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The Political Economy of International Trade

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- LO¹** Identify the policy instruments used by governments to influence international trade flows.
- LO²** Understand why governments sometimes intervene in international trade.
- LO³** Summarize and explain the arguments against strategic trade policy.
- LO⁴** Describe the development of the world trading system and the current trade issue.
- LO⁵** Explain the implications for managers of developments in the world trading system.

U.S. Tariffs on Tire Imports from China

In September 2009 President Obama placed a tariff on imports of tires from China. The tariff was a response to a rising tide of imports from China and intense lobbying from the United Steelworkers union, which represents 15,000 workers at 13 tire plants in the United States. Tires imported from China are usually low-end models that sell for half the price of American-made name-brand tires. In 2008, the United States imported 46 million tires from China, three times as many as it did in 2004. China's share of the American market leaped from 5 percent to almost 17 percent over the same period, while U.S. employment in the industry fell by more than 5,000 and domestic production slumped from 218 million tires to 160 million tires.

The United Steelworkers had petitioned the International Trade Commission, which is a unit of the U.S. Department of Commerce, for protection. After reviewing the case, the commission concluded that the surge in Chinese tire imports was causing significant "market disruption" and recommended imposing a three-year tariff on Chinese imports of tires. The Obama administration agreed and placed a 35 percent tariff for one year on tire imports from China, followed by a 30 percent tariff in the second year and a 25 percent tariff in the final year. These tariffs were placed upon top of an existing 4 percent import tariff.

The Chinese quickly objected, calling the tariffs "a serious case of protectionism" and arguing that the United States was violating World Trade Organization (WTO)



rules, of which both countries were members. For its part, the United States argued that the tariffs were allowed for under the terms of a special safeguard provision that was part of the U.S. agreement to support China's entry into the WTO in 2001. Under that provision, U.S. companies or workers harmed by imports from China can ask the government for protection simply by demonstrating that American producers have suffered a "market disruption" or have experienced a surge in imports from China.

The WTO's dispute resolution panel quickly took on the case. In December 2010 the panel issued its ruling, finding that the United States "did not fail to comply with its obligations" under world trade agreements, and allowing the tariffs to remain. China immediately appealed

the ruling. Chinese officials stated the tariff has hurt the interests of both China and the United States. They argued that the tariffs cost jobs in the U.S. sales sector, causing some small and medium-size wholesalers and dealers to go out of business. Moreover, they argued that the tariff has burdened low-income consumers in the United States, with the average price of tires increasing 10 to 20 percent since the tariffs were imposed. For its part, the United Steelworkers argued that the tariff had been a big success. For the first six months after the tariffs were imposed, U.S. production increased more than 15 percent, and U.S. producers were making plans to add additional capacity. During the same period, tire imports from China fell by 34 percent.¹



Introduction

The review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin in Chapter 6 showed that in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products that they can make most efficiently, while importing products that they can produce less efficiently. Chapter 6 also laid out the intellectual case for free trade. Remember, **free trade** refers to a situation in which a government does not attempt to restrict what its citizens can buy from or sell to another country. As we saw in Chapter 6, the theories of Smith, Ricardo, and Heckscher-Ohlin predict that the consequences of free trade include both static economic gains (because free trade supports a higher level of domestic consumption and more efficient utilization of resources) and dynamic economic gains (because free trade stimulates economic growth and the creation of wealth).

This chapter looks at the political reality of international trade. Although many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups or promote the interests of key domestic producers. The opening case illustrates one such situation. In late 2009 the Obama administration placed a three-year tariff on tire imports from China. The tariff was designed to protect American producers from low-cost Chinese imports, thereby helping to create jobs in the U.S. tire industry. However, it may also have raised the average price of tires to American consumers, leaving them with less money to spend on other goods and services. For its part, the Obama administration clearly believes that the gains, in terms of jobs saved or created, outweigh any losses from higher prices. The Chinese clearly hold a different view. The World Trade Organization (WTO), which both nations belong to, has had to adjudicate this case. So far it has supported the American position (at the time of this writing, the case is still ongoing with an appeal in progress). In most cases like this, the WTO would probably have ruled against the United States. However, the United States extracted major concessions from China as part of its agreement to support the Chinese entry into the WTO in 2001. Under the terms of these concessions, the United States has the ability to impose such temporary tariffs (see the case for details). The interesting question is what will happen once the tariffs expire. Will Chinese imports surge again, in which case what was the point of the tariff, or will U.S. producers have improved their position sufficiently to hold on to market share?

This chapter explores the political and economic reasons that governments have for intervening in international trade. When governments intervene, they often do so by restricting imports of goods and services into their nation, while adopting policies that promote domestic production and exports. Normally their motives are to protect domestic producers. In recent years, social issues have intruded into the decision-making calculus. In the United States, for example, a movement is growing to ban imports of goods from countries that do not abide by the same labor, health, and environmental regulations as the United States.

This chapter starts by describing the range of policy instruments that governments use to intervene in international trade. A detailed review of governments' various political and economic motives for intervention follows. In the third section of this chapter, we consider how the case for free trade stands up in view of the various justifications given for government intervention in international trade. Then we look at the emergence of the modern international trading system, which is based on the General Agreement on Tariffs and Trade and its successor, the WTO. The GATT and WTO are the creations of a series of multinational treaties. The most recent was completed in 1995, involved more than 120 countries, and resulted in the creation of the WTO. The purpose of these treaties has been to lower barriers to the free flow of goods and services between nations. Like the GATT before it, the WTO promotes free trade by limiting the ability of national governments to adopt policies that restrict imports into their nations. The final section of this chapter discusses the implications of this material for management practice.



Instruments of Trade Policy

LO¹

Trade policy uses seven main instruments: tariffs, subsidies, import quotas, voluntary export restraints, local content requirements, administrative policies, and antidumping duties. Tariffs are the oldest and simplest instrument of trade policy. As we shall see later in this chapter, they are also the instrument that the GATT and WTO have been most successful in limiting. A fall in tariff barriers in recent decades has been accompanied by a rise in nontariff barriers, such as subsidies, quotas, voluntary export restraints, and antidumping duties.

TARIFFS

A **tariff** is a tax levied on imports (or exports). Tariffs fall into two categories. **Specific tariffs** are levied as a fixed charge for each unit of a good imported (for example, \$3 per barrel of oil). **Ad valorem tariffs** are levied as a proportion of the value of the imported good. In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. However, tariffs also produce revenue for the government. Until the income tax was introduced, for example, the U.S. government received most of its revenues from tariffs.

The important thing to understand about an import tariff is who suffers and who gains. The government gains, because the tariff increases government revenues. Domestic producers gain, because the tariff affords them some protection against foreign competitors by increasing the cost of imported foreign goods. Consumers lose because they must pay more for certain imports. For example, in 2002 the U.S. government placed an ad valorem tariff of 8 percent to 30 percent on imports of foreign steel. The idea was to protect domestic steel producers from cheap imports of foreign steel. The effect, however, was to raise the price of steel products in the United States between 30 and 50 percent. A number of U.S. steel consumers, ranging from appliance makers to automobile companies, objected that the steel tariffs would raise their costs of production and make it more difficult for them to compete in the global marketplace. Whether the gains to the government and domestic producers exceed the loss to consumers depends on various factors such as the amount of the tariff, the importance of the imported good to domestic consumers, the number of jobs saved in the protected industry, and so on. In the steel case, many argued that the losses to steel consumers apparently outweighed the gains to steel producers. In November 2003, the World Trade Organization declared that the tariffs represented a violation of the WTO treaty, and the United States removed them in December of that year.

In general, two conclusions can be derived from economic analysis of the effect of import tariffs.² First, tariffs are generally pro-producer and anti-consumer. While they protect producers from foreign competitors, this restriction of supply also raises domestic prices. For example, a study by Japanese economists calculated that tariffs on imports of foodstuffs, cosmetics, and chemicals into Japan cost the average Japanese consumer about \$890 per year in the form of higher prices.³ Similarly, the opening case suggests that prices for tires in the United States rose by 10 to 20 percent after the Obama administration placed a high tariff on tire imports from China. Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices.⁴

Second, import tariffs reduce the overall efficiency of the world economy. They reduce efficiency because a protective tariff encourages domestic firms to produce products at home that, in theory, could be produced more efficiently abroad. The consequence is an inefficient utilization of resources. For example, tariffs on the importation of rice into South Korea have led to an increase in rice production in that country; however, rice farming is an unproductive use of land in South Korea. It would make more sense for the South Koreans to purchase their rice from lower-cost foreign producers and to utilize the land now employed in rice production in some other way, such as growing foodstuffs

that cannot be produced more efficiently elsewhere or for residential and industrial purposes.

Sometimes tariffs are levied on exports of a product from a country. Export tariffs are far less common than import tariffs. In general, export tariffs have two objectives: first, to raise revenue for the government, and second, to reduce exports from a sector, often for political reasons. For example, in 2004 China imposed a tariff on textile exports. The primary objective was to moderate the growth in exports of textiles from China, thereby alleviating tensions with other trading partners.

SUBSIDIES

A **subsidy** is a government payment to a domestic producer. Subsidies take many forms, including cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms. By lowering production costs, subsidies help domestic producers in two ways: (1) competing against foreign imports and (2) gaining export markets. According to the World Trade Organization, in the mid-2000s countries spent some \$300 billion on subsidies, \$250 billion of which was spent by 21 developed nations.⁵ In response to a severe sales slump following the global financial crisis, between mid-2008 and mid-2009 some developed nations gave \$45 billion in subsidies to their automobile makers. While the purpose of the subsidies was to help them survive a very difficult economic climate, one of the consequences was to give subsidized companies an unfair competitive advantage in the global auto industry.

Agriculture tends to be one of the largest beneficiaries of subsidies in most countries. In the mid-2000s, the European Union was paying about €44 billion annually (\$55 billion) in farm subsidies. Not to be outdone, in May 2002 President George W. Bush signed into law a bill that contained subsidies of more than \$180 billion for U.S. farmers spread over 10 years. This was followed in 2007 by a farm bill that contained \$286 billion in subsidies for the next 10 years. The Japanese also have a long history of supporting inefficient domestic producers with farm subsidies. The accompanying Country Focus looks at subsidies to wheat producers in Japan.

Nonagricultural subsidies are much lower, but they are still significant. For example, subsidies historically were given to Boeing and Airbus to help them lower the cost of developing new commercial jet aircraft. In Boeing's case, subsidies came in the form of tax credits for R&D spending or Pentagon money that was used to develop military technology, which then was transferred to civil aviation projects. In the case of Airbus, subsidies took the form of government loans at below-market interest rates.

The main gains from subsidies accrue to domestic producers, whose international competitiveness is increased as a result. Advocates of strategic trade policy (which, as you will recall from Chapter 6, is an outgrowth of the new trade theory) favor subsidies to help domestic firms achieve a dominant position in those industries in which economies of scale are important and the world market is not large enough to profitably support more than a few firms (aerospace and semiconductors are two such industries). According to this argument, subsidies can help a firm achieve a first-mover advantage in an emerging industry (just as U.S. government subsidies, in the form of substantial R&D grants, allegedly helped Boeing). If this is achieved, further gains to the domestic economy arise from the employment and tax revenues that a major global company can generate. However, government subsidies must be paid for, typically by taxing individuals and corporations.

Whether subsidies generate national benefits that exceed their national costs is debatable. In practice, many subsidies are not that successful at increasing the international competitiveness of domestic producers. Rather, they tend to protect the inefficient and promote excess production. One study estimated that if advanced countries abandoned subsidies to farmers, global trade in agricultural products would be 50 percent higher and the world as a whole would be better off by \$160 billion.⁶ Another study estimated that removing all barriers to trade in agriculture (both subsidies and tariffs)



Subsidized Wheat Production in Japan

Japan is not a particularly good environment for growing wheat. Wheat produced on large fields in the dry climates of North America, Australia, and Argentina is far cheaper and of much higher quality than anything produced in Japan. Indeed, Japan imports some 80 percent of its wheat from foreign producers. Yet tens of thousands of farmers in Japan still grow wheat, usually on small fields where yields are low and costs high, and production is rising. The reason is government subsidies designed to keep inefficient Japanese wheat producers in business. In the mid-2000s, Japanese farmers were selling their output at market prices, which were running at \$9 per bushel, but they received an average of at least \$35 per bushel for their production! The difference—\$26 a bushel—was government subsidies paid to producers. The estimated costs of these subsidies were more than \$700 million a year.

