Supply Chain Scene

Hot Topics: Effects of US/China Trade on the Food Service Industry

The Trump administration recently announced plans to enact a series of tariffs on a wide range of imported goods. In response, China is threatening to enact new tariffs of its own and promises to match any additional US tariffs in "scale and strength." Such rhetoric is sparking fears of the development of an all-out trade war between the two nations. Manufacturing could be hit hard, (Kitroeff and Casselman 2018; Smith 2018), possibly impacting the food service industry in a multitude of ways.

What commodities are targeted?

President Trump initially imposed a 25% tariff on all US steel imports and a 10% tariff on aluminum imports (with exemptions for Canada and Mexico). These were followed by a list of 1,300 additional Chinese items on which a 25% tariff might be levied (see Docket Number USTR-2018-0005 for the full list). Broadly, these additional tariffs target Chinese aerospace, technology, and machinery (Gillespie and Horowitz 2018). Machinery is set to include:

- Stoves and ranges
- Refrigerators and freezers
- Cash registers
- Dishwashing machines
- Brewing equipment

In addition, there are countless other machines on the target list used by direct suppliers to the Food Service industry, such as can filling and sealing equipment, milking machines, and an assortment of crop harvesting devices. Beyond steel and aluminum, none of these tariffs have taken effect yet, but are on course for implementation in June 2018, after a period of public comment and review. (See timeline).

China's response to the steel and aluminum tariffs is a 25% import tariff on fresh fruit, nuts, wine, pork, and about 100 other products from the US (Daniels 2018). The Chinese government also warns of additional 25% tariffs on 106 further items should the US follow through with their plans (Laing and Aguilar 2018).

Why This Matters: Potential Impacts on the US Food Service Industry

To understand the full picture, Food Service industry managers should consider both the direct and indirect impacts of the existing and potential tariffs, as well as the ways in which they will impact key supply chain partners.

Direct costs

Cost of equipment

Many Chinese-made machines used in food service are set for tariff penalties, becoming 25% more expensive to purchase. In addition, steel is one of the items targeted most specifically by the tariffs. Any domestically-produced items that use imported steel as a raw material, (except from Mexico or Canada), will be affected. This most obviously applies to large pieces of kitchen equipment, such as mixers, ovens, dishwashers, and refrigerators, but there are thousands of other items made of steel that are less conspicuous. Baking sheets, utensils, knives, and carts are just a few of such items, as well as countless other appliances containing steel parts and internal components. These will all likely be subject to some measure of cost increase.

Cost of materials, supplies, and ingredients

Aluminum is also a targeted metal. While it, like steel, is used to make equipment and kitchen appliances in the Food Service industry, it is perhaps most commonly used to make beverage cans. Of even more critical importance, aluminum foil is commonly used to wrap food and line sandwich paper. (e.g. burritos at Chipotle or sandwiches at Chick-Fil-A). Aluminum also covers items such as yogurt containers and jars of peanut butter. All of these items will likely be more expensive.

A recent Federal Reserve Beige Book report noted that surveyed manufacturers facing higher steel and aluminum costs expect, on average, to pass on around 50% of their increased costs to customers (Federal Reserve Bank of Dallas 2018).

Indirect costs

Market prices increase as demand increases/supply decreases

If Chinese goods become more expensive, buyers will search for other sources. This run on the remaining pool of supply can dramatically increase the price of alternatives. One buyer of aluminum foil mentioned that he has been forced to consider suppliers in new, unfamiliar markets such as Russia, Bulgaria, South Korea, or Taiwan, all of which have raised their prices in response to the situation. Another buyer looking domestically said that there are only two US suppliers making the product that he needs, and both are already selling their entire production capacity (Postrel 2017).

Quality issues

Any time a new supplier is used, there is a risk with potential product quality issues. Chinese mills are state-of-the-art, while other suppliers, including those in the US, are described as old and outdated. “At one point, the 25% of our total foil that was supplied domestically was the source of over 95% of our raw material rejection,” recalled one buyer (Postrel 2017). Such problems further reduce usable supply, and impose costs related to inspection, returns, and lost consumer goodwill resulting from stock-outs and reduced quality.

