appendix

International Trade and the Balance of Payments

International trade involves the sale of goods and services to residents in other countries (exports) and the purchase of goods and services from residents in other countries (imports). A country's **balance-of-payments accounts** keep track of the payments to and receipts from other countries for a particular time period. These include payments to foreigners for imports of goods and services, and receipts from foreigners for goods and services exported to them. A summary copy of the U.S. balance-of-payments accounts for 2017 is given in Table A.1. In this appendix, we briefly describe the form of the balance-of-payments accounts, and we discuss whether a current account deficit, often a cause of much concern in the popular press, is something to worry about.

balance-of-payments accounts
National accounts that track both payments to and receipts from foreigners.

A.1 TABLE
U.S. Balance-of-Payments Accounts, 2017

Current Account	$ Millions
Exports of goods, services, and income receipts (credits)	$3,408,188
Goods	1,550,720
Services	780,879
Primary income receipts	926,862
Secondary income receipts	149,728
Imports of goods, services, and income (debits)	**3,874,434**
Goods	2,361,932
Services	538,108
Primary income payments	709,864
Secondary income payments	264,530
Capital Account	
Capital transfer receipts	24,868
Capital transfer debits	21
Financial Account	
Net U.S. acquisition of financial assets	1,212,361
Net U.S. incurrence of liabilities	1,587,915
Net financial derivatives	26,363
Statistical discrepancy	92,208
Balances	
Balance on current account	−466,246
Balance on capital account	24,847
Balance on financial account	−441,399

Source: Bureau of Economic Analysis.

current account
In the balance of payments, records transactions involving the export or import of goods and services.

current account deficit
The current account of the balance of payments is in deficit when a country imports more goods, services, and income than it exports.

current account surplus
The current account of the balance of payments is in surplus when a country exports more goods, services, and income than it imports.

capital account
In the balance of payments, records transactions involving one-time changes in the stock of assets.

financial account
In the balance of payments, transactions that involve the purchase or sale of assets.

BALANCE-OF-PAYMENTS ACCOUNTS

Balance-of-payments accounts are divided into three main sections: the current account, the capital account, and the financial account (to confuse matters, what is now called the capital account until recently was part of the current account, and the financial account used to be called the capital account). The **current account** records transactions that pertain to four categories, all of which can be seen in Table A.1. The first category, goods, refers to the export or import of physical goods (e.g., agricultural foodstuffs, autos, computers, chemicals). The second category is the export or import of services (e.g., intangible products such as banking and insurance services, royalty payments on intellectual property, and earnings from foreign tourists who visit the U.S.). The third category, primary income receipts or payments, refers to income from foreign investments or payments to foreign investors (e.g., interest and dividend receipts or payments). The third category also includes payments that foreigners have made to U.S. residents for work performed outside the United States and payments that U.S. entities make to foreign residents. The fourth category, secondary income receipts or payments, refers to the transfer of a good, service, or asset to the U.S. government or U.S. private entities, or the transfer to a foreign government or entity in the case of payments (this includes tax payments, foreign pension payments, cash transfers, etc.).

A **current account deficit** occurs when a country imports more goods, services, and income than it exports. A **current account surplus** occurs when a country exports more goods, services, and income than it imports. Table A.1 shows that in 2017 the United States ran a current account deficit of $466.25 billion. This is often a headline-grabbing figure and is widely reported in the news media. The U.S. current account deficit reflects the fact that America imports far more physical goods than it exports. (The United States typically runs a surplus on trade in services and on income payments.)

The 2006 current account deficit of $803 billion was the largest on record and was equivalent to about 6.5 percent of the country's GDP. The deficit has shrunk since then. The 2017 current account deficit represented just 2.4 percent of GDP. Many people find the fact that the United States runs a persistent deficit on its current account to be disturbing, the common assumption being that high import of goods displaces domestic production, causes unemployment, and reduces the growth of the U.S. economy. However, the issue is more complex than this. Fully understanding the implications of a large and persistent deficit requires that we look at the rest of the balance-of-payments accounts.

The **capital account** records one-time changes in the stock of assets. As noted earlier, until recently this item was included in the current account. The capital account includes capital transfers, such as debt forgiveness and migrants' transfers (the goods and financial assets that accompany migrants as they enter or leave the country). In the big scheme of things, this is a relatively small figure amounting to $24.8 billion in 2017.

The **financial account** (formerly the capital account) records transactions that involve the purchase or sale of assets. Thus, when a German firm purchases stock in a U.S. company or buys a U.S. bond, the transaction enters the U.S. balance of payments as a credit on the financial account. This is because capital is flowing into the country. When capital flows out of the United States, it enters the financial account as a debit.

The financial account is comprised of a number of elements. The net U.S. acquisition of financial assets includes the change in foreign assets owned by the U.S. government (e.g., U.S. official reserve assets) and the change in foreign assets owned by private individuals and corporations (including changes in assets owned through foreign direct investment). As can be seen from Table A.1, in 2017 there was a $1.212 trillion increase in U.S. ownership of foreign assets, which tells us that the U.S. government and U.S. private entities were purchasing more foreign assets than they were selling. The net U.S. incurrence of liabilities refers to the change in U.S. assets owned by foreigners. In 2017 foreigners increased their holdings of U.S. assets by $1.587 trillion, signifying that foreigners were net acquirers of U.S. stocks, bonds (including Treasury bills), and physical assets such as real estate.

A basic principle of balance-of-payments accounting is double-entry bookkeeping. Every international transaction automatically enters the balance of payments twice—once as a credit and once as a debit. Imagine that you purchase a car produced in Japan by Toyota for $20,000.

Because your purchase represents a payment to another country for goods, it will enter the balance of payments as a debit on the current account. Toyota now has the $20,000 and must do

something with it. If Toyota deposits the money at a U.S. bank, Toyota has purchased a U.S. asset—a bank deposit worth $20,000—and the transaction will show up as a $20,000 credit on the financial account. Or Toyota might deposit the cash in a Japanese bank in return for Japanese yen. Now the Japanese bank must decide what to do with the $20,000. Any action that it takes will ultimately result in a credit for the U.S. balance of payments. For example, if the bank lends the $20,000 to a Japanese firm that uses it to import personal computers from the United States, then the $20,000 must be credited to the U.S. balance-of-payments current account. Or the Japanese bank might use the $20,000 to purchase U.S. government bonds, in which case it will show up as a credit on the U.S. balance-of-payments financial account.

