

# Chief economist's comment

## Are trade taxes changing trade?

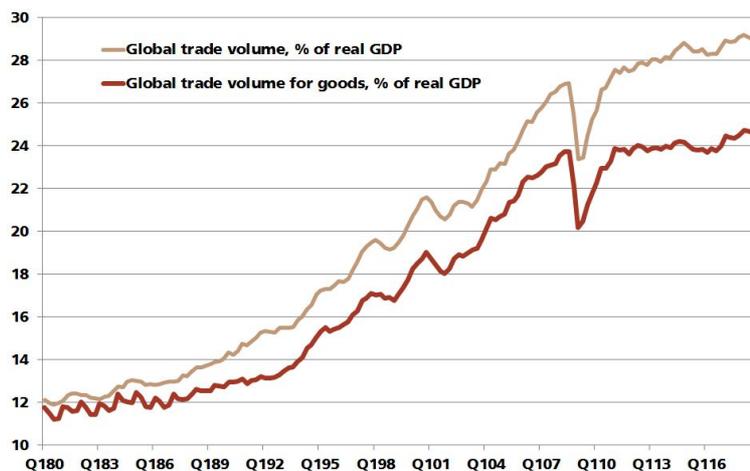
Chief Investment Office WM | 21 November 2018 7:16 pm GMT  
 Paul Donovan, Global Chief Economist GWM, paul.donovan@ubs.com

- Globalization had peaked before the recent US trade taxes. However, US taxes have led to shifts in supply chains.
- If the US put in place a universal tax on imports (e.g., washing machines), the cost eventually passed to US consumers.
- If the US has a country-specific tax on imports (e.g., against China) companies have found ways to evade the tax. For a few products, other countries are substituting for China.
- US data suggests that Chinese exports still make it to the US, but they may be going via a third country. Additional production takes place in the third country (rather than the US), allowing US importers to avoid the trade taxes.

The US began raising consumer taxes on imports over nine months ago. How have these tariffs changed global trade?

Even before the US tax increases, globalization had peaked. In real terms, global trade has been basically stable as a share of GDP since 2011. From the 1990s onwards, global trade surged as supply chains became longer and more complicated. More complicated supply chains needed more international trades to produce one product.

**Fig. 1: Real global trade in goods and services, and goods, as a share of real GDP**



Source: UBS calculations. Intra-Euro area trade is considered domestic trade and is not included in these calculations

Now supply chains are becoming shorter and simpler. In some cases, trade in goods and services (like music) is being reduced by services alone (digitization). This means that real global trade is likely to become less important to the world economy in the future.

Thus the starting point for trade was one where trade was unlikely to be accelerating. Global trade volumes have barely moved relative to GDP over the first three quarters of this year.

This data only runs to the end of September. That means that the tax on US consumers of washing machines, solar panels, steel, aluminum and USD 50bn of Chinese imports are fully included. The more recent, larger taxes on goods partially made in China are not included.

### What do companies think comes next?

Unfortunately, there is no reliable way of assessing what companies think will happen next with trade. Business sentiment surveys (like the ISM and PMI data) do ask companies what is happening to the volume of their export orders. There are two problems with this data.

First, companies do not answer the question they are asked. There is very strong evidence that companies give the value of export orders, not the volume.

Second, companies may give an answer to fit their political lobbying, not their economic reality. Companies are fighting against taxes. Saying that the taxes are destroying their trade is a good way of doing this. If you are telling politicians that trade taxes are destroying trade, it is sensible to say the same thing on a survey form. A weak survey will reinforce your argument. Giving a wrong answer on a survey to influence the survey result is "gaming" the system. It does not matter that this is "fake news."

All is fair in love and trade wars.

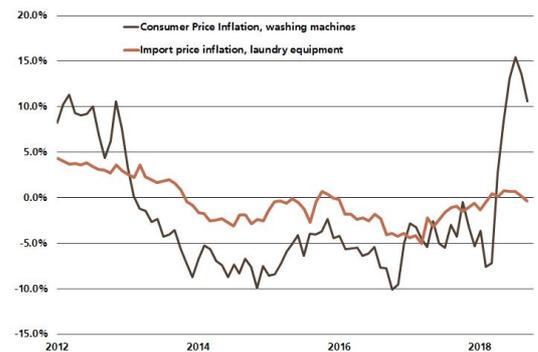
The result is a complete collapse in the correlation of export orders sentiment with export reality. Companies have said all year that export orders are slowing, but the data so far does not back their claims.

