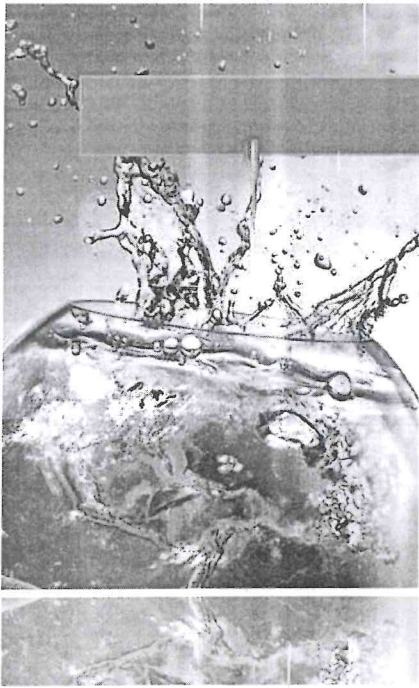




## Chapter Six

# Political Economy of Trade

### Learning Objectives

After studying this chapter, you should be able to

- 6.1** Explain why governments sometimes intervene in trade.
- 6.2** Outline the instruments that governments use to promote trade.
- 6.3** Describe the instruments that governments use to restrict trade.
- 6.4** Summarize the main features of the global trading system.

### A Look Back

Chapter 5 explored theories that have been developed to explain the pattern international trade should take. We examined the important concept of comparative advantage and the conceptual basis for how international trade benefits nations.

### A Look at This Chapter

This chapter discusses the active role of national governments in international trade. We examine the motives for government intervention and the tools that nations use to accomplish their goals. We then explore the global trading system and show how it promotes free trade.

### A Look Ahead

Chapter 7 continues our discussion of the international business environment. We explore recent patterns of foreign direct investment, theories that try to explain why it occurs, and how governments influence investment flows.

## MyLab Management

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## Lord of the Movies

HOLLYWOOD, California—Time Warner ([www.timewarner.com](http://www.timewarner.com)) is a global leader in the media and entertainment industry. Its businesses include television networks (HBO, Turner Broadcasting), publishing (*Time*, *Sports Illustrated*), and film entertainment (New Line Cinema, Warner Bros.). People in almost every nation on the planet view Time Warner's media creations as the firm marches across the globe.

New Line Cinema's *The Lord of the Rings* trilogy, based on the books by J.R.R. Tolkien and directed by filmmaker Peter Jackson, is the most successful film franchise in history. The final installment in the trilogy, *The Lord of the Rings: The Return of the King*, earned more than \$1 billion at the worldwide box office. The entire trilogy earned nearly \$3 billion worldwide and won 17 Academy Awards. New Line Cinema also found enormous success in *The Hobbit* trilogy, also directed by Peter Jackson. Shown here is character Samwise Gamgee's hobbit hole (or *smial*) in Hobbiton, New Zealand.



Jean Mauduit/Alamy Stock Photo

Warner Bros.'s series of *Harry Potter* films, based on the novels of former British schoolteacher J.K. Rowling, have been magically successful. Kids worldwide poured into cinemas to watch young Harry on the silver screen and snatched up *Harry Potter* books in every major language. Warner Bros. also hit it big with the *Batman* film *The Dark Knight*—one of the highest-grossing films ever—and *Wonder Woman*. Warner Bros. also produces mini-movies and games exclusively for its website.

Yet, Time Warner must tread carefully as it expands its reach. Some governments fear that their own nations' writers, actors, directors, and producers will be drowned out by big-budget Hollywood productions such as *The Lord of the Rings*, *Harry Potter*, and *Batman*. Others fear the replacement of their traditional values with those depicted in imported entertainment. Time Warner's global reach is evidenced by the fact that AT&T offered to buy it for \$85 billion. If it obtains regulatory approval, AT&T hopes the deal will help grow and diversify its revenues. As you read this chapter, consider all the cultural, political, and economic reasons why governments regulate international trade.<sup>1</sup>

Chapter 5 presented theories that describe what the patterns of international trade *should* look like. The theory of comparative advantage says that the country that has a comparative advantage in the production of a certain good will produce that good when barriers to trade do not exist. But this ideal does not accurately characterize trade in today's global marketplace. Despite efforts by organizations such as the World Trade Organization ([www.wto.org](http://www.wto.org)) and smaller groups of countries, nations still retain many barriers to trade.