Reduced spending by consumers

As tariffs force prices to increase across a multitude of industries, end consumers will have less discretionary income to put toward leisure activities and dining out. As Hazlitt (1946) put it, "Because (the consumer) must pay more for (…) protected goods, he can buy less of everything else." Dining out is among the first things consumers cut when there is less to spend (CBS/AP 2008).

Some industries harmed by the tariffs might even be forced to forgo raises, reduce salaries, or lay off workers, which would further reduce consumer spending. Thus, at a time when food service providers would be facing increased operating costs, they are also likely to also be hit with a decrease in sales, making tariffs a double-edged sword.

What's going to happen? Three potential outcomes

While it is impossible to predict with complete certainty, commentary suggests that there are three general outcomes that could develop from this tariff face-off (in order from most likely to least likely): nothing, more tariffs, or an all-out trade war

Outcome 1: Nothing

While there has been a lot of tough talk and posturing on both sides, most seem to believe that this will all eventually come to one big "nothingburger," (food pun totally intended), where no new tariffs are implemented and the recently imposed ones on steel and aluminum will be rolled back. There are many reasons why:

- Mutual dependency – The US and China are too intertwined economically for a trade war to be profitable for either side (Gooley 2018). One can hardly take a shot at the other without shooting oneself in the foot. Consider just a few examples:
    - Most of the toys and appliances that the US imports from China are made from the $3.2 billion dollars' worth of plastic resins that China imports from US (Kitroeff and Casselman 2018).
    - The 25% tariff that China recently imposed on US pork is arguably doing its most damage to Chinese business. The largest US exporter of pork to China is Smithfield, a subsidiary of a Hong-Kong-based firm (Dewey 2018).
    - China has a domestic livestock industry, but its primary source of feed for pigs is imported US soybeans, which is set to be hit with a 25% tariff (Dewey 2018).

  - Many Chinese companies have invested in US wine makers, to which a 15% Chinese import tariff was recently applied (Dewey 2018).

- Limited efficacy – In today's globalized supply chains, getting around tariffs is easier than any time in history. For example, brokers in Shanghai are available to "transship" goods to Malaysia before they are sent the US, simply to disguise their origin. This avoids tariffs targeted directly at China (Bradsher 2018). The US can respond by applying the tariffs to imports from all locations, but doing so risks angering other trade partners and violates World Trade Organization (WTO) agreements. Plus, even these can be circumvented. American manufacturers could simply buy aluminum products, for example, from converters in Mexico or Canada, who can both source from China and export (under NAFTA) to the US tariff-free (Postrel 2017).

  Tariff systems can also be "gamed," as Ford did for years with its Transit Connect vans. The US had a 25% tariff on imported commercial vehicles, but only a 2.5% on passenger vans. As a result, Ford would import the vans from its plant in Turkey with a rear seat included and glass in the back doors, thus qualifying for the significantly lower passenger vehicle tariff. Once the vehicles were offloaded at the Port of Baltimore, a contractor would remove the seat and replace the glass with sheet metal before sending them to dealerships, (TTAC Staff, 2013).

- Votes – Despite efforts to avoid targeting consumer products such as clothes and toys, any tariffs that the US imposes on China will hurt the general American public as increased material costs cascade in to the price of finished goods. Perhaps most importantly, reciprocal tariffs by China will have serious impact on manufacturers and farmers in states like Michigan and Iowa – states that helped carry Trump to victory in the 2016 election (Laing and Aguilar 2018). While US import tariffs on steel might help the limited number of steel industry workers in Pennsylvania, exponentially more potential voters will be harmed – not a wise political strategy.