To finance its production subsidy, Japan operates a tariff rate quota on wheat imports in which a higher tariff rate is imposed once wheat imports exceed the quota level. The in-quota rate tariff is zero, while the over-quota tariff rate for wheat is \$500 a ton. The tariff raises the cost so much that it deters over-quota imports, essentially restricting supply and raising the price for wheat inside Japan. The Japanese Ministry of Agriculture, Forestry, and Fisheries (MAFF) has the sole right to purchase wheat imports within the quota (and because there are very few over-quota imports, the MAFF is a monopoly buyer on wheat imports into Japan). The MAFF

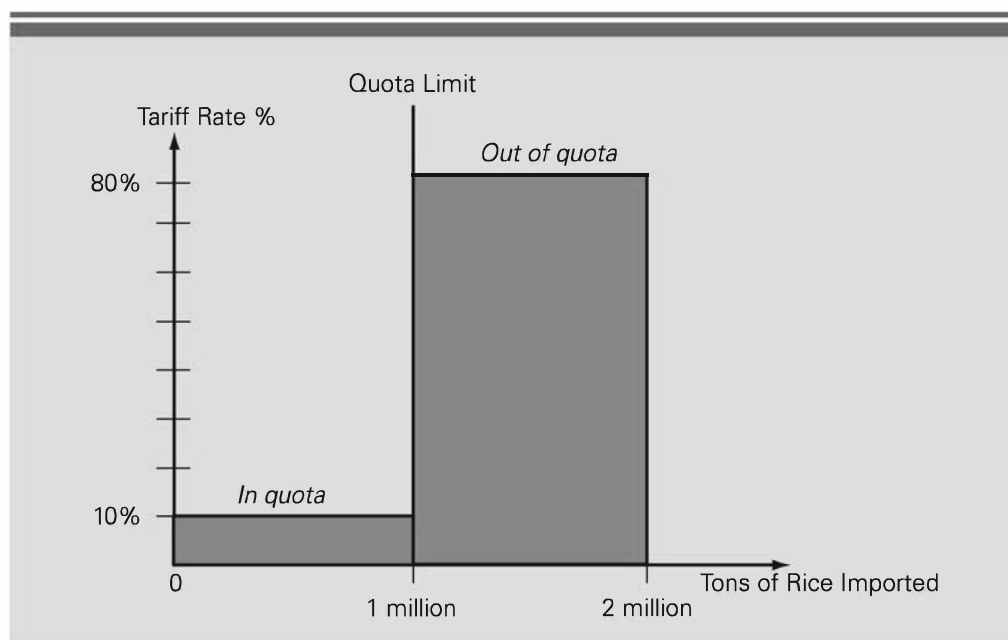
buys wheat at world prices and then resells it to millers in Japan at the artificially high prices that arise due to the restriction on supply engineered by the tariff rate quota. Estimates suggest that in 2004, the world market price for wheat was \$5.96 per bushel, but within Japan the average price for imported wheat was \$10.23 a bushel. The markup of \$4.27 a bushel yielded the MAFF in excess of \$450 million in profit. This “profit” was then used to help cover the \$700 million cost of subsidies to inefficient wheat farmers, with the rest of the funds coming from general government tax revenues.

Thanks to these policies, the price of wheat in Japan can be anything from 80 to 120 percent higher than the world price, and Japanese wheat production, which exceeded 850,000 tons in 2004, is significantly greater than it would be if a free market was allowed to operate. Indeed, under free market conditions, there would be virtually no wheat production in Japan because the costs of production are simply too high. The beneficiaries of this policy are the thousands of small farmers in Japan who grow wheat. The losers include Japanese consumers, who must pay more for products containing wheat and who must finance wheat subsidies through taxes, and foreign producers, who are denied access to a chunk of the Japanese market by the over-quota tariff rate. Why then does the Japanese government continue to pursue this policy? It continues because small farmers are an important constituency and Japanese politicians want their votes.⁸

would raise world income by \$182 billion.⁷ This increase in wealth arises from the more efficient use of agricultural land. For a specific example, see the Country Focus on wheat subsidies in Japan.

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. The restriction is usually enforced by issuing import licenses to a group of individuals or firms. For example, the United States has a quota on cheese imports. The only firms allowed to import cheese are certain trading companies, each of which is allocated the right to import a maximum number of pounds of cheese each year. In some cases, the right to sell is given directly to the governments of exporting countries. Historically this is the case for sugar and textile imports in the United States.

FIGURE 7.1Hypothetical Tariff
Rate Quota

However, the international agreement governing the imposition of import quotas on textiles, the Multi-Fiber Agreement, expired in December 2004.

A common hybrid of a quota and a tariff is known as a tariff rate quota. Under a **tariff rate quota**, a lower tariff rate is applied to imports within the quota than those over the quota. For example, as illustrated in Figure 7.1, an ad valorem tariff rate of 10 percent might be levied on 1 million tons of rice imports into South Korea, after which an out-of-quota rate of 80 percent might be applied. Thus, South Korea might import 2 million tons of rice, 1 million at a 10 percent tariff rate and another 1 million at an 80 percent tariff. Tariff rate quotas are common in agriculture, where their goal is to limit imports over quota. An example is given in the Country Focus that looks at how Japan uses the combination of a tariff rate quota and subsidies to protect inefficient Japanese wheat farmers from foreign competition.

A variant on the import quota is the voluntary export restraint. A **voluntary export restraint (VER)** is a quota on trade imposed by the exporting country, typically at the request of the importing country's government. One of the most famous historical examples is the limitation on auto exports to the United States enforced by Japanese automobile producers in 1981. A response to direct pressure from the U.S. government, this VER limited Japanese imports to no more than 1.68 million vehicles per year. The agreement was revised in 1984 to allow 1.85 million Japanese vehicles per year. The agreement was allowed to lapse in 1985, but the Japanese government indicated its intentions at that time to continue to restrict exports to the United States to 1.85 million vehicles per year.⁹ Foreign producers agree to VERs because they fear more damaging punitive tariffs or import quotas might follow if they do not. Agreeing to a VER is seen as a way to make the best of a bad situation by appeasing protectionist pressures in a country.

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. As with all restrictions on trade, quotas do not benefit consumers. An import quota or VER always raises the domestic price of an imported good. When imports are limited to a low percentage of the market by a quota or VER, the price is bid up for that limited foreign supply. The automobile industry VER mentioned above increased the price of the limited supply of Japanese imports. According to a study by the U.S. Federal Trade Commission, the automobile VER cost U.S. consumers about \$1 billion per year between 1981 and 1985. That \$1 billion per year went to Japanese producers in the form of higher prices.¹⁰ The extra profit that producers make when supply is artificially limited by an import quota is referred to as a **quota rent**.

If a domestic industry lacks the capacity to meet demand, an import quota can raise prices for *both* the domestically produced and the imported good. This happened in the U.S. sugar industry, in which a tariff rate quota system has long limited the amount foreign producers can sell in the U.S. market. According to one study, import quotas have caused the price of sugar in the United States to be as much as 40 percent greater than the world price.¹¹ These higher prices have translated into greater profits for U.S. sugar producers, which have lobbied politicians to keep the lucrative agreement. They argue U.S. jobs in the sugar industry will be lost to foreign producers if the quota system is scrapped.

LOCAL CONTENT REQUIREMENTS

A **local content requirement** is a requirement that some specific fraction of a good be produced domestically. The requirement can be expressed either in physical terms (e.g., 75 percent of component parts for this product must be produced locally) or in value terms (e.g., 75 percent of the value of this product must be produced locally). Local content regulations have been widely used by developing countries to shift their manufacturing base from the simple assembly of products whose parts are manufactured elsewhere into the local manufacture of component parts. They have also been used in developed countries to try to protect local jobs and industry from foreign competition. For example, a little-known law in the United States, the Buy America Act, specifies that government agencies must give preference to American products when putting contracts for equipment out to bid unless the foreign products have a significant price advantage. The law specifies a product as “American” if 51 percent of the materials by value are produced domestically. This amounts to a local content requirement. If a foreign company, or an American one for that matter, wishes to win a contract from a U.S. government agency to provide some equipment, it must ensure that at least 51 percent of the product by value is manufactured in the United States.

Local content regulations provide protection for a domestic producer of parts in the same way an import quota does: by limiting foreign competition. The aggregate economic effects are also the same; domestic producers benefit, but the restrictions on imports raise the prices of imported components. In turn, higher prices for imported components are passed on to consumers of the final product in the form of higher final prices. So as with all trade policies, local content regulations tend to benefit producers and not consumers.

ADMINISTRATIVE POLICIES

In addition to the formal instruments of trade policy, governments of all types sometimes use informal or administrative policies to restrict imports and boost exports. **Administrative trade policies** are bureaucratic rules designed to make it difficult for imports to enter a country. It has been argued that the Japanese are the masters of this trade barrier. In recent decades Japan’s formal tariff and nontariff barriers have been among the lowest in the world. However, critics charge that the country’s informal administrative barriers to imports more than compensate for this. For example, at one point the Netherlands exported tulip bulbs to almost every country in the world except Japan. In Japan, customs inspectors insisted on checking every tulip bulb by cutting it vertically down the middle, and even Japanese ingenuity could not put them back together. Federal Express also initially had a tough time expanding its global express shipping services into Japan because Japanese customs inspectors insist on opening a large proportion of express packages to check for pornography, a process that delayed an “express” package for days. Japan is not the only country that engages in such policies. France once required that all imported videotape recorders arrive through a small customs entry point that was both remote and poorly staffed. The resulting delays kept Japanese VCRs out of the French market until a VER agreement was negotiated.¹² As with all instruments of trade policy, administrative instruments benefit producers and hurt consumers, who are denied access to possibly superior foreign products.



MANAGEMENT FOCUS

U.S. Magnesium Seeks Protection

In February 2004, U.S. Magnesium, the sole surviving U.S. producer of magnesium, a metal that is primarily used in the manufacture of certain automobile parts and aluminum cans, filed a petition with the U.S. International Trade Commission (ITC) contending that a surge in imports had caused material damage to the U.S. industry's employment, sales, market share, and profitability. According to U.S. Magnesium, Russian and Chinese producers had been selling the metal at prices significantly below market value. During 2002 and 2003, imports of magnesium into the United States rose 70 percent, while prices fell by 40 percent and the market share accounted for by imports jumped to 50 percent from 25 percent.

"The United States used to be the largest producer of magnesium in the world," a U.S. Magnesium spokesman said at the time of the filing. "What's really sad is that you can be state of the art and have modern technology, and if the Chinese, who pay people less than 90 cents an hour, want to run you out of business, they can do it. And that's why we are seeking relief."

During a yearlong investigation, the ITC solicited input from various sides in the dispute. Foreign producers and consumers of magnesium in the United States argued that falling prices for magnesium during 2002 and 2003 simply reflected an imbalance between supply and demand due to additional capacity coming on stream not from Russia or China but from a new Canadian plant that opened in 2001 and from a planned Australian plant. The Canadian plant shut down in 2003, the Australian plant never came on stream, and prices for magnesium rose again in 2004.

Magnesium consumers in the United States also argued to the ITC that imposing antidumping duties on foreign imports of magnesium would raise prices in the United States significantly above world levels.

A spokesman for Alcoa, which mixes magnesium with aluminum to make alloys for cans, predicted that if antidumping duties were imposed, high magnesium prices in the United States would force Alcoa to move some production out of the United States. Alcoa also noted that in 2003, U.S. Magnesium was unable to supply all of Alcoa's needs, forcing the company to turn to imports. Consumers of magnesium in the automobile industry asserted that high prices in the United States would drive engineers to design magnesium out of automobiles, or force manufacturing elsewhere, which would ultimately hurt everyone.

The six members of the ITC were not convinced by these arguments. In March 2005, the ITC ruled that both China and Russia had been dumping magnesium in the United States. The government decided to impose duties ranging from 50 percent to more than 140 percent on imports of magnesium from China. Russian producers face duties ranging from 19 percent to 22 percent. The duties were to be levied for five years, after which the ITC would revisit the situation.

According to U.S. Magnesium, the favorable ruling would allow the company to reap the benefits of nearly \$50 million in investments made in its manufacturing plant and enable the company to boost its capacity by 28 percent by the end of 2005. Commenting on the favorable ruling, a U.S. Magnesium spokesman noted, "Once unfair trade is removed from the marketplace we'll be able to compete with anyone." U.S. Magnesium's customers and competitors, however, did not view the situation in the 2002–2003 period as one of unfair trade. While the imposition of antidumping duties no doubt will help to protect U.S. Magnesium and the 400 people it employs from foreign competition, magnesium consumers in the United States are left wondering if they will be the ultimate losers.¹³

ANTIDUMPING POLICIES

In the context of international trade, **dumping** is variously defined as selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their "fair" market value. There is a difference between these two definitions; the fair market value of a good is normally judged to be greater than the costs of producing that good because the former includes a "fair" profit margin. Dumping is viewed as a method by which firms unload excess production in foreign markets. Some dumping may

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. Once this has been achieved, so the argument goes, the predatory firm can raise prices and earn substantial profits.

