Global trade: The evolving world order

Controlling trade costs in chaotic times
After decades of stability and certainty in the global trade environment, all bets are off as the world’s economic powers struggle for dominance and deploy tariffs in what may devolve over time into a full-blown trade war.

Managing abrupt new trade costs is top of mind for the leadership of many global companies. Reducing these expenses in the short term is critical. And with turbulent trade conditions expected to continue for an unknown length of time, companies also need to plot their strategy to compete and stay profitable for the long term.

With this publication, cross-functional leaders of KPMG’s Intelligent Supply Chain Design team aim to help international business leaders understand the current trade environment and what they can do to steer their businesses to success.

This report begins with insights from the geopolitical risk analysis and consulting firm Eurasia Group, who explain the sources of this current disruption, how trade conditions are being affected, and where this all might lead us in the future. We then offer some leading practices for company leaders to consider for both the near and longer terms.

While we can expect uncertainty to cloud the future of trade for years or even decades to come, one message becomes clear. Based on the advice and analysis in these pages, tariffs and trade have become an important new element in the geopolitical dynamic and they need a proactively orchestrated response. Companies that take a holistic, strategic approach can turn global trade management into a source of significant competitive advantage.
Managing tariff costs — Key takeaways for business leaders

With countries growing more concerned about protecting industry, the trend toward eliminating tariffs has reversed. As tariff disputes escalate, companies can get caught in the middle, which increases costs. Here are some strategies for managing the impact.

Strategies for the near term

— Some leading companies are embracing southbound moves from China or even on-shoring options. Others are adopting dual and multi-origin strategies, which offer the flexibility to deliver into various markets from differing locations, depending on the current tariff, free trade and geopolitical factors.

— More than 50 tried-and-true methods are available to mitigate, or recover new tariff costs. These involve, among others, tariff exclusions and re-classifications, customs valuation planning, and duty deferral and drawback programs.

— By bringing together product designers, supply chain and global trade professionals, companies can ensure the products they make are designed to relieve tariffs in the short term.

— We estimate that a company can ease its tariff burden by over 50 percent on average, depending on the industry and the company’s appetite for refining its business processes.

Strategies for the long term

Businesses can prepare for the new strategic and operational challenges they may face in the years and decades ahead by:

— Integrating enterprise risk assessment with day-to-day operations so their strategic planning gives attention to geopolitical forces and their possible impacts.

— Using game boarding and scenario planning to evaluate the possible impact of these forces and determine their best options now and as the future unfolds.

— Understanding the behaviors of customers, suppliers and competitors to help ensure that your cost structure and supply chain remain better than market.

— Ensuring the company’s approach to trade compliance and costs issues aligns with its policy on tax responsibility and social contribution to the countries it operates in.

— Establishing strong governance for global trade management, including policies, minimum standards, global business processes, standard documentation, performance tracking and reporting processes.

By investing in a flexible supply chain strategy and strong global trade management infrastructure and by basing their strategies on robust scenario planning, companies can sharpen their competitive advantage, no matter what the future holds.
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From multilateralism to me first: How did we get here?

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An extended period of calm in the global trade environment is being swept away as protectionism spreads, tariffs climb, trade barriers rise and multilateral global institutions lose influence. It now seems likely that international companies will see heightened uncertainty over trade — and higher costs — for years to come.

The shift might seem abrupt, and many may attribute it to the trade policies of the current US administration. But changing attitudes toward trade, and globalization more broadly, have been building beneath the surface globally for almost 2 decades.
The roots of trade disruption

In the wake of World War II, the General Agreement on Tariffs and Trade (GATT) was one of many agreements and institutions — like the United Nations, the International Monetary Fund and the North Atlantic Treaty Organization — that were established to keep the peace and forge a new world order. The World Trade Organization was formed in 1995 to succeed the GATT and quickly became the dominant force shaping the global trade environment.

Under US leadership and with the participation of most Western democracies, Australia and Japan, these institutions promoted multilateral cooperation in areas ranging from trade to monetary policy and economic development to security, and generally reflected democratic-capitalist values and ideals. Although global trade conditions have evolved, many of the GATT’s principles remain enshrined in the multilateral WTO Agreement as it exists today.

When China, a much less-dominant commercial force at the time, joined the WTO in 2001, cross-border trade was anchored by well-established agreements, rules and practices that helped drive globalization, liberalize trade and encourage multilateral cooperation. Since then, China has become one of the world’s predominant economic powers, eclipsing the US as the number one trade partner of most countries around the world.