Thus, any international transaction automatically gives rise to two offsetting entries in the balance of payments. Because of this, the sum of the current account balance, the capital account, and the financial account balance should always add up to zero. In practice, this does not always occur due to the existence of "statistical discrepancies," the source of which need not concern us here (note that in 2017, the statistical discrepancy amounted to $92.2 billion).

DOES THE CURRENT ACCOUNT DEFICIT MATTER?

As discussed earlier, there is some concern when a country is running a deficit on the current account of its balance of payments.[40] In recent years, a number of rich countries, including most notably the United States, have run persistent current account deficits. When a country runs a current account deficit, the money that flows to other countries can then be used by those countries to purchase assets in the deficit country. Thus, when the United States runs a trade deficit with China, the Chinese use the money that they receive from U.S. consumers to purchase U.S. assets such as stocks, bonds, and the like. Put another way, a deficit on the current account is financed by selling assets to other countries—that is, by increasing liabilities on the financial account. Thus, the persistent U.S. current account deficit is being financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to other countries. In short, countries that run current account deficits become net debtors.

For example, as a result of financing its current account deficit through asset sales, the United States must deliver a stream of interest payments to foreign bondholders, rents to foreign landowners, and dividends to foreign stockholders. One might argue that such payments to foreigners drain resources from a country and limit the funds available for investment within the country. Because investment within a country is necessary to stimulate economic growth, a persistent current account deficit can choke off a country's future economic growth. This is the basis of the argument that persistent deficits are bad for an economy. However, things are not this simple. For one thing, in an era of global capital markets, money is efficiently directed toward its highest value uses, and over the past quarter of a century, many of the highest value uses of capital have been in the United States. So even though capital is flowing out of the United States in the form of payments to foreigners, much of that capital finds its way right back into the country to fund productive investments in the United States. In short, it is not clear that the current account deficit chokes off U.S. economic growth. In fact, notwithstanding the 2008–2009 recession, the U.S. economy has grown substantially over the past 30 years, despite running a persistent current account deficit and despite financing that deficit by selling U.S. assets to foreigners. This is precisely because foreigners reinvest much of the income earned from U.S. assets and from exports to the United States right back into the United States. This revisionist view, which has gained in popularity in recent years, suggests that a persistent current account deficit might not be the drag on economic growth it was once thought to be.[41]

Having said this, there is still a nagging fear that at some point, the appetite that foreigners have for U.S. assets might decline. If foreigners suddenly reduced their investments in the United States, what would happen? In short, instead of reinvesting the dollars that they earn from exports and investment in the United States back into the country, they would sell those dollars for another currency, European euros, Japanese yen, or Chinese yuan, for example, and invest in euro-, yen-, and yuan-denominated assets instead. This would lead to a fall in the value of the dollar on foreign exchange markets, and that in turn would increase the price of imports and lower the price of U.S. exports, making them more competitive, which should reduce the overall level of the current account deficit. Thus, in the long run, the persistent U.S. current account deficit could be corrected via a reduction in the value of the U.S. dollar. The concern is

U.S. and South Korea Strike a Revised Trade Deal

opening case

In 2012, a free trade deal between the United States and South Korea went into effect. In 2016, the United States exported $63.8 billion in goods and services to South Korea, and imported $80.8 billion, resulting in a trade deficit of $17 billion. During the U.S. election campaign in 2016, Donald Trump, who became President in 2017, called the deal "horrible" and a "job killer."

Given Trump's hostility to the free trade deal, it was no surprise when in January 2018, the U.S. announced that it was entering into negotiations with South Korea to revise the terms of the agreement. Complicating matters were two factors. First, in early March 2018, the Trump administration placed a 25 percent tariff on imports of steel. As the third largest supplier of foreign steel to the United States, these tariffs threatened to harm the South Korean steel industry. Moreover, the global tariffs were technically in violation of the World Trade Organization treaty, to which both the United States and South Korea were signatories. Second, South Korea is an important U.S. ally. The country's support was crucial in putting pressure on North Korea to halt its nuclear weapons program. Given this, many observers wondered why the Trump Administration was pressuring South Korea at a time when it needed to work together with the nation to keep North Korea in check.

Perhaps because of geopolitical considerations, the negotiations proceeded very quickly. Trade in automobiles was central to the negotiations, since the Trump Administration saw that as a primary cause of the trade deficit. In 2017, the United States imported nearly $16 billion worth of South Korean passenger cars, but exported only $1.5 billion worth to South Korea. It should also be noted that significant automobile production in the U.S. is concentrated in swing states such as Michigan and Ohio, which helped elect Trump to the presidency.

In late March, the two countries announced that they had reached a revised deal. Under the terms of this deal, South Korea would be exempt from the 25 percent tariff on steel imports into the United States. Instead, South Korea agreed to a quota which would limit its steel exports to the U.S. to about 70 percent of what they had been in 2017.

In return, South Korea made two concessions. First, the deal extended for 20 years a 25 percent tariff on exports of South Korean light trucks to the United States (under the original agreement, the 25 percent tariff was set to expire in 2021). This will likely be a significant boon to U.S. auto manufactures, since the light truck segment is one that they dominate. Second, the Koreans agreed to lift their annual quota on imports of U.S. cars into the country from 25,000 per manufacturer to 50,000 per manufacturer. Beyond that, U.S. cars sold in South Korea would have to adhere to Korea's stringent safety and environmental standards, which the Trump Administration has characterized as "burdensome regulations" designed to

continued

make it difficult for U.S. companies to sell vehicles in Korea. That being said, the reality is that U.S. auto companies were not even close to reaching the old quota limit of 25,000 cars a year, so lifting the cap may be primarily symbolic.

The deal will also establish a side agreement between the United States and South Korea that is intended to deter "competitive devaluation" of both countries' currencies—which can artificially lower the cost of imports bought by consumers—and to create more transparency on issues of monetary policy. Administration officials suggested that this new type of arrangement was likely to be replicated in other trade deals, though they acknowledged that it was not enforceable.

