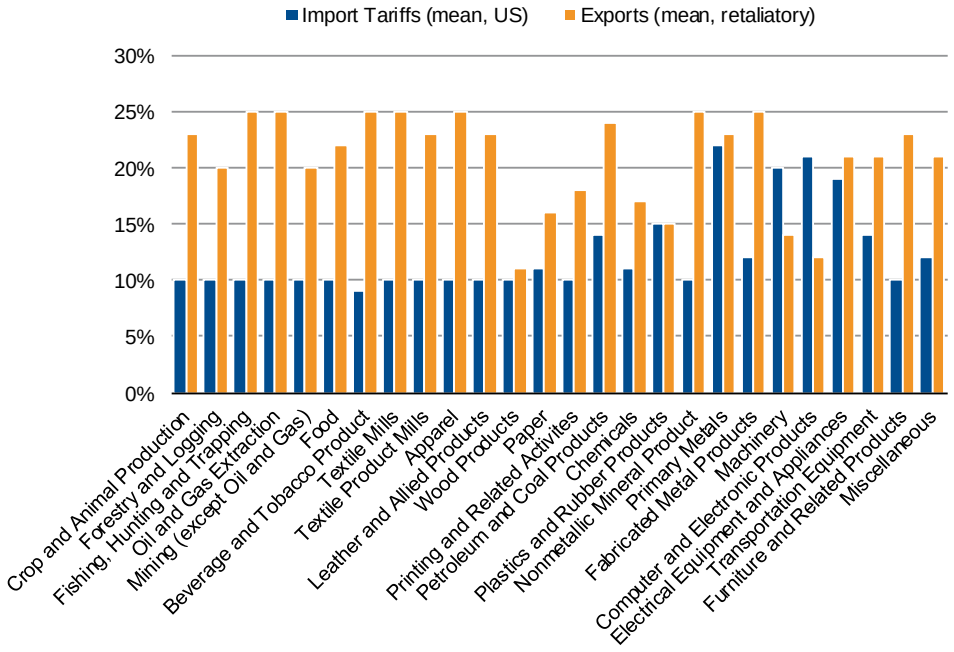
Trump Tariffs: Impact on German Automakers

Updating its previous comment, Scope identified some potential winners among the many losers when tariffs are imposed. While tariff discussions with China are ongoing, research is emerging for the potential effects of the Trump tariffs on German automakers with extensive trade and manufacturing ties with the US. Here more losers are becoming apparent, with winners harder to find (and not in Germany). Scope continues to view the use of tariffs to implement policy with concern.

The relative asymmetry of the traded content in auto[1] supply chains places the EU at a disadvantage: US imports outpaced exports to the EU by USD 44bn in 2017. As EU auto exports use relatively few inputs originating in the US, second-round effects of new auto tariffs are marginal. US exports of autos, however, have an import content from the EU of approximately 25%. As a result, the imposition of tariffs, until manufacturers replace that import content, would result in higher US costs and for US manufacturers, higher prices. The Alliance of Automobile Manufacturers has estimated that US-built auto costs could increase by as much as USD 2,270 dollars if tariffs of 25% were to be imposed.

Figure 1: Tariffs by sector, in percentage



Source: Fajgelbaum et al. (footnote 1)

What are the implications of additional US tariffs on autos? When tariffs are imposed, domestic manufacturers affected either absorb all or some of the costs or pass all or some of the costs on to consumers, depending on competition and market position. While recent research[2] shows US automakers passing virtually all retaliatory tariffs on to consumers, Scope anticipates relatively few price increases for European automakers due to both strong competition and reluctance to lose market share. This affects not only the direct import into the US of light vehicles, but also the US import of auto parts, as supply chain inputs face cost increases due to tariffs, albeit with a reduced impact.