China’s economic reach grows | Largest trading partner by total trade value

Source: UN Comtrade
The emergence of a major non-market economy like China is challenging the global trading system. Some have asserted that China’s practices in areas such as subsidies, intellectual property and technology transfers often run counter to the spirit of the WTO and are out of step with China’s WTO-sanctioned agreements with European countries, Canada and the US.

Western governments tended to turn a blind eye, however, rather than engage China in the WTO’s dispute resolution mechanisms. But by the time of the 2016 US presidential election, some Western countries — and particularly the US — had started to more openly challenge certain aspects of the current multilateral trading system and China’s role within it. And with the election of the current US administration, rising skepticism about the existing model of global trade broke the surface.

Tensions break the surface

After years of simmering tension over some of China’s commercial policies and, more recently, eroding US support for the WTO and other global multilateral institutions, escalating tariffs in 2018 between the US and China is only one sign that the world is entering a vastly different environment for global trade.

Shortly after taking office, the current US administration withdrew from the final stages of negotiation over the Trans-Pacific Partnership (TPP) negotiations and began to renegotiate the terms of the North American Free Trade Agreement. The administration’s trade policies are backed by a significant portion of Americans, many of whom believe that free trade and globalization have cost them jobs.

Instead of joining the TPP, the US government showed its preference for bilateral deals in Asia by entering trade deal talks with the Republic of Korea and Japan directly. In its dealings with Canada, Mexico, European Union member states and other historical trading partners, the US has focused largely on reducing its bilateral trade deficits. The US administration also has shown it is willing to take risks in these negotiations, for example, by using the possible imposition of steep tariffs on imports of cars and auto parts, aluminum and steel to win trade concessions. And by including provisions in these new trade agreements that limit the ability of the trading partners to enter into agreements with certain ‘non-market’ economies, the US has also shown its resolve to take on China’s role in global trade from multiple angles.

Meanwhile, the remaining 11 countries in the TPP talks moved ahead with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership. China has been developing its own trade networks, with 16 free trade agreements in place, including one with the Association of Southeast Asian Nations, and eight more in development. China’s state-owned enterprises have different objectives and operations than Western-based multinational companies, and many of China’s bilateral and regional agreements reflect these priorities.

In Europe, the United Kingdom’s exit from the European Union will profoundly affect how businesses inside and outside the UK structure and conduct cross-border businesses. As a Brexit deal remains elusive, the risk of new costs and barriers to trade between the UK and other European countries is climbing higher as the UK’s withdrawal from the EU approaches.

So where most of the past few decades were defined by economic convergence and the creation of ever larger and more integrated regional trading blocs, the current wave of bilateralism risks creating a more fragmented global trading system — a system characterized by a complex web of concessions, costs and barriers that will make cross-border trade more unpredictable and harder to navigate in the years ahead.

All signs suggest that China will continue to rise as major economic and political force in the world. For example, China’s Belt and Road Initiative (BRI) is promoting massive investment in developing infrastructure and trade across much of greater Asia. If it succeeds, the BRI will likely spur significant cross-border economic activity between more than 70 countries across Asia, Europe, the Middle East and Oceania. It will open new trade routes and connections between China and many developing countries, especially in Eurasia.

At the same time, China’s “Made in China 2025” policy aims to make the country a world leader in developing industries like robotics, information technology and clean energy, among other sectors. This policy may drive tensions that could fragment the world’s data and communications technologies between competing systems led by China and the west.

So at a time when the US is taking a more nationalistic approach to trade and investment, China’s more global approach may put it at the center of a new network of commercial and economic relationships.

In this new era, the WTO’s role as chief arbiter of the rules of international trade may be increasingly contested. In July 2018, the US administration claimed the WTO was treating the US unfairly and threatened to withdraw from the organization unless it is reformed. The US administration’s justification for steel and aluminum tariffs on national security grounds challenges the WTO’s view on what
is constitutes a valid national security concern. With a rising number of trade disputes registered with the WTO, the US has refused to make new appointments to the WTO’s arbitration board, effectively restricting its ability to rule on disputes involving the US and China.

There have been many proposals to modernize and reform the WTO, but the prospects of meaningful reform appear unlikely. In the absence of US leadership, the other G7 countries lack the influence to win multilateral agreement on the sweeping changes needed to update the WTO’s principles in areas such as services, technology and data, and dispute resolution. Some argue that the WTO’s principles are incompatible with some of China’s practices around intellectual property, competition and state subsidies. Amid accusations of state involvement in technology, data security and surveillance, hopes that China might sufficiently reform its policies in these areas remain dim.