An alleged example of dumping occurred in 1997, when two South Korean manufacturers of semiconductors, LG Semicon and Hyundai Electronics, were accused of selling dynamic random access memory chips (DRAMs) in the U.S. market at below their costs of production. This action occurred in the middle of a worldwide glut of chip-making capacity. It was alleged that the firms were trying to unload their excess production in the United States.

Antidumping policies are designed to punish foreign firms that engage in dumping. The ultimate objective is to protect domestic producers from unfair foreign competition. Although antidumping policies vary somewhat from country to country, the majority are similar to those used in the United States. If a domestic producer believes that a foreign firm is dumping production in the U.S. market, it can file a petition with two government agencies, the Commerce Department and the International Trade Commission. In the Korean DRAM case, Micron Technology, a U.S. manufacturer of DRAMs, filed the petition. The government agencies then investigate the complaint. If a complaint has merit, the Commerce Department may impose an antidumping duty on the offending foreign imports (antidumping duties are often called **countervailing duties**). These duties, which represent a special tariff, can be fairly substantial and stay in place for up to five years. For example, after reviewing Micron's complaint, the Commerce Department imposed 9 percent and 4 percent countervailing duties on LG Semicon and Hyundai DRAM chips, respectively. The accompanying Management Focus discusses another example of how a firm, U.S. Magnesium, used antidumping legislation to gain protection from unfair foreign competitors.



The Case for Government Intervention

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Now that we have reviewed the various instruments of trade policy that governments can use, it is time to look at the case for government intervention in international trade. Arguments for government intervention take two paths: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers), or with achieving some political objective that lies outside the sphere of economic relationships, such as protecting the environment or human rights. Economic arguments for intervention 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 cover a range of issues, including preserving jobs, protecting industries deemed important for national security, retaliating against unfair foreign competition, protecting consumers from “dangerous” products, furthering the goals of foreign policy, and advancing the human rights of individuals in exporting countries.

Protecting Jobs and Industries

Perhaps the most common political argument for government intervention is that it is necessary for protecting jobs and industries from unfair foreign competition. The tariffs placed on imports of foreign steel by President George W. Bush in 2002 were designed to do this (many steel producers were located in states that Bush needed to win reelection in 2004), as were the tariffs placed by President Obama on Chinese tire imports (see the opening case). A political motive also underlay establishment of the Common Agricultural Policy

(CAP) by the European Union. The CAP was designed to protect the jobs of Europe's politically powerful farmers by restricting imports and guaranteeing prices. However, the higher prices that resulted from the CAP have cost Europe's consumers dearly. This is true of many attempts to protect jobs and industries through government intervention. For example, the imposition of steel tariffs in 2002 raised steel prices for American consumers, such as automobile companies, making them less competitive in the global marketplace.

National Security

Countries sometimes argue that it is necessary to protect certain industries because they are important for national security. Defense-related industries often get this kind of attention (e.g., aerospace, advanced electronics, semiconductors, etc.). Although not as common as it used to be, this argument is still made. Those in favor of protecting the U.S. semiconductor industry from foreign competition, for example, argue that semiconductors are now such important components of defense products that it would be dangerous to rely primarily on foreign producers for them. In 1986, this argument helped persuade the federal government to support Sematech, a consortium of 14 U.S. semiconductor companies that accounted for 90 percent of the U.S. industry's revenues. Sematech's mission was to conduct joint research into manufacturing techniques that can be parceled out to members. The government saw the venture as so critical that Sematech was specially protected from antitrust laws. Initially, the U.S. government provided Sematech with \$100 million per year in subsidies. By the mid-1990s, however, the U.S. semiconductor industry had regained its leading market position, largely through the personal computer boom and demand for microprocessor chips made by Intel. In 1994, the consortium's board voted to seek an end to federal funding, and since 1996 the consortium has been funded entirely by private money.¹⁴

Retaliation

Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to "play by the rules of the game." The U.S. government has used the threat of punitive trade sanctions to try to get the Chinese government to enforce its intellectual property laws. Lax enforcement of these laws had given rise to massive copyright infringements in China that had been costing U.S. companies such as Microsoft hundreds of millions of dollars per year in lost sales revenues. After the United States threatened to impose 100 percent tariffs on a range of Chinese imports, and after harsh words between officials from the two countries, the Chinese agreed to tighter enforcement of intellectual property regulations.¹⁵

If it works, such a politically motivated rationale for government intervention may liberalize trade and bring with it resulting economic gains. It is a risky strategy, however. A country that is being pressured may not back down and instead may respond to the imposition of punitive tariffs by raising trade barriers of its own. This is exactly what the Chinese government threatened to do when pressured by the United States, although it ultimately did back down. If a government does not back down, however, the results could be higher trade barriers all around and an economic loss to all involved.

Protecting Consumers

Many governments have long had regulations to protect consumers from unsafe products. The indirect effect of such regulations often is to limit or ban the importation of such products. For example, in 2003 several countries, including Japan and South Korea, decided to ban imports of American beef after a single case of mad cow disease was found in Washington state. The ban was motivated to protect consumers from what was seen to be an unsafe product. Together, Japan and South Korea accounted for about \$2 billion of U.S. beef sales, so the ban had a significant impact on U.S. beef producers. After two years, both countries lifted the ban, although they placed stringent requirements on U.S. beef imports to reduce the risk of importing beef that might be tainted by mad cow disease (for example, Japan required that all beef must come from cattle under 21 months of age).¹⁶

The accompanying Country Focus describes how the European Union banned the sale and importation of hormone-treated beef. The ban was motivated by a desire to protect European consumers from the possible health consequences of eating meat from animals treated with growth hormones. The conflict over the importation of hormone-treated beef into the EU may prove to be a taste of things to come. In addition to the use of hormones to promote animal growth and meat production, biotechnology has made it possible to genetically alter many crops so that they resist common herbicides, produce proteins that are natural insecticides, grow dramatically improved yields, or withstand inclement weather conditions. A new breed of genetically modified tomatoes has an antifreeze gene inserted into its genome and can thus be grown in colder climates than hitherto possible. Another example is a genetically engineered cotton seed produced by Monsanto. The seed has been engineered to express a protein that protects against three common insect pests: the cotton bollworm, tobacco budworm, and pink bollworm. Use of this seed reduces or eliminates the need for traditional pesticide applications for these pests.

As enticing as such innovations sound, they have met with intense resistance from consumer groups, particularly in Europe. The fear is that the widespread use of genetically altered seed corn could have unanticipated and harmful effects on human health and may result in “genetic pollution.” (An example of genetic pollution would be when the widespread use of crops that produce natural pesticides stimulates the evolution of “superbugs” that are resistant to those pesticides.) Such concerns have led Austria and Luxembourg to outlaw the importation, sale, or use of genetically altered organisms. Sentiment against genetically altered organisms also runs strong in several other European countries, most notably Germany and Switzerland. It seems likely, therefore, that the World Trade Organization will be drawn into the conflict between those that want to expand the global market for genetically altered organisms, such as Monsanto, and those that want to limit it, such as Austria and Luxembourg.¹⁷

Furthering Foreign Policy Objectives

Governments sometimes use trade policy to support their foreign policy objectives.¹⁸ A government may grant preferential trade terms to a country with which it wants to build strong relations. Trade policy has also been used several times to pressure or punish “rogue states” that do not abide by international law or norms. Iraq labored under extensive trade sanctions after the UN coalition defeated the country in the 1991 Gulf War until the 2003 invasion of Iraq by U.S.-led forces. The theory is that such pressure might persuade the rogue state to mend its ways, or it might hasten a change of government. In the case of Iraq, the sanctions were seen as a way of forcing that country to comply with several UN resolutions. The United States has maintained long-running trade sanctions against Cuba. Their principal function is to impoverish Cuba in the hope that the resulting economic hardship will lead to the downfall of Cuba’s Communist government and its replacement with a more democratically inclined (and pro-U.S.) regime. The United States also has had trade sanctions in place against Libya and Iran, both of which it accuses of supporting terrorist action against U.S. interests and building weapons of mass destruction. In late 2003, the sanctions against Libya seemed to yield some returns when that country announced it would terminate a program to build nuclear weapons, and the U.S. government responded by relaxing those sanctions.

Other countries can undermine unilateral trade sanctions. The U.S. sanctions against Cuba, for example, have not stopped other Western countries from trading with Cuba. The U.S. sanctions have done little more than help create a vacuum into which other trading nations, such as Canada and Germany, have stepped. In an attempt to halt



Even though the United States holds trade sanctions with Cuba, other Western countries continue to trade with the island nation.

this and further tighten the screws on Cuba, in 1996 the U.S. Congress passed the **Helms-Burton Act**. This act allows Americans to sue foreign firms that use property in Cuba confiscated from them after the 1959 revolution. Later in 1996, Congress passed a similar law, the **D'Amato Act**, aimed at Libya and Iran.

The passage of Helms-Burton elicited protests from America's trading partners, including the European Union, Canada, and Mexico, all of which claim the law violates their sovereignty and is illegal under World Trade Organization rules. For example, Canadian companies that have been doing business in Cuba for years see no reason they should suddenly be sued in U.S. courts when Canada does not restrict trade with Cuba. They are not violating Canadian law, and they are not U.S. companies, so why should they be subject to U.S. law? Despite such protests, the law is still on the books in the United States, although the U.S. government has not enforced this act—probably because it is unenforceable.

Protecting Human Rights

Protecting and promoting human rights in other countries is an important element of foreign policy for many democracies. Governments sometimes use trade policy to try to improve the human rights policies of trading partners. For years, the most obvious example of this was the annual debate in the United States over whether to grant most favored nation (MFN) status to China. MFN status allows countries to export goods to the United States under favorable terms. Under MFN rules, the average tariff on Chinese goods imported into the United States was 8 percent. If China's MFN status were rescinded, tariffs could have risen to about 40 percent. Trading partners who are signatories of the World Trade Organization, as most are, automatically receive MFN status. However, China did not join the WTO until 2001, so historically the decision of whether to grant MFN status to China was a real one. The decision was made more difficult by the perception that China had a poor human rights record. As indications of the country's disregard for human rights, critics of China often point to the 1989 Tiananmen Square massacre, China's continuing subjugation of Tibet (which China occupied in the 1950s), and the squashing of political dissent in China.¹⁹ These critics argue that it was wrong for the United States to grant MFN status to China, and that instead, the United States should withhold MFN status until China showed measurable improvement in its human rights record. The critics argue that trade policy should be used as a political weapon to force China to change its internal policies toward human rights.

Others contend that limiting trade with such countries would make matters worse, not better. They argue that the best way to change the internal human rights stance of a country is to engage it through international trade. At its core, the argument is simple: Growing bilateral trade raises the income levels of both countries, and as a state becomes richer, its people begin to demand, and generally receive, better treatment with regard to their human rights. This is a variant of the argument in Chapter 3 that economic progress begets political progress (if political progress is measured by the adoption of a democratic government that respects human rights). This argument ultimately won the day in 1999 when the Clinton administration blessed China's application to join the WTO and announced that trade and human rights issues should be decoupled.

Protecting the Environment

Protecting the environment has become an important policy objective of many nations. Increasingly, environmental interest groups such as Friends of the Earth and the Sierra Club have been pressuring governments to regulate international trade in a way that protects the environment. The growing concern over climate change has added an important dimension to this debate.

One argument frequently made by environmental organizations is that there is a strong relationship between income levels and environmental pollution and degradation (i.e., industrial development leads to more pollution). Thus, to the extent that international trade leads to higher income levels, it can also be expected to lead to a decline in environmental quality. Organizations such as the Sierra Club argue that as a

consequence, strong environmental safeguards need to be part of any trade agreements, and governments should be allowed to restrict trade if doing so benefits the environment.

As noted in Chapter 1, the empirical evidence suggests the relationship between income levels and pollution is not a linear one, rather it is an inverted U-shaped relationship (see Figure 1.5).²⁰ To begin with, as countries start to climb the ladder of economic progress, pollution levels do increase, but past some threshold point, they start to decline. As societies get richer, citizens lobby for environmental protections, and governments tend to respond. We can see this process starting to unfold today in China. China has had an awful reputation for pollution, but in the past few years the Chinese government has been working hard to improve the air quality in its major cities (although it still has a considerable way to go). In developed nations such as the United States and the United Kingdom, the air is much cleaner than it was half a century ago. This data suggests that ultimately, international trade, and the growth that results from it, may not be damaging to the environment.

