International Business 7e

by Charles W.L. Hill
(adapted for LIUC09 by R.Helg)

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

6-3

Instruments of trade policy

Two major categories:

a) **Tariffs barriers: the tariff**

b) **Non-tariff barriers (NTB):** every barrier to trade which is not a tariff

- Subsides
- Import Quotas
- Voluntary Export Restraints
- Local Content Requirements
- Administrative Polices
- Standards
- Antidumping Policies
- Etc.

6-4

Tariffs

Tariffs – oldest form of trade policy.
They are taxes levied on imports that effectively raise the cost of imported products relative to domestic products.
They drive a wedge between the international (import) price and the domestic price. Two kinds:

- Specific (sp) tariffs are levied as a fixed charge for each unit of a good imported

$$P_D = P_{INT} + t_{sp}$$

- Ad valorem tariffs are levied as a proportion of the value of the imported good

$$P_D = P_{INT} + t_{av} * P_{INT} =$$

$$= (1 + t_{av}) * P_{INT}$$

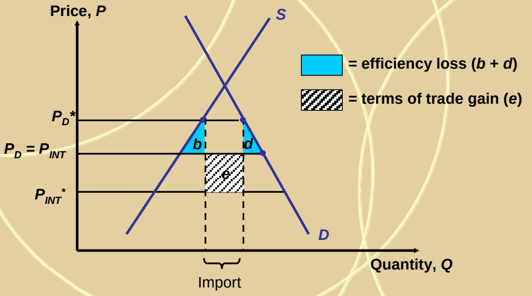
6-5

Economic effects of a tariff

- Good for government (**increase revenues**)
- Protects domestic producers
  - Reduces efficiency
- Bad for consumers
  - Increases cost of goods

6-6

Economic effects of a tariff (big country case)



6-7

Economic effects of a tariff

When a tariff is introduced the economic effects are (big country case):

$t_{sp} \uparrow \rightarrow P_{INT} \downarrow$

$\rightarrow P_D \uparrow$

$\rightarrow Q_D \downarrow$

$\rightarrow Q_S \uparrow$

$\rightarrow$ IMP $\downarrow$

$\rightarrow$ GR $\uparrow$

6-8

Economic effects of a tariff: gainers and losers (big country case)

- At home:

Gainers: producers
government

Looser: consumers

- Abroad:

Gainers: consumers

Looser: producers

6-9

Economic effects of a tariff: (small country case)

The effect of a tariff in a "small country" are similar to those in a "big country", but for the fact that the international price is doesn't change.

As a consequence it is possible to show that country economic welfare is reduced by the introduction of a tariff.

6-10

Instruments of Trade Policy: Export 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

6-11

Instruments of Trade Policy: Quotas

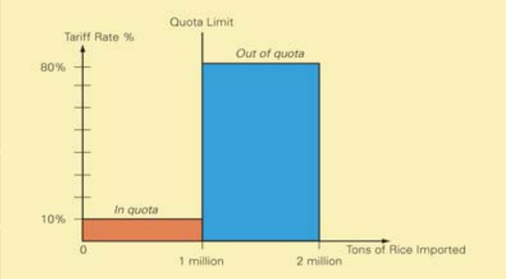
Import quotas directly restrict the quantity of some good that may be imported into a country

- 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

A quota rent is the extra profit that producers make when supply is artificially limited by an import quota

6-12

Instruments of Trade Policy: Tariff Rate Quota



6-13

Instruments of Trade Policy: VER

- **Voluntary export restraint (VER)**
  Quota on trade imposed by exporting country, typically at the request of the importing country (ex. cars, semiconductors, sugar)
- Benefits importing country producers by limiting import competition: ex. US-Japan VER on auto
  – Japan – limited exports to 1.85 m vehicles/year
  – Cost to consumers - $1b/year between ‘81 - 85.
  – Money went to Japanese producers in the form of higher prices
  – Encourages strategic action by firms in order to circumvent quota

6-14

Instruments of Trade Policy: Local Content Requirements

A local content requirement (LCR) demands that some specific fraction of a good be produced domestically

-Local content requirements benefit domestic producers, but consumers face higher prices

- Initially used by developing countries to help shift from assembly to production of goods.