At the end of 2018, the US and China agreed to a temporary truce on trade to avoid further escalatory tariffs. The agreement called for the US to postpone its planned tariff hike on US$200 billion in Chinese products for 90 days and for China to increase purchases of US agricultural and industrial products. Based on the progress of ongoing discussions, the US announced it would extend the 90-day period and not raise tariff rates or add new products to the list. At the time of writing, an announced deal on trade between the US and China looks possible, with China committing to increased purchases of US goods, greater market access in some industries, and enhanced protection of intellectual property. In return, the US would remove some of the tariffs currently in place on Chinese goods.

Despite the progress being made on a short-term halt to the dispute, the long-term outlook for bilateral trade negotiations — and the broader US-China relationship — remains challenging. A near-term deal is unlikely to settle all trade issues between Washington and Beijing amid heightened bilateral tensions and disagreements on structural issues. Considerable uncertainty remains about the deal’s enforcement mechanisms, which could be a source of future tension. And it remains unclear whether China will actually implement policy shifts big enough to accommodate US demands in areas such as market access and IP protection, which would
further worsen the prospect of a lasting truce.

As China, the US and other countries clash over trade, the pendulum has only begun to shift from cooperation to intensifying bilateral competition. Beyond trade, China and the US are expected to jockey for dominance in areas such as technology and security for years to come. While Mexico, Latin America and some other locations stand to see more trade and investment as a result, escalating trade tensions remain a significant risk for much of the global economy. The long-term future of the US-China trade and investment relationship is uncertain, but a return to the previous status quo is perhaps the least likely outcome.
Preparing for success in unstable times

Most of today’s business leaders grew up with stable trade conditions and well-defined rules, and they arranged their capital investments, sources of supply and supply chain networks accordingly. But with today’s unprecedented geopolitical disruption resulting in new trade and non-trade barriers and a changing web of regional and bilateral trade agreements, multinational organizations need to consider both the immediate and longer term implications to their businesses.

Many companies affected by the current round of US-initiated tariffs and the responses of other countries are facing significant cost increases that need to be managed. Companies in some industries might get along by passing those costs to their customers for the short term. But this strategy can only succeed until a competitor decides to absorb the margin hit to buy market share, or, more realistically, starts to fundamentally change to its operating footprint to reduce its cost base and better align with the brewing geopolitical storm.

Adjusting to today’s conditions may be difficult and costly, but it is critical for companies to stay competitive and profitable. This means companies need to focus on the impacts of geopolitical developments like never before and put supply chain transparency, flexibility and global trade management at the center of their business strategy.
Short-term fixes to mitigate trade costs

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With geopolitical disruption now among the top risks to long-term business growth, today’s corporate boards want to understand management’s approach to addressing the acute challenges of the global trading environment. Boards also want to know management’s plans to address the reality that tariffs and non-tariff barriers have become a policy tool for countries seeking advance their own interests.

The new trade environment — as well as changes in consumer preferences, labor, energy and freight costs, evolving technologies, talent pools and other factors — is providing business leaders with ripe opportunities to rethink their overall supply chain and customer strategies. While a number of companies are embracing southbound moves from China or even on-shoring options, we are seeing many of the winners in today’s market adopt dual and multi-origin strategies. These moves are giving them the flexibility to deliver into various markets from differing locations depending on the current tariff, free trade and geopolitical factors at the time.
Addressing global trade uncertainty —

common strategies of leading companies

How are the world’s leading companies managing their supply changes in today’s tumultuous trade environment? Here are some of the most popular current strategies.

**On-shoring:**
Some companies are moving operations in-country to get closer to their customers. For example, a company might move a manufacturing location into Europe to serve European customers.

**Near-shoring:**
Other companies are moving operations closer to their end customers with an eye to preserving their access to low cost labor and using free trade agreements to enter the end destination market. For example, Mexico is a near-shore option for many companies with US-based customers.

**South of China relocation:**
Some companies are moving operations out of China but staying in Asia for reasons such as supplier proximity and lower cost labor. Common destinations include Vietnam, Malaysia and Thailand.