The deal allows President Trump to claim that his "get tough" approach to trade negotiations works. For their part, the South Koreans were reportedly pleased that they didn't have to give ground on opening up their agricultural industry to U.S. imports, where administrative tariff barriers have limited importation of some low-priced American foodstuffs such as rice and potatoes. ●

Sources: Michael Shear and Alan Rappeport, "Trump Secures Trade Deal with South Korea Ahead of Nuclear Talks," *The New York Times*, March 27, 2018; Scott Horsley, "Trump Administration Strikes Trade Deal with South Korea," *NPR Politics*, March 27, 2018; Patrick Gillespie, "New US Deal with South Korea: What You Need to Know," *CNN Money*, March 28, 2018.

Introduction

free trade
The absence of barriers to the free flow of goods and services between countries.

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 they can make most efficiently, while importing products 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. For example, the opening case suggests that the United States renegotiated a free trade deal with South Korea in order to protect the interests of U.S. automobile companies, particularly in the profitable light truck segment where Korean imports will face a 25 percent tariff for another 20 years (the tariff was set to expire in 2021). 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 (one could argue that this was the case with the South Korean trade deal). Normally, their motives are to protect domestic producers (in this case, U.S. steel and auto producers). In recent years, social issues have also 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 (GATT)** and its successor, the World Trade Organization. The GATT and WTO are the creations of a series of multinational treaties. The final section of this chapter discusses the implications of this material for management practice.

General Agreement on Tariffs and Trade (GATT)
International treaty that committed signatories to lowering barriers to the free flow of goods across national borders and led to the WTO.

Instruments of Trade Policy

LO 7-1
Identify the policy instruments used by governments to influence international trade flows.

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.

tariff
A tax levied on imports.

specific tariff
Tariff levied as a fixed charge for each unit of good imported.

ad valorem tariff
A tariff levied as a proportion of the value of an imported good.

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 (e.g., $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 to 30 percent on imports of foreign steel. The idea was to protect domestic steel producers from cheap imports of foreign steel. In this case, however, the effect 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. Interestingly, this ruling did not stop Donald Trump from imposing a 25 percent tariff on imports of foreign steel in March 2018. If the tariffs are challenged, as seems likely, the WTO will in all probability reach a similar conclusion.

Did You Know?
Did you know that the high price of SUVs in the United States is the result of the "chicken tariff"?

Visit your instructor's Connect® course and click on your eBook or SmartBook® to view a short video explanation from the authors.

In general, two conclusions can be derived from economic analysis of the effect of import tariffs.[1] First, tariffs are generally pro-producer and anticonsumer. 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. Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices. 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 could be produced more efficiently abroad. The consequence is an inefficient utilization of resources.[2]

Sometimes tariffs are levied on exports of a product from a country. Export tariffs are 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

Which Country Is Really the Most Globally Competitive?

The World Economic Forum is an independent international organization committed to improving the state of the world by engaging business, political, academic, and other leaders of society to shape global, regional, and industry agendas. The World Economic Forum also conducts global economic research and annually publishes country competitive rankings. Over the years, northern and western European countries have dominated the top 10 most globally competitive nations. The United States and Japan typically also hold strong positions. But is it really fair that the "global competitiveness" ranking indicates that relatively small Nordic countries such as Finland and Sweden are viewed as being as competitive as the United States and Japan? Should larger countries, with more people and a larger economy be given preferential treatment in ranking such as when the topic is on "global competitiveness"?

Source: www.weforum.org.

alleviating tensions with other trading partners. China also had tariffs on steel exports but removed many of those in late 2015.

subsidy
Government financial assistance to a domestic producer.

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. Agriculture tends to be one of the largest beneficiaries of subsidies in most countries. The European Union has been paying out about €44 billion annually ($55 billion) in farm subsidies. The farm bill that passed the U.S. Congress in 2007 contained subsidies of $289 billion for the next 10 years. The Japanese also have a long history of supporting inefficient domestic producers with farm subsidies. According to the World Trade Organization, in mid-2000 countries spent some $300 billion on subsidies, $250 billion of which was spent by 21 developed nations.[3] 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. Somewhat ironically, given the government bailouts of U.S. auto companies during the global financial crisis, in 2012 the Obama administration filed a complaint with the WTO arguing that the Chinese were illegally subsidizing exports of autos and auto parts. Details are given in the accompanying Country Focus feature.

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

country FOCUS

Are the Chinese Illegally Subsidizing Auto Exports?

In late 2012, during that year's presidential election campaign, the Obama administration filed a complaint against China with the World Trade Organization. The complaint claimed that China was providing export subsidies to its auto and auto parts industries. The subsidies included cash grants for exporting, grants for R&D, subsidies to pay interest on loans, and preferential tax treatment.

The United States estimated the value of the subsidies to be at least $1 billion between 2009 and 2011. The complaint also pointed out that in the years 2002 through 2011, the value of China's exports of autos and auto parts increased more than ninefold from $7.4 billion to $69.1 billion. The United States was China's largest market for exports of auto parts during this period. The United States asserted that, to some degree, this growth may have been helped by subsidies. The complaint went on to claim that these subsidies hurt producers of automobiles and auto parts in the United States. This is a large industry in the United States, employing more than 800,000 people and generating some $350 billion in sales.

While some in the labor movement applauded the move, the response from U.S. auto companies and auto parts producers was muted. One reason for this is that many U.S. producers do business in China and, in all probability, want to avoid retaliation from the Chinese government. GM, for example, has a joint venture and two wholly owned subsidiaries in China and is doing very well there. In addition, some U.S. producers benefit by purchasing cheap Chinese auto parts, so any retaliatory tariffs imposed on those imports might actually raise their costs.

More cynical observers saw the move as nothing more than political theater. The week before the complaint was filed, the Republican presidential candidate, Mitt Romney, had accused the Obama administration of "failing American workers" by not labeling China a currency manipulator. So perhaps the complaint was in part simply another move on the presidential campaign chessboard.

In February 2014, the United States expanded its complaint with the WTO against China, arguing that the country had an illegal export subsidy program that includes not only auto parts, but also textiles, apparel and footwear, advanced materials and metals, speciality chemicals, medical products and agriculture. In 2016, after pressure from the WTO and U.S., China agreed to eliminate a wide range of subsidies for its exporters. Michael Froman, the U.S. Trade Representative, announced the deal, calling it "a win for Americans employed in seven diverse sectors that run the gamut from agriculture to textiles."

