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INVESTMENT MANAGEMENT

BIG PICTURE

Tariffs: Illusion Versus Reality

BIG PICTURE | Q4 2025

Advocates of tariffs insist that higher barriers will bring jobs home, yet U.S. manufacturing remains structurally uncompetitive. While China's share of U.S. imports may have declined, its grip on critical goods, from rare minerals to electric-vehicle batteries, remains firm. The debate is still framed in outdated country versus country terms, while in reality, supply chains stretch across sectors that traverse dozens of borders. Those chains may bend, but they will not break. Markets need to better understand the illusion versus the reality of tariffs.

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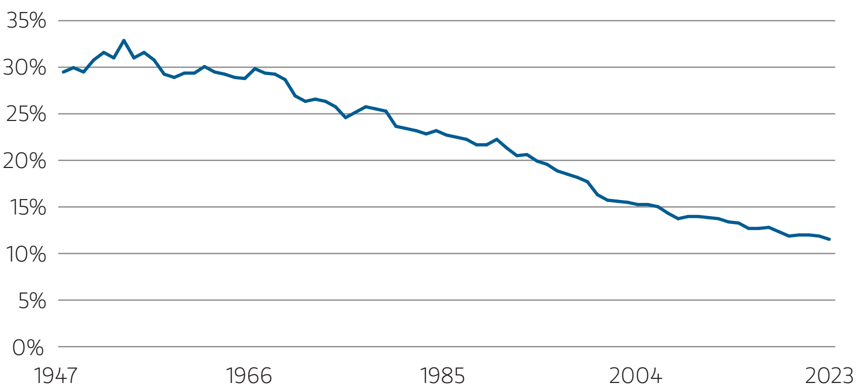
In a previous paper from March 2023 titled "Untangling Supply Chain Linkages," we argued that despite the political narrative around "bringing jobs home," U.S. onshoring will be limited to a few strategic industries. The recent surge in private capital expenditure has flowed mainly into data centers and artificial intelligence, not into broad-based manufacturing. High labor and capital costs, combined with an expensive U.S. dollar (USD), make U.S. manufacturing largely uncompetitive (*Display 1*).

DISPLAY 1

The Decline of U.S. Manufacturing

U.S. manufacturing share of GDP (%)



Source: Bureau of Economics Analysis. As of December 2023.

We also highlighted how the U.S. is accelerating its "China Plus One" strategy, diversifying parts of manufacturing away from China and benefitting emerging market (EM) countries like India, Vietnam, Mexico, Malaysia and Indonesia *(Display 2)*. China's share of U.S. imports has continued to decline, from 21% in 2016 to 13% in 2024, with production migrating to other EMs in Southeast Asia and Latin America.

However, China still plays a central role in supplying the U.S. and the world with strategic exports such as rare minerals, electronics, battery cells and semiconductor wafers. Beijing has managed to evade some U.S. tariffs by rerouting trade through other countries. Studies suggest that 50% of these trans-shipments flow through Vietnam and another 25% via Thailand. In response, Washington has extended tariffs on a country-by-country basis in an effort to close loopholes and build a more impermeable trade barrier.

Multiple Border Crossings

Following China's retaliation against Trump's "Liberation Day" levies, the average U.S. tariff rate spiked from under 3% to around 25% in April. Sector-specific rates were even higher: aluminum 50%, autos 25%, copper 50%, lumber 25% and movies 100%. Subsequent exemptions for electronics and pharmaceuticals, as well as ad hoc bilateral deals, eventually brought the effective average rate down to around 15%, far above the 2.4% at the start of the year.