[1] Scope uses this term for automobiles, parts and light trucks; likewise, automakers includes parts and light trucks
[2] The Return to Protectionism, Pablo D. Fajgelbaum, Pinelopi K. Goldberg, Patrick J. Kennedy, and Amit K. Khandelwal, Draft: March 3, 2019, retrieved from http://www.econ.ucla.edu/pfajgelbaum/RTP.pdf

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Related Research

Trump's tariffs: Detecting some early winners among the many losers - January 2019

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Short-term positive effects from threats of sanctions

Scope notes that imposed sanctions have negative effects on trade flows, but threatened sanctions tend to lead to temporary increased trade flows due to inventory draw-forward based on the anticipated effects of sanctions once imposed (stockpiling)[3]. This is due to the time differential between the threat of sanctions and their imposition, which provides companies involved with affected trade significant incentives to prepare and adapt, which are supported by strong sunk-cost effects (market position, infrastructure) that leads to a reluctance to abandon suppliers and customers. On the demand side, tastes and preferences are key determinants of demand, leading to reluctance of consumers to change short-run preferences, leading to stockpiling effects. Hence both supply and demand factors may lead to a positive effect in the time period between the threat of sanctions and their imposition.

Strong effects on German automakers

The German auto industry would be particularly affected, with exports to the US making up 12% of the EUR 230bn of autos and parts exported by Germany world-wide in 2018: one estimate[4] for places increased costs to BMW, if the company were to absorb all the effects of a 25% tariff on its goods imported to the US, at EUR 1.7bn on a 2017 EBIT of EUR 9.88bn, a potential reduction of over 17%. VW would face increased costs of EUR 2.5bn on an EBIT in 2018 of EUR 13.9bn, a potential reduction of EBIT by close to 18%. This is not limited to German makers: FIAT/Chrysler may stand to lose as much as USD 866mn[5] on an adjusted EBIT in 2018 of USD 6.738bn, a potential loss of not quite 13%. Toyota estimates that US tariffs would increase the price of a Toyota Corolla by over 9%[6].

German presence in US pre-dates US tariffs and Trump

German automakers appear to be increasing their value chains in the US: VW has stated that they will invest USD 800mn in Chattanooga; BMW is exploring starting the manufacturing of motors in the US to increase the US local content to over 75%; Daimler is building a battery factory near Tuscaloosa and is opening up the first manufacturing facility for Sprinters in South Carolina; Continental is investing USD 1.5bn in Mississippi for a new facility to manufacture truck tires. However, these decisions were taken long before President Trump started to impose tariffs, as building new plants/assembly lines take years from initial decision to the start of production. Hence these decisions were not driven primarily by the recent threat of tariffs.

Scope automotive forecast unchanged

Scope does not include uncertainties from a continuation of the trade war between the US and China and potential additional changes to tariff regimes in our forecast for automakers. We continue to see a decline in 2020 to between 16.3m-16.5m from peak levels of 17.2m om 2018, driven by declines in used auto prices, higher interest rates, tighter auto credit conditions and market saturation after the high market volumes from 2014-2018.

Supply chain effects for aluminum/steel already visible

According to LMC Automotive in June 2018, the full pass-through of higher costs to consumers by US automakers from retaliatory tariffs (steel and aluminium) could reduce auto sales in the US by up to 10%[7], dropping volume sales as far down as 15.3m units. Scope does not see any meaningful impact on tariff-related cost increases for steel and aluminium, as auto sales in the US remained robust despite the introduction of tariffs on steel in the middle of 2018. Longer-term, however, Scope believes that both steel and aluminium tariffs may present a threat to auto demand: the US National Automobile Dealers Association (NADA) estimated in July 2018[8] that a 25% import duty on non-US built cars, if enacted under U.S. Section 232 ('protection of the national interest') for