Sources: James Healey, "U.S. Alleges Unfair China Auto Subsidies in WTO Action," *USA Today*, September 17, 2012; M. A. Memoli, "Obama to Tell WTO That China Illegally Subsidizes Auto Imports," *Los Angeles Times*, September 17, 2012; Vicki Needham, "US Launches Trade Case against China's Export Subsidy Program," *The Hill*, February 11, 2014; and David J. Lynch, "China Eliminates Subsidies for Its Exporters," *Financial Times*, April 14, 2016.

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. 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.[4] Another study estimated that removing all barriers to trade in agriculture (both subsidies and tariffs) would raise world income by $182 billion.[5] This increase in wealth arises from the more efficient use of agricultural land.

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. Similarly, under the terms of a new trade agreement, South Korea has agreed to a quota on exports of its steel to the United States (see the opening case).

import quota
A direct restriction on the quantity of a good that can be imported into a country.

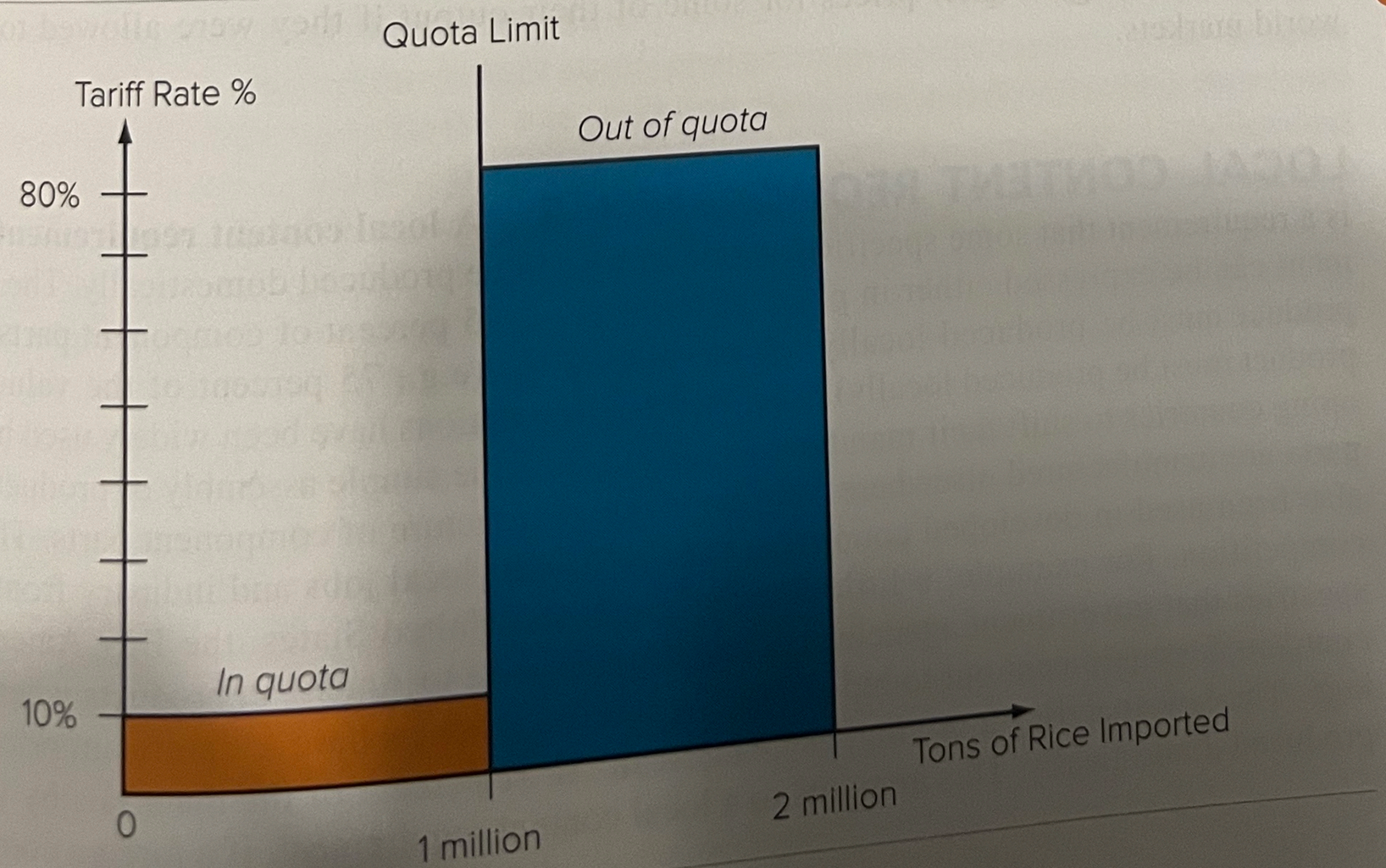
A common hybrid of a quota and a tariff is known as a tariff rate quota. Under a **tariff rate quota**, a lower tariff rate is applied to imports within the quota than those over the quota. For example, as illustrated in Figure 7.1, an ad valorem tariff rate of 10 percent might be levied on 1 million 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.

tariff rate quota
Lower tariff rates applied to imports within the quota than those over the quota.

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. For example, in 2012 Brazil imposed what amounts to voluntary export restraints on shipments of vehicles from Mexico to Brazil. The two countries

voluntary export restraint (VER)
A quota on trade imposed from the exporting country's side, instead of the importer's; usually imposed at the request of the importing country's government.

7.1 FIGURE
Hypothetical tariff rate quota.



have a decade-old free trade agreement, but a surge in vehicles heading to Brazil from Mexico prompted Brazil to raise its protectionist walls. Mexico has agreed to quotas on Brazil-bound vehicle exports for the next three years.[6] 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 extra profit that producers make when supply is artificially limited by an import quota is referred to as a **quota rent**.

quota rent
Extra profit producers make when supply is artificially limited by an import quota.

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.[7] 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.

EXPORT TARIFFS AND BANS

export tariff
A tax placed on the export of a good.

An **export tariff** is a tax placed on the export of a good. The goal behind an export tariff is to discriminate *against* exporting in order to ensure that there is sufficient supply of a good within a country. For example, in the past, China has placed an export tariff on the export of grain to ensure that there is sufficient supply in China. Similarly, during its infrastructure building boom, China had an export tariff in place on certain kinds of steel products to ensure that there was sufficient supply of steel within the country. The steel tariffs were removed in late 2015. Because most countries try to encourage exports, export tariffs are relatively rare.

export ban
A policy that partially or entirely restricts the export of a good.