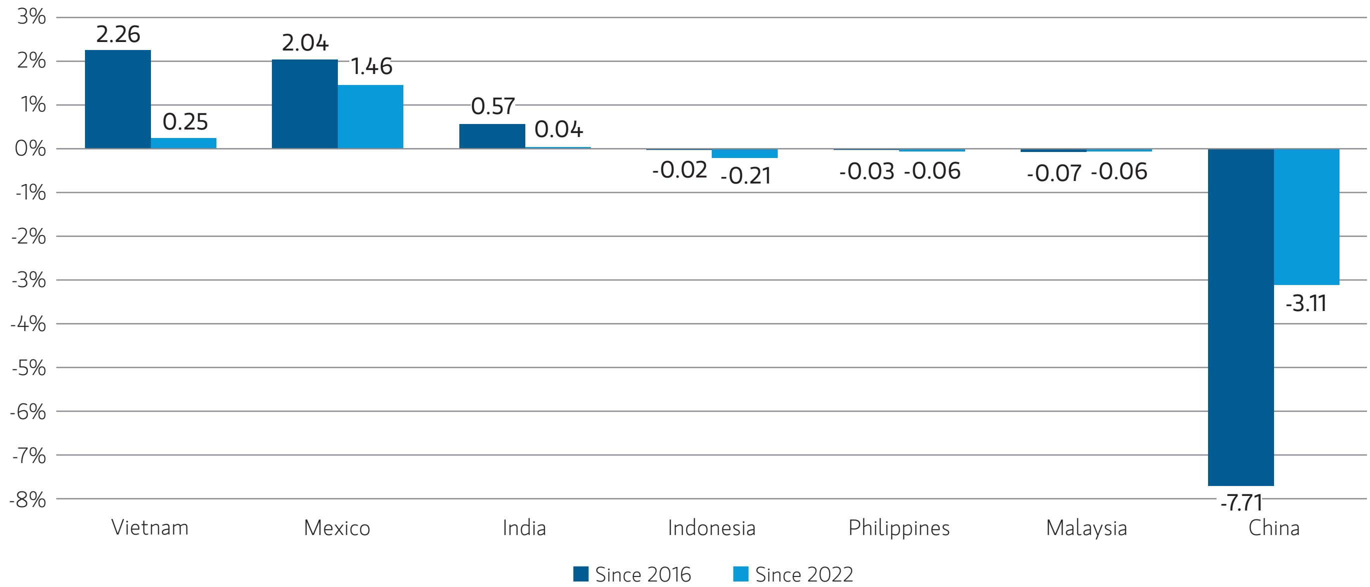
However, the prevailing tariff playbook still often assumes that trade can be neatly reshaped along national boundaries. The reality is far more complex: Supply chains are deeply entangled beyond the boundaries of any single country. An iPhone, for example, relies on 200 suppliers spread across 40 countries. Its memory chips can come from South Korea, its camera from Japan and its accelerometer from Europe, with final assembly in India or China. Even for strategic industries such as semiconductors, chips fabricated in Arizona are predominately designed in the U.S., but the foundries are located in Taiwan, South Korea, China and Japan. Lithography machines come from the Netherlands, assembly occurs in Malaysia and the finished products are finally sold to various companies worldwide.

Similarly, a Tesla battery uses lithium from Australia or Chile (which is then processed and refined in China), nickel from Indonesia, graphite from China and cathode technology from South Korea, with materials crossing borders four to five times leading up to the final battery assembly in Nevada. *(Display 3)*.

DISPLAY 2

Illusion: Shifting Trade, Safer Chains

Change in country share of U.S. imports (%)



Source: U.S. International Trade Commission. As of September 2025.

Country Tariffs Miss the Point

In today's integrated world, a country-based policy has become a blunt instrument. A sector-by-sector tariff plan, targeted at strategic technologies and inputs, would be more consistent with the way supply chains actually operate.

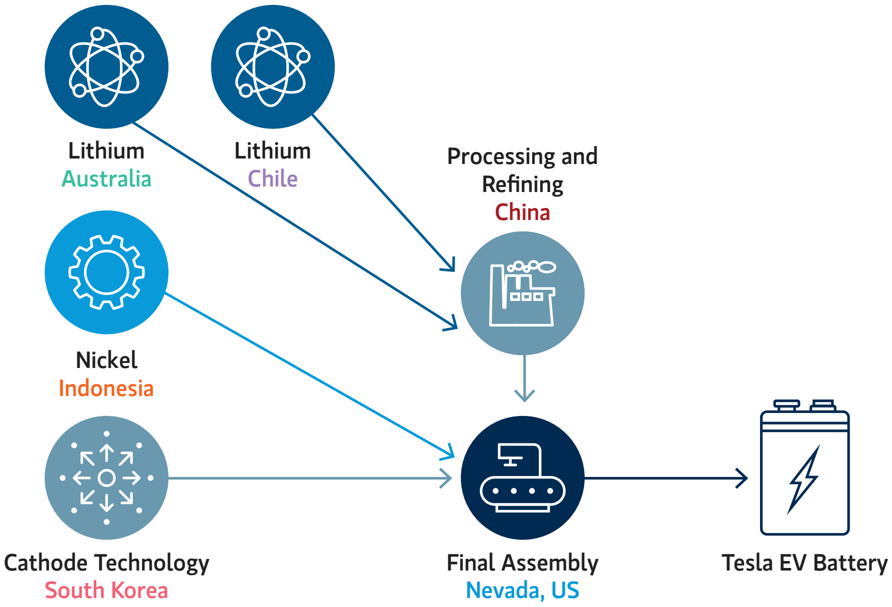
Tariffs on a single link can ripple across cost structures, inventory cycles and supplier relationships, undermining their impact by raising costs for U.S. consumers and manufacturers while leaving critical dependencies intact.