[3] The impact of economic sanctions on international trade: How do threatened sanctions compare with imposed sanctions? Sylvanus Kwaku Afesorgbor, European Journal of Political Economy, Volume 56, January 2019, Pages 11-26, retrievable under https://doi.org/10.1016/j.ejpoleco.2018.06.002
[4] Der schwierige US-Markt, Handelsblatt, 25.02.219, s. 4
[5] https://www.autonews.com/article/20180628/COPY01/306289969/fiat-chrysler-would-take-big-hit-from-u-s-import-tariffs
[6] https://www.autoblog.com/2018/06/28/toyota-tariffs-add-1800-to-corolla-price/
[7] https://www.forbes.com/sites/greggardner/2018/06/13/trump-tariffs-could-cut-u-s-auto-sales-by-up-to-10/#1b954aaadf41
[8] https://blog.nada.org/2018/07/02/nada-auto-tariffs-will-raise-prices-limit-choice-and-depress-demand-for-new-cars-and-trucks/

imported vehicles and auto parts and passed on 100% to customers, would increase the average cost of a vehicle by USD 4.4k, with prices for imported vehicles rising by USD 6.9k and domestic vehicles up by USD 2.3k, reflecting the asymmetric effect of tariffs on imported and domestic automakers.

Possible effects of increases on tariffs for light vehicles and parts

Scope believes that in general automakers prefer 'volume over margin' and are likely to absorb tariff-related costs at the expense of deteriorating EBIT margins. Scope includes the real-world effects of the 10% steel and aluminium tariffs in its forecast. The negative effects of a 25% tariff on autos would be incorporated if they were to be enacted. Under such a scenario, according to NADA, annual vehicle sales could drop by as much as 2m units or more than a 10% market decline. While any such estimate from an industry lobbying group (NADA) must be viewed with caveats, LMC Automotive estimates point to similar results: LMC estimated[9] that the combination of the 10% steel/aluminium tariffs with a 25% tariff on vehicles, enacted in 2019, would drop volume by 5.4% to 16.2m vehicles in 2019, based on the assumption that 50% of tariff-based cost increases would be passed on to consumers, with a drop of 11% to 15.3m vehicles if 100% were to be passed on.

Real-world reaction of car OEMs

Scope recognizes that the real-world reaction of automakers will likely imply changes in supply-side production set-up, but such changes are not quickly achievable in the short-run and require significant capital expenditures in any case. Further, Scope explicitly recognises that such scenarios do not take into account secondary and tertiary effects (actions in one region may increase the risk for an extended trade war with retaliatory measures ultimately leading to a strong negative impact on world-wide GDP, which in turn would negatively affect global auto sales).

Move to US with multiple incentives

The development of foreign-owned manufacturing capacity in the US over the past decades has been predicated on multiple supportive factors: 1) few or no constraints on trade; ii) reduction of supply chain costs; iii) improved natural currency hedging; iv) local governments/municipalities offering attractive incentives to localise production; and v) strategic decisions to locate final assembly/production set-up at least initially close to key markets**. I**f these were to change, the business model underlying these investments will face significant pressure to change as well.

Moving supply chains out of China and the US?

One alternative for European companies is to move production out of both the US and China (as mentioned in the previous comment, significant anecdotal evidence exists that this is already happening for US companies with supply chains in China) in order to avoid the effects of tariffs on products and services destined for multiple markets. This is one of the more expensive options, as it directly affects workers both in the US and China, as well as the associated capex costs.

Moving supply chains into China and the US?

Alternatively, companies with these high exposures may consider increasing their presence and expanding supply chains in the US and China to reduce the dependence on imported goods, with the added benefit of increased closeness to customers and markets. While this approach may increase profits as the effects of tariffs are reduced, positive factors for international supply chains – full usage of comparative advantages and economies of scale – will be reduced if the global climate for trade continues to become protectionist, further reducing profitability and/or increasing costs.

Will tariffs change investment decisions?

While the threat of imposed tariffs may help shape future decisions, the relative attraction of the US for German manufacturers – low interest rates coupled with reduced corporate

[9] https://lmc-auto.com/impact-of-25-tariff-on-us-auto-industry/

tax rates and accelerated tax write-offs for investments, as well as strong market growth supported by demographic growth – will continue to play the primary role. Scope does not view tariffs alone as a driver for investments in the US.