In this chapter, we investigate the political economy of trade. We first explain why nations erect barriers to trade by exploring their cultural, political, and economic motives. We then examine the instruments countries use to restrict imports and exports. Efforts to promote trade by reducing barriers within the context of the global trading system are then presented. In Chapter 8 we discuss how smaller groups of countries are eliminating barriers to both trade and investment.

## 6.1 Why do Governments Intervene in Trade?

**6.1** Explain why governments sometimes intervene in trade.

### free trade

Pattern of imports and exports that occurs in the absence of trade barriers.

The pattern of imports and exports that occurs in the absence of trade barriers is called **free trade**. Despite the advantages of open and free trade among nations, governments have long intervened in the trade of goods and services. Governments impose restrictions on free trade for political, economic, or cultural reasons. For example, countries often intervene in trade by strongly supporting their domestic companies' exporting activities. But the more emotionally charged intervention occurs when a nation's economy is underperforming. In tough economic times, businesses and workers often lobby their governments for protection from imports that are eliminating jobs in the domestic market. Let's take a closer look at the political, economic, and cultural motives for intervention.

### Political Motives

Government officials often make trade-related decisions based on political motives because a politician's career can depend on pleasing voters and getting reelected. Yet, a trade policy based purely on political motives is seldom wise in the long run. The main political motives behind government intervention in trade include protecting jobs, preserving national security, responding to other nations' unfair trade practices, and gaining influence over other nations.

**PROTECT JOBS** Short of an unpopular war, nothing will oust a government faster than high rates of unemployment. Thus, practically all governments become involved when free trade creates job losses at home. For example, Ohio lost around 215,000 manufacturing jobs over a recent 14-year period. Most of those jobs went to China and the nations of Central and Eastern Europe. The despair of unemployed workers and the pivotal role of Ohio in presidential elections lured politicians to the state, who promised Ohio lower income taxes, expanded worker retraining, and greater investment in the state's infrastructure.

But political efforts to protect jobs can draw attention away from free trade's real benefits. General Electric (GE) certainly sent many jobs from the United States to Mexico over the years. GE now employs 30,000 Mexicans at 35 factories that manufacture all sorts of its appliances and other goods. But less known is that GE also sold Mexican companies \$350 million worth of its turbines made in Texas, 100 of its locomotives made in Pennsylvania, and dozens of its US-made aircraft engines. Mexico specializes in making products that require less-expensive labor, and the United States specializes in producing goods that require advanced technology and a large investment of capital.<sup>2</sup>

**PRESERVE NATIONAL SECURITY** Human, economic, and environmental security are closely related to national security. The globalization of markets and production creates new security risks for companies. To read about these risks, see this chapter's Global Sustainability feature, titled "Managing Security in the Age of Globalization."

**National Security and Imports** Certain imports can be restricted in the name of preserving national security. In the event of war, governments must have access to a domestic supply of certain items such as weapons, fuel, and air, land, and sea transportation in case their availability is restricted. Many nations continue to search for oil within their borders in case war disrupts its flow from outside sources. Legitimate national security reasons for intervention can be difficult to argue against, particularly when they have the support of most of a country's people.

## GLOBAL SUSTAINABILITY

## Managing Security in the Age of Globalization

As well as the need to secure lengthy supply chains and distribution channels, companies must secure their facilities, information systems, and reputations.