Academic studies suggest that since bilateral tariffs are subject to reciprocal tariffs, a more effective trade policy is to implement a single tariff rate across all trade partners. This could be calculated based on the overall U.S. trade deficit and trade price elasticity. With supply chains intertwined, and goods moving in and out of the U.S. multiple times, implementing different tariff rates on different countries is not an optimal strategy.

DISPLAY 3

Reality: One Good, Global Route

Tesla EV battery supply chain



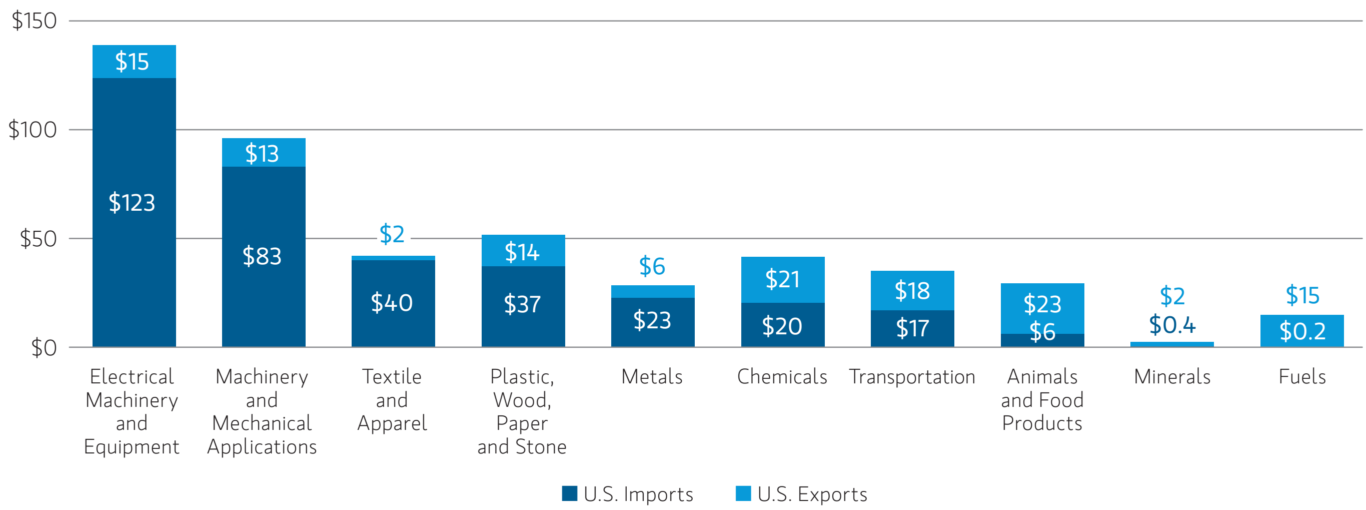
Source: Morgan Stanley research, Tesla. As of June 2025.

Other research suggests that broad-based sectoral tariffs generate more revenue, and are more effective in offsetting GDP losses, than country-specific tariffs. Sectoral tariffs also offer more predictability compared to bilateral tariffs, which are subject to political uncertainty. The EU has adopted a similar approach by investigating each product separately and imposing levies based on the level of government subsidies or evidence of dumping by the exporting country.

DISPLAY 4

U.S. Import Complexity Versus Export Simplicity

Breakdown of U.S.-China trade (in $billions)



Source: UN Comtrade, Morgan Stanley research. As of December 2023.

Current U.S. tariffs are implemented under the International Emergency Economic Powers Act (IEEPA), which is the swiftest way for the administration to implement tariff policy. However, with the IEEPA facing legal challenges, we expect the current policy to shift rationally toward sectoral tariffs. While more permanent, these tariffs take months to investigate and implement.