There is a very important exception to these trends, however, and that is emissions of carbon dioxide. Carbon dioxide emissions do rise with income levels. Thus, the country with the highest income per capita, the United States, also produces the greatest carbon dioxide emissions per capita. Carbon dioxide emissions are a by-product of energy use (i.e., oil, gas, or coal burning). Richer societies are more energy intensive, and to the extent that they use hydrocarbons to produce that energy, this leads to higher carbon dioxide emissions.

Carbon dioxide is the greenhouse gas at the center of concerns over global warming. These concerns can be stated simply.²¹ First, the burning of fossil fuels to produce energy also releases carbon dioxide into the atmosphere (and atmospheric carbon dioxide concentrations have steadily increased since preindustrial times). Second, carbon dioxide absorbs heat radiated from the earth, warming the atmosphere. Third, as a consequence, average global temperatures will increase. Indeed, estimates suggest average global temperatures increased by 0.7 degree Centigrade during the last century, and they are forecasted to rise by between 1.1 and 6.4 degrees centigrade this century.²² Fourth, as global temperatures increase, there will be environmental dislocation, ice caps will melt, sea levels will rise and flood low-lying coastal areas, weather patterns will change, the frequency of violent storms will increase, tropical diseases (such as malaria) will move northward, species will go extinct, and so on.

Of course, the global climate varies naturally due to, for example, changes in solar radiation connected with the well-known sunspot cycle, volcanic activity (which can inject large amounts of sulfur dioxide particles into the atmosphere, temporarily cooling it), changes in the circulation of ocean currents, and long-term changes in the orbit of the earth and the tilt of its axis. Human-induced climate change is overlaid on these natural variations. Thus, a natural cooling trend might be moderated by greater atmospheric carbon dioxide concentrations, and a natural warming trend exacerbated by them.

Although there is debate over the precise relationship between carbon dioxide concentrations and the extent of future global warming, the vast majority of climate scientists have concluded that unless we take rapid action, we are faced with a rate of warming that is unprecedented during the history of our civilization and may cause major environmental dislocation.²³ Given this, they advocate restricting greenhouse gas emissions, particularly carbon dioxide. The first international agreement to limit global warming, the Kyoto Protocol, was signed in 1997, although its impact was reduced by the failure of two of the world's largest producers of carbon dioxide, the United States and China, to sign. A second international agreement was reached in Copenhagen in 2009, this time with the participation of the United States and China.

What does this have to do with international trade? So far, there has been little direct connection between the global warming debate and international trade. However, looking forward, adherence to targets regarding carbon emissions might start to factor into trade agreements. Specifically, if countries do not meet their targets for reducing carbon emissions specified in international treaties, they may find themselves the targets of

retaliatory action. The EU, for example, might respond to the failure of the United States to meet its treaty commitments by placing a carbon tariff on the import of certain goods from the United States. Ten years ago this was a remote possibility. Ten years from now it may be a significant factor in the international trade environment.

A second argument made with regard to environmental regulations is that in order to save money, corporations will move production to countries where environmental regulations are lax. Thus, for example, if tight environmental standards in the United States raise costs, a manufacturing firm might move production to a *pollution haven* such as Mexico where environmental standards are weaker. To protect against this possibility, environmental organizations argue that governments should place tariffs or other limitations on goods imported from countries where environmental regulations are lax.

Economists have studied this issue, but have found little evidence that firms do move production in response to changes in pollution regulations.²⁴ Their findings suggest that pollution abatement costs are a relatively small component of the cost structure of most enterprises, and that other factors, such as labor productivity, access to technological know-how, and transportation costs, are far more important in determining location decisions. It is also worth noting that migrating to a *pollution haven* would violate the ethical principles of many organizations (see Chapter 4 for details).

In sum, although environmental concerns have not figured significantly in trade treaties to date, there is a good chance they will do so in the future, particularly with regard to the emission of carbon dioxide and other greenhouse gases.

ECONOMIC ARGUMENTS FOR INTERVENTION

With the development of the new trade theory and strategic trade policy (see Chapter 6), the economic arguments for government intervention have undergone a renaissance in recent years. Until the early 1980s, most economists saw little benefit in government intervention and strongly advocated a free trade policy. This position has changed at the margins with the development of strategic trade policy, although as we will see in the next section, there are still strong economic arguments for sticking to a free trade stance.

The Infant Industry Argument

The **infant industry argument** is by far the oldest economic argument for government intervention. Alexander Hamilton proposed it in 1792. According to this argument, many developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries cannot initially compete with established industries in developed countries. To allow manufacturing to get a toehold, the argument is that governments should temporarily support new industries (with tariffs, import quotas, and subsidies) until they have grown strong enough to meet international competition.

This argument has had substantial appeal for the governments of developing nations during the past 50 years, and the GATT has recognized the infant industry argument as a legitimate reason for protectionism. Nevertheless, many economists remain critical of this argument for two main reasons. First, protection of manufacturing from foreign competition does no good unless the protection helps make the industry efficient. In case after case, however, protection seems to have done little more than foster the development of inefficient industries that have little hope of ever competing in the world market. Brazil, for example, built the world's 10th-largest auto industry behind tariff barriers and quotas. Once those barriers were removed in the late 1980s, however, foreign imports soared, and the industry was forced to face up to the fact that after 30 years of protection, the Brazilian auto industry was one of the world's most inefficient.²⁵

Second, the infant industry argument relies on an assumption that firms are unable to make efficient long-term investments by borrowing money from the domestic or international capital market. Consequently, governments have been required to subsidize long-term investments. Given the development of global capital markets over the past



Trade in Hormone-Treated Beef

In the 1970s, scientists discovered how to synthesize certain hormones and use them to accelerate the growth rate of livestock animals, reduce the fat content of meat, and increase milk production. Bovine somatotropin (BST), a growth hormone produced by cattle, was first synthesized by the biotechnology firm Genentech. Injections of BST could be used to supplement an animal's own hormone production and increase its growth rate. These hormones soon became popular among farmers, who found they could cut costs and help satisfy consumer demands for leaner meat. Although these hormones occurred naturally in animals, consumer groups in several countries soon raised concerns about the practice. They argued that the use of hormone supplements was unnatural and that the health consequences of consuming hormone-treated meat were unknown but might include hormonal irregularities and cancer.

The European Union responded to these concerns in 1989 by banning the importation of hormone-treated meat and the use of growth-promoting hormones in the production of livestock. The ban was controversial because a reasonable consensus existed among scientists that the hormones posed no health risk. Although the EU banned hormone-treated meat, many other countries did not, including big meat-producing countries such as Australia, Canada, New Zealand, and the United States. The use of hormones soon became widespread in these countries. According to trade officials outside the EU, the European ban constituted an unfair restraint on trade. As a result of this ban, exports of meat to the EU fell. For example, U.S. red meat exports to the EU declined from \$231 million in 1988 to \$98 million in 1994. The complaints of meat exporters were bolstered in 1995 when Codex Alimentarius, the international food standards body of the UN's Food and Agriculture Organization and

the World Health Organization, approved the use of growth hormones. In making this decision, Codex reviewed the scientific literature and found no evidence of a link between the consumption of hormone-treated meat and human health problems, such as cancer.

Fortified by such decisions, in 1995 the United States pressed the EU to drop the import ban on hormone-treated beef. The EU refused, citing "consumer concerns about food safety." In response, both Canada and the United States independently filed formal complaints with the World Trade Organization. The United States was joined in its complaint by a number of other countries, including Australia and New Zealand. The WTO created a trade panel of three independent experts. After reviewing evidence and hearing from a range of experts and representatives of both parties, the panel in May 1997 ruled that the EU ban on hormone-treated beef was illegal because it had no scientific justification. The EU immediately indicated it would appeal the finding to the WTO court of appeals. The WTO court heard the appeal in November 1997 and in February 1998 agreed with the findings of the trade panel that the EU had not presented any scientific evidence to justify the hormone ban.

This ruling left the EU in a difficult position. Legally, the EU had to lift the ban or face punitive sanctions, but the ban had wide public support in Europe. The EU feared that lifting the ban could produce a consumer backlash. Instead the EU did nothing, so in February 1999 the United States asked the WTO for permission to impose punitive sanctions on the EU. The WTO responded by allowing the United States to impose punitive tariffs valued at \$120 million on EU exports to the United States. The EU decided to accept these tariffs rather than lift the ban on hormone-treated beef, and as of 2011, the ban and punitive tariffs were still in place.²⁶

20 years, this assumption no longer looks as valid as it once did. Today, if a developing country has a potential comparative advantage in a manufacturing industry, firms in that country should be able to borrow money from the capital markets to finance the required investments. Given financial support, firms based in countries with a potential comparative advantage have an incentive to endure the necessary initial losses in order to make long-run gains without requiring government protection. Many Taiwanese and South Korean firms did this in industries such as textiles, semiconductors, machine tools, steel, and shipping. Thus, given efficient global capital markets, the only industries that would require government protection would be those that are not worthwhile.

Strategic Trade Policy

Some new trade theorists have proposed the strategic trade policy argument.²⁷ We reviewed the basic argument in Chapter 6 when we considered the new trade theory. The new trade theory argues that in industries in which the existence of substantial economies of scale implies that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they have firms that were able to capture first-mover advantages. The long-term dominance of Boeing in the commercial aircraft industry has been attributed to such factors.

The **strategic trade policy** argument has two components. First, it is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm or firms that gain first-mover advantages in an industry are domestic rather than foreign enterprises. Thus, according to the strategic trade policy argument, a government should use subsidies to support promising firms that are active in newly emerging industries. Advocates of this argument point out that the substantial R&D grants that the U.S. government gave Boeing in the 1950s and 1960s probably helped tilt the field of competition in the newly emerging market for passenger jets in Boeing's favor. (Boeing's first commercial jet airliner, the 707, was derived from a military plane.) Similar arguments have been made with regard to Japan's dominance in the production of liquid crystal display screens (used in laptop computers). Although these screens were invented in the United States, the Japanese government, in cooperation with major electronics companies, targeted this industry for research support in the late 1970s and early 1980s. The result was that Japanese firms, not U.S. firms, subsequently captured first-mover advantages in this market.

The second component of the strategic trade policy argument is that it might pay a government to intervene in an industry by helping domestic firms overcome the barriers to entry created by foreign firms that have already reaped first-mover advantages. This argument underlies government support of Airbus Industrie, Boeing's major competitor. Formed in 1966 as a consortium of four companies from Great Britain, France, Germany, and Spain, Airbus had less than 5 percent of the world commercial aircraft market when it began production in the mid-1970s. By 2010, it had increased its share to 45 percent, threatening Boeing's long-term dominance of the market. How did Airbus achieve this? According to the U.S. government, the answer is a \$15 billion subsidy from the governments of Great Britain, France, Germany, and Spain.²⁸ Without this subsidy, Airbus would never have been able to break into the world market.

If these arguments are correct, they support a rationale for government intervention in international trade. Governments should target technologies that may be important in the future and use subsidies to support development work aimed at commercializing those technologies. Furthermore, government should provide export subsidies until the domestic firms have established first-mover advantages in the world market. Government support may also be justified if it can help domestic firms overcome the first-mover advantages enjoyed by foreign competitors and emerge as viable competitors in the world market (as in the Airbus and semiconductor examples). In this case, a combination of home-market protection and export-promoting subsidies may be needed.

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The Revised Case for Free Trade

The strategic trade policy arguments of the new trade theorists suggest an economic justification for government intervention in international trade. This justification challenges the rationale for unrestricted free trade found in the work of classic trade theorists such as Adam Smith and David Ricardo. In response to this challenge to economic orthodoxy, a number of economists—including some of those responsible for the development of the new trade theory, such as Paul Krugman—point out that although strategic trade policy looks appealing in theory, in practice it may be unworkable. This response to the strategic trade policy argument constitutes the revised case for free trade.²⁹

RETALIATION AND TRADE WAR

Krugman argues that a strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry is a beggar-thy-neighbor policy that boosts national income at the expense of other countries. A country that attempts to use such policies will probably provoke retaliation. In many cases, the resulting trade war between two or more interventionist governments will leave all countries involved worse off than if a hands-off approach had been adopted in the first place. If the U.S. government were to respond to the Airbus subsidy by increasing its own subsidies to Boeing, for example, the result might be that the subsidies would cancel each other out. In the process, both European and U.S. taxpayers would end up supporting an expensive and pointless trade war, and both Europe and the United States would be worse off.

Krugman may be right about the danger of a strategic trade policy leading to a trade war. The problem, however, is how to respond when one's competitors are already being supported by government subsidies; that is, how should Boeing and the United States respond to the subsidization of Airbus? According to Krugman, the answer is probably not to engage in retaliatory action but to help establish rules of the game that minimize the use of trade-distorting subsidies. This is what the World Trade Organization seeks to do.

