Shifting US tariff policy: Industry impact and how firms can respond

Contacts

Daniel Kahn, PhD
Principal
Transaction Advisory Services
Ernst & Young LLP
daniel.kahn@ey.com
+1 202 327 6695

Louise Keely, PhD
Principal
Transaction Advisory Services
Ernst & Young LLP
louise.c.keely@ey.com
+1 312 879 2994

Brian Anderson also contributed to this article.

Through the first half of 2018, the Trump Administration has made a series of announcements regarding new tariff policies that are likely to significantly raise costs for American businesses, from equipment manufacturers to construction companies to a host of other industries.

Executives need to understand the potential impact now and prepare their businesses to mitigate the effects of the tariffs. They need to take steps to improve pricing power by aligning their businesses with consumer demand and differentiating the businesses from the competition. These actions can prepare businesses for long-term growth in an environment of constantly shifting end-user demand.

History can help predict which industries will be most affected. Many of them use large amounts of metal in their manufacturing processes. But even companies that do not use a significant amount of steel or aluminum may still be subject to secondary effects, as the equipment they use becomes more expensive or consumers adjust their buying habits.

Even temporary tariffs have had long-lasting effects in the past, increasing prices and hindering job growth.

In this article, we outline the tariff policies being proposed and enacted by the US Administration, particularly those for steel and aluminum imports. We present a framework for how CFOs and heads of business units can project the potential impact on their businesses. We identify which industries are likely to be most affected by the proposed tariffs on metals, and share historical examples of tariffs to help firms prepare for long-term changes.

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Which new trade policies are being discussed?

Most of the Trump Administration's recent trade policy proposals focus on implementing a set of new tariffs and quotas on select imports from select countries. Announced on April 3, the centerpiece of the proposals is a list of 1,300 products from China that would be subject to new tariffs. The list of products and countries has expanded since, with new tariffs being announced and finalized several times. Several trade partners have also announced retaliatory measures.

The list of products covered by the tariffs is long. Over time, it has evolved to include a variety of both final goods that are likely to affect consumers directly and intermediate goods that will influence the cost structure of firms that use those goods in production. For the purposes of this paper, we limit our analysis to the tariffs on those intermediate goods that will require action from companies.

Among the tariffs affecting intermediate goods, no single topic has garnered more attention than the imports of steel and aluminum. There were previously no tariffs or quotas in place for any steel or aluminum imports, which, some argue, has contributed to the relatively low levels of American metal production. The US steel industry is operating at 73% capacity, while the aluminum industry is only operating at 48% capacity.[1] In an attempt to boost domestic production of both metals to 80% capacity, a level that is considered necessary for the long-term survival of these industries, the Administration has proposed a number of options:

Steel

- A global tariff of at least 24% on all steel imports from all countries
- A large tariff of at least 53% on steel imports from 12 countries (Brazil, China, Costa Rica, Egypt, India, Malaysia, Republic of Korea, Russia, South Africa, Thailand, Turkey and Vietnam)
- A quota on all steel products from all countries equal to 63% of each country's 2017 exports to the US

Aluminum

- A global tariff of at least 7.7% on all aluminum imports from all countries
- A tariff of 23.6% on all aluminum imports from China, Hong Kong, Russia, Venezuela and Vietnam. All other countries would be subject to quotas equal to 100% of their 2017 exports to the US
- A quota on all imports from all countries equal to a maximum of 86.7% of their 2017 exports to the US

In March, tariffs of 25% on steel imports and 10% on aluminum imports were enacted. The European Union, Canada and Mexico originally received exemptions, but those expired in June. The exact details of the tariffs are subject to change at any moment, and there has been no public discussion of how long they are to remain in place.

These tariffs will have different impacts on different firms based on how much steel and aluminum each firm uses in production.

Which industries are most exposed to the tariffs on metals?

Across all industries in 2014, the most recent period for which data is available,[2] American businesses and the public sector spent $13.5 trillion on intermediate goods — goods that are used as inputs into the production of other goods and services. Of that, $330 billion (2.4%) was spent on basic metals. Spending on basic metals, of course, was not evenly spread across industries. Of the $330 billion spent, nearly $290 billion was spent by only nine industries that are the largest direct buyers of metals.

Those industries in which total metal spending is very high — most of which are in manufacturing — are the most directly exposed to the proposed tariffs. An increase in metal prices will have the largest direct impact on these industries.

Other industries will experience secondary impacts as the tariffs filter through the supply chain. Even if they do not rely heavily upon metal directly, some industries rely upon the output of other industries that do rely upon metal directly. Those industries can expect to have their costs affected as well.

