U.S.-China trade war could structurally alter supply chains

Short-term workarounds to circumvent tariffs may lead to more lasting shifts

The trade dispute between the United States and China has the potential to reconfigure supply chains around the world on a long-term basis, noted **Randall Chafetz**, Managing Executive Officer and Deputy Head of Global Corporate and Investment Banking at MUFG.

Mr. Chafetz shared his perspectives on the trade environment and its implications in an interview with Soumaya Keynes, trade and globalization editor of *The Economist*, at the **2019 World Trade Symposium** in November 2019 in New York. Programmed by *The Economist*, the two-day conference featured a range of interviews with policymakers and leaders from government, intergovernmental organizations, trade groups, think tanks, academia, and the financial-services industry.

Mr. Chafetz spoke from the perspective of MUFG's trade-finance business, which has visibility into world trade across a nexus of client supply chains and through its close relationships with commodity traders and export credit agencies.

MUFG is the world's fifth-largest financial institution, with approximately $2.9 trillion in total assets.

Short-term redirection of supply chains could turn permanent

"We're seeing what everyone is seeing, which is a meaningful supply-chain disruption. It's still at a point where there's a lot of redirection as opposed to permanent shifts around the supply chain," Mr. Chafetz said. However, he noted, the U.S.-China trade tussle has spurred a "great awakening" that supply chains have become vulnerable—especially in places where they are highly centralized or concentrated.

"The supply chain is front and center because of the chaotic environment" precipitated by the trade dispute, Mr. Chafetz said, adding that supply-chain issues are now routinely escalated to the level of CFOs, CEOs and boards of directors. If the current disruptions persist, he added, company executives could be pressed into making more lasting decisions about their supply-chain footprint—perhaps as soon as next year. MUFG estimates the continuation of supply-chain disruptions could result in the redirection of $20 billion to $50 billion out of China in 2020.

The effects of trade on finance

Mr. Chafetz said the U.S.-China trade conflict, combined with other economic and geopolitical factors, is exacerbating global uncertainty and weighing on strategic decision-making in areas such as foreign direct investment, and mergers and acquisitions (M&A). He pointed to the

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recent downward trend in global M&A volume as being partially due to high valuations, but also a result of the ambiguity surrounding trade. "People who are committed to making acquisitions [in support of] growth [are reluctant to] pull the trigger because of ... the uncertainty that tariffs and trade are presenting right now," he said.

Mr. Chafetz noted that, in spite of the trade war, there is a slight boom in trade-finance notional revenues (i.e., the underlying revenues generated by the trade activity being financed), even as trade volumes are generally down. Yet "there's less liquidity within the commercial-banking sector being applied against trade finance," he said, "mainly because of the structural change we've seen in the correspondent banking business. It's about 20% smaller today than [it was] 10 years ago on the back of the financial crisis." Mr. Chafetz cited this fact as the reason for higher trade-finance costs—particularly in emerging markets—despite the "very low-cost environment for finance in general."

Sectors that stand to weather trade tensions

Mr. Chafetz expects certain sectors of the economy "in which there's still a strong demand for the underlying commodity or resource" to exhibit resilience despite the adverse trade conditions. Singling out liquefied natural gas (LNG) as one example, he said: "There's been a great demand for LNG happening amid a very complicated environment of world trade."

He cited two factors that should help the sector thrive in the current environment: the transition from long-term contracts to the so-called "spot market", which has increased supply and lowered pricing in the LNG market; and the ability to provide LNG inexpensively through terminals in countries that cannot afford costly dedicated pipelines.

New trends in trade finance

During his interview, Mr. Chafetz mentioned the application of new and disruptive technologies to international trade such as *(i)* artificial intelligence, which can be used to improve predictions of future trends and manage risk along the supply chain; *(ii)* 3D printing, which opens the possibility of shipping digital files across the world—in lieu of physical parts or finished goods—that would enable the local manufacturing of products on demand; and *(iii)* consortium-supported blockchain applications that help streamline the trade-finance process.

Mr. Chafetz noted that MUFG is a member of Komgo, a blockchain consortium and independent venture of shareholders that include large commodity traders, oil companies and a number of peer banks. Komgo supports digital letters of credit, he said, which allow traders to submit their data to banks through a swifter and more secure electronic system. Mr. Chafetz added that Komgo has already begun supporting a digitally based know-your-customer (KYC) process by which banks obtain information about the identity and addresses of clients to ensure their services are not misused. KYC will remain a secure and confidential process with the use of blockchain technology, but it will also be greatly accelerated, he said.

The inexorable shift of labor to lower-cost locations

Mr. Chafetz pointed out that a good deal of supply-chain movement is actually unrelated to trade disputes or tariffs, but rather to the cost of labor. He cited, as one example, the textile and apparel industries, which have shifted production from China to lower-cost locations including Vietnam and Cambodia. Mr. Chafetz believes such "labor arbitrage" will continue irrespective of developments on the trade front.

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