An **export ban** is a policy that partially or entirely restricts the export of a good. One well-known example was the ban on exports of U.S. crude oil production that was enacted by Congress in 1975. At the time, Organization of the Petroleum Exporting Countries (OPEC) was restricting the supply of oil in order to drive up prices and punish Western nations for their support of Israel during conflicts between Arab nations and Israel. The export ban in the United States was seen as a way of ensuring a sufficient supply of domestic oil at home, thereby helping to keep the domestic price down and boosting national security. The ban was lifted in 2015 after lobbying from American oil producers, who believed that they could get higher prices for some of their output if they were allowed to sell on world markets.

LOCAL CONTENT REQUIREMENTS

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

A **local content requirement** (LCR) 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.

Is Having a Local Content Requirement a Good Idea?

Local content requirements refer to a specific fraction of a product that needs to be manufactured domestically. Basically, LCRs establish a minimum level of local content required under trade law when giving foreign companies the right to manufacture in a particular place. In the wake of the economic downturn in 2008, many economists feared that some governments would institute protectionist policies similar to the tariff escalations during the Great Depression of the 1930s. However, most public policy officials avoided traditional forms of protection (e.g., tariffs, quotas). This led some observers to underestimate the degree of protectionism. Instead, what had happened was that so-called nontariff barriers in the form of local content requirements had become increasingly popular. As a (1) citizen of a specific country and (2) as a global customer, do you think local content requirements help you as a citizen of a country, as a global customer, as both, or as neither?

Source: G. C. Hufbauer and J. J. Scott, "Local Content Requirements: A Global Problem," Washington, D.C., Peterson Institute for Global Economics, 2013.

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, Japan's car market has been hard for foreigners to crack. In 2016, only 6 percent of the 4.9 million cars sold in Japan were foreign, and only 1 percent were U.S. cars. American car makers have argued for decades that Japan makes it difficult to compete by setting up regulatory hurdles, such as vehicle parts standards, that don't exist anywhere else in the world. Ironically, the Trans Pacific Partnership (TPP) addressed this issue. America would have reduced tariffs on imports of Japanese light trucks in return for Japan adopting U.S. standards on auto parts, which would have made it easier to import and sell American cars in Japan. However, President Donald Trump pulled America out of the TPP in January 2017.[8]

administrative trade policies
Administrative policies, typically adopted by government bureaucracies, that can be used to restrict imports or boost exports.

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.

dumping
Selling goods in a foreign market for less than their cost of production or below their "fair" market value.

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 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 (ITC). 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. The accompanying Management Focus discusses how a firm, U.S. Magnesium, used antidumping legislation to gain protection from unfair foreign competitors.

antidumping policies
Designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.

countervailing duties
Antidumping duties.

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Protecting U.S. Magnesium

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 spokesperson 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 spokesperson 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 faced 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. The ITC revoked the antidumping order on Russia in February 2011 but decided to continue placing the duties on Chinese producers. They were finally removed by the ITC in 2014.

According to U.S. Magnesium, the initial favorable ruling allowed the company to reap the benefits of nearly $50 million in investments made in its manufacturing plant and enabled the company to boost its capacity by 28 percent by the end of 2005. Commenting on the favorable ruling, a U.S. Magnesium spokesperson 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 as one of unfair trade. While the imposition of antidumping duties no doubt helped to protect U.S. Magnesium and the 400 people it employed from foreign competition, magnesium consumers in the United States felt they were the ultimate losers, a view that seemed to be confirmed by price data. In early 2010, the price for magnesium alloy in the United States was $2.30 per pound, compared to $1.54 in Mexico, $1.49 in Europe, and $1.36 in China.

Sources: D. Anderton, "U.S. Magnesium Lands Ruling on Unfair Imports," *Deseret News*, October 1, 2004, p. D10; "U.S. Magnesium and Its Largest Consumers Debate before U.S. ITC," *Platt's Metals Week*, February 28, 2005, p. 2; S. Oberbeck, "U.S. Magnesium Plans Big Utah Production Expansion," *Salt Lake Tribune*, March 30, 2005; "US to Keep Antidumping Duty on China Pure Magnesium," *Chinadaily.com*, September 13, 2012.; Lance Duronl, "No Duties for Chinese Magnesium Exporter, CIT Affirms," *Law360*, June 2, 2015; and Dan Ikenson, "Death by Antidumping," *Forbes*, January 3, 2011.

LO 7-2
Understand why governments sometimes intervene in international trade.

The Case for Government Intervention

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. Competition is most often viewed as unfair when producers in an exporting country are subsidized in some way by their government. For example, it has been repeatedly claimed that Chinese enterprises in several industries, including aluminum, steel, and auto parts, have benefited from extensive government subsidies. Such logic was behind the complaint that the Obama administration filed with the WTO against Chinese auto parts producers in 2012 (see the Country Focus "Are the Chinese Illegally Subsidizing Auto Exports?" in this chapter). More generally, Robert Scott of the Economic Policy Institute has claimed that the growth in the U.S.–China trade deficit between 2001 and 2015 was, to a significant degree, the result of unfair competition, including direct subsidies to Chinese producers and currency manipulations. Scott estimated that as many as 3.4 million U.S. jobs were lost as a consequence.[9] Donald Trump tapped into anxiety about job losses due to unfair trade from China during his successful 2016 presidential run.

On the other hand, critics charge that claims of unfair competition are often overstated for political reasons. For example, President George W. Bush placed tariffs on imports of foreign steel in 2002 as a response to "unfair competition," but critics were quick to point out that many of the U.S. steel producers that benefited from these tariffs were located in states that Bush needed to win reelection in 2004. 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.