Manufacturers of basic metals — the very metals being hit by the tariffs — and of fabricated metal products — final products made of metal — spent nearly $160 million on basic metals in 2014, more than one-third of their total input spending. These companies are likely to be the most affected by the tariffs. Other manufacturers — for example, manufacturers of heavy machinery, electrical products, furniture and vehicles — rely heavily upon the metals as well and should anticipate large, direct impacts.

The secondary impacts of the tariffs are also potentially significant. The manufacturing industries that are heavily and directly affected will likely respond by raising their prices or reducing production. Consequently, other industries that rely upon the output of these manufacturing industries for their own production will also be influenced by the tariffs. Take construction, for example. The construction industry spent nearly $6 billion on basic metals in 2014, but that only accounts for just over 1% of total input spending. However, the construction industry relies heavily upon machinery and tools manufactured by other industries that use raw metals as inputs. So the construction industry is likely to experience a large secondary impact from the tariffs — more than 6% of its total costs are exposed.

What can we learn from history?

This is not the first time the US has enacted tariffs on steel in an attempt to boost the domestic steel industry. Beginning in March 2002 and lasting three years, the Bush Administration imposed a series of tariffs on steel imports, ranging from 8% on steel wire to 30% on rolled steel.

Figure 1 shows the impact of the Bush steel tariffs on steel prices. For the 20 years between 1982 and 2002, steel prices grew only slightly compared to total inflation throughout the economy. During the three

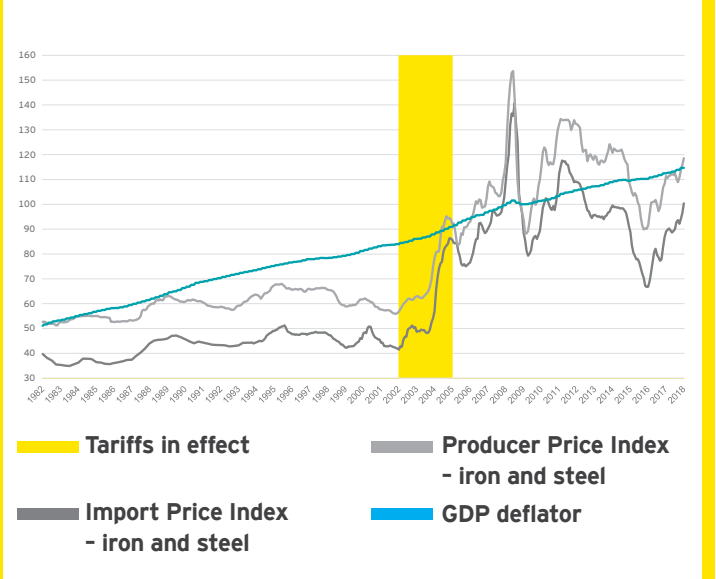
[1] Oxford Economics Research Briefing | US, "Weather advisory: Strong protectionist winds," March 1, 2018.

[2] World Input-Output Database, Release 2016.

years from 2002 to 2005, when the tariffs were in place, steel prices rose by 60% to 100%, depending on the metric, while the overall economy experienced only 8% total inflation.[3]

It is not surprising that the tariffs on steel imports led to an increase in the price of steel. What may be surprising, however, is the long-lasting impact of the temporary tariffs. Prices fell somewhat immediately after the tariffs ended, but they quickly rose again well beyond the levels during the tariff years. Even today, steel prices remain high by historical standards, 13 years since the tariffs were lifted. Moreover, the price of steel has been much more volatile after the tariffs, changing more dramatically on a month-by-month basis than before.

Figure 1: Domestic steel prices
(index, January 2009 = 100)



How will the tariffs affect individual firms?

The policies being discussed — as well as the probable fallout from a broader trade war — threaten to affect goods across a wide variety of firms and industries.

The fundamental question facing CFOs and the heads of business units is what should I do to minimize the impact of tariffs on my bottom line in the near term and on my firm's growth trajectory?

In order to answer the above question, each firm needs to assess the answers to two key questions, which will help inform the firm's response to the tariffs:

- How exposed is my cost structure to the proposed tariffs?
- How much pricing power do I have?

Figure 2 demonstrates how company profits are affected by tariffs under different circumstances related to these questions.

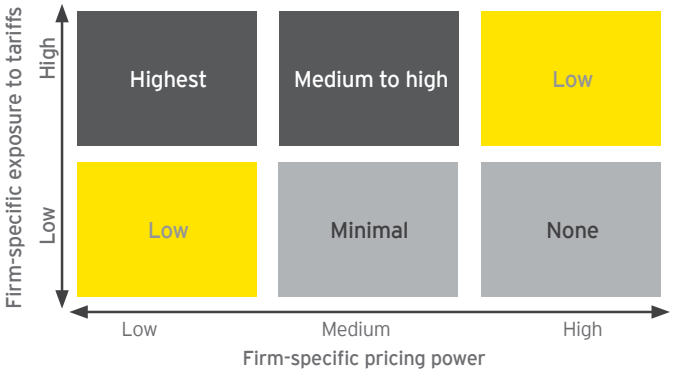
[3] Sources: U.S. Bureau of Labor Statistics; Bureau of Economic Analysis.

