Chief economist's comment

Is the trade conflict hurting less?

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- At first, US President Trump's trade taxes (tariffs) were mainly paid by Americans.
- In recent months trade data shows that more and more supply chains have shifted. Over half the taxed items have had a meaningful change in supply to the US. This reduces the damage that trade taxes do to the US economy.
- Supply chains have shifted to Taiwan, Korea and Mexico, mainly in the electronics sector.
- Trade taxes are still hurting. Shifting supply chains means US customers are no longer buying from their first choice supplier. Trade uncertainty damages investment, and that slows growth.
- The flexibility of modern supply chains should continue to moderate the drag of the trade conflict on US growth.

The economic damage from taxing trade should fade over time. Companies find it easier and easier to avoid trade taxes as time goes on. Trade data suggests that the damage to the US economy from last year's trade taxes is becoming less severe. This is because President Trump's September/May tax increases were not universal. The taxes only hit goods from China. As time has gone on companies have found it easier to adjust supply chains. That should reduce but not stop the damage to the US economy.

What has changed?

In September 2018 the United States imposed a tax (or tariff) on USD200bn of goods from China. Almost 4,500 items were listed, although some were items that China does not sell to the United States. At first the tax was set at 10%. This was raised to 25% in May 2019.

The impact of trade tax increases is complicated. Trade uncertainty has slowed the world economy. Global investment growth has fallen as uncertainty has risen. At about a third of global trade, global investment matters much more to trade than to the overall economy. It varies from country to country, but investment is two or three times as important to trade as it is to the overall economy.

Only looking at import and export values will be misleading. Such data includes the effects of the trade tax. It also includes the effects of the growth and investment slowdown.

One way around this is to look item by item at changes in China's share of US imports. If China's US market share is stable, the damage of trade taxes is likely to hit the US economy. If China's market share is falling, that suggests supply chains are adjusting. If supply chains adjust, the damage to the US economy will be reduced.

Around two thirds of global trade is in the hands of multinational companies. A multinational company should find it easier to adjust its supply chain than a small company. If exports from one location are taxed, a multinational company may be able to move to another factory in another location. US sales from the multinational company can continue. It is the place of origin, not the company that is the target of the trade tax.

Companies cannot change location immediately. There will be a delay to adjusting supply chains. But eventually supply chains can shift.

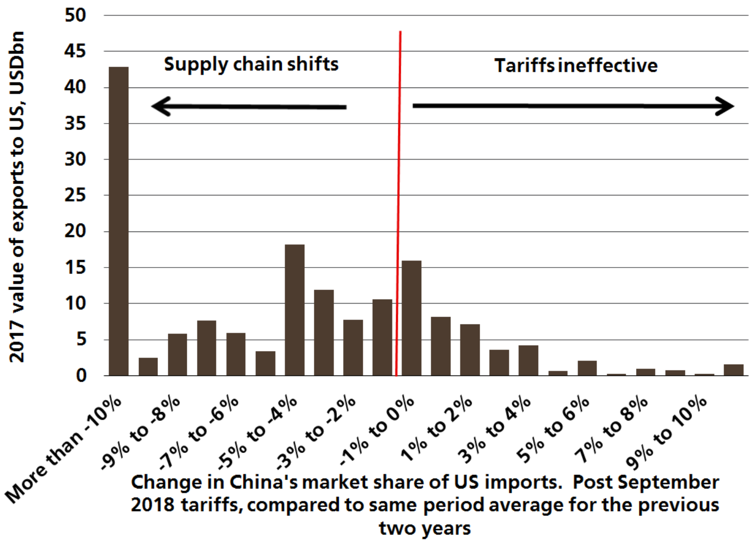
In the first six months of operation, the September 2018 trade tax did not do what the US wanted. China either maintained or increased its market share for half the impacted items (by value). Supply chains did not shift. US companies and consumers had to pay the tax.

In recent months supply chains have adjusted more and more.

The next chart shows that for almost USD45bn of items imported from China, China's market share has fallen by more than 10%. (The bar on the furthest left). The focus on market share means, by definition, that supply is now coming via other locations. The *company* supplying the goods need not change.

More and more products subject to tariff are changing supply chains

Chinese imports into the US in USDbn (2017 values), broken down by the change in market share



Source: US Bureau of Census, UBS calculation. The change in market share compares China's post tax market share of US imports (October 2018 to August 2019) with China's average market share of US imports for the same eleven month period over the previous two years.

For over half the taxed items China has seen a significant (more than 4%) drop in US import market share. (The seven bars on the left of the chart). For over a quarter of the taxed items, the drop in market share has been more than 10%.