DOMESTIC POLICIES

Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them. The European Union's support for the Common Agricultural Policy (CAP), which arose because of the political power of French and German farmers, is an example. The CAP benefits inefficient farmers and the politicians who rely on the farm vote, but not consumers in the EU, who end up paying more for their foodstuffs. Thus, a further reason for not embracing strategic trade policy, according to Krugman, is that such a policy is almost certain to be captured by special-interest groups within the economy, which will distort it to their own ends. Krugman concludes that in the United States,

To ask the Commerce Department to ignore special-interest politics while formulating detailed policy for many industries is not realistic: To establish a blanket policy of free trade, with exceptions granted only under extreme pressure, may not be the optimal policy according to the theory but may be the best policy that the country is likely to get.³⁰



Development of the World Trading System

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Strong economic arguments support unrestricted free trade. While many governments have recognized the value of these arguments, they have been unwilling to unilaterally lower their trade barriers for fear that other nations might not follow suit. Consider the problem that two neighboring countries, say, Brazil and Argentina, face when deciding whether to lower trade barriers between them. In principle, the government of Brazil might favor lowering trade barriers, but it might be unwilling to do so for fear that Argentina will not do the same. Instead, the government might fear that the Argentineans will take advantage of Brazil's low barriers to enter the Brazilian market, while at the same time continuing to shut Brazilian products out of their market through high trade barriers. The Argentinean government might believe that it faces the same dilemma. The essence of the problem is a lack of trust. Both governments recognize that their respective nations will benefit from lower trade barriers between them, but neither government is willing to lower barriers for fear that the other might not follow.³¹

Such a deadlock can be resolved if both countries negotiate a set of rules to govern cross-border trade and lower trade barriers. But who is to monitor the governments to make sure they are playing by the trade rules? And who is to impose sanctions on a government that cheats? Both governments could set up an independent body to act as a

referee. This referee could monitor trade between the countries, make sure that no side cheats, and impose sanctions on a country if it does cheat in the trade game.

While it might sound unlikely that any government would compromise its national sovereignty by submitting to such an arrangement, since World War II an international trading framework has evolved that has exactly these features. For its first 50 years, this framework was known as the General Agreement on Tariffs and Trade. Since 1995, it has been known as the World Trade Organization. Here we look at the evolution and workings of the GATT and WTO.

FROM SMITH TO THE GREAT DEPRESSION

As noted in Chapter 5, the theoretical case for free trade dates to the late eighteenth century and the work of Adam Smith and David Ricardo. Free trade as a government policy was first officially embraced by Great Britain in 1846, when the British Parliament repealed the Corn Laws. The Corn Laws placed a high tariff on imports of foreign corn. The objectives of the Corn Laws tariff were to raise government revenues and to protect British corn producers. There had been annual motions in Parliament in favor of free trade since the 1820s when David Ricardo was a member. However, agricultural protection was withdrawn only as a result of a protracted debate when the effects of a harvest failure in Great Britain were compounded by the imminent threat of famine in Ireland. Faced with considerable hardship and suffering among the populace, Parliament narrowly reversed its long-held position.

During the next 80 years or so, Great Britain, as one of the world's dominant trading powers, pushed the case for trade liberalization, but the British government was a voice in the wilderness. Its major trading partners did not reciprocate the British policy of unilateral free trade. The only reason Britain kept this policy for so long was that as the world's largest exporting nation, it had far more to lose from a trade war than did any other country.

By the 1930s, the British attempt to stimulate free trade was buried under the economic rubble of the Great Depression. The Great Depression had roots in the failure of the world economy to mount a sustained economic recovery after the end of World War I in 1918. Things got worse in 1929 with the U.S. stock market collapse and the subsequent run on the U.S. banking system. Economic problems were compounded in 1930 when the U.S. Congress passed the Smoot-Hawley tariff. Aimed at avoiding rising unemployment by protecting domestic industries and diverting consumer demand away from foreign products, the **Smoot-Hawley Act** erected an enormous wall of tariff barriers. Almost every industry was rewarded with its "made-to-order" tariff. A particularly odd aspect of the Smoot-Hawley tariff-raising binge was that the United States was running a balance-of-payment surplus at the time and it was the world's largest creditor nation. The Smoot-Hawley Act had a damaging effect on employment abroad. Other countries reacted to the U.S. action by raising their own tariff barriers. U.S. exports tumbled in response, and the world slid further into the Great Depression.³²

1947–1979: GATT, TRADE LIBERALIZATION, AND ECONOMIC GROWTH

Economic damage caused by the beggar-thy-neighbor trade policies that the Smoot-Hawley Act ushered in exerted a profound influence on the economic institutions and ideology of the post-World War II world. The United States emerged from the war both victorious and economically dominant. After the debacle of the Great Depression, opinion in the U.S. Congress had swung strongly in favor of free trade. Under U.S. leadership, the GATT was established in 1947.

The GATT was a multilateral agreement whose objective was to liberalize trade by eliminating tariffs, subsidies, import quotas, and the like. From its foundation in 1947 until it was superseded by the WTO, the GATT's membership grew from 19 to more

than 120 nations. The GATT did not attempt to liberalize trade restrictions in one fell swoop; that would have been impossible. Rather, tariff reduction was spread over eight rounds. The last, the Uruguay Round, was launched in 1986 and completed in December 1993. In these rounds, mutual tariff reductions were negotiated among all members, who then committed themselves not to raise import tariffs above negotiated rates. GATT regulations were enforced by a mutual monitoring mechanism. If a country believed that one of its trading partners was violating a GATT regulation, it could ask the Geneva-based bureaucracy that administered the GATT to investigate. If GATT investigators found the complaints to be valid, member countries could be asked to pressure the offending party to change its policies. In general, such pressure was sufficient to get an offending country to change its policies. If it were not, the offending country could be expelled from the GATT.

In its early years, the GATT was by most measures very successful. For example, the average tariff declined by nearly 92 percent in the United States between the Geneva Round of 1947 and the Tokyo Round of 1973–79. Consistent with the theoretical arguments first advanced by Ricardo and reviewed in Chapter 5, the move toward free trade under the GATT appeared to stimulate economic growth. From 1953 to 1963, world trade grew at an annual rate of 6.1 percent, and world income grew at an annual rate of 4.3 percent. Performance from 1963 to 1973 was even better; world trade grew at 8.9 percent annually, and world income grew at 5.1 percent annually.³³

1980–1993: PROTECTIONIST TRENDS

During the 1980s and early 1990s, the world trading system erected by the GATT came under strain as pressures for greater protectionism increased around the world. Three reasons caused the rise in such pressures during the 1980s. First, the economic success of Japan during that time strained the world trading system (much as the success of China has created strains today). Japan was in ruins when the GATT was created. By the early 1980s, however, it had become the world's second-largest economy and its largest exporter. Japan's success in such industries as automobiles and semiconductors might have been enough to strain the world trading system. Things were made worse by the widespread perception in the West that despite low tariff rates and subsidies, Japanese markets were closed to imports and foreign investment by administrative trade barriers.

Second, the world trading system was strained by the persistent trade deficit in the world's largest economy, the United States. Although the deficit peaked in 1987 at more than \$170 billion, by the end of 1992 the annual rate was still running about \$80 billion. From a political perspective, the matter was worsened in 1992 by the \$45 billion U.S. trade deficit with Japan, a country perceived as not playing by the rules. The consequences of the U.S. deficit included painful adjustments in industries such as automobiles, machine tools, semiconductors, steel, and textiles, where domestic producers steadily lost market share to foreign competitors. The resulting unemployment gave rise to renewed demands in the U.S. Congress for protection against imports.

A third reason for the trend toward greater protectionism was that many countries found ways to get around GATT regulations. Bilateral voluntary export restraints, or VERs, circumvent GATT agreements, because neither the importing country nor the exporting country complains to the GATT bureaucracy in Geneva—and without a complaint, the GATT bureaucracy can do nothing. Exporting countries agreed to VERs to avoid more damaging punitive tariffs. One of the best-known examples is the automobile VER between Japan and the United States, under which Japanese producers promised to limit their auto imports into the United States as a way of defusing growing trade tensions. According to a World Bank study, 13 percent of the imports of industrialized countries in 1981 were subjected to nontariff trade barriers such as VERs. By 1986, this figure had increased to 16 percent. The most rapid rise was in the United States, where the value of imports affected by nontariff barriers (primarily VERs) increased by 23 percent between 1981 and 1986.³⁴

THE URUGUAY ROUND AND THE WORLD TRADE ORGANIZATION

Against the background of rising pressures for protectionism, in 1986 GATT members embarked on their eighth round of negotiations to reduce tariffs, the Uruguay Round (so named because it occurred in Uruguay). This was the most difficult round of negotiations yet, primarily because it was also the most ambitious. Until then, GATT rules had applied only to trade in manufactured goods and commodities. In the Uruguay Round, member countries sought to extend GATT rules to cover trade in services. They also sought to write rules governing the protection of intellectual property, to reduce agricultural subsidies, and to strengthen the GATT's monitoring and enforcement mechanisms.

The Uruguay Round dragged on for seven years before an agreement was reached December 15, 1993. It went into effect July 1, 1995. The Uruguay Round contained the following provisions:

1. Tariffs on industrial goods were to be reduced by more than one-third, and tariffs were to be scrapped on more than 40 percent of manufactured goods.
2. Average tariff rates imposed by developed nations on manufactured goods were to be reduced to less than 4 percent of value, the lowest level in modern history.
3. Agricultural subsidies were to be substantially reduced.
4. GATT fair trade and market access rules were to be extended to cover a wide range of services.
5. GATT rules also were to be extended to provide enhanced protection for patents, copyrights, and trademarks (intellectual property).
6. Barriers on trade in textiles were to be significantly reduced over 10 years.
7. The World Trade Organization was to be created to implement the GATT agreement.

Services and Intellectual Property

In the long run, the extension of GATT rules to cover services and intellectual property may be particularly significant. Until 1995, GATT rules applied only to industrial goods (i.e., manufactured goods and commodities). In 2007, world trade in services amounted to \$3.260 billion (compared to world trade in goods of \$13,570 billion).³⁵ Ultimately, extension of GATT rules to this important trading arena could significantly increase both the total share of world trade accounted for by services and the overall volume of world trade. The extension of GATT rules to cover intellectual property will make it much easier for high-technology companies to do business in developing nations where intellectual property rules historically have been poorly enforced (see Chapter 2 for details).

The World Trade Organization

The clarification and strengthening of GATT rules and the creation of the World Trade Organization also hold out the promise of more effective policing and enforcement of GATT rules. The WTO acts as an umbrella organization that encompasses the GATT along with two new sister bodies, one on services and the other on intellectual property. The WTO's General Agreement on Trade in Services (GATS) has taken the lead to extending free trade agreements to services. The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is an attempt to narrow the gaps in the way intellectual property rights are protected around the world and to bring them under common international rules. WTO has taken over responsibility for arbitrating trade disputes and monitoring the trade policies of member countries. While the WTO operates on the basis of consensus as the GATT did, in the area of dispute settlement, member countries are no longer able to block adoption of arbitration reports. Arbitration panel reports on trade disputes between member countries are automatically adopted by the WTO unless there is a consensus to reject them. Countries that have been found by

the arbitration panel to violate GATT rules may appeal to a permanent appellate body, but its verdict is binding. If offenders fail to comply with the recommendations of the arbitration panel, trading partners have the right to compensation or, in the last resort, to impose (commensurate) trade sanctions. Every stage of the procedure is subject to strict time limits. Thus, the WTO has something that the GATT never had—teeth.³⁶

WTO: EXPERIENCE TO DATE

By 2011, the WTO had 153 members, including China, which joined at the end of 2001, and those countries collectively account for 97 percent of world trade. Another 25 countries, including the Russian Federation, were negotiating for membership into the organization. Since its formation, the WTO has remained at the forefront of efforts to promote global free trade. Its creators expressed the hope that the enforcement mechanisms granted to the WTO would make it more effective at policing global trade rules than the GATT had been. The great hope was that the WTO might emerge as an effective advocate and facilitator of future trade deals, particularly in areas such as services. The experience so far has been encouraging, although the collapse of WTO talks in Seattle in late 1999, slow progress with the next round of trade talks (the Doha Round), and a shift back toward some limited protectionism following the global financial crisis of 2008–2009 have raised a number of questions about the future direction of the WTO.

WTO as Global Police

The first 15 years in the life of the WTO suggests that its policing and enforcement mechanisms are having a positive effect.³⁷ Between 1995 and 2010 more than 400 trade disputes between member countries were brought to the WTO.³⁸ This record compares with a total of 196 cases handled by the GATT over almost half a century. Of the cases brought to the WTO, three-fourths had been resolved by informal consultations between the disputing countries. Resolving the remainder has involved more formal procedures, but these have been largely successful. In general, countries involved have adopted the WTO's recommendations. The fact that countries are using the WTO represents an important vote of confidence in the organization's dispute resolution procedures.