Minimal to low impact on profits

Firms fortunate enough to be in the green or yellow areas of Figure 2 — i.e., they have either very low exposure to the proposed tariffs or very high pricing power or both — are unlikely to see any dramatic changes.

In the first case, they either (1) do not use many of the proposed goods that will see increased tariff inputs (primary or secondary) to production or (2) the proposed tariff increases for the goods

Figure 2: Impact of tariffs on firm profits



they do use in production are particularly small. Thus, they will not experience a large increase in marginal costs, and there need be very little offsetting response. These are industries such as fishing and aquaculture that spend very little on basic metals.

In the second case, firms are able to take advantage of their pricing power to offset increases in marginal cost caused by the tariffs without a significant decline in demand. The tariff is essentially passed on to the consumer, and profits remain relatively unchanged. This applies especially to firms selling goods and services with highly inelastic demand — for example, gasoline, the production of which relies heavily upon machinery made of metal, and for which there are very few substitutes in the short term.

Though the direct impact of the tariffs on the supply side is unlikely to harm these firms much, some may experience indirect effects on the demand side. For example, firms that produce goods that are complementary to other goods that are negatively affected by the tariffs may see a small decline in demand. If steel tariffs lead to an increase in the cost of cars (and, thus, a decrease in the quantity sold), then tire manufacturers are likely to experience a decrease in demand for tires.

Medium to high impact on profits

The firms that will be most negatively influenced by tariffs share two things in common: (1) their cost structure has high exposure to the tariffs and (2) they have minimal pricing power to pass the increased cost along to consumers. For these firms, the tariffs will lead to a relatively large increase in marginal cost since they lack the pricing power to pass it along to consumers. They will be forced to either take a hit to their margins or face a large decrease in demand after raising their prices.

These firms often need help increasing pricing power. Some operate in highly competitive industries with lots of viable substitutes, while others produce products with highly elastic consumer demand.

How can firms increase pricing power?

For firms that can expect to be negatively affected by tariffs due to a lack of pricing power, the mechanism of that impact depends on why they lack pricing power. Likewise, the strategies for growing pricing power depend on why it is low.

A firm's pricing power can be low for two reasons:

- The firm operates in a highly competitive industry, where lots of other firms make similar products
- Consumer demand for the products the firm makes is highly elastic — a small increase in prices sends consumers hunting for alternatives or cutting spending disproportionately

In some cases, firms operating in a highly competitive market can consider consolidation through mergers and acquisitions to address their lack of pricing power, but that possibility brings with it another set of risks and uncertainties that need to be addressed. In cases where consolidation is not a sensible approach, firms should instead focus on strategies that distinguish them from their competitors in the minds of the consumer. On the other hand, for firms facing highly elastic consumer demand, the strategies used to increase pricing power should focus more on product innovation — creating new products and features that consumers have to have and are willing to pay for.

There are two fundamental investments a firm can make to drive pricing power. These will help to offset the negative impacts of tariffs on profits in the short term. Beyond that, these steps will improve the strength of a firm's top line more broadly, positioning the firm for sustainable growth into the future.

- Decrease your competition by setting yourself apart from your competitors
- Decrease consumer demand elasticity through innovation to better align your portfolio with what customers want

We recommend four foundational actions firms can take now to drive higher pricing power in the future:

1. Optimize your existing portfolio of products and services to align with consumer demand and differentiate yourself from competitors, focusing on:
   - The features and characteristics of your individual products and services
   - Your portfolio range of different products and services
   - Your innovation pipeline
2. Optimize pricing across your portfolio of products and services, with a focus on:
   - The prices of individual products and services
   - How your offerings span different price tiers
   - Promotion and discount mechanisms and strategies
3. Optimize your investment decisions going forward, focusing on driving pricing power across:
   - Product markets
   - Geographies
   - Consumer groups
4. Optimize your allocation of resources and marketing investments to activate the strategies across:
   - Different retailers
   - Different channels

Taking the appropriate actions — now and in preparation for the future — requires a thorough understanding of the economic impact of the proposed tariffs on different industries, the competitive environment of those industries and multiple dimensions of consumer demand. EY can help you assess these implications and provide actionable recommendations in preparation for these changes.

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