- **Facilities Risk.** Large companies with top-notch property risk-management programs produce more stable earnings. Companies practicing weak risk management experience 55 times greater risk of property loss due to fire and 29 times greater risk of property loss caused by natural hazards. Planning and facilities assessment (around \$12,000 for a midsize company, \$1 million for a large firm) can be well worth the cost.
- **Information Risk.** Computer viruses, software worms, malicious code, and cyber criminals cost companies around the world many billions of dollars each year. Disgruntled employees, dishonest competitors, and hackers who steal customers' personal and financial data can then sell it to the highest bidder. Upon termination, employees sometimes leave with digital devices containing confidential memos, competitive data, and private e-mails.
- **Reputational Risk.** News today travels worldwide quickly. Reputational risk is anything that can harm a firm's image, including product recalls, workers' rights violations, and lawsuits. The damaged reputation of Goldman Sachs following a \$550 million settlement with the Securities and Exchange Commission for its actions before and during recent financial crises cost the firm 40 percent (\$6 billion) of its brand value in one year.
- **What to Do.** Like the risks themselves, the challenges are varied. Companies should identify all potential risks to their facilities and then develop a best-practice property risk program. It sounds simple, but employees must change passwords frequently, safeguard their computers and mobile devices from attack, and return company-owned digital devices when leaving the firm. Finally, ever-increasing scrutiny means that companies should act ethically and within the law to protect their reputations.
- **Want to Know More?** Visit Sustainable Security ([sustainablesecurity.org](http://sustainablesecurity.org)), the Foundation for Environmental Security and Sustainability ([www.fess-global.org](http://www.fess-global.org)), Kroll ([www.krollworldwide.com](http://www.krollworldwide.com)), and Check Point Software Technologies ([www.checkpoint.com](http://www.checkpoint.com)).

Some countries claim that national security is the reason for fierce protection of their agricultural sector, since food security is essential at a time of war. France was criticized by many nations for ardently protecting its agricultural sector. French agricultural subsidies are intended to provide a fair financial return for French farmers, who traditionally operate on a small scale and therefore have high production costs and low profit margins. But many developed nations are exposing agribusiness to market forces and prompting their farmers to discover new ways to manage risk and increase efficiency. Innovative farmers are experimenting with more intensive land management, high-tech precision farming, and greater use of biotechnology.

Yet, protection from import competition does have its drawbacks. Perhaps the main one is the added cost of continuing to produce a good or provide a service domestically that could be supplied more efficiently from abroad. Also, a policy of protection may remain in place much longer than necessary once it is adopted. Thus, policy makers should consider whether an issue truly is a matter of national security before intervening in trade.

**National Security and Exports** Governments also have national security motives for banning certain defense-related goods from export to other nations. Most industrialized nations have agencies that review requests to export technologies or products that are said to have *dual uses*—meaning they have both industrial and military applications. Products designated as dual use are classified as such and require special governmental approval before export can take place.

Products on the dual-use lists of most nations include nuclear materials, technological equipment, certain chemicals and toxins, some sensors and lasers, and specific devices related to weapons, navigation, aerospace, and propulsion. Bans on the export of dual-use products were strictly enforced during the Cold War years between the West and the former Soviet Union. Whereas many countries relaxed enforcement of these controls in recent years, the continued threat of terrorism and fears of weapons of mass destruction are renewing support for such bans.

Nations also place certain companies and organizations in other countries on a list of entities that are restricted from receiving their exports. For example, the owner of an electronics firm pleaded guilty to charges of conspiracy to illegally export dual-use items from the United States to India for possible use in ballistic missiles, space launch vehicles, and fighter jets. The individual admitted that he provided the components to government entities in India, including two companies on the US Department of Commerce's "Entity List" and received a 35-month jail sentence and was fined \$60,000.