Protecting 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, and semiconductors). Although now uncommon, this argument is still made sometimes. When the Trump Administration announced tariffs on imports of foreign steel and aluminum on March 1, 2018, national security issues were cited as a primary justification. This was the first time since 1986 that a national security threat was used to justify tariffs imposed by the United States. In 2017, the United States was importing about 30 percent of steel used in the country, with the largest source of imports being Canada and Mexico. Interestingly, and counter to the argument of the Trump Administration, critics argued that by raising input prices for many U.S. defense contractors, who tend to be big consumers of steel and aluminum, the tariffs would actually harm the U.S. defense industry and have a negative impact on national security.[10]

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Trade Law

Government policy and international trade is the core focus of this chapter. This topic area has far-ranging implications, such as trade policy, free trade, and the world's international trading system. Basically, we are talking about a lot of legalistic aspects starting at the government level and moving all the way to what organizations and even individuals can and cannot do globally when trading. The globalEDGE™ section "Trade Law" (globaledge.msu.edu/global-resources/trade-law) is a unique compilation of globalEDGE™ partner-designed "compendiums of trade laws," country- and region-specific trade law, free online learning modules created for globalEDGE™ on various aspects of trade law, and much more. One fascinating resource related to trade law is the Anti-Counterfeiting and Product Protection Program (A-CAPPP). A-CAPPP includes counterfeiting-related webinars, presentations, and research-related materials and working papers. Do you know what counterfeiting is? Take a look at the "Trade Law" section of globalEDGE™ and especially the A-CAPPP site to become more familiar with the topic. (Is China really as bad as many in the international community think?)

Retaliating

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.[11]

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, 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 designed 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 (e.g., Japan required that all beef must come from cattle under 21 months of age).

Furthering Foreign Policy Objectives

Governments sometimes use trade policy to support their foreign policy objectives.[12] 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 (despite the move by the Obama administration to "normalize" relations with Cuba, these sanctions are still in place). 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 has also had trade sanctions in place against Libya and Iran, both of which were accused 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. The U.S. government responded by relaxing those sanctions. Similarly, the U.S. government used trade sanctions to pressure the Iranian government to halt its alleged nuclear weapons program. Following a 2015 agreement to limit Iran's nuclear program, it relaxed some of those sanctions.

Other countries can undermine unilateral trade sanctions. The U.S. sanctions against Cuba, for example, did not stop 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.



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The famous cigar maker Jose Castelar Cairo, better known as El Cueto, about to roll a cigar, in Havana, Cuba.

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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 example, as discussed in Chapter 5, the U.S. government long had trade sanctions in place against the nation of Myanmar, in no small part due to the poor human rights practices in that nation. In late 2012, the United States said that it would ease trade sanctions against Myanmar in response to democratic reforms in that country. Similarly, in the 1980s and 1990s, Western governments used trade sanctions against South Africa as a way of pressuring that nation to drop its apartheid policies, which were seen as a violation of basic human rights.

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.

infant industry argument
New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with the firms of developed nations.

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.[13]

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 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.[14] 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.

strategic trade policy
Government policy aimed at improving the competitive position of a domestic industry and/or domestic firm in the world market.

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 rise to dominance in the production of liquid crystal display screens (used in 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, Boeing's major competitor (see the opening case). 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 2017, it was splitting the market with Boeing. How did Airbus achieve this? According to the U.S. government, the answer is an $18 billion subsidy from the governments of Great Britain, France, Germany, and Spain.[15] 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

LO 7-3
Summarize and explain the arguments against strategic trade policy.

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.[16]

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. It should also be noted that antidumping policies can be used to target competitors supported by subsidies who are selling goods at prices that are below their costs of production.

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.[17]

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LO 7-4
Describe the development of the world trading system and the current trade issue.

Development of the World Trading System

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 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.[18]

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 (GATT). Since 1995, it has been known as the World Trade Organization (WTO). Here, we look at the evolution and workings of the GATT and WTO.

FROM SMITH TO THE GREAT DEPRESSION

Smoot–Hawley Act
Enacted in 1930 by the U.S. Congress, this act erected a wall of tariff barriers against imports into the United States.

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. 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"

Do You Believe in Free Trade Agreements?

The benefits of free trade agreements are often hard to see. At the same time, the benefits of protecting certain industries and/or companies from foreign competition are often very visible. Given these scenarios, many people often argue that free trade agreements are bad for their country. Perhaps as a result, many governments impose many tariffs, quotas, and other nontariff barriers to trade. For example, the common perception is that by establishing trade barriers, a country keeps the jobs at home instead of jobs being shipped overseas. But is this really true?

Source: D. J. Boudreaux, *The Benefits of Free Trade: Addressing the Myths* (Washington, DC: Mercatus Center, George Mason University, 2013).

tariff. The Smoot–Hawley Act had a damaging effect on employment abroad. Other countries reacted by raising their own tariff barriers. U.S. exports tumbled in response, and the world slid further into the Great Depression.[19]

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.

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 1973–1979. 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.

1980–1993: PROTECTIONIST TRENDS

During the 1980s and early 1990s, the trading system erected by the GATT came under strain as pressures for greater protectionism increased around the world. There were three reasons for 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. 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 (VERs) circumvented GATT agreements, because neither the importing country nor the exporting country complained to the GATT bureaucracy in Geneva—and without a complaint, the GATT bureaucracy could do nothing. Exporting countries agreed to VERs to avoid more damaging punitive tariffs. One of the best-known examples was 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, 16 percent of the imports of industrialized countries in 1986 were subjected to nontariff trade barriers such as VERs.[20]

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 ambitious round of negotiations yet. 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 on 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.

The World Trade Organization

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 in 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.[21]

WTO: EXPERIENCE TO DATE

By 2017, the WTO had 164 members, including China, which joined at the end of 2001, and Russia, which joined in 2012. WTO members collectively account for 98 percent of world trade. Since its formation, the WTO has remained at the forefront of efforts to promote global free trade. Its creators expressed the belief 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 mixed. After a strong early start, since the late 1990s the WTO has been unable to get agreements to further reduce barriers to international trade and trade and investment. There has been very slow progress with the current round of trade talks (the Doha Round). There was also a shift back toward some limited protectionism following the global financial crisis of 2008–2009. More recently, the 2016 vote by the British to leave the European Union (Brexit) and the election of Donald Trump to the presidency in the United States have suggested that the world may be shifting back toward greater protectionism. These developments have raised a number of questions about the future direction of the WTO.

WTO as Global Police

The first two decades in the life of the WTO suggest that its policing and enforcement mechanisms are having a positive effect.[22] Between 1995 and 2017, more than 500 trade disputes between member countries were brought to the WTO.[23] 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 have 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.

