Report on Supply Chain Compliance Volume 2, Number 13. July 18, 2019
US-China trade war pivots; other trade agreements show promise for global supply chains

By Sascha Matuszak

The United States and China have promised to return to the negotiating table after a meeting between President Donald Trump and President Xi Jinping during the G20 conference in Osaka, Japan. The agreement at the G20 conference involved some concessions on both sides, but it is unclear what actions will be taken in the immediate future. The U.S. agreed to shelve an additional USD 300 billion in tariffs and remove some restrictions on the sale of electronic components to Huawei Technologies Co. Ltd. China bought 544,000 metric tons of soybeans in the days leading up to the G20 conference, and there has been discussion of future purchases to come.

These moves may bring some slight relief to global supply chains rocked by a year of trade conflict between the two powers, but the reordering that began last year has gained an unstoppable momentum. Global supply chains have shifted and will continue to shift into new configurations — and be governed by a whole new set of trade regulations — and there is little chance of undoing the changes that are happening right now.

Among the major drivers of global supply chain changes are:

- Increased risk mitigation by global companies affected by tariffs and trade conflict.
- New and expanded free trade agreements between a wide variety of nations.
- The development of new manufacturing and logistics capacities by nations formerly in the shadow of China.

Compliance vs. profitability

The big choice facing companies since the trade conflict erupted between the U.S. and China has been whether to comply with new tariffs and regulations, or move production. The answers to that question have been varied.

Apple Inc.'s supply chain, for example, is deeply entrenched in China, where it employs approximately 3 million people and assembles every major product it sells globally. Apple recently asked its suppliers — primarily Taiwanese companies Foxconn (Hon Hai Precision Industry Co., Ltd.), Pegatron Corp. and Wistron Corp. — to explore possibilities in Southeast Asia. Moving any aspect of the sprawling supply chain it has in China would involve years of training the workforce and ensuring quality control, but the move has started. Additionally, Apple has moved production of its Mac Pro computer to China from the U.S. This move emphasizes where Apple sees its opportunities in the future and its pragmatic approach to the risk of tariffs and other duties: moving production closer to the market removes unnecessary costs and fees.

Harley-Davidson, Inc. recently announced a joint venture with Chinese manufacturer Zhejiang Qianjiang Motorcycle Group Co., a company majority-controlled by Geely, to produce motorcycles in China for the Chinese market. The motorcycle is smaller than its American counterpart but will reportedly look and sound unmistakably like a Harley. The move here takes advantage of the opportunities presented by a trade war to establish a manufacturing and supply chain base in China and to market a new product for new consumers.

Companies and trade associations have banded together to send several letters to the Trump Administration protesting the lack of an agreement between the two nations, including a letter sent on June 13, entitled "Tariffs hurt the Heartland."

"Tariffs are taxes paid directly by U.S. companies, including those listed below— not China," the letter reads. "Furthermore, we have seen repeatedly that tariff increases and uncertainty around these trade negotiations have created turmoil in the markets, threatening our historic economic growth."

Although these letters may have played a role in preventing an escalation of the trade conflict at the G20, the damage has been done for many companies. In a June 17 *Washington Post* article, several companies admitted they were choosing profitability over compliance, and contemplated moving production out of China to nearby Asian countries, such as Vietnam and Malaysia. Most, however, also admitted that moving supply chains would be very difficult, if not impossible.

"If we are forced to move production from China, it will take a long time to make sure that new factories will make the garment correctly and can get the proper materials," wrote Mark Corrado, president of Leading Lady, a bra maker in Beachwood, Ohio, who testified before the U.S. Trade Representative in June. "The costs may be too great, too, as we are barely profitable now."

The world reacts

While the U.S. and China have been bumping heads, the rest of the world has been forging agreements. The most impactful of these have been the EU-Japan Economic Partnership Agreement and the EU-Japan Strategic Partnership Agreement (EU-Japan EPA), the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and the pending Regional Comprehensive Economic Partnership. These three agreements include many of the largest economies of the world and, together, encompass hundreds of millions of people and at least half of the world's trade.

The most important aspect of these agreements is how they dovetail with one another. Under the EU-Japan EPA, components and parts sourced from CPTPP members are considered value added, and companies trading with the EU-Japan EPA and the CPTPP receive many reciprocal benefits. In practice, this opens the EU up to the 11 other members of the CPTPP, and vice versa.

The same synergy is possible with the Regional Comprehensive Economic Partnership, which is currently under negotiation. If and when it is finalized, this trade agreement has a considerably larger impact than the CPTPP. The deal covers 24% of global GDP and almost half of the world's population. Although the agreement reduces only 80% of custom duties (as of the current draft) due to the very high duties in place with current members, the reduction has a greater effect than either the CPTPP or the EU-Japan EPA. The Brookings Institution estimates the agreement would possibly increase global incomes by as much as USD 300 billion per year by 2030.

Vietnam's big moment

Companies have been shifting out of China for more than a decade, but the rate of change has accelerated in the past year as companies seek refuge from the trade war. One of the primary destinations has been Vietnam, for three major reasons:

- Cheap labor.
- Regulatory framework.

- Proximity to China.

Vietnamese workers earn about half of what Chinese workers earn, and utilities are also very cheap. Coupled with government subsidies and business-friendly attitude, re-shoring to Vietnam is one of the cheaper options available to companies seeking to diversify their global value chains.

Vietnam is a member of the CPTPP, which eliminates a slew of tariffs and other costs between multiple Asian nations. Vietnam also signed a free trade agreement with Europe that went into effect the beginning of 2019. This and other deals mean Vietnamese businesses enjoy free trade with a large number of established and growing economies. Vietnam's government is also very business-friendly: If a new securities law is passed, foreign investors may be allowed to own 100% of public companies — a benefit they never enjoyed in China.

The U.S. has accused Vietnam as being a major transshipment hub for goods originating in China, and the data bears that out. According to numbers provided by the Vietnamese government, exports to the U.S. and imports from China have both risen exponentially in the last 10 months. An article in *The Wall Street Journal* detailed the efforts of both the Vietnamese and U.S. governments to stem the transshipped goods and create a healthy manufacturing base in Vietnam, instead of a transit center for goods trying to evade tariffs:

> Vietnam, which has benefited from the trade dispute between the U.S. and China, is vulnerable to losing some of its newfound business if the country is perceived as a transshipment center. It is primed to benefit from a reordering of the global supply chain. Many companies, including Apple Inc. supplier Foxconn Technology Group and electronics giant Sharp Corp. are weighing plans to migrate manufacturing capacity out of China to hedge against the cost of the U.S.-China trade fight.

Takeaways

- Global supply chains have been severely disrupted in the last year by the Sino-U.S. trade conflict, and the trend will not stop, even if a deal is reached in the very near term.
- Several initiatives, including free trade agreements between various nations and the rise of Southeast Asia's manufacturing capacity, ensure that the supply chains of the future will be very different. The trade war has caused much change, but the restructuring of the global supply chain to reduce risk and increase sustainability was already underway and will continue.