increases?

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