A Gray Market Problem In The Making?

Effective January 1, a wide range of Chinese music and audio products will be subject to a 25% tariff, up from the previous levels that ranged between 4% and 6%. The sharp increase is part of the Trump administration's tough stance on what it calls China's "unfair and illegal" trade practices. The administration is attempting to use the new levies to prod the Chinese government to eliminate stiff tariff and non-tariff barriers to U.S.-made goods, and crack down on the many well-documented cases of intellectual property theft. There are plausible cases to be made both for raising tariffs on Chinese imports and for continuing with the status quo. However, we'll leave that debate to others and address the more limited question of how the new policy will impact the music products industry.

Two fairly safe predictions can be made. First, prices of Chinese-made goods will edge up because industry margins are simply not rich enough to allow distributors or manufacturers to absorb a 25% increase in landed costs. Second, companies will step up the search for other production sites. Expect to see more country of origin labels from Indonesia, Vietnam, Mexico, and even the U.S. This process is already underway. What's unknown is how consumers will react to higher prices and what actions they will take to thwart the new import levies. If the past is any guide, count on great displays of ingenuity in the pursuit of saving a few bucks.

Will consumers shun an effects pedal from China that used to sell for $150 if it now carries a $190 price tag? Or the formerly $300 guitar that is now priced at $375? Some manufacturers and retailers we talk to say the looming price increases will have a significant impact on demand or may provide additional stimulus to the used market. Others shrug them off as insignificant. This lack of clarity shouldn't come as a surprise. According to Procter & Gamble, the company that practically invented market research, even the most sophisticated focus groups and consumer surveys rarely answer the question, "What is the consumer willing to pay?" Thus, we'll probably have to wait and see what impact higher prices have on demand. On an inflation adjusted basis, the musical products currently available have never been cheaper. The fact that comparatively higher prices in the recent past haven't been much of a deterrent should be somewhat comforting.

The same Chinese-made instrument or piece of audio gear that gets hit with a 25% tariff at the U.S. border is only taxed at 4% to 5% upon entering the European Union or Canada. This disparity gives Canadian and European retailers a significant pricing advantage that could very well encourage a gray market and inject additional chaos into an already complex global distribution channel. Potential cross-border trade has also been facilitated by a rule buried in the U.S. Customers and Border Protection (CBP) guidelines that allows individuals to bring in $800 worth of goods for their personal use duty free. The internet makes it possible for foreign retailers to connect with U.S. consumers, and there are economically viable shipping options. Don't be surprised if a number of intrepid foreign retailers view these factors, along with the $800 exemption, as their opportunity to take a slice of the U.S. market, which accounts for more than 40% of global music product sales.

The scenario where a foreign online retailer exploits a tariff discrepancy to secure export business is not without precedent. In Australia, where there is a 10% tariff on imported guitars, several American retailers have exploited a $1,500 personal exemption to do a significant volume "Down Under." This practice, which has been going on for the better part of a decade, is a continuing source of irritation for Aussie retailers and distributors who complain about being undermined by their own government.

Gray market sales are just one way creative buyers and sellers might exploit price differentials caused by the new U.S. tariffs. Be prepared for people a lot sharper than us to devise numerous other creative strategies that appeal to consumers' desire for the best deal.

Tariffs have fluctuated widely over the years. Before 1915, they were the major funding source of the U.S. government. Today, they provide less than 5% of federal funding. Since the creation of the European Union in 1992, they have trended down, and global trade has flourished. The current rules are hardly the final word, and trade policy will no doubt be adjusted in election cycles to come. The one rule that will stay on the books long after these Chinese tariffs have been replaced is the law of unintended consequences. It's probably more powerful today than ever, given the interconnectedness of the global economy, and it makes the impact of 25% tariffs even harder to predict.

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