- Developed countries (US - Buy American Act) beginning to implement

6-15

Instruments of Trade Policy: 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

6-16

Instruments of Trade Policy: Standards

- Usually introduced to protect the consumer: for ex. health standards
- Controversial because they might have the effect of discriminating against foreign products (ex. GMO food, hormone beef)

6-17

Instruments of Trade Policy: 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
- Dumping might be the result of:

-**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

- **normal profit maximization behavior** (due to segmented market with different demand elasticity)

- Antidumping polices (or countervailing duties) are designed to punish foreign firms that engage in dumping and protect domestic producers under the assumption of predatory foreign competition

6-18

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)

6-19

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

6-20

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

6-21

National Security

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

6-22

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

6-23

Protecting Consumers

❖Governments may intervene in markets to protect consumers (es. GMO)

6-24

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

6-25

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

6-26

Economic Arguments for Intervention

Economic arguments for intervention include:

- tariff in a big country (terms of trade argument)
- the infant industry argument
- strategic trade policy

6-27

Economic Arguments for Intervention

- **Tariff in a big country** (or terms of trade argument)

  as seen before, a proper tariff might increase national welfare in a big country

6-28

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” and to resist to the lobbies willing to maintain protection
- 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

6-29

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 (ex. Airbus case).
- Good theoretical argument difficult to be implemented

6-30

Revised Case For Free Trade

Restrictions on trade may be inappropriate in the cases of:

- Retaliation and Trade War
- Domestic Politics (lobbies activity)
- Lack of information

6-31

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

6-32

Domestic Policies

- Krugman also 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

6-33

Lack of information

- in many cases the government doesn't have the necessary set of precise information to design and implement the policy correctly

6-34

Development Of The World Trading System

- How has the current world trade system emerged?

6-35

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

6-36

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

-19 original members grew to 153

❖One basic principle: **Non discrimination**

Two applications of this principle

- **Most favored nation** clause
- **National treatment** clause

6-37

Why do we need the GATT/WTO ?

The creation of GATT allowed to solve a sort of *prisoners dilemma.*

In fact, international negotiations can help avoiding a trade war. Consider the following example:

TABLE 9-4 The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	10 / 10	20 / −10
Protection	−10 / 20	−5 / −5

Why do we need the GATT/WTO ?

❖ This is a non-cooperative game. The only Nash equilibrium is "Protectionism-Protectionism"

❖ Note: both country would be better off in the "Free trade-Free trade" situation (prisoners' dilemma), but this cannot be an equilibrium given the characteristics of this game.

This example tries to mimic the trade war escalation between the two world wars.

In this set up one can interpret the role of the GATT in terms of a change of the rules of the game: from a non-cooperative game to a cooperative one

6-39

Development of the World Trading System

- Used 'rounds of talks' to gradually reduce trade barriers

6-40

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

6-41

The World Trade Organization

- The WTO was created in 1994 during the Uruguay Round of GATT to police and enforce GATT rules
- Most comprehensive trade agreement in history
- Formation of WTO had an impact on
  - Agriculture subsidies (stumbling block: US/EU)
  - Applied GATT rules to services (GATS) and intellectual property (TRIPS)
  - Strengthened GATT monitoring and enforcement

6-42

The WTO

- 153 members as of September 2009
- Represents more than 90% of world trade
- 9 of 10 disputes satisfactorily settled
- Tariff reduction from 40% to 5%
- Trade volume of manufactured goods has increased 20 times

6-43

The WTO

- Policing organization for:
  - Manufacturing trade (GATT)
  - Service trade (GATS)
  - Intellectual property rights (TRIPS)
- Responsibility for trade arbitration:
  - Reports adopted unless specifically rejected
  - After appeal, failure to comply can result in compensation to injured country or trade sanctions

6-44

WTO at Work

- 351 disputes brought to WTO between 1995 and October 2006
- 196 handled by GATT during its 50 year history
- US is biggest WTO user
  - Big wins: beef - bananas
  - Big loss: Kodak

6-45

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**

6-46

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

6-47

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

The current agenda of the WTO focuses on:

- reducing 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
- Phasing out subsidies

6-48

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

6-49

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

6-50

The Doha Round

The **Doha Round** officially started at Doha, Qatar in November 2001, after the collapse of the Seattle meeting two years before.

- The contrasts among the various countries have produced a series of failures at the Ministerial Meetings of Cancun (September 2003) and Hong Kong (December 2006). Recently, in July 2008 the negotiations failed again.
- In the next few days (mid-September 2009) meeting in Geneva to try to revive the round

6-51

The Doha Round

- One of the tables on which the negotiation stalled has been that of agricultural liberalization.

  The European Union with the Common Agricultural Policy and the United States with their agricultural subsidies have opposed the request of substantial liberalization advanced by a group of emerging economies with a comparative advantage in that sector.

6-52

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

6-53

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

6-54

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

6-55