**Multi-origin sourcing:**
By establishing a source of supply in more than one jurisdiction while ensuring visibility and agility, companies can be ready for quick sourcing changes in the event of new tariffs or other market barriers such as sanctions and quotas. For example, if China assesses new tariffs on US origin products, a company could shift the sale of US products to another market and fill the Chinese demand from another jurisdiction. This hedging strategy has positioned a number of companies ahead of their peers in profitability and global market share.
But substantial supply chain network changes are costly and take time to develop and implement, so companies are also looking at more immediate actions they can take to mitigate the impacts of these new trade costs. Many items that were low-tariff, or even tariff-free, into the US, China and nine other countries are now subject to 8–25 percent tariffs at the border. These new costs add directly to cost of goods sold and often eat into the company’s profits. Some companies, especially those in industries that were historically subject to higher tariff rates, have plenty of experience managing the tariff implications throughout the business cycle, from product design and material sourcing to manufacturing locations, supply chain flows and income tax planning. However, most companies are not used to dealing with these costs and may not be aware of the many tried-and-true levers that are available to mitigate or recover such costs.

KPMG has cataloged over 50 proven trade levers that apply in various situations. The most common trade levers are:

- tariff exclusions
- tariff re-classifications
- country of origin shifts
- customs valuation
- duty deferral programs
- duty drawback programs.

Within these categories, there are steps companies can take to address the impact of tariffs, depending on the specific imported items, manufacturing processes, supply chain flows and customer requirements. In some cases, a company can eliminate the impact of the tariffs entirely. Overall, however, we estimate that a company can ease its tariff burden by about 25 to 50 percent on average, depending on the industry and the company’s appetite for refining its business processes.

While these approaches can make a difference, most companies will likely be left with additional costs that need to be mitigated. In addition to passing on increases to customers, some companies are also looking to their suppliers to help manage these costs. Many have encouraged their suppliers to reduce their prices or held them strictly to commercial terms in existing contracts.

This may work in some cases, but without transparency into the suppliers’ operations and finances, these tactics can also bring substantial risk. Some suppliers may compromise on quality to meet reduced price points, which could result in inferior products and damage to a brand’s reputation. Other suppliers may be unable to meet required volumes, or they may feel compelled to absorb costs and accept intolerably low margins, putting their own financial health in jeopardy — as well as the company’s source of key inputs.

Companies that recognize that tariffs and other geopolitical shifts will likely have long-term effects can gain advantages by moving early to identify and lock in limited resources in the short term. This can in turn drive their ability to minimize cost increases to their customers and gain market share.
Managing tariff costs —
Tried-and-true methods from historically high-tariff companies

Tariff schedules are detailed and often based on the product’s make-up and condition as imported, so there are often simple steps you can take to manage tariff costs. For example, for some products, making minor changes to certain materials used in the imported product can change its classification so it attracts a lower tariff rate, or no tariff at all.

Country of origin is often determined where the essential characteristic of an item was last substantially transformed. It is often possible to change the origin of the imported product by strategically sourcing essential inputs from other jurisdictions rather than completely moving foreign manufacturing operations from that jurisdiction.

Valuation of imported items is the basis for assessing the ad-valorem (percentage-based) tariffs. Proven methods for reducing that value include:

— unbundling items that are otherwise non-dutiable
— evaluating the transfer pricing methodology used to value imported products between related parties
— understanding when it is permissible to use an early sale price for valuation purposes into the importing jurisdiction.

Tariffs are often refundable when the imported items are later exported in the condition imported or as part of a further manufactured or assembled product.

Tariff payments can often be deferred when goods are entered into customs-bonded areas, such as bonded warehouses, free trade zones and foreign trade zones. These duty deferral programs have evolved significantly over the years to provide importers with enhanced flexibility and operational and financial benefits.
By bringing together product designers, supply chain and global trade professionals, companies can ensure the products they make are designed to relieve tariffs in the short term. And as we will see in the next section, a multifunctional approach that factors in the need for transparent and flexible operations is also the key to managing global trade disruption over the long term.

Crafting your strategy for the long term

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In recent years, management teams have come under increasing pressure from the demands of greater customer centricty and the pace of technological innovation. On top of these challenges, they now need to respond to increased costs and supply chain challenges arising from trade practices and tariffs, country of origin concentration risk, and the evolving world order. Presented below is a collection of leading practices your company can use to gain control over the longer-term impacts of trade disruption.

