Global Business Today 6e

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Chapter 6

The Political Economy of International Trade

Introduction

- Free trade refers to a situation where a government does 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

Question: How do governments intervene in international trade?

- There are seven main instruments of trade policy
  1. Tariffs
  2. Subsidies
  3. Import quotas
  4. Voluntary export restraints
  5. Local content requirements
  6. Antidumping policies
  7. Administrative policies

Tariffs

- A tariff is a tax levied on imports that effectively raises 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

Question: Why do governments impose tariffs?

- Tariffs
  - increase government revenues
  - provide protection to domestic producers against foreign competitors by increasing the cost of imported foreign goods
  - 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

Classroom Performance System

A tariff levied as a fixed charge for each unit of a good imported is a(n)

a) Fixed tariff

b) Specific tariff

c) Ad valorem tariff

d) Transit tariff

Subsidies

- A subsidy is a government payment to a domestic producer
- Subsidies help domestic producers
  - compete against low-cost foreign imports
  - gain export markets
- Consumers typically absorb the costs of subsidies

Import Quotas and Voluntary Export Restraints

- An import quota is a direct restriction on 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

Question: Who benefits from import quotas and voluntary export restraints?

- Import quotas and voluntary export restraints benefit domestic producers by limiting import competition, but they raise the prices of imported goods for consumers

Local Content Requirements

- A local content requirement demands that some specific fraction of a good be produced domestically
  - The requirement can be in physical terms or in value terms
- Local content requirements benefit domestic producers and jobs, but consumers face higher prices

Administrative Policies

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

Administrative Policies

- Dumping is selling goods in a foreign market below their cost of production, or selling goods in a foreign market at below their "fair" market value
  - It can be a way for 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

Administrative Policies

- Antidumping polices are designed to punish foreign firms that engage in dumping
- The goal is to protect domestic producers from “unfair” foreign competition
- U.S. firms that believe a foreign firm is dumping can file a complaint with the government
- If the complaint has merit, antidumping duties, also known as countervailing duties may be imposed

Classroom Performance System

A quota on trade imposed from the exporting country's side is a(n)

a) Voluntary export restraint

b) Quota rent

c) Local content requirement

d) Administrative trade policy

The Case for Government Intervention

Question: Why do governments intervene in trade?

- There are two types of arguments

1. 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)
2. 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 Intervention

- Political arguments for government intervention include
  1. protecting jobs
  2. protecting industries deemed important for national security
  3. retaliating to unfair foreign competition
  4. protecting consumers from “dangerous” products
  5. furthering the goals of foreign policy
  6. protecting the human rights of individuals in exporting countries

Political Arguments for Intervention

1. Protecting jobs and industries

- This is the most common political reason for trade restrictions
- This is typically the result of political pressures by unions or industries that are "threatened" by more efficient foreign producers, and have more political clout than the consumers who will eventually pay the costs

Political Arguments for Intervention

2. National Security

- Governments sometimes protect certain industries such as aerospace or advanced electronics because they are important for national security
- This argument is less common today than in the past

Political Arguments for Intervention

3. Retaliation

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

Political Arguments for Intervention

4. Protecting Consumers

- Protecting consumers from unsafe products is also be an argument for restricting imports
- This often involves limiting or banning the import of certain products

Political Arguments for Intervention

5. Furthering Foreign Policy Objectives

- Trade policy can be used to support foreign policy objectives
  - Preferential trade terms can be granted to countries that a government wants to build strong relations with
  - Rogue states that do not abide by international laws or norms can be punished
- However, it might cause other countries to undermine unilateral trade sanctions
- Two acts, the Helms-Burton Act and the D'Amato Act, have been passed to protect American companies from such actions

Political Arguments for Intervention

6. Protecting Human Rights

- Governments can use trade policy to improve the human rights policies of trading partners
  - Unless a large number of countries choose to take such action, however, it is unlikely to prove 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 government intervention in international trade include

1. The infant industry argument
2. Strategic trade policy

Economic Arguments for Intervention

1. 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
  - This has been accepted as a justification for temporary trade restrictions under the WTO
- However, this argument has been criticized because
  - it is useless unless it makes the industry more efficient
  - if a country has the potential to develop a viable competitive position, its firms should be capable of raising necessary funds
- Critics argue that

Economic Arguments for Intervention

2. 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

Classroom Performance System

Which argument for government intervention suggests that an industry should be protected until it can develop and be viable and competitive internationally?

a) Strategic trade policy

b) National security

c) Retaliation

d) Infant industry

The Revised Case for Free Trade

- New trade theorists believe government intervention in international trade is justified
- Classic trade theorists disagree
- Some new trade theorists believe that while strategic trade theory is appealing in theory, it may not be workable in practice – they suggest a revised case for free trade
- Two situations where restrictions on trade may be inappropriate
  - Retaliation
  - Domestic Policies

