

International Business 7e

by Charles W.L. Hill

Chapter 6

The Political Economy of International Trade

Introduction

- ❖ **Free trade** occurs when governments do not attempt to restrict what its citizens can buy from another country or what they can sell to another country
- ❖ While many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups

Instruments Of Trade Policy

The main instruments of trade policy are:

- ❖ Tariffs
- ❖ Subsidies
- ❖ Import Quotas
- ❖ Voluntary Export Restraints
- ❖ Local Content Requirements
- ❖ Administrative Policies
- ❖ Antidumping Policies

Tariffs

- ❖ **Tariffs** are taxes levied on imports that effectively raise the cost of imported products relative to domestic products
- ❖ **Specific tariffs** are levied as a fixed charge for each unit of a good imported
- ❖ **Ad valorem tariffs** are levied as a proportion of the value of the imported good
- ❖ Tariffs increase government revenues, provide protection to domestic producers against foreign competitors by increasing the cost of imported foreign goods, and force consumers to pay more for certain imports
- ❖ So, tariffs are unambiguously pro-producer and anti-consumer, and tariffs reduce the overall efficiency of the world economy

Subsidies

- ❖ Subsidies are government payments to domestic producers
- ❖ Consumers typically absorb the costs of subsidies

Subsidies help domestic producers in two ways:

- ❖ they help them compete against low-cost foreign imports
- ❖ they help them gain export markets

Classroom Performance System

When tariffs are levied as a fixed charge for each unit of a good imported, they are called

- a) Specific tariffs
- b) Ad valorem tariffs
- c) Tariff rate quotas
- d) Transit tariffs

Import Quotas And Voluntary Export Restraints

- ❖ **Import quotas** directly restrict the quantity of some good that may be imported into a country
- ❖ **Tariff rate quotas** are a hybrid of a quota and a tariff where a lower tariff is applied to imports within the quota than to those over the quota
- ❖ **Voluntary export restraints** are quotas on trade imposed by the exporting country, typically at the request of the importing country's government
- ❖ A **quota rent** is the extra profit that producers make when supply is artificially limited by an import quota
- ❖ Import quotas and voluntary export restraints benefit domestic producers by limiting import competition, but they raise the prices of imported goods

Local Content Requirements

- ❖ A **local content requirement** demands that some specific fraction of a good be produced domestically
- ❖ Local content requirements benefit domestic producers, but consumers face higher prices

Classroom Performance System

A _____ demands that some specific fraction of a good be produced domestically

- a) subsidy
- b) quota rent
- c) voluntary export requirement
- d) local content requirement

Administrative Policies

- ❖ **Administrative trade policies** are bureaucratic rules that are designed to make it difficult for imports to enter a country
- ❖ These policies hurt consumers by denying access to possibly superior foreign products

Antidumping Policies

- ❖ Dumping refers to selling goods in a foreign market below their costs of production, or selling goods in a foreign market below their “fair” market value
- ❖ Dumping enables firms to unload excess production in foreign markets
- ❖ Some dumping may be predatory behavior, with producers using substantial profits from their home markets to subsidize prices in a foreign market with a view to driving indigenous competitors out of that market, and later raising prices and earning substantial profits
- ❖ **Antidumping polices** (or **countervailing duties**) are designed to punish foreign firms that engage in dumping and protect domestic producers from “unfair” foreign competition

The Case For Government Intervention

Arguments for government intervention:

- ❖ **Political arguments** are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)
- ❖ **Economic arguments** are typically concerned with boosting the overall wealth of a nation (to the benefit of all, both producers and consumers)

Political Arguments For Free Trade

Political arguments for government intervention include:

- ❖ protecting jobs
- ❖ protecting industries deemed important for national security
- ❖ retaliating to unfair foreign competition
- ❖ protecting consumers from “dangerous” products
- ❖ furthering the goals of foreign policy
- ❖ protecting the human rights of individuals in exporting countries

Classroom Performance System

Which of the following is not a political argument for government intervention?