Export Complexity Matters

An often overlooked and underappreciated dimension of these trade dynamics is the complexity of goods exchanged between the U.S. and the countries it seeks to tariff. A country that exports highly advanced goods holds greater leverage in negotiations than a country that ships less-advanced goods.

Contrary to popular belief, U.S. imports are not dominated by cheap, low-complexity goods. About 30% of imports are machinery parts and electronics. Autos make up 12.5% and pharmaceuticals 5%. These are harder to substitute domestically or replace with alternative trading partners *(Display 4)*.

At the same time, U.S. export complexity is lower than that of countries like Japan, Germany or Ireland, with many exports to EMs consisting of commodities like oil and soybeans. While there is still a substitution cost for less-complex goods, they are far easier to replace than goods with highly complex supply chains like electronics, machinery, chemicals and pharmaceuticals. This is evidenced by the fact that China now buys most of its soybeans from Brazil. Previously, 25% of U.S. soybeans were exported to China, but that demand from China has plummeted to almost zero this year.

This imbalance, namely export simplicity of the U.S. compared to import complexity, limits Washington's leverage in a full-scale tariff confrontation. By contrast, China's export complexity, and its shift towards reducing dependence on foreign technology and supply chains, places it in a stronger position.

The Domestic Constraint

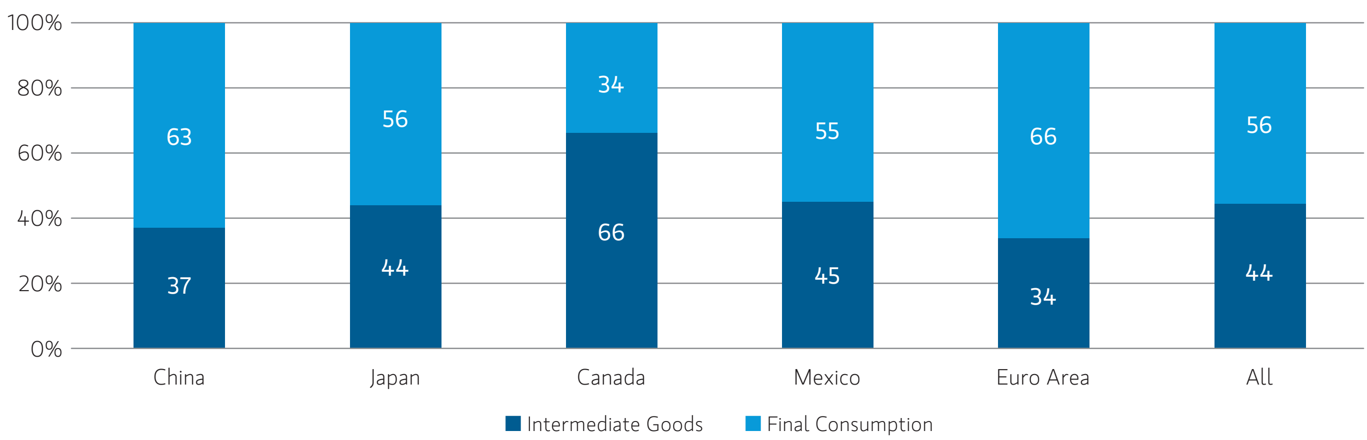
Tariffs hurt the U.S. too. By raising costs for consumers, they undermine the very manufacturing sectors they are meant to protect. The U.S. lacks both the trained labor and capital stock to replace imported complex goods, and decades of decline have only widened this gap. U.S. manufacturing capital stock as a share of total capital stock has declined by eight percentage points over 30-plus years, from 28% in 1990 to 20% in 2024,[1] an indication of how dependent the U.S. has become on imports to supplement the capital stock it has lost in the last three decades.

Data also suggests that 44% of U.S. imports are intermediate goods *(Display 5)*. A country-specific tariff is essentially an indirect tax on domestic manufacturers, resulting in U.S. production becoming even less competitive. For example, the U.S. imposes 50% tariffs on steel and aluminum, but only 15% tariffs on Japanese cars, even though steel is a key input. This may actually make Japanese cars more competitive than those assembled in the U.S.

DISPLAY 5

Intermediate Goods Are an Important Share of U.S. Imports

U.S. share of intermediate and final goods imports (%)



Source: U.S. International Trade Commission. As of September 2025.