Expanding Trade Agreements

As explained above, the Uruguay Round of GATT negotiations extended global trading rules to cover trade in services. The WTO was given the role of brokering future agreements to open up global trade in services. The WTO was also encouraged to extend its reach to encompass regulations governing foreign direct investment, something the GATT had never done. Two of the first industries targeted for reform were the global telecommunication and financial services industries.

In February 1997, the WTO brokered a deal to get countries to agree to open their telecommunication markets to competition, allowing foreign operators to purchase ownership stakes in domestic telecommunication providers and establishing a set of common rules for fair competition. Under the pact, 68 countries accounting for more than 90 percent of world telecommunication revenues pledged to start opening their markets to foreign competition and to abide by common rules for fair competition in telecommunications. Most of the world's biggest markets, including the United States, European Union, and Japan, were fully liberalized by January 1, 1998, when the pact went into effect. All forms of basic telecommunication service are covered, including voice telephony, data and fax transmissions, and satellite and radio communications. Many telecommunication companies responded positively to the deal, pointing out that it would give them a much greater ability to offer their business customers one-stop shopping—a global, seamless service for all their corporate needs and a single bill.³⁹

This was followed in December 1997 with an agreement to liberalize cross-border trade in financial services.⁴⁰ The deal covers more than 95 percent of the world's financial services market. Under the agreement, which took effect at the beginning of March

1999, 102 countries pledged to open to varying degrees their banking, securities, and insurance sectors to foreign competition. In common with the telecommunication deal, the accord covers not just cross-border trade but also foreign direct investment. Seventy countries agreed to dramatically lower or eradicate barriers to foreign direct investment in their financial services sector. The United States and the European Union, with minor exceptions, are fully open to inward investment by foreign banks, insurance, and securities companies. As part of the deal, many Asian countries made important concessions that allow significant foreign participation in their financial services sectors for the first time.

The WTO in Seattle: A Watershed?

At the end of November 1999, representatives from the WTO's member states met in Seattle, Washington. The goal of the meeting was to launch a new round of talks—dubbed “the millennium round”—aimed at further reducing barriers to cross-border trade and investment. Prominent on the agenda was an attempt to get the assembled countries to agree to work toward the reduction of barriers to cross-border trade in agricultural products and trade and investment in services.

These expectations were dashed on the rocks of a hard and unexpected reality. The talks ended December 3, 1999, without any agreement being reached. Inside the meeting rooms, the problem was an inability to reach consensus on the primary goals for the next round of talks. A major stumbling block was friction between the United States and the European Union over whether to endorse the aim of ultimately eliminating subsidies to agricultural exporters. The United States wanted the elimination of such subsidies to be a priority. The EU, with its politically powerful farm lobby and long history of farm subsidies, was unwilling to take this step. Another stumbling block was related to efforts by the United States to write “basic labor rights” into the law of the world trading system. The United States wanted the WTO to allow governments to impose tariffs on goods imported from countries that did not abide by what the United States saw as fair labor practices. Representatives from developing nations reacted angrily to this proposal, suggesting it was simply an attempt by the United States to find a legal way of restricting imports from poorer nations.

WTO protesters gather in downtown Seattle before the opening of the WTO sessions in Seattle in 1999.



While the disputes inside the meeting rooms were acrimonious, it was events outside that captured the attention of the world press. The WTO talks proved to be a lightning rod for a diverse collection of organizations from environmentalists and human rights groups to labor unions. For various reasons, these groups oppose free trade. All these organizations argued that the WTO is an undemocratic institution that was usurping the national sovereignty of member states and making decisions of great importance behind closed doors. They took advantage of the Seattle meetings to voice their opposition, which the world press recorded.

Environmentalists expressed concern about the impact that free trade in agricultural products might have on the rate of global deforestation. They argued that lower tariffs on imports of lumber from developing nations will stimulate demand and accelerate the rate at which virgin forests are logged, particularly in nations such as Malaysia and Indonesia. They also pointed to the adverse impact that some WTO rulings have had on environmental policies. For example, the WTO had blocked a U.S. rule that ordered shrimp nets be equipped with a device that allows endangered sea turtles to escape. The WTO found the rule discriminated against foreign importers who lacked such nets.⁴¹ Environmentalists argued that the rule was necessary to protect the turtles from extinction.

Human rights activists see WTO rules as outlawing the ability of nations to stop imports from countries where child labor is used or working conditions are hazardous. Similarly, labor unions oppose trade laws that allow imports from low-wage countries and result in a loss of jobs in high-wage countries. They buttress their position by arguing that American workers are losing their jobs to imports from developing nations that do not have adequate labor standards.

Supporters of the WTO and free trade dismiss these concerns. They have repeatedly pointed out that the WTO exists to serve the interests of its member states, not subvert them. The WTO lacks the ability to force any member nation to take an action to which it is opposed. The WTO can allow member nations to impose retaliatory tariffs on countries that do not abide by WTO rules, but that is the limit of its power. Furthermore, supporters argue, it is rich countries that pass strict environmental laws and laws governing labor standards, not poor ones. In their view, free trade, by raising living standards in developing nations, will be followed by the passage of such laws in these nations. Using trade regulations to try to impose such practices on developing nations, they believe, will produce a self-defeating backlash.

Many representatives from developing nations, which make up about 70 percent of the WTO's members, also reject the position taken by environmentalists and advocates of human and labor rights. Poor countries, which depend on exports to boost their economic growth rates and work their way out of poverty, fear that rich countries will use environmental concerns, human rights, and labor-related issues to erect barriers to the products of the developing world. They believe that attempts to incorporate language about the environment or labor standards in future trade agreements will amount to little more than trade barriers by another name.⁴² If this were to occur, they argue that the effect would be to trap the developing nations of the world in a grinding cycle of poverty and debt.

As the WTO representatives gathered in Seattle, environmentalists, human rights activists, and labor unions marched in the streets. Some of the more radical elements in these organizations, together with groups of anarchists who were philosophically opposed to "global capitalism" and "the rape of the world by multinationals," succeeded not only in shutting down the opening ceremonies of the WTO but also in sparking violence in the normally peaceful streets of Seattle. A number of demonstrators damaged property and looted, and the police responded with tear gas, rubber bullets, pepper spray, and baton charges. When it was over, 600 demonstrators had been arrested, millions of dollars in property had been damaged in downtown Seattle, and the global news media had their headline: "WTO Talks Collapse amid Violent Demonstrations."

What happened in Seattle is notable because it may have been a watershed of sorts. In the past, previous trade talks were pursued in relative obscurity with only interested economists, politicians, and businesspeople paying much attention. Seattle demonstrated

that the issues surrounding the global trend toward free trade have moved to center stage in the popular consciousness, and they have remained there ever since. The debate on the merits of free trade and globalization has become mainstream. Whether further liberalization occurs, therefore, may depend on the importance that popular opinion in countries such as the United States attaches to issues such as human rights and labor standards, job security, environmental policies, and national sovereignty. It will also depend on the ability of advocates of free trade to articulate in a clear and compelling manner the argument that, in the long run, free trade is the best way of promoting adequate labor standards, of providing more jobs, and of protecting the environment.

THE FUTURE OF THE WTO: UNRESOLVED ISSUES AND THE DOHA ROUND

Much remains to be done on the international trade front. Four issues at the forefront of the current agenda of the WTO are the increase in antidumping policies, the high level of protectionism in agriculture, the lack of strong protection for intellectual property rights in many nations, and continued high tariff rates on nonagricultural goods and services in many nations. We shall look at each in turn before discussing the latest round of talks between WTO members aimed at reducing trade barriers, the Doha Round, which began in 2001 and was still ongoing as of 2011.

Antidumping Actions

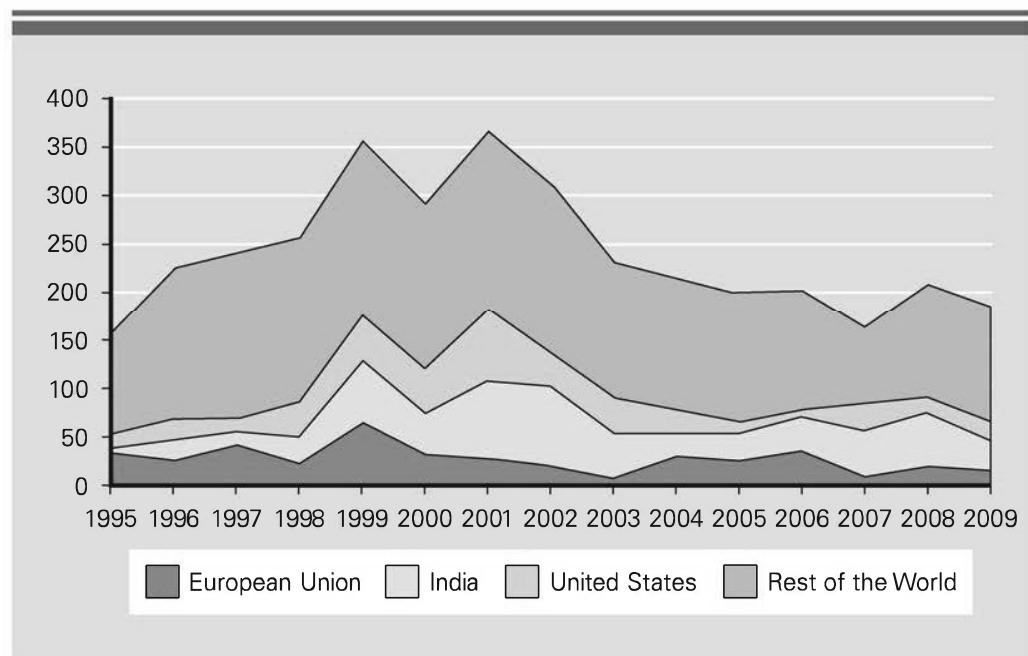
Antidumping actions proliferated during the 1990s. WTO rules allow countries to impose antidumping duties on foreign goods that are being sold cheaper than at home, or below their cost of production, when domestic producers can show that they are being harmed. Unfortunately, the rather vague definition of what constitutes “dumping” has proved to be a loophole that many countries are exploiting to pursue protectionism.

Between 1995 and mid-2010, WTO members had reported implementation of some 3,752 antidumping actions to the WTO. India initiated the largest number of antidumping actions, some 613; the EU initiated 414 over the same period, and the United States 442 (see Figure 7.2). Antidumping actions seem to be concentrated in certain sectors of the economy such as basic metal industries (e.g., aluminum and steel), chemicals, plastics, and machinery and electrical equipment.⁴³ These sectors account for some

FIGURE 7.2

Antidumping Actions

Source: Constructed by author from WTO data.



70 percent of all antidumping actions reported to the WTO. These four sectors since 1995 have been characterized by periods of intense competition and excess productive capacity, which have led to low prices and profits (or losses) for firms in those industries. It is not unreasonable, therefore, to hypothesize that the high level of antidumping actions in these industries represents an attempt by beleaguered manufacturers to use the political process in their nations to seek protection from foreign competitors, who they claim are engaging in unfair competition. While some of these claims may have merit, the process can become very politicized as representatives of businesses and their employees lobby government officials to “protect domestic jobs from unfair foreign competition,” and government officials, mindful of the need to get votes in future elections, oblige by pushing for antidumping actions. The WTO is clearly worried by this trend, suggesting that it reflects persistent protectionist tendencies and pushing members to strengthen the regulations governing the imposition of antidumping duties.

Figure 7.2 suggests that antidumping actions peaked in the 1999–2001 time period and declined thereafter until the WTO reported a small rise in antidumping actions in 2008 as the global financial crisis took hold. Many of these actions seem to have been a direct response to the decline in global demand that followed the financial crisis, and the increase suggests that countries were using antidumping actions as a means of protecting domestic producers. The most frequent target of these actions was China.

Protectionism in Agriculture

Another recent focus of the WTO has been the high level of tariffs and subsidies in the agricultural sector of many economies. Tariff rates on agricultural products are generally much higher than tariff rates on manufactured products or services. For example, in the mid-2000s the average tariff rates on nonagricultural products were 4.2 percent for Canada, 3.8 percent for the European Union, 3.9 percent for Japan, and 4.4 percent for the United States. On agricultural products, however, the average tariff rates were 21.2 percent for Canada, 15.9 percent for the European Union, 18.6 percent for Japan, and 10.3 percent for the United States.⁴⁴ The implication is that consumers in these countries are paying significantly higher prices than necessary for agricultural products imported from abroad, which leaves them with less money to spend on other goods and services.