- a) protecting jobs
- b) protecting infant industries
- c) protecting industries deemed important for national security
- d) protecting consumers from “dangerous” products

Protecting Jobs And Industries

- ❖ Protecting jobs and industries is the most common political reason for trade restrictions
- ❖ Usually this results from political pressures by unions or industries that are "threatened" by more efficient foreign producers, and have more political clout than the consumers that will eventually pay the costs

National Security

❖ Industries such as aerospace or electronics are often protected because they are deemed important for national security

Retaliation

- ❖ When governments take, or threaten to take, specific actions, other countries may remove trade barriers
- ❖ If threatened governments don't back down, tensions can escalate and new trade barriers may be enacted

Protecting Consumers

❖ Governments may intervene in markets to protect consumers

Furthering Policy Objectives

- ❖ Foreign policy objectives can be supported through trade policy
- ❖ Preferential trade terms can be granted to countries that a government wants to build strong relations with
- ❖ Trade policy can also be used to punish rogue states that do not abide by international laws or norms
- ❖ However, it might cause other countries to undermine unilateral trade sanctions
- ❖ The **Helms-Burton Act** and the **D'Amato Act**, have been passed to protect American companies from such actions

Protecting Human Rights

- ❖ Trade policy can be used to improve the human rights policies of trading partners
- ❖ However, unless a large number of countries choose to take such action, it is unlikely to be successful
- ❖ Some critics have argued that the best way to change the internal human rights of a country is to engage it in international trade
- ❖ The decision to grant China MFN status in 1999 was based on this philosophy

Economic Arguments For Intervention

Economic arguments for intervention include:

- ❖ the infant industry argument
- ❖ strategic trade policy

Classroom Performance System

What is the most common political reason for trade barriers?

- a) To protect infant industries
- b) Strategic trade policy
- c) To protect jobs
- d) To protect industries that are important for national security

The Infant Industry Argument

- ❖ The **infant industry argument** suggests that an industry should be protected until it can develop and be viable and competitive internationally
- ❖ The infant industry argument has been accepted as a justification for temporary trade restrictions under the WTO
- ❖ However, it can be difficult to gauge when an industry has “grown up”
- ❖ Critics argue that if a country has the potential to develop a viable competitive position its firms should be capable of raising necessary funds without additional support from the government

Strategic Trade Policy

- ❖ **Strategic trade policy** suggests that in cases where there may be important first mover advantages, governments can help firms from their countries attain these advantages
- ❖ Strategic trade policy also suggests that governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage

Revised Case For Free Trade

Restrictions on trade may be inappropriate in the cases of:

- ❖ Retaliation and Trade War
- ❖ Domestic Politics

Retaliation And Trade War

- ❖ Paul Krugman argues that strategic trade policies aimed at establishing domestic firms in a dominant position in a global industry are beggar-thy-neighbor policies that boost national income at the expense of other countries
- ❖ Countries that attempt to use such policies will probably provoke retaliation

Domestic Policies

❖ Krugman argues that since special interest groups can influence governments, strategic trade policy is almost certain to be captured by such groups who will distort it to their own ends

Classroom Performance System

Which theory suggests that in cases where there may be important first mover advantages, governments can help firms from their countries attain these advantages?

- a) The infant industry argument
- b) Strategic trade theory
- c) Comparative advantage theory
- d) The Leontief paradox

Development Of The World Trading System

❖ How has the current world trade system emerged?

From Smith To The Great Depression

- ❖ Until the Great Depression of the 1930s, most countries had some degree of protectionism
- ❖ The Smoot-Hawley tariff was enacted in 1930 in the U.S creating significant import tariffs on foreign goods
- ❖ Other nations took similar steps and as the depression deepened, world trade fell further

1947-79: GATT, Trade Liberalization, And Economic Growth

- ❖ After WWII, the U.S. and other nations realized the value of freer trade, and established the General Agreement on Tariffs and Trade (GATT)
- ❖ The approach of GATT (a multilateral agreement to liberalize trade) was to gradually eliminate barriers to trade