[1] Bureau of Economic Analysis, Federal Reserve Bank of St. Louis. As of December 2024.

Such dynamics limit Washington's leverage over other countries. Especially in the case of the United States-Mexico-Canada Agreement (USMCA), intermediate goods make up 66% of U.S. imports from Canada, 45% from Mexico. We believe this should result in favorable trade outcomes for these countries in the foreseeable future.

Tariff costs can be borne by the exporters, importers or consumers. The U.S. Chamber of Commerce reported that 97% of U.S. importers are small businesses with fewer than 500 employees. They are responsible for a third of the total value of goods imported, but generally have little bargaining power with the supplier, meaning tariffs will be absorbed by the businesses or passed on to the consumer or both. The report calculates that tariffs amount to $200 billion annually in additional taxes on these businesses.

Similarly, costs are rising for U.S. farmers, partly due to tariffs on fertilizers and tractors, increasing the likelihood of a relief package to the agriculture sector, which would offset some of the government's tariff revenue.

As most of the consumer products like electronics and generic pharmaceuticals are currently exempt from tariffs, the impact on inflation will trickle down slowly from increasing input prices. The combined burden on small businesses and consumers will increase the risk of tariffs becoming politically unpopular.

Producing domestically could cost 50–80% more than current imports, depending on the category. U.S. labor costs are about 10 times that of India, six times greater than Vietnam's, twice China's and 1.5 times that of France *(Display 6)*. Given higher costs and decreased competitiveness, reshoring will be limited to strategic sectors like defense, advanced chips and critical energy technologies.

China's Inward Focus and Outward Influence

While the U.S. has pursued a "China Plus One" approach, China has retaliated with a "U.S. Plus One" strategy of its own. Since 2016, the U.S. share of Chinese exports has declined from 18% in 2016 to 15% in 2024. However, EM's share has risen from 34% to 45% and deliveries to EM Asia have grown from 14% to 19%. Much of the growth reflects a rerouting of goods originally destined for the U.S., a reminder that trade is more about networks than nodes.

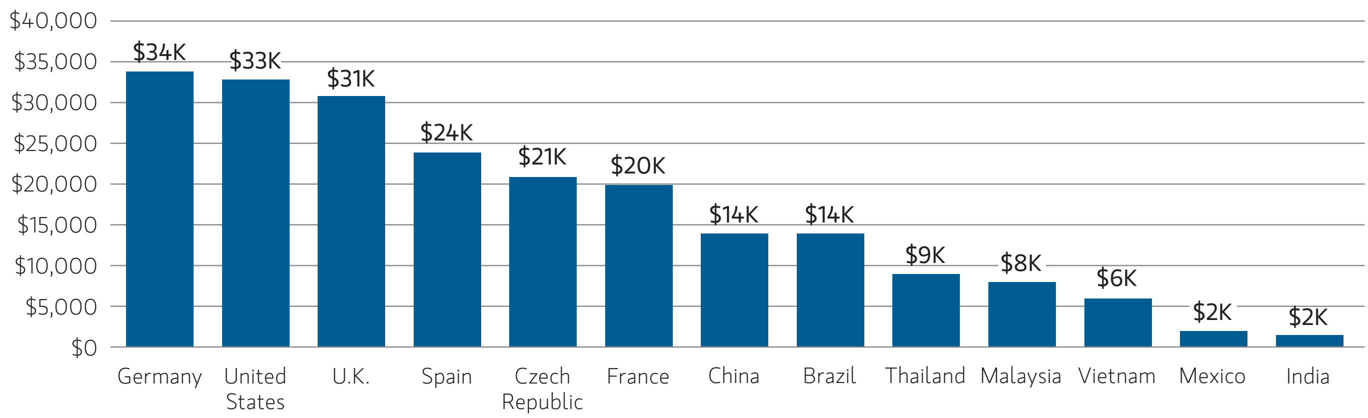
China is also advancing its "dual circulation" model aimed at greater self-reliance. It has become a net exporter of finished autos, including internal-combustion engine vehicles, and has increased its exports of auto parts. Even as the U.S. and Europe try to boost domestic production through their industrial policies, they rely greatly on China for machinery and equipment, critical minerals, and intermediate goods. Machinery, appliances and electronics represent around 50% of U.S. trade with China versus 40% for the EU.