Tariff bring retaliation

The data in **Figure 1** shows the mean of both the US tariffs imposed by the Trump administration at the end of 2018 and retaliatory tariffs put into place by affected trading partners: while US import tariffs have an average value of 12%, retaliatory tariffs have an average value of 21%, reflecting the strength of foreign retaliatory reaction to US tariffs (and, in some cases, higher tariffs to begin with). The strongest differential is for beverages and tobacco products with a differential of 16 percentage points; the lowest differential is for computer and electronic products, with US tariffs of 21% facing retaliatory tariffs of 12% for a negative nine percentage point differential. The key transportation equipment sector shows a seven percentage point differential, with US tariffs of 14% and foreign tariffs of 21%.

Some sectors with lower tariffs

The sectors where retaliatory tariffs are lower than the imposed US tariffs reflect the relative importance of goods from these sectors (machinery, computer and electronic products): lower retaliatory tariffs result form the reluctance of trading partners to raise costs for key investment goods they acquire from the US.

Potential negative rating effects

Scope continues to view the use of tariffs to implement policy with concern. Given the asymmetric effects for the EU, Scope notes that if further tariffs are imposed, the resulting absorption of additional costs would most likely come as a significant reduction in profitability, potentially leading to negative and rating-relevant changes in key credit metrics. Further, if cost increases are passed directly to consumers, domestic competitiveness is eroded, and the imposition of tariffs may lead to a counter-productive need to protect the industries affected.

Research on real-world effects emerging

Research is now emerging on the real-world effects of tariff impositions by the US and retaliatory moves by other countries. While one study shows the overall effect to be negative, some interesting effects are also visible: for US companies, there is a general complete pass-through of retaliatory tariffs to end customers[10]. Further, there is a substantial redistribution of revenues to the government and to US producers at the cost of buyers of imported goods, with a small current net loss to the US economy overall (which will accelerate if further tariffs are imposed). While the US tariffs were initially expected to benefit industrial republican-voting counties in the US, the resulting retaliatory tariffs have largely offset any benefits. Imports from targeted countries were down by 31.5% through the end of 2018, with US exports falling by 9.5% for the same period.

Emerging winner in the US?

While recognizing the overwhelmingly negative effects, one trend appears to be emerging of increased US manufacturing activity and employment[11]. Over the last two years in a significant development, more factory jobs have been added than in 40 years. Politically, manufacturing has also started to return to being seen a key driver for economic growth, rather than a declining relic of an industrial past. Scope recognizes that sustaining this will depend on shifting any nascent US industrial policy away from tax cuts and trade deals to worker training and promotion of research to improve US productivity, key to any long-term future competitiveness.

US industrial employment with climbing wages…

While not all of these positive effects may be directly attributed to tariffs and may more reflect the introduction of more effective industrial policies and US tax law changes, US

[10] Fajgelbaumm et al., ibid
[11] https://www.csmonitor.com/Business/2019/0304/A-Trump-Obama-trend-revival-of-Made-in-the-USA

industrial employment is up by 3.7% over the last two years and wages are up by 3.3%, averaging USD 27.21 per hour, reflecting as well an increasingly tight labour market.

…with improved leverage against China…

According to the National association of Manufacturers, manufacturers, normally reluctant to support tariffs, now recognize that tariffs and the threat of tariffs may lead to a better trade deal with China, with increasing emphasis on enforceability of any tariff agreement. The fundamental challenge is that in order to bring back more manufacturing jobs, imports will have to permanently decline, and productivity will have to out-track growth.

…but at a cost of USD 4.4bn/month

However, the cost of tariffs for the US economy is real: one estimate places the costs at USD 3bn/month for US companies and consumers, with another corporate cost of USD 1.4bn in deadweight losses, as well as increasing costs as companies reorganize supply chains[12]. The US trade deficit in goods hit a new record in 2018 as inventories were built up ahead of tariff implementation and in anticipation of further tariffs. Hence any gains for US industrial employment comes at a relatively high price: at the end of the day, US consumers will pay for it via higher prices.

[12] https://www.bloomberg.com/news/articles/2019-03-04/evidence-grows-that-trump-s-trade-wars-are-hitting-u-s-economy

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