Retaliation and War

- 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
- A country that attempts to use such policies will probably provoke retaliation
  - A trade war could leave both countries worse off

Domestic Policies

- Governments can be influenced by special interest
- Consequently, a government's decision to intervene in a market may appease a certain group, but not necessarily the support the interests of the country as a whole

Development of the World Trading System

- Since World War II, an international trading framework has evolved to govern world trade
- In its first fifty years, the framework was known as the General Agreement on Tariffs and Trade (GATT)
- Since 1995, the framework has been known as the World Trade Organization (WTO)

From Smith to the Great Depression

- Up until the Great Depression of the 1930s, most countries had some degree of protectionism
- In 1930, the U.S. enacted the Smoot-Hawley Act, which created significant import tariffs on foreign goods
- Other nations took similar steps and as the depression deepened, world trade fell further

1947-1979: 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 in 1947
- The approach of GATT (a multilateral agreement to liberalize trade) was to gradually eliminate barriers to trade
  - GATT's membership grew from 19 to more than 120 nations
  - Tariff reduction was spread over eight rounds of negotiation
  - GATT regulations were enforce by a mutual monitoring system

1980-1993: Protectionist Trends

- The world trading system came under strain during the 1980s and early 1990s because
  - Japan's economic success strained what had been more equal trading patterns
  - Persistent trade deficits by the U.S caused significant problems in some industries and political problems for the government
  - Many countries found that although GATT limited the use of tariffs, there were many other forms of intervention that had the same effect that did not technically violate GATT

The Uruguay Round and the World Trade Organization

- The Uruguay Round (1986) focused on

1. Services and Intellectual Property
   - Trade issues related to services and intellectual property and agriculture were emphasized

2. The World Trade Organization
   - The WTO was established as a more effective policeman of the global trade rules
   - The WTO encompassed GATT and 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, most countries have adopted WTO recommendations for trade disputes
  - The WTO has brokered negotiations to reform the global telecommunications and financial services industries
  - The 1999 meeting of the WTO in Seattle demonstrated that issues surrounding free trade have become mainstream, and dependent on popular opinion

The Future of the WTO: Unresolved Issues and the Doha Round

The WTO is currently focusing on

1. Anti-dumping policies
   - The WTO is encouraging members to strengthen the regulations governing the imposition of antidumping duties

2. Protectionism in agriculture
   - The WTO is concerned with the high level of tariffs and subsidies in the agricultural sector of many economies
3. Protecting intellectual property
   - Members believe that the protection of intellectual property rights is essential to the international trading system
   - TRIPS obliges WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years

The Future of the WTO: Unresolved Issues and the Doha Round

4. Market access for nonagricultural goods and services

- 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

5. A new round of talks: Doha

- The WTO launched a new round of talks in 2001 to focus on
  - 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

The main issues on the table at the Doha Round include all of the following except

a) Anti-dumping policies

b) Protectionism in agriculture

c) Intellectual property rights

d) Infant industry protection

Implications for Managers

Question: Why should international managers care about the political economy of free trade or about the relative merits of arguments for free trade and protectionism?

- Trade barriers impact firm strategy
- Firms can play a role in promoting free trade or trade barriers

Trade Barriers and Firm Strategy

- Trade theory suggests why dispersing production activities globally can be beneficial
- However, trade barriers may limit a firm's ability to do so
  - Trade barriers raise the cost of exporting
  - Quotas limit exports
  - Firms may have to locate production activities within a country to meet local content regulations
  - The threat of future trade barriers can influence firm strategy
- All of these can raise costs above what they may have been in a world of free trade

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 government protection in some situations, in the long run these can backfire and other governments can retaliate making it more difficult to construct a globally dispersed production system

Critical Discussion Question

1. Do you think the U.S. government should consider human rights when granting preferential trading rights to countries? What are the arguments for and against taking such a position?

Critical Discussion Question

2. Whose interests should be the paramount concern of government trade policy - the interests of producers (businesses and their employees) or those of consumers?

Critical Discussion Question

3. Given the arguments relating to the new trade theory and strategic trade policy, what kind of trade policy should business be pressuring government to adopt?

Critical Discussion Question

4. You are an employee of an U.S. firm that produces personal computers in Thailand and then exports them to the U.S. and other countries for sale. The personal computers were originally produced in Thailand to take advantage of relatively low labor costs and a skilled workforce. Other possible locations considered at that time were Malaysia and Hong Kong. The U.S. government decides to impose punitive 100 percent ad valorem tariffs on imports of computers from Thailand to punish the country for administrative trade barriers that restrict U.S. exports to Thailand. How should your firm respond? What does this tell you about the use of targeted trade barriers?

Critical Discussion Question

5. Reread the Management Focus feature on U.S. Magnesium Seeks Protection. Who gains most from the anti-dumping duties levied by the United States on imports of magnesium from China and Russia? Who are the losers? Are these duties in the best national interests of the United States?