1980-1993: Protectionist Trends

- ❖ In the 1980s and early 1990s, the world trading system was strained
- ❖ Japan's economic strength and huge trade surplus stressed what had been more equal trading patterns, and Japan's perceived protectionist (neo-mercantilist) policies created intense political pressures in other countries
- ❖ Persistent trade deficits by the U.S., the world's largest economy, caused significant economic problems for some industries and political problems for the government
- ❖ Many countries found that although limited by GATT from utilizing tariffs, there were many other more subtle forms of intervention that had the same effects and did not technically violate GATT

The Uruguay Round And The World Trade Organization

- ❖ The Uruguay Round of GATT negotiations began in 1986

The talks focused on several areas:

- ❖ Services and Intellectual Property
- ❖ -going beyond manufactured goods to address trade issues related to services and intellectual property, and agriculture
- ❖ The World Trade Organization
- ❖ -it was hoped that enforcement mechanisms would make the WTO a more effective policeman of the global trade rules

- ❖ The WTO encompassed GATT along with two sisters organizations, the General Agreement on Trade in Services (GATS) and the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)

WTO: Experience To Date

- ❖ Since its establishment, the WTO has emerged as an effective advocate and facilitator of future trade deals, particularly in such areas as services
- ❖ So far, the WTO's policing and enforcement mechanisms are having a positive effect
- ❖ Most countries have adopted WTO recommendations for trade disputes

WTO: Experience To Date

- ❖ In 1997, 68 countries that account for more than 90% of world telecommunications revenues pledged to open their markets to foreign competition and to abide by common rules for fair competition in telecommunications
- ❖ 102 countries pledged to open to varying degrees their banking, securities, and insurance sectors to foreign competition
- ❖ The agreement covers not just cross-border trade, but also foreign direct investment

WTO: Experience To Date

- ❖ The 1999 meeting of the WTO in Seattle was important not only for what happened between the member countries, but also for what occurred outside the building
- ❖ Inside, members failed to agree on how to work toward the reduction of barriers to cross-border trade in agricultural products and cross-border trade and investment in services
- ❖ Outside, the WTO became a magnet for various groups protesting free trade

The Future Of The WTO: Unresolved Issues And The Doha Round

The current agenda of the WTO focuses on:

- ❖ the rise of anti-dumping policies
- ❖ the high level of protectionism in agriculture
- ❖ the lack of strong protection for intellectual property rights in many nations
- ❖ continued high tariffs on nonagricultural goods and services in many nations

The Future Of The WTO: Unresolved Issues And The Doha Round

- ❖ The WTO is encouraging members to strengthen the regulations governing the imposition of antidumping duties
- ❖ The WTO is concerned with the high level of tariffs and subsidies in the agricultural sector of many economies
- ❖ TRIPS obliges WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years
- ❖ The WTO would like to bring down tariff rates on nonagricultural goods and services, and reduce the scope for the selective use of high tariff rates

The Future Of The WTO: Unresolved Issues And The Doha Round

❖ The WTO launched a new round of talks at Doha, Qatar in 2001

The agenda includes:

- ❖ cutting tariffs on industrial goods and services
- ❖ phasing out subsidies to agricultural producers
- ❖ reducing barriers to cross-border investment
- ❖ limiting the use of anti-dumping laws

Classroom Performance System

All of the following except _____ are key issues on the table at the Doha Round.

- a) Anti-dumping policies
- b) Protectionism in agriculture
- c) Intellectual property rights
- d) Infant industry protection

Implications For Managers

- ❖ Managers need to consider how trade barriers affect the strategy of the firm and the implications of government policy on the firm

Trade Barriers And Firm Strategy

- ❖ Trade barriers raise the cost of exporting products to a country
- ❖ Voluntary export restraints (VERs) may limit a firm's ability to serve a country from locations outside that country
- ❖ To conform to local content requirements, a firm may have to locate more production activities in a given market than it would otherwise
- ❖ All of these can raise the firm's costs above the level that could be achieved in a world without trade barriers

Policy Implications

- ❖ International firms have an incentive to lobby for free trade, and keep protectionist pressures from causing them to have to change strategies
- ❖ While there may be short run benefits to having governmental protection in some situations, in the long run these can backfire and other governments can retaliate