The historically high tariff rates on agricultural products reflect a desire to protect domestic agriculture and traditional farming communities from foreign competition. In addition to high tariffs, agricultural producers also benefit from substantial subsidies. According to estimates from the Organization for Economic Cooperation and Development (OECD), government subsidies on average account for some 17 percent of the cost of agricultural production in Canada, 21 percent in the United States, 35 percent in the European Union, and 59 percent in Japan.⁴⁵ In total, OECD countries spend more than \$300 billion a year in subsidies to agricultural producers.

Not surprisingly, the combination of high tariff barriers and significant subsidies introduces significant distortions into the production of agricultural products and international trade of those products. The net effect is to raise prices to consumers, reduce the volume of agricultural trade, and encourage the overproduction of products that are heavily subsidized (with the government typically buying the surplus). Because global trade in agriculture currently amounts to 10.5 percent of total merchandized trade, or about \$750 billion per year, the WTO argues that removing tariff barriers and subsidies could significantly boost the overall level of trade, lower prices to consumers, and raise global economic growth by freeing consumption and investment resources for more productive uses. According to estimates from the International Monetary Fund, removal of tariffs and subsidies on agricultural products would raise global economic welfare by \$128 billion annually.⁴⁶ Others suggest gains as high as \$182 billion.⁴⁷

The biggest defenders of the existing system have been the advanced nations of the world, which want to protect their agricultural sectors from competition by low-cost producers in developing nations. In contrast, developing nations have been pushing hard for reforms that would allow their producers greater access to the protected markets

of the developed nations. Estimates suggest that removing all subsidies on agricultural production alone in OECD countries could return to the developing nations of the world three times more than all the foreign aid they currently receive from the OECD nations.⁴⁸ In other words, free trade in agriculture could help to jump-start economic growth among the world's poorer nations and alleviate global poverty.

Protecting Intellectual Property

Another issue that has become increasingly important to the WTO has been protecting intellectual property. The 1995 Uruguay agreement that established the WTO also contained an agreement to protect intellectual property (the Trade-Related Aspects of Intellectual Property Rights, or TRIPS, agreement). The TRIPS regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years' grace, and the very poorest had 10 years. The basis for this agreement was a strong belief among signatory nations that the protection of intellectual property through patents, trademarks, and copyrights must be an essential element of the international trading system. Inadequate protections for intellectual property reduce the incentive for innovation. Because innovation is a central engine of economic growth and rising living standards, the argument has been that a multilateral agreement is needed to protect intellectual property.

Without such an agreement it is feared that producers in a country, let's say India, might market imitations of patented innovations pioneered in a different country, say the United States. This can affect international trade in two ways. First, it reduces the export opportunities in India for the original innovator in the United States. Second, to the extent that the Indian producer is able to export its pirated imitation to additional countries, it also reduces the export opportunities in those countries for the U.S. inventor. Also, one can argue that because the size of the total world market for the innovator is reduced, its incentive to pursue risky and expensive innovations is also reduced. The net effect would be less innovation in the world economy and less economic growth.

Something very similar to this occurred in the pharmaceutical industry, with Indian drug companies making copies of patented drugs discovered elsewhere. In 1970, the Indian government stopped recognizing product patents on drugs, but it elected to continue respecting process patents. This permitted Indian companies to reverse-engineer Western pharmaceuticals without paying licensing fees. As a result, foreigners' share of the Indian drug market fell from 75 percent in 1970 to 30 percent in 2000. For example, an Indian company sold a version of Bayer's patented antibiotic Cipro for \$0.12 a pill, versus the \$5.50 it costs in the United States. Under the WTO TRIPS agreement, India agreed to adopt and enforce the international drug patent regime in 2005.⁴⁹

As noted in Chapter 2, intellectual property rights violation is also an endemic problem in several other industries, most notably computer software and music. The WTO believes that reducing piracy rates in areas such as drugs, software, and music recordings would have a significant impact on the volume of world trade and increase the incentive for producers to invest in the creation of intellectual property. A world without piracy would have more new drugs, computer software, and music recordings produced every year. In turn, this would boost economic and social welfare, and global economic growth rates. It is thus in the interests of WTO members to make sure that intellectual property rights are respected and enforced. While the 1995 Uruguay agreement that created the WTO did make headway with the TRIPS agreement, some believe these requirements do not go far enough and further commitments are necessary.

Market Access for Nonagricultural Goods and Services

Although the WTO and the GATT have made big strides in reducing the tariff rates on nonagricultural products, much work remains. Although most developed nations have brought their tariff rates on industrial products down to an *average* of 3.8 percent of value, exceptions still remain. In particular, while average tariffs are low, high tariff rates

Country	Metals	Transportation Equipment	Electric Machinery
Canada	2.8%	6.8%	5.2%
United States	1.8	2.7	2.1
Brazil	33.4	33.6	31.9
Mexico	34.7	35.8	34.1
European Union	1.6	4.7	3.3
Australia	4.5	15.1	13.3
Japan	0.9	0.0	0.2
South Korea	7.7	24.6	16.1

TABLE 7.1

Bound Tariffs on Select Industrial Products (Simple Averages)

Source: WTO.

persist on certain imports into developed nations, which limit market access and economic growth. For example, Australia and South Korea, both OECD countries, still have bound tariff rates of 15.1 percent and 24.6 percent, respectively, on imports of transportation equipment (*bound tariff rates* are the highest rate that can be charged, which is often, but not always, the rate that is charged). In contrast, the bound tariff rates on imports of transportation equipment into the United States, EU, and Japan are 2.7 percent, 4.8 percent, and 0 percent, respectively (see Table 7.1). A particular area for concern is high tariff rates on imports of selected goods from developing nations into developed nations.

In addition, tariffs on services remain higher than on industrial goods. The average tariff on business and financial services imported into the United States, for example, is 8.2 percent, into the EU it is 8.5 percent, and into Japan it is 19.7 percent.⁵⁰ Given the rising value of cross-border trade in services, reducing these figures can be expected to yield substantial gains.

The WTO would like to bring down tariff rates still further and reduce the scope for the selective use of high tariff rates. The ultimate aim is to reduce tariff rates to zero. Although this might sound ambitious, 40 nations have already moved to zero tariffs on information technology goods, so a precedent exists. Empirical work suggests that further reductions in average tariff rates toward zero would yield substantial gains. One estimate by economists at the World Bank suggests that a broad global trade agreement coming out of the current Doha negotiations could increase world income by \$263 billion annually, of which \$109 billion would go to poor countries.⁵¹ Another estimate from the OECD suggest a figure closer to \$300 billion annually.⁵² See the accompanying Country Focus for estimates of the benefits to the American economy from free trade.

Looking further out, the WTO would like to bring down tariff rates on imports of nonagricultural goods into developing nations. Many of these nations use the infant industry argument to justify the continued imposition of high tariff rates; however, ultimately these rates need to come down for these nations to reap the full benefits of international trade. For example, the bound tariff rates of 53.9 percent on imports of transportation equipment into India and 33.6 percent on imports into Brazil, by raising domestic prices, help to protect inefficient domestic producers and limit economic growth by reducing the real income of consumers who must pay more for transportation equipment and related services.

A New Round of Talks: Doha

Antidumping actions, trade in agricultural products, better enforcement of intellectual property laws, and expanded market access were four of the issues the WTO wanted to tackle at the 1999 meetings in Seattle, but those meetings were derailed. In late 2001, the WTO tried again to launch a new round of talks between member states aimed at



Estimating the Gains from Trade for America

A study published by the Institute for International Economics tried to estimate the gains to the American economy from free trade. According to the study, due to reductions in tariff barriers under the GATT and WTO since 1947, by 2003 the gross domestic product (GDP) of the United States was 7.3 percent higher than would otherwise be the case. The benefits of that amounted to roughly \$1 trillion a year, or \$9,000 extra income for each American household per year.

The same study tried to estimate what would happen if America concluded free trade deals with all its trading partners, reducing tariff barriers on all goods and services to zero. Using several methods to estimate the impact, the study concluded that additional annual gains of between \$450 billion and \$1.3 trillion could be realized. This final march to free trade, according to the authors of the study, could safely be expected to raise incomes of the average American household by an additional \$4,500 per year.

The authors also tried to estimate the scale and cost of employment disruption that would be caused by a

move to universal free trade. Jobs would be lost in certain sectors and gained in others if the country abolished all tariff barriers. Using historical data as a guide, they estimated that 226,000 jobs would be lost every year due to expanded trade, although some two-thirds of those losing jobs would find reemployment after a year. Reemployment, however, would be at a wage that was 13 to 14 percent lower. The study concluded that the disruption costs would total some \$54 billion annually, primarily in the form of lower lifetime wages to those whose jobs were disrupted as a result of free trade. Offset against this, however, must be the higher economic growth resulting from free trade, which creates many new jobs and raises household incomes, creating another \$450 billion to \$1.3 trillion annually in *net* gains to the economy. In other words, the estimated annual gains from trade are far greater than the estimated annual costs associated with job disruption, and more people benefit than lose as result of shift to a universal free trade regime.⁵³

further liberalizing the global trade and investment framework. For this meeting, it picked the remote location of Doha in the Persian Gulf state of Qatar, no doubt with an eye on the difficulties that antiglobalization protesters would have in getting there. Unlike the Seattle meetings, at Doha, the member states of the WTO agreed to launch a new round of talks and staked out an agenda. The talks were originally scheduled to last three years, although they have already gone on longer and may not be concluded for a while.

The agenda includes cutting tariffs on industrial goods and services, phasing out subsidies to agricultural producers, reducing barriers to cross-border investment, and limiting the use of antidumping laws. Some difficult compromises were made to reach agreement on this agenda. The EU and Japan had to give significant ground on the issue of agricultural subsidies, which are used extensively by both entities to support politically powerful farmers. The United States bowed to pressure from virtually every other nation to negotiate revisions of antidumping rules, which the United States has used extensively to protect its steel producers from foreign competition. Europe had to scale back its efforts to include environmental policy in the trade talks, primarily because of pressure from developing nations that see environmental protection policies as trade barriers by another name. Excluded from the agenda was any language pertaining to attempts to tie trade to labor standards in a country.

Countries with big pharmaceutical sectors acquiesced to demands from African, Asian, and Latin American nations on the issue of drug patents. Specifically, the language in the agreement declares that WTO regulation on intellectual property “does not and should not prevent members from taking measures to protect public health.” This language was meant to assure the world’s poorer nations that they can make or buy generic equivalents to fight such killers as AIDS and malaria.

Clearly, it is one thing to agree to an agenda and quite another to reach a consensus on a new treaty. Nevertheless, if an agreement is reached there are some clear potential winners. These include low-cost agricultural producers in the developing world and developed nations such as Australia and the United States. If the talks are successful, agricultural producers in these nations will ultimately see the global markets for their goods expand. Developing nations also gain from the lack of language on labor standards, which many saw as an attempt by rich nations to erect trade barriers. The sick and poor of the world also benefit from guaranteed access to cheaper medicines. There are also clear losers in this agreement, including EU and Japanese farmers, U.S. steelmakers, environmental activists, and pharmaceutical firms in the developed world. These losers can be expected to lobby their governments hard during the ensuing years to make sure the final agreement is more in their favor.⁵⁴ In general, though, if ultimately successful, the Doha Round of negotiations could significantly raise global economic welfare. As noted above, estimates suggest that a successful Doha Round would raise global incomes by as much as \$300 billion annually, with 60 percent of the gain going to the world's poorer nations, which would help to pull 150 million people out of poverty.⁵⁵

The talks are currently ongoing, and as seems normal in these cases, they are characterized by halting progress punctuated by significant setbacks and missed deadlines. A September 2003 meeting in Cancun, Mexico, broke down, primarily because there was no agreement on how to proceed with reducing agricultural subsidies and tariffs; the EU, United States, and India, among others, proved less than willing to reduce tariffs and subsidies to their politically important farmers, while countries such as Brazil and certain West African nations wanted free trade as quickly as possible. In 2004, both the United States and the EU made a determined push to start the talks again. However, since then little progress has been made and the talks are in deadlock, primarily because of disagreements over how deep the cuts in subsidies to agricultural produces should be. As of early 2011, the goal was to reduce tariffs for manufactured and agricultural goods by 60 to 70 percent, and to cut subsidies to half of their current level, but getting nations to agree to these goals was proving exceedingly difficult.

IMPLICATION FOR MANAGERS



What are the implications of all this for business practice? Why should the international manager care about the political economy of free trade or about the relative merits of arguments for free trade and protectionism? There are two answers to this question. The first concerns the impact of trade barriers on a firm's strategy. The second concerns the role that business firms can play in promoting free trade or trade barriers.