### Universal trade taxes

When the US has taxed imports from lots of countries, consumers are bearing the cost. When President Trump put a 20% on all washing machine imports, washing machine consumer prices in the US were falling over 7.5% y-over-year. The latest data has washing machine consumer prices rising over 10.5%. Pretax import prices are hovering around 0%. This suggests non-US washing machine makers are not prepared to cut their profits to offset President Trump's taxes.

The washing machine tariff is a difficult tax to avoid. All foreign washing machines are taxed. A washing machine is a finished product. It is hard to change supply chains to avoid a tariff like this.

### US consumers are paying the washing machine taxes



Source: Haver, UBS. Import prices are the prices before the new import taxes are imposed - showing that exporters to the US are not cutting their profit margins to offset US taxes, and that the burden therefore falls on US buyers.

## Taxing goods partially made in China

Some of the more recent taxes are easier to avoid. The early July wave of US trade taxes included a 20% tax on various products made in China. US data suggests that imports from China of these products fell 20% to 30%. In the case of many of these products, the rest of the world is not substituting for China (some items, like fiber optic cable, are exceptions).

So big a drop in the numbers should ring alarm bells for economists. There is no reason for US companies to stop buying in so dramatic a fashion. A 20% increase in import prices is not that unusual. Instead the data hints that US companies are being clever in evading these tariffs. There has clearly been some "front-running" of imports. Companies ordered early, so as to receive supplies before the taxes took effect. That can be seen in a spike in import data before July. There is then a natural drop in imports in August and September.

Aside from front-running effects, about 15% of the items on the first US tariff list had a meaningful drop in imports. In 2017, the import value of these items was about 27% of the total list value.

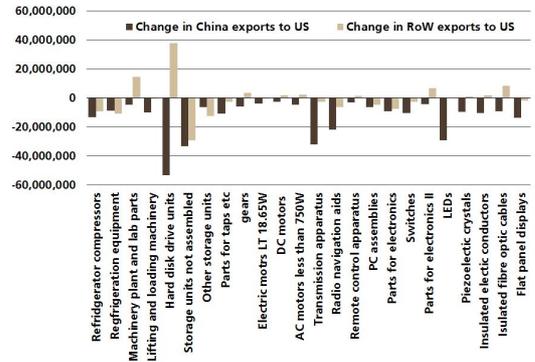
The most valuable imports to have a meaningful drop are almost all components of some sort or another. This gives a hint as to how companies might evade the tariffs. A US company importing electrical switches from China now has to pay the new trade tax. A US company importing something that uses Chinese electrical switches from a Canadian subsidiary does not have to pay the new trade tax. If US companies move a stage of their manufacturing overseas (to a country other than China), the trade tax is avoided. The US is, in reality, importing as many Chinese electrical switches as ever it did. It is just now they come packaged up as something else, and that package is made somewhere other than China.

It is important to note that China is not losing out in this scenario. Asian companies that might be considered rivals to China are not necessarily going to win trade share. Instead it is the US that is losing out, and it is countries that can provide similar production facilities to those of the US that stand to gain.

This is not just about US tariffs. There is evidence of European car manufacturers exporting cars in pieces to be assembled in Thailand, for onward sale to China. This lowers the tariff applied.

How easy is this to do? Switching complete production is difficult. Harley Davidson estimates it will take from nine to 18 months to move production out of the US to avoid trade taxes. In many cases, however, it is not the whole production process that is changing location, just one part of it. Around 40% of all global trade is done by multinational companies. These companies by definition have factories in more than one country. It is not easy to spot this in the data. However, exports of Chinese electrical switches to Canada increased substantially after the US taxes, as US imports fell. Other products saw similar surges in Canadian demand. The patterns of trade after the July trade taxes are certainly suggestive.

**Change in exports to the US after the tariffs - few areas of foreign substitution**



Source: US Department of Census, UBS. Change shown is the average imports in USD for August and September 2018, compared to the average imports for January to June 2018.

## What now?

We have hit peak globalization. Globalization would almost certainly have reversed without the US trade taxes.

A limited number of taxes – mainly the universal taxes applied to all countries – have been passed onto consumers. The evidence is that part of the other taxes has been evaded. However, as the US taxes its consumers and companies for more and more goods, the taxes will become harder to evade. Tweaking supply chains will work less well as taxes move from components to finished goods.

The risk is that the US administration feels emboldened by the limited economic damage from its earlier trade taxes. The taxes have not done much damage, because they have been evaded. That means, of course, that they have also had little to no impact on the burgeoning US trade deficit.

## Appendix

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