- Signs of progress – There has already been notable progress toward resolution in recent weeks. On April 10, Chinese President Xi Jinping announced that China would significantly lower the vehicle tariffs which President Trump had complained about, while further opening the country's economy. He additionally pledged to strengthen IP protection, improve foreign access to China's financial sector, and ease restrictions on foreign ownership of companies in certain industries (Curl 2018; Mullen 2018). In another positive move, on April 21, US Treasury Secretary, Steven Mnuchin, announced plans to visit China for discussion, stating that he is "cautiously optimistic" about negotiating a deal to end the trade stand-off (Mayeda 2018).

Some suggest that Trump never intended to follow through with tariffs, but instead is simply using them as a bargaining tactic to extract concession and cooperation from China (Shapiro 2018; Fickling and Ren 2018). Whether or not this is true is impossible to know; however, Trump has demonstrated that he is prone to sudden shifts on trade policy. (Bryan 2018, April 15).

Outcome 2: US and China go through with more tariffs

It is possible that no significant agreement is reached in the coming weeks and the US goes through with implementing a series of tariffs, which China has promised to immediately reciprocate. While the USTR has presented a detailed proposal of what those tariffs might look like, (Docket Number USTR-2018-0005) they are subject to revision over the coming weeks as the US Department of Commerce considers public feedback, as well as applications for exemption from US businesses.

If history provides any indication, any tariffs that are imposed will be short-lived. President George W. Bush levied tariffs on imported steel in 2002, but they were lifted the following year (Porter 2018). In 2009, President Obama levied a tariff of 35% on Chinese tires; it was lifted by 2012 (Gillespie 2017).

Outcome 3: All-out global trade war

An global trade war is a much less likely scenario. Germany, Canada, and the European Union (EU) have condemned the US steel and aluminum tariffs, and the EU published a list of US products that it would slap with retaliatory tariffs (Tankersley 2018). The US responded by temporarily exempting the EU from the tariffs, along with Argentina, Australia, Brazil, and South Korea. (Mexico and Canada are exempt under NAFTA). Japan has argued that it should also be granted exemption (VOA News 2018), and could complain to the World Trade Organization or retaliate if its request is denied.

Should a tariff war expand, countries with export-driven economies would be particularly harmed, including many in Southeast Asia. Even nations with low direct impact by global tariffs could be significantly affected as stock market volatility and currency fluctuations cause financial hardship. A board member for the Central European Bank reports that borrowing costs are already increasing in response to the potential trade war, and that stock prices are falling (Iyengar 2018). A slow-down in global economic growth would be an almost certain outcome which would in turn impact employment and welfare virtually everywhere, (Iyengar 2018; Tankersley 2018). The result could be another global recession (Tankersley 2018).

What Should Food Service Managers Do?

Much will be determined in the weeks to come, but in the meantime, managers in the food service industry can consider the following steps.

- *Identify goods and suppliers that might be affected* – Work with procurement managers to determine which foreign-sourced items might be subject to tariffs, and which domestic suppliers rely heavily on vulnerable goods for production.

- *Explore alternative sources of supply* – Determine whether there are alternative suppliers available, if they have available capacity, and the feasibility of sourcing from their location. Any potential impacts on product quality should also be considered.

- *Develop a cost strategy* – If cost increases due to tariffs are unavoidable, begin to strategize about their mitigation. How much will be absorbed by the company vs. passed on to the customer, and how will this be decided? Are there cost-savings initiatives that could be undertaken which might offset the increases? Now might be the time to launch those plans.

- *Buy now* – Depending on the cost of capital vs. the expected cost increase due to tariffs, it might be advantageous to buy certain equipment now instead of waiting until a planned date in the future. The same might be true of some materials or ingredients, though the potential savings must be weighed against the cost of carrying inventory.

- *Request exemption* – Manufacturers can request a tariff exemption from the US Commerce Department if they can show that the type of steel or aluminum they need for production isn't available in sufficient quantity or quality from a US supplier (Bryan 2018, April 17). Food service companies might consider partnering with key suppliers in helping them build a strong case for their exemption. This might include sharing demand forecasts to establish purchase volume or certain materials, or planned purchases of large equipment.

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