Expanded Trade Agreements As explained earlier, 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. 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 telephone, data, 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.

This was followed in December 1997 with an agreement to liberalize cross-border trade in financial services. The deal covered 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.

Should a Standard Process Be in Place for Import Licenses?

Import licenses are permits granted before a product is imported. The administrative procedures for obtaining the licenses should be simple, neutral, equitable, and transparent. Where possible, they should be given automatically and quickly, and even if they are nonautomatic, they should not obstruct trade unnecessarily. Australia, Turkey, the European Union, Norway, Thailand, the United States, New Zealand, Costa Rica, Colombia, Peru, Chinese Taipei, Japan, the Republic of Korea, Switzerland, and Canada said their producers and traders reported that exports to Argentina have declined or been delayed by Argentina's licensing processes and requirements, which some described as "protectionist." Should there be a standardized process and timeline for processing import licenses in member countries of the World Trade Organization?

Source: World Trade Organization, "Members Continue to Criticize Argentina's Import Licensing," 2012, www.wto.org/english/news_e/news12_e/impl_27apr12_e.htm.

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

Since the successes of the 1990s, the World Trade Organization has struggled to make progress on the international trade front. Confronted by a slower growing world economy after 2001, many national governments have been reluctant to agree to a fresh round of policies designed to reduce trade barriers. Political opposition to the WTO has been growing in many nations. As the public face of globalization, some politicians and nongovernmental organizations blame the WTO for a variety of ills, including high unemployment, environmental degradation, poor working conditions in developing nations, falling real wage rates among the lower paid in developed nations, and rising income inequality. The rapid rise of China as a dominant trading nation has also played a role here. Reflecting sentiments like those toward Japan 25 years ago, many perceive China as failing to play by the international trading rules, even as it embraces the WTO.

Against this difficult political backdrop, much remains to be done on the international trade front. Four issues at the forefront of the agenda of the WTO are 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 now seem to be stalled.

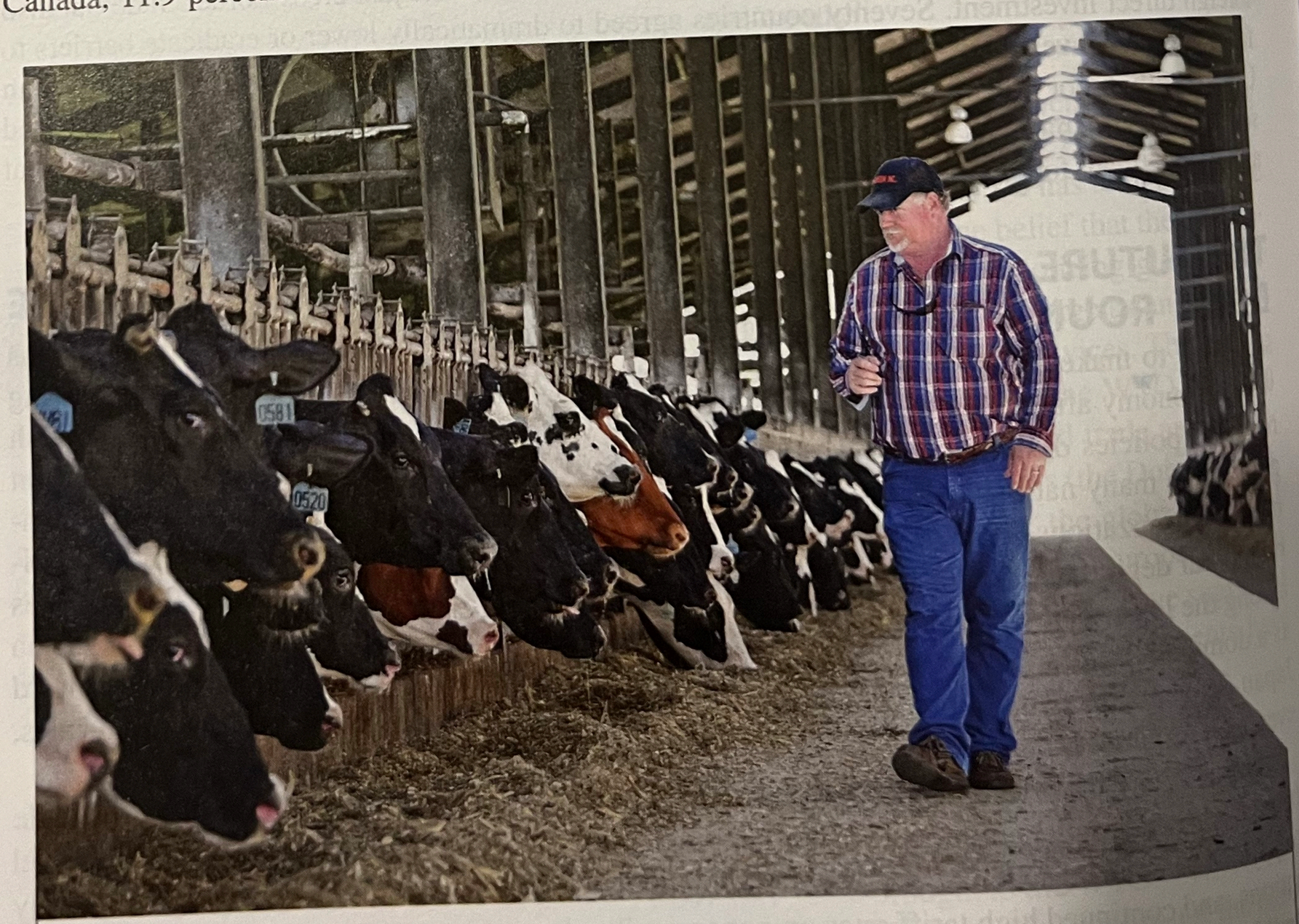
Antidumping Actions

Antidumping actions proliferated during the 1990s and 2000s. 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-2016, WTO members had reported implementation of some 5,132 antidumping actions to the WTO. India initiated the largest number of antidumping actions, some 818; the EU initiated 485 over the same period, and the United States, 593. China accounted for 1,170 complaints, South Korea for 384, the United States for 273, Taipei for 279, and Japan for 202. 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.[24] These sectors account for approximately 70 percent of all antidumping actions reported to the WTO. Since 1995, these four sectors 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, which 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 the use of antidumping policies, suggesting that it reflects persistent protectionist tendencies and pushing members to strengthen the regulations governing the imposition of antidumping duties.