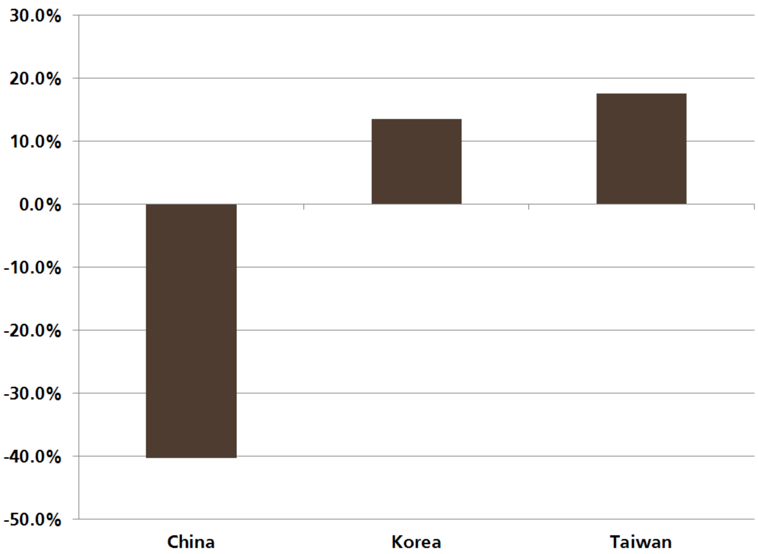
China has maintained or increased its market share for just over a quarter of the taxed items. (The bars to the right of the red line on the chart). This is where the trade tax still does obvious damage to American buyers.

Where have supply chains shifted to?

It depends on the product. Compared to six months ago, supply chain adjustments are affecting a slightly broader range of products. However, the biggest supply chain changes are the same as they were six months ago – certain electronic items, and luggage and handbags.

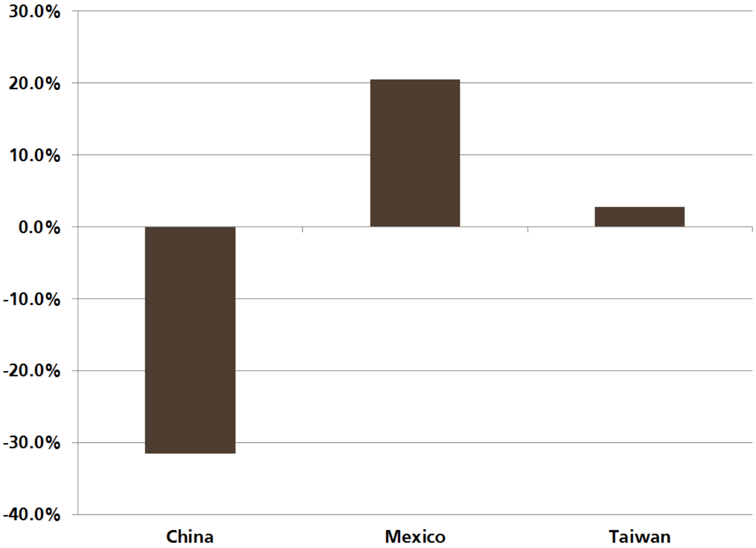
The same places are gaining market share in the US. For circuit boards, Korea and Taiwan have picked up market share. For transmission based electronics, investment in production before September 2018 has allowed Mexico to increase its market share. (Some of the Mexican gains will be independent of the trade taxes, therefore). The Euro area has gained market share in the luggage industry. Supply chains have shifted to locations with the capacity to produce. This is not about using new factories. This is about moving to existing factories in places that are not subject to the trade tax.

Supply chains shifting to Korea and Taiwan
Change in share of US imported circuit boards



Source: UBS Bureau of Census, UBS calculation. Data shows the change in US import market share between the period from October 2018 to August 2019 and the same period over the two previous years

Supply chains shifting to Mexico
Change in share of US imported mobile phone equipment



Source: UBS Bureau of Census, UBS calculation. Data shows the change in US import market share between the period from October 2018 to August 2019 and the same period over the two previous years

What does this mean for the US?

For the first six months of the September 2018 trade taxes, American customers felt most of the pain. The increase in the tax to 25% in May 2019 will have increased the damage to the US economy. However, that damage is being mitigated by the flexibility of supply chains.

Shifting supply chains is not costless. Taxes are forcing Americans to abandon their first choice option and settle for their second choice. This may be more expensive, offer a different quality, or be more inconvenient to source from. Even with shifting supply chains American importers still pay a price because of the trade taxes. However, since May 2019 the US has gone from no shift in the supply chain for almost half the taxed items, to a meaningful shift in the supply chain for over half the taxed items.

It is sensible to assume that the direct impact of trade taxes is having a fading effect on the US economy. The uncertainty that trade policy has caused is likely to be the longer lasting cause of damage.

Appendix

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