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TRADE BARRIERS AND FIRM STRATEGY

To understand how trade barriers affect a firm's strategy, consider first the material in Chapter 6. Drawing on the theories of international trade, we discussed how it makes sense for the firm to disperse its various production activities to those countries around the globe where they can be performed most efficiently. Thus, it may make sense for a firm to design and engineer its product in one country, to manufacture components in another, to perform final assembly operations in yet another country, and then export the finished product to the rest of the world.

Clearly, trade barriers constrain a firm's ability to disperse its productive activities in such a manner. First and most obvious, tariff barriers raise the costs of exporting products to a country (or of exporting partly finished products between countries). This may put the firm at a competitive disadvantage to indigenous competitors in that country. In response, the firm may then find it economical to locate production facilities

in that country so that it can compete on an even footing. Second, quotas may limit a firm's ability to serve a country from locations outside of that country. Again, the response by the firm might be to set up production facilities in that country—even though it may result in higher production costs. Such reasoning was one of the factors behind the rapid expansion of Japanese automaking capacity in the United States during the 1980s and 1990s. This followed the establishment of a VER agreement between the United States and Japan that limited U.S. imports of Japanese automobiles.

Third, to conform to local content regulations, a firm may have to locate more production activities in a given market than it would otherwise. Again, from the firm's perspective, the consequence might be to raise costs above the level that could be achieved if each production activity was dispersed to the optimal location for that activity. And finally, even when trade barriers do not exist, the firm may still want to locate some production activities in a given country to reduce the threat of trade barriers being imposed in the future.

All these effects are likely to raise the firm's costs above the level that could be achieved in a world without trade barriers. The higher costs that result need not translate into a significant competitive disadvantage relative to other foreign firms, however, if the countries imposing trade barriers do so to the imported products of all foreign firms, irrespective of their national origin. But when trade barriers are targeted at exports from a particular nation, firms based in that nation are at a competitive disadvantage to firms of other nations. The firm may deal with such targeted trade barriers by moving production into the country imposing barriers. Another strategy may be to move production to countries whose exports are not targeted by the specific trade barrier.

Finally, the threat of antidumping action limits the ability of a firm to use aggressive pricing to gain market share in a country. Firms in a country also can make strategic use of antidumping measures to limit aggressive competition from low-cost foreign producers. For example, the U.S. steel industry has been very aggressive in bringing antidumping actions against foreign steelmakers, particularly in times of weak global demand for steel and excess capacity. In 1998 and 1999, the United States faced a surge in low-cost steel imports as a severe recession in Asia left producers there with excess capacity. The U.S. producers filed several complaints with the International Trade Commission. One argued that Japanese producers of hot rolled steel were selling it at below cost in the United States. The ITC agreed and levied tariffs ranging from 18 percent to 67 percent on imports of certain steel products from Japan (these tariffs are separate from the steel tariffs discussed earlier).⁵⁶

POLICY IMPLICATIONS

As noted in Chapter 6, business firms are major players on the international trade scene. Because of their pivotal role in international trade, firms can and do exert a strong influence on government policy toward trade. This influence can encourage protectionism or it can encourage the government to support the WTO and push for open markets and freer trade among all nations. Government policies with regard to international trade can have a direct impact on business.

Consistent with strategic trade policy, examples can be found of government intervention in the form of tariffs, quotas, antidumping actions, and subsidies helping firms and industries establish a competitive advantage in the world economy. In general, however, the arguments contained in this chapter and in Chapter 6 suggest that government intervention has three drawbacks. Intervention can be self-defeating because it tends to protect the inefficient rather than help firms become efficient global competitors. Intervention is dangerous; it may invite retaliation and trigger a trade war. Finally, intervention is unlikely to be well executed, given the opportunity for such a policy to be captured by special-interest groups. Does this mean that business should simply encourage government to adopt a *laissez-faire* free trade policy?

Most economists would probably argue that the best interests of international business are served by a free trade stance, but not a *laissez-faire* stance. It is probably in the best long-run interests of the business community to encourage the government to aggressively

promote greater free trade by, for example, strengthening the WTO. Business probably has much more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to support certain domestic industries in a manner consistent with the recommendations of strategic trade policy.

This conclusion is reinforced by a phenomenon we touched on in Chapter 1—the increasing integration of the world economy and internationalization of production that has occurred over the past two decades. We live in a world where many firms of all national origins increasingly depend for their competitive advantage on globally dispersed production systems. Such systems are the result of freer trade. Freer trade has brought great advantages to firms that have exploited it and to consumers who benefit from the resulting lower prices. Given the danger of retaliatory action, business firms that lobby their governments to engage in protectionism must realize that by doing so they may be denying themselves the opportunity to build a competitive advantage by constructing a globally dispersed production system. By encouraging their governments to engage in protectionism, their own activities and sales overseas may be jeopardized if other governments retaliate. This does not mean a firm should never seek protection in the form of antidumping actions and the like, but it should review its options carefully and think through the larger consequences.

CHAPTER SUMMARY

This chapter described how the reality of international trade deviates from the theoretical ideal of unrestricted free trade reviewed in Chapter 6. In this chapter, we reported the various instruments of trade policy, reviewed the political and economic arguments for government intervention in international trade, reexamined the economic case for free trade in light of the strategic trade policy argument, and looked at the evolution of the world trading framework. While a policy of free trade may not always be the theoretically optimal policy (given the arguments of the new trade theorists), in practice it is probably the best policy for a government to pursue. In particular, the long-run interests of business and consumers may be best served by strengthening international institutions such as the WTO. Given the danger that isolated protectionism might escalate into a trade war, business probably has far more to gain from government efforts to open protected markets to imports and foreign direct investment (through the WTO) than from government efforts to protect domestic industries from foreign competition. The chapter made the following points:

1. Trade policies such as tariffs, subsidies, antidumping regulations, and local content requirements tend to be pro-producer and anti-consumer. Gains accrue to producers (who are protected from foreign competitors), but consumers lose because they must pay more for imports.
2. There are two types of arguments for government intervention in international trade: political and

economic. Political arguments for intervention are concerned with protecting the interests of certain groups, often at the expense of other groups, or with promoting goals with regard to foreign policy, human rights, consumer protection, and the like. Economic arguments for intervention are about boosting the overall wealth of a nation.

3. A common political argument for intervention is that it is necessary to protect jobs. However, political intervention often hurts consumers and it can be self-defeating. Countries sometimes argue that it is important to protect certain industries for reasons of national security. Some argue that government should use the threat to intervene in trade policy as a bargaining tool to open foreign markets. This can be a risky policy; if it fails, the result can be higher trade barriers.
4. The infant industry argument for government intervention contends that to let manufacturing get a toehold, governments should temporarily support new industries. In practice, however, governments often end up protecting the inefficient.
5. Strategic trade policy suggests that with subsidies, government can help domestic firms gain first-mover advantages in global industries where economies of scale are important. Government subsidies may also help domestic firms overcome barriers to entry into such industries.

6. The problems with strategic trade policy are two-fold: (a) such a policy may invite retaliation, in which case all will lose, and (b) strategic trade policy may be captured by special-interest groups, which will distort it to their own ends.
7. The GATT was a product of the postwar free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move toward greater free trade under the GATT appeared to stimulate economic growth.
8. The completion of the Uruguay Round of GATT talks and the establishment of the World Trade Organization have strengthened the world trading system by extending GATT rules to services, increasing protection for intellectual property, reducing agricultural subsidies, and enhancing monitoring and enforcement mechanisms.
9. Trade barriers act as a constraint on a firm's ability to disperse its various production activities to optimal locations around the globe. One response to trade barriers is to establish more production activities in the protected country.
10. Business may have more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to protect domestic industries from foreign competition.

Critical Thinking and Discussion Questions

1. Do you think governments should consider human rights when granting preferential trading rights to countries? What are the arguments for and against taking such a position?
2. Whose interests should be the paramount concern of government trade policy—the interests of producers (businesses and their employees) or those of consumers?
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?
4. You are an employee of a U.S. firm that produces personal computers in Thailand and then exports them to the United States 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 the 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?
5. Reread the Management Focus, "U.S. Magnesium Seeks Protection." Who gains most from the antidumping 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?

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The Political Economy of International Trade

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The European subsidiary of your company is considering exporting its products to Egypt. Yet, management's current knowledge of this country's trade policies and barriers is limited. Before your company's management decides to export, a more detailed analysis of the political and economic conditions in Egypt is required. In fact, you have heard that the *Market Access Database* may be a good place to start. Begin your search and identify Egypt's current import policies with respect to

fundamental issues such as tariffs and restrictions. Prepare an executive summary of your findings.

Exercise 2

The number of member nations of the World Trade Organization (WTO) has increased considerably in recent years. As a *global international organization*, some non-member countries have observer status in the WTO. Such status requires accession negotiations to begin within five years of attaining this preliminary position. Identify the current total number of WTO members. Also, prepare a list of current observer countries. Do you notice anything in particular about the countries that have observer status?

CLOSING CASE**The Global Financial Crisis and Protectionism**

Two facts have characterized international trade between 1986 and 2007. First, the volume of world trade grew every year, creating an increasingly interdependent global economy, and second, barriers to international trade were progressively reduced. Between 1990 and 2007 international trade grew by 6 percent annually compounded, while import tariffs on goods fell from an average of 26 percent in 1986 to 8.8 percent in 2007. In the wake of the global financial crisis that started in the United States in 2008 and quickly spread around the world, this changed. As global demand slumped and financing for international trade dried up in the wake of tight credit conditions, so did the volume of international trade. The volume of world trade fell by 2 percent in 2008, the first decline since 1982, and then slumped a further 12 percent in 2009.

This contraction is alarming because past sharp declines in trade have been followed by calls for greater protectionism from foreign competition as governments try to protect jobs at home in the wake of declining demand. This is what occurred in the 1930s, when shrinking trade was followed quickly by increases in trade barriers, mostly in the form of higher tariffs. This actually made the situation far worse and led to the Great Depression.

Much has changed since the 1930s. Treaties now in place limit the ability of national governments to raise trade barriers. Most notably, World Trade Organization rules in theory constrain the ability of countries to implement significant increases in trade barriers. But WTO rules are not perfect and there is plenty of evidence that countries are finding ways to raise barriers to international trade. Many developing countries have latitude under WTO rules to raise some tariffs, and according to the World Bank, in 2008 and 2009 they were doing just that. For example, Ecuador raised duties on 600 goods, Russia increased import tariffs on used cars, while India placed them on some sorts of steel imports.

According to the World Bank, however, two-thirds of the protectionist measures taken in 2008 and 2009 were various kinds of “non-tariff barriers that are designed to get around WTO rules.” Indonesia, for example, specified that certain kinds of goods, including clothes, shoes, and toys, can be imported only through five ports. Since these ports have limited capacity, this constrains the ability of foreign companies to sell into the Indonesian market. Argentina has imposed discretionary licensing requirements on a range of goods including car parts, textiles, and televisions. If you can’t get a license, you

can’t sell into Argentina. China has stopped a wide range of imports of food and drink products from Europe, citing safety rules and environmental concerns, while India has banned imports of toys from China for safety reasons.

Developed nations in general did not take similar actions, but they sharply increased subsidies to troubled domestic producers, which gave them an advantage against unsubsidized international competitors, and therefore may have distorted trade. The key example of this in 2008 and 2009 was the automobile industry. To protect national producers, hold on to jobs, and stave off bankruptcies, rich countries including the United States, Britain, Canada, France, Germany, Italy, and Sweden gave over \$45 billion in subsidies to car companies between mid-2008 and mid-2009. The problem with such subsidies is that they could cause production to switch from more efficient plants to less efficient plants that have an advantage due to state support. Although the WTO has rules against trade-distorting subsidies, its enforcement mechanisms are weaker than in the case of tariffs, and so far countries that have been increasing subsidies have not been challenged.

The volume of international trade has since rebounded strongly, growing by around 14.5 percent on the back of a 3.1 percent increase in the size of the global economy in 2010. As this happened, protectionist pressures abated somewhat. Trade rebounded more strongly in developing nations than in the developed world. China, in particular, saw a massive 28.5 percent leap in the volume of its exports, which created additional trade tensions.⁵⁷

Case Discussion Questions

1. Why do you think calls for protectionism are greater during sharp economic contractions than during boom periods?
2. Despite the sharp economic contraction during 2008–2009, the increase in protectionist measures was fairly modest. Why do you think this was the case?
3. During 2008–2009 many developed nations gave subsidies to their automobile producers. How might this have distorted international trade? Was this a reasonable thing to do given the circumstances?
4. What might occur if a renewed economic slowdown triggered a wave of protectionist measures

around the world? Would protectionism actually protect jobs, or would it make things worse?

5. The volume of world trade rebounded sharply in 2010 on the back of a fairly modest growth rate in the world economy. What does this tell you

about the nature of international production in today's global economy? What does this tell you about the vulnerability of the world economy to any future trade wars?

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