Protectionism in Agriculture

Another 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, the average tariff rates on nonagricultural products among developed nations are around 4 percent. On agricultural products, however, the average tariff rates are 15.4 percent for Canada, 11.9 percent for the European Union, 17.4 percent for Japan, and 4.8 percent for the



Production operations at J.M. Larson Dairy.

©Bloomberg/Getty Images

United States.[25] The implication is that consumers in countries with high tariffs 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 Organisation for Economic Co-operation and Development (OECD), government subsidies on average account for about 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.[26] OECD countries spend more than $300 billion a year in agricultural subsidies.

Not surprisingly, the combination of high tariff barriers and 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 around 10 percent of total merchandized trade, 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.[27] Others suggest gains as high as $182 billion.[28]

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.[29] In other words, free trade in agriculture could help jump-start economic growth among the world's poorer nations and alleviate global poverty.

Protection of 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 was generally 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.

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 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, European Union, and Japan are 2.7 percent, 4.8 percent, and 0 percent, respectively. 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.[30] 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 Doha negotiations could increase world income by $263 billion annually, of which $109 billion would go to poor countries.[31] Another estimate from the OECD suggests a figure closer to $300 billion annually.[32] See the accompanying Country Focus for estimates of the benefits to the American economy from free trade.

Looking farther 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 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.

country FOCUS

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 a result of a shift to a universal free trade regime.

Source: S. C. Bradford, P. L. E. Grieco, and G. C. Hufbauer, "The Payoff to America from Global Integration," in *The United States and the World Economy: Foreign Policy for the Next Decade*, C. F. Bergsten, ed. (Washington, DC: Institute for International Economics, 2005).

A New Round of Talks: Doha

In 2001, the WTO launched a new round of talks between member states aimed at 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. The talks were originally scheduled to last three years, although they have already gone on for 15 years and are currently stalled.

The Doha 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. The talks are currently ongoing. They have been characterized by halting progress punctuated by significant setbacks and missed deadlines. A September 2003 meeting in Cancún, 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. Since then, however, little progress has been made, and the talks are in deadlock, primarily because of disagreements over how deep the cuts in subsidies to agricultural producers should be. As of 2017, 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.

MULTILATERAL AND BILATERAL TRADE AGREEMENTS

In response to the apparent failure of the Doha Round to progress, many nations have pushed forward with **multilateral or bilateral trade agreements**, which are reciprocal trade agreements between two or more partners. For example, in 2014 Australia and China entered into a bilateral free trade agreement. Similarly, in March 2012 the United States entered into a bilateral free trade agreement with South Korea. Under this agreement, 80 percent of U.S. exports of consumer and industrial products became duty free, and 95 percent of bilateral trade in industrial and consumer products will be duty free by 2017 (this agreement was revised in 2018, see the opening case). The agreement is estimated to boost U.S. GDP by some $10 to $12 billion. Under the Obama Administration the United States was pursuing two major multilateral trade agreements, one with 11 other Pacific Rim countries including Australia, New Zealand, Japan, Malaysia, and Chile (the TPP), and another with the European Union. However, following the accession of Donald Trump to the presidency in the United States, the U.S. withdrew from the TPP (although the remaining 11 nations went ahead with a revised agreement) and the trade agreement being negotiated with the EU was put on ice.

multilateral or bilateral trade agreements
Reciprocal trade agreements between two or more partners.

Multilateral and bilateral trade agreements are designed to capture gain from trade beyond those agreements currently attainable under WTO treaties. Multilateral and bilateral trade agreements are allowed under WTO rules, and countries entering into these agreements are required to notify the WTO. As of 2017, more than 440 regional or bilateral trade agreements were in force. Reflecting the lack of progress on the Doha Round, the number of such agreements has increased significantly since the early 2000s, when fewer than 100 were in force.

THE WORLD TRADING SYSTEM UNDER THREAT

In 2016, two events challenged the long-held belief that there was a global consensus behind the 70-year push to embrace free trade and lower barriers to the cross-border flow of goods and services. The first was the decision by the British to withdraw from the European Union following a national referendum (Brexit). We discuss Brexit in more detail in Chapter 9, but it is worth noting that the British intention to withdraw from what is arguably one of the most successful free trade zones in the world is a big setback for those who argue that free trade is a good thing. The second event was the victory of Donald Trump in the 2016 U.S. presidential election. As discussed in Chapter 6, Trump appears to hold mercantilist views on trade. He seems opposed to many free trade deals. Indeed, one of his first actions was to pull the United States

out of the Trans Pacific Partnership, a 12-nation free trade zone that was close to ratification. In early 2018, he placed tariffs on imports of solar panels, washing machines, steel, and aluminum into the United States, in all probability in violation of WTO rules. Trump also initiated the renegotiation of NAFTA and has expressed hostility to the WTO. The significance of these developments is that heretofore both Britain and America have been leaders in the global push toward greater free trade. While Britain still seems committed to free trade, despite the Brexit decision, the position of the United States, the world's largest economy, is less clear. If the U.S. continues to turn its back on new free trade deals (such as the TPP) and dismantles existing ones (as Trump has threatened to do with NAFTA), other nations could follow. If this happens, the impact on the world economy will almost certainly be negative, resulting in greater protectionism, slower economic growth, and higher unemployment around the globe.

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Focus on Managerial Implications

TRADE BARRIERS, FIRM STRATEGY, AND POLICY IMPLICATIONS

LO 7-5

Explain the implications for managers of developments in the world trading system.

What are the implications 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.

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 relative 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 even footing. Second, quotas may limit a firm's ability to serve a country from locations outside 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. Today, Donald Trump's threat to impose high tariffs on companies that shift their production to other nations in order to reduce costs—and then export goods back to the United States—is forcing some enterprises to rethink their outsourcing strategy. In particular, a number of automobile companies, including Ford and General Motors, have modified their plans to shift some production to factories in Mexico and have announced plans to expand U.S. production in order to appease the Trump administration.[33]

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 were 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. For example, 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 to 67 percent on imports of certain steel products from Japan (these tariffs are separate from the steel tariffs discussed earlier).[34]

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 on globally dispersed production systems for their competitive advantage. 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.