**RESPOND TO “UNFAIR” TRADE** Many observers argue that it makes no sense for one nation to allow free trade if other nations actively protect their own industries. Governments often threaten to close their ports to another nation’s ships or to impose extremely high tariffs on its goods if the other nation does not concede on some trade issue that is seen as being unfair. In other words, if one government thinks another nation is not “playing fair,” it will often threaten to retaliate unless certain concessions are made.

**GAIN INFLUENCE** Governments of the world’s largest nations may become involved in trade to gain influence over smaller nations. The United States goes to great lengths to gain and maintain control over events in all of Central, North, and South America, and the Caribbean basin.

In 1962, the United States banned all trade and investment with Cuba in the hope of exerting political influence against its communist leaders. Designed to pressure Cuba’s government to change, the policy unintentionally caused suffering among Cuba’s citizens. But change is occurring in Cuba, albeit slowly. Even the concept of performance-related pay was introduced. These seemingly trivial freedoms represent monumental change to ordinary Cubans, who now hope for continually greater freedom.

### Economic Motives

Although governments intervene in trade for highly charged cultural and political reasons, they also have economic motives for their intervention. The most common economic reasons for nations’ attempts to influence international trade are the protection of young industries from competition and the promotion of a strategic trade policy.

**PROTECT INFANT INDUSTRIES** According to the *infant industry argument*, a country’s emerging industries need protection from international competition during their development phase until they become sufficiently competitive internationally. This argument is based on the idea that infant industries need protection because of a steep learning curve. In other words, only as an industry grows and matures does it gain the knowledge it needs to become more innovative, efficient, and competitive.

Although this argument is conceptually appealing, it does have several problems. First, it requires governments to distinguish between industries that are worth protecting and those that are not. This is difficult, if not impossible, to do. For years, Japan targeted infant industries for protection, low interest loans, and other benefits. Its performance on assisting these industries was very good through the early 1980s but was less successful since then. Until the government

All types of crops today, including corn, soybeans, and wheat, are grown with genetically enhanced seed technology to resist insects and disease. Genetically modified plants like those shown here have had their DNA genetically altered in laboratories. Many people in Europe fiercely resist efforts by the United States to export genetically modified crops to their markets. Do you believe Europeans are right to be wary of the importation of genetically modified crops?

Hero Images Inc./Alamy Stock Photo



achieves future success in identifying and targeting industries, supporting this type of policy remains questionable.

Second, protection from international competition can cause domestic companies to become complacent toward innovation. This can limit a company's incentives to obtain the knowledge it needs to become more competitive. The most extreme examples of complacency are industries within formerly communist nations. When their communist protections collapsed, nearly all companies that were run by the state were decades behind their competitors from capitalist nations. To survive, many government-owned businesses required financial assistance in the form of infusions of capital or outright purchase.

Third, protection can do more economic harm than good. Consumers often end up paying more for products because a lack of competition typically creates fewer incentives to cut production costs or improve quality. Meanwhile, companies become less competitive and more reliant on protection. Protection in Japan created a two-tier economy where, in one tier, highly competitive multinational corporations faced rivals in overseas markets and learned to become strong competitors. In the other tier, domestic industries were made noncompetitive through protected markets, high wages, and barriers to imports.

Fourth, the infant industry argument also says that it is not always possible for small, promising companies to obtain funding in capital markets, and thus they need financial support from their government. However, international capital markets today are far more sophisticated than in the past, and promising business ventures can normally obtain funding from private sources.

**PURSUE STRATEGIC TRADE POLICY** Recall from our discussion in Chapter 5 that new trade theorists believe government intervention can help companies take advantage of economies of scale and become the first movers in their industries. First-mover advantages arise because economies of scale in production limit the number of companies that an industry can sustain.