The U.S. imports almost 75% of its lithium-ion batteries from China, which supplies 43% of graphite and 79% of sheet mica used in the U.S. On average, the U.S. relies on China for 47% of its antibiotics, and for certain types, the dependency can reach 100%. In Europe, diversification away from China is limited due to the region's reliance on Chinese clean tech and chemicals. Tariffs can trigger some change, but they also expose the stickiness of dependencies.

DISPLAY 6

Domestic Production in the U.S. Will Be Costly

Average Annual Salaries: Production Workers and Machine Operators



Source: Reshoring Initiative. As of December 31, 2022.

China's Hard and Soft Power

China's influence extends far beyond direct trade. For many countries, including developed markets like Japan and Germany, China is a larger export market than the U.S. Through its Belt and Road Initiative (BRI), China has built deep ties across Africa, Asia, the Middle East and Latin America. Trump's tariff threat pushed Colombia to join the BRI, despite U.S. opposition. Brazil also gravitates towards China, seeking opportunities to expand its agricultural exports. Sanctioned states like Iran and Russia rely heavily on Chinese trade which has become a lifeline for their economies.

China's non-financial outbound direct investment (ODI) doubled to $33.7 billion from 2019 levels. The BRI accounts for 25% of this ODI, up from 15% in 2017. China now controls more than 50% of global shipbuilding tonnage and has a near monopoly in container shipbuilding, with ownership of 93 foreign ports across 50 countries. It is also investing in a new rail link across southeast Asia (Laos, China, Thailand, Vietnam and Malaysia).

Outside Asia, Peru's mega-port and Brazil's grain terminal help diversify China's imports away from the U.S. agricultural sector. At the same time, China is shifting its focus from large, long-horizon infrastructure projects to smaller initiatives with higher private sector participation.

Additionally, China is reducing its own reliance on the U.S. currency. About 50% of its cross-border payments are now settled in the yuan, up from 1% in 2010. More than 30% of China's trade in goods and services is now done in its own currency, compared with 14% in 2019, while 45% of China's overseas loans are yuan-denominated, up from 15% in 2019. Clearing banks to settle yuan payments (almost all of which are operated by Chinese institutions) have been set up in 33 markets, including Turkey and Mauritius. In June, China began working with the United Arab Emirates to expand CIPS (its cross-border payments system, an alternative to the global SWIFT payment system) into North Africa and the Middle East. Firms are expected to issue the highest level of "dim sum" yuan bonds[2] in 2025. It is rumored that Kenya might switch their USD-denominated debts owed to China into yuan.

Tariff Hard Truths

The tariff debate is still framed around countries, but the global economy operates across sectors. By continuing to treat a tangled network like a set of national silos, the U.S. risks breaking fragile connections in ways that raise costs without reducing strategic dependencies.

Broad, country-based tariffs are a blunt tool. They distort incentives, invite retaliation and act as an indirect tax on U.S. manufacturers, squeezing margins and hitting small- and mid-sized businesses hardest.

Bilateral tariffs on China will not be effective. The U.S. imports relatively more complex goods such as electronics, pharmaceuticals and machinery, while exporting replaceable commodities like oil and agricultural products. As U.S. consumers have become more reliant on imports, China has intensified its pursuit of self-reliance in strategic sectors and diversified its trade across the rest of the world. Through the BRI and foreign direct investments, Beijing also has deepened diplomatic and commercial ties. For many countries, choosing between the U.S. and China will be harder than it was a generation ago. Taken together, that leverage helps China's negotiation power in trade talks with the U.S.

A smarter approach is to target sectors rather than countries. Calibrating tariffs toward strategic technologies and critical inputs, as the EU has done, offers a more precise tool to protect critical industries and better align with the way the global economy functions.

In areas where supply chains are less complex, such as apparel, footwear, agricultural goods and commodities, tariffs are more likely to succeed. But these are not strategic industries.

The very sectors policymakers most want to protect, like semiconductors, batteries and advanced machinery, are also those most entangled in global supply chains. The complexity of U.S. imports and the country's large share of intermediate goods should limit how much onshoring will be possible. Incentives will spur some moves, supported by tax breaks and subsidies, but onshoring will be limited and costly.

The tariff debate must therefore shift from an illusion of self-sufficiency to the reality of sectoral nuances with intertwined supply chains.

[2] "Dim sum" bonds are issued outside of China but denominated in Chinese yuan, rather than the local currency.

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