Plan for many possible futures. However the future may unfold, businesses need to keep a close eye on geopolitical developments so they can be ready for the new strategic and operational challenges they will face in the years ahead. Companies need to focus on how geopolitical trends will play out in the short, medium and long term.

Because of Brexit, many companies with operations or investments in the UK and Europe are already practiced in this area. The uncertainty over the terms of trade and other aspects following the UK’s withdrawal from the European Union (EU) remains to this day. Leading companies in the UK and EU have undertaken detailed scenario planning to develop their responses to the full spectrum of possibilities for the UK-EU Brexit deal — including the possibility of no deal whatsoever.

Broadly speaking, for many companies, enterprise-wide risk assessment is part of a periodic review, which is not well integrated with day-to-day operations. These assessments often do not give adequate weight or attention to geopolitical forces and their consequences. By using game boarding and scenario planning, companies can evaluate the possible impact of these forces and determine what alternative actions to take now and as the future unfolds.

Monitor your customers, suppliers and competitors. Your suppliers and competitors are working to adapt to the same forces as your company. Some believe that through a combination of price increases to customers, along with vendors absorbing some or all of the new tariffs, little else needs to be done. Yet it is too early to know how long these levers will hold. Gaining deep insight into the behaviors of your customers, suppliers and competitors can help ensure that your cost structure and supply chain remain better than market. Understanding and managing your concentration risks — i.e. vendor, customer and country of origin — are equally necessary for maintaining and growing market share and profit.

Make use of smart technology. Supply chain resiliency has been high on the radar for global companies for years. What’s different now is that geopolitical forces may require quick action to maintain access to high-quality supplies of critical goods and components — which in turn requires transparency across your entire supply chain. But even after investing significant sums in technology over the past several years, many enterprises still find their existing technology tools fail to provide complete visibility at the source or otherwise fail short because of limits in data and critical information that is actionable by senior executives.

Tackle tariffs and trade with multifunctional teams. With new and increased tariffs being imposed on short notice, companies need to ensure they have the right resources in place to deal with trade compliance. US and other customs authorities are expected to become more aggressive in enforcing tariffs and customs regulations, so managing these obligations is gaining new importance.

Some companies delegate these activities to external brokers. These new higher tariffs mean that ensuring imported goods are properly classified and local legal obligations are met is critical when you, your suppliers and your customers are all striving to address increased costs. Getting the right external advice can help your company avoid the potential for significant unrecorded liabilities and ensure ongoing compliance with internal control reporting standards.

Leading companies consider this as not just a compliance issue but as a strategic one that requires the attention of all company functions involved in the supply and distribution chain, from procurement to product design and manufacturing to sales and marketing. This requires a cross-functional team led by an executive who understands both the business and the intricacies of trade rules so they can identify and assess risk. Until now, many companies have had no reason to develop these capabilities in-house, so third-party advisors are often sought to provide this expertise.
Establish strong governance for all of the above. Finally, in good times and especially times of turbulence, strong governance structures and processes are crucial. Clear accountabilities and strong oversight help steer companies toward strong operating compliance and business sustainability, and give boards and senior management visibility over how trade is being managed. Important governance elements for global trade may include the development or revision of formal policies, minimum standards, global business processes, standard documentation, performance tracking and reporting processes.

We all know that the price that you or your customer pay for a product is derived from balancing a complicated equation based on cost, quality and service levels. A cross-functional team of senior executives needs to be at the forefront of assessing these trade-offs, possessing the insights needed to ensure these trade-offs optimize the enterprise’s brand, reputation, market share and margins. Leaving these decisions solely to functional leaders may result in choices that achieve narrow goals at the expense of the enterprise.

What's next?

The outlook for global trade is expected to stay uncertain for many years to come. No one can say how long for sure, but the current tensions are likely to outlast the current US administration and could go on as long as 20 years, according to Jack Ma, the chair of Alibaba Group, the China-based international tech company.¹

However, forward-thinking companies can turn disruption into opportunity. By investing in a flexible supply chain strategy, strong global trade management infrastructure and by basing their strategies on robust scenario planning, companies can gain an edge over their competitors and be in a much stronger position than they are now, no matter what the future holds.

We can help

KPMG’s Intelligent Supply Chain Design professionals are leading edge in helping companies thrive in this unprecedented time. Our end-to-end support encompasses business strategy, tariff mitigation, and stakeholder management through both program and change management. Working shoulder to shoulder with our professionals worldwide, KPMG member firm clients are well positioned to outflank their competitors and emerge as winners in the new environment.
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