**Benefits of Strategic Trade Policy** Supporters of strategic trade policy argue that it results in increased national income. Companies should earn a good profit if they obtain first-mover advantages and solidify positions in their markets around the world. Advocates claim that strategic trade policies helped South Korea build global conglomerates (called *chaebol*) that dwarf competitors. For years, South Korean shipbuilders received a variety of government subsidies, including low-cost financing. The *chaebol* helped South Korea to emerge strongly from the recent global economic crisis because of their market power and the wide range of industries in which they compete. Such policies had spin-off effects on related industries, and local suppliers to the *chaebol* are now thriving.<sup>3</sup>

**Drawbacks of Strategic Trade Policy** Although it sounds as if strategic trade policy only has benefits, there can be drawbacks as well. Lavish government assistance to domestic companies in the past caused inefficiency and high costs for both South Korean and Japanese companies. Large government concessions to local labor unions hiked wages and forced Korea's *chaebol* to accept low profit margins. Yet, over time, the *chaebol* overcame these difficulties.

In addition, when governments decide to support specific industries, their choice is often subject to political lobbying by the groups seeking government assistance. It is possible that special interest groups could capture all the gains from assistance with no benefit for consumers. If this were to occur, consumers could end up paying more for goods of lower-quality than they could otherwise obtain.

## Cultural Motives

Nations often restrict trade in goods and services to achieve cultural objectives, the most common being protection of national identity. Culture and trade are intertwined and greatly affect one another. The cultures of countries are slowly altered by exposure to the people and products of other cultures. Unwanted cultural influence in a nation can cause great distress and force a government to block imports that it believes are harmful (recall our discussion of *cultural imperialism* in Chapter 2).

French law bans foreign-language words from virtually all business and government communications, radio and TV broadcasts, public announcements, and advertising messages—at least whenever a suitable French alternative is available. You can't advertise a *best seller*; it has to be a *succès de librairie*. You can't sell *popcorn* at *le cinéma*; French moviegoers must snack on *maïs soufflé*. The Higher Council on French Language works against the inclusion of so-called

Franglais phrases such as *le marketing*, *le cash flow*, and *le brainstorming* into commerce and other areas of French culture. Not to be outdone by neighboring France, German bureaucrats exchanged governmental use of English words with German ones, for example, replacing *brainstorming* with *ideensammlung* and *meeting points* with *treffpunkte*.<sup>4</sup>

Canada also tries to mitigate the cultural influence of entertainment products imported from the United States. Canada requires at least 35 percent of music played over Canadian radio to be by Canadian artists. In fact, many countries are considering laws to protect their media programming for cultural reasons. The downside of such restrictions is they reduce the selection of products available to consumers.

**CULTURAL INFLUENCE OF THE UNITED STATES** International trade is the vehicle by which the English language swiftly infiltrates the cultures of other nations. International trade in all sorts of goods and services is exposing people around the world to new words, ideas, products, and ways of life. Still, as international trade continues to expand, many governments try to limit potential adverse effects on their cultures and economies.

The United States, more than any other nation, is seen by many around the world as a threat to local culture. The reason is the global strength of the United States in entertainment and media (such as movies, magazines, and music) and consumer goods. These products are highly visible to all consumers and cause groups of various kinds to lobby government officials for protection from their cultural influence. Domestic producers find it easy to join in the calls for protection because the rhetoric of protectionism often receives widespread public support.

Oddly, many small businesses capable of exporting have not yet begun to do so. By some estimates, only 10 percent of US companies with fewer than 100 employees export. Encouraging greater export activity may require US companies to undergo a cultural shift in mindset. Although a lack of investment capital can be a real obstacle to exporting for small businesses, some common myths in the business culture create artificial obstacles. To explore some of these myths and the facts that dispute them, see this chapter's Culture Matters feature, titled "Myths of Small Business Exporting."

### QUICK STUDY 1

1. Free trade is the pattern of imports and exports that occurs in the *what*?
2. For what political reasons does a government intervene in trade?
3. What are some economic reasons why a government intervenes in trade?
4. Some people see the products of what country as the greatest threat to local cultures around the world?

## CULTURE MATTERS

### Myths of Small Business Exporting

- **Myth 1:** Only large companies can export successfully.  
**Fact:** Most exporters are small and medium-sized enterprises with fewer than 50 employees. Exporting can reduce the dependency of small firms on domestic markets and can help them avoid seasonal sales fluctuations. A product popular domestically, or perhaps even unsuccessful at home, may be wanted elsewhere in the global market.
- **Myth 2:** Small businesses can find little export advice.  
**Fact:** Novice and experienced exporters alike can receive comprehensive export assistance from federal agencies ([www.export.gov](http://www.export.gov)). International trade specialists can help small businesses locate and use federal, state, local, and private-sector programs. They are also an excellent source of market research, trade leads, financing, and trade events.
- **Myth 3:** Licensing requirements needed to export are too complicated.  
**Fact:** Most products do not need export licenses. Exporters need only to write "NLR" for "no license required" on their Shipper's Export Declaration. A license is generally needed only for high-tech or defense-related goods or when the receiving country is under a US embargo or other restriction.
- **Myth 4:** Small businesses cannot obtain export financing.  
**Fact:** The Small Business Administration ([www.sba.gov](http://www.sba.gov)) and the Export-Import Bank ([www.exim.gov](http://www.exim.gov)) work together in lending money to small businesses. Whereas the SBA is responsible for loan requests below \$750,000, the Export-Import Bank handles transactions more than \$750,000. The Trade and Development Agency ([www.ustda.gov](http://www.ustda.gov)) also helps small and medium-sized firms obtain financing for international projects.

## 6.2 Instruments of Trade Promotion

The previous discussion alluded to the types of instruments governments use to promote or restrict trade with other nations. The most common instruments that governments use are shown in Table 6.1. In this section, we examine methods of trade promotion. We cover methods of trade restriction in the next section.

### Subsidies

Financial assistance to domestic producers in the form of cash payments, low-interest loans, tax breaks, product price supports, or other forms is called a **subsidy**. Regardless of the form a subsidy takes, it is intended to assist domestic companies in fending off international competitors. This can mean becoming more competitive in the home market or increasing competitiveness in international markets through exports. It is extremely difficult to calculate the amount of subsidies a country offers its producers because of the many forms that subsidies take. This makes the work of the World Trade Organization difficult when it is called on to settle arguments over subsidies (the World Trade Organization is discussed later in this chapter).

**DRAWBACKS OF SUBSIDIES** Critics say that subsidies encourage inefficiency and complacency by covering costs that truly competitive industries should be able to absorb on their own. Many believe subsidies benefit companies and industries that receive them but harm consumers because they tend to be paid for with income and sales taxes. Thus, although subsidies provide short-term relief to companies and industries, whether they help a nation's citizens in the long term is questionable.

Some observers say that far more devastating is the effect of subsidies on farmers in developing and emerging markets. We've already seen that many wealthy nations award subsidies to their farmers to ensure an adequate food supply for their people. It is said that these subsidies, worth billions of dollars, make it difficult if not impossible for farmers from poor countries to sell their unsubsidized (i.e., more expensive) food on world markets. Compounding the plight of these farmers is the fact that their nations are being forced to eliminate trade barriers by international organizations. The economic consequences for poor farmers in Africa, Asia, and Latin America are higher unemployment and poverty.

Subsidies can lead to an overuse of resources, negative environmental effects, and higher costs for commodities. Subsidies tend to drive fuel prices higher and eliminate incentives to conserve fuel. A period of rising fuel prices gave researchers to examine the effects of subsidies on fuel usage. Research supported the notion that whereas countries without fuel subsidies saw steady or falling demand, subsidizing countries saw rising demand that threatened to outstrip growth in global fuel supplies.

### Export Financing

Governments often promote exports by helping companies finance their export activities. They can offer loans that a company could otherwise not obtain or can charge them an interest rate that is lower than the market rate. Another option is for a government to guarantee that it will repay the loan of a company if the company should default on repayment; this is called a *loan guarantee*.

**6.2** Outline the instruments that governments use to promote trade.

### subsidy

Financial assistance to domestic producers in the form of cash payments, low-interest loans, tax breaks, product price supports, or other forms.

**TABLE 6.1** Instruments of Trade Policy

| Trade Promotion             | Trade Restriction          |
|-----------------------------|----------------------------|
| Subsidies                   | Tariffs                    |
| Export financing            | Quotas                     |
| Foreign trade zones         | Embargoes                  |
| Special government agencies | Local content requirements |
|                             | Administrative delays      |
|                             | Currency controls          |

Many nations have special agencies dedicated to helping their domestic companies obtain export financing. For example, a very well-known institution is called the *Export-Import Bank of the United States*—or *Ex-Im Bank* for short. The Ex-Im Bank ([www.exim.gov](http://www.exim.gov)) finances the export activities of companies in the United States and offers insurance on foreign accounts receivable. Another US government agency, the *Overseas Private Investment Corporation (OPIC)*, also provides insurance services but for investors. Through OPIC ([www.opic.gov](http://www.opic.gov)), companies that invest abroad can insure against losses due to (1) expropriation, (2) currency inconvertibility, and (3) war, revolution, and insurrection.

Receiving financing from government agencies is often crucial to the success of small businesses that are just beginning to export. Taken together, small businesses account for more than 80 percent of all transactions handled by the Ex-Im Bank. For instance, the Ex-Im Bank guaranteed to cover a loan of nearly \$4 million to help fund development of an amusement park in Accra, Ghana. The investment in Africa is in response to rising demand for world-class amusement parks across West Africa. The park will employ at least 175 local Ghanaians under the supervision of US expatriate managers. For more on how the Ex-Im Bank helps businesses gain export financing, see the Manager's Briefcase, titled "Experts in Export Financing."

### Foreign Trade Zones

Most countries promote trade with other nations by creating what is called a **foreign trade zone (FTZ)**—a designated geographic region through which merchandise is allowed to pass with lower customs duties (taxes) and/or fewer customs procedures. Increased employment is often the intended purpose of FTZs, with a by-product being increased trade. A good example of a foreign trade zone is Turkey's Aegean Free Zone, in which the Turkish government allows companies to conduct manufacturing operations free from taxes.

Customs duties increase the total amount of a good's production cost and increase the time needed to get it to market. Companies can reduce such costs and time by establishing a facility inside an FTZ. A common purpose of many companies' facilities in such zones is final product assembly. The US Department of Commerce ([www.commerce.gov](http://www.commerce.gov)) administers dozens of FTZs within the United States. Many of these zones allow components to be imported at a discount from the normal duty. Once assembled, the finished product can be sold within the US market with no further duties charged. State governments welcome such zones in order to obtain the jobs that the assembly operations create.

China established a number of large FTZs in order to reap the employment advantages they offer. Goods imported into these zones do not require import licenses or other documents, nor are

#### foreign trade zone (FTZ)

Designated geographic region through which merchandise is allowed to pass with lower customs duties (taxes) and/or fewer customs procedures.

### MANAGER'S BRIEFCASE

#### Experts in Export Financing

Several Ex-Im Bank ([www.exim.gov](http://www.exim.gov)) programs can help US businesses expand abroad:

- **City/State Program** This program brings financing services to small and medium-sized US companies that are ready to export. This program currently exists with 38 state and local government offices and private sector organizations.
- **Working Capital Guarantee Program** This program encourages commercial banks to loan money to companies with export potential. The guarantee covers 90 percent of the loan's principal and accrued interest. The guaranteed financing can help purchase finished products for export or pay for raw materials, for example.
- **Credit Information Services** The Ex-Im Bank supplies credit information to US exporters and commercial lenders. It provides information on a country or specific company abroad. But the bank does not divulge either confidential financial data on non-US buyers to whom it has extended credit or confidential information on specific conditions in other countries.
- **Credit Insurance** This program helps US exporters by protecting them against loss should a non-US buyer or debtor default for political or commercial reasons. The proceeds of the policy can be used as collateral and therefore can make obtaining export financing easier.
- **Guarantee Program** This program provides repayment protection for private sector loans made to creditworthy buyers of US capital equipment, projects, and services. The bank guarantees the principal and interest on the loan if the borrower defaults. Most guarantees provide comprehensive coverage against political and commercial risks.
- **Loan Program** The bank makes loans directly to non-US buyers of US exports and intermediary loans to creditworthy parties that provide loans to non-US buyers. The program provides fixed-interest-rate financing for export sales of US-made capital equipment and related services.

Source: Export-Import Bank of the United States website ([www.exim.gov](http://www.exim.gov)).

they subject to import duties. International companies can also store goods in these zones before shipping them to other countries without incurring taxes in China. Moreover, five of these zones are located within specially designated economic zones in which local governments can offer additional opportunities and tax breaks to international investors.

Another country that enjoys the beneficial effects of FTZs is Mexico. Decades ago, Mexico established such a zone along its northern border with the United States. Creation of the zone caused development of companies called *maquiladoras* along the border inside Mexico. The *maquiladoras* import materials or parts from the United States duty free, process them to some extent, and export them back to the United States, which charges duties only on the value added to the product in Mexico. The program expanded rapidly over the five decades since its inception, employing hundreds of thousands of people from all across Mexico who move north looking for work.

### Special Government Agencies

Learning the government regulations of other countries can be a daunting task. A company must know whether its product is subject to a tariff or quota, for example. Governments of most nations, therefore, have special agencies responsible for promoting exports. Such agencies can be particularly helpful to small and medium-sized businesses that have limited financial resources.

Government trade-promotion agencies often organize trips for trade officials and businesspeople to visit other countries in order to meet potential business partners and generate contacts for new business. They also typically open trade offices in other countries. These offices are designed to promote the home country's exports and introduce businesses to potential partners in the host nation. Government trade-promotion agencies typically do a great deal of advertising in other countries promoting the nation's exports. For example, Chile's Trade Commission, ProChile, has commercial offices in 40 countries and a website ([www.chileinfo.com](http://www.chileinfo.com)).

Governments not only promote trade by encouraging exports but also encourage imports that the nation does not or cannot produce. For example, the Japan External Trade Organization (JETRO; [www.jetro.go.jp](http://www.jetro.go.jp)) is a trade-promotion agency of the Japanese government. The agency coaches small and medium-sized overseas businesses on the protocols of Japanese deal making, arranges meetings with suitable Japanese distributors and partners, and even assists in finding temporary office spaces.

#### QUICK STUDY 2

1. Financial assistance from a government to domestic producers is called a *what*?
2. What are the hoped-for outcomes of a foreign trade zone?
3. What are some of the ways that governments provide export financing?

## 6.3 Instruments of Trade Restriction

Earlier in this chapter, we read about the political, economic, and cultural reasons for governmental intervention in trade. In this section, we discuss the methods governments can use to restrict unwanted trade. There are two general categories of trade barriers available to governments: tariffs and nontariff barriers. A **tariff** is a government tax levied on a product as it enters or leaves a country. A tariff increases the price of an imported product *directly* and, therefore, reduces its appeal to buyers. A nontariff barrier limits the availability of an imported product, which increases its price *indirectly* and, therefore, reduces its appeal to buyers. Let's take a closer look at tariffs and the various types of nontariff barriers.

### Tariffs

We can classify a tariff into one of three categories. An *export tariff* is levied by the government of a country that is exporting a product. Countries can use export tariffs when they believe an export's price is lower than it should be. Developing nations whose exports consist mostly of low-priced natural resources often levy export tariffs. A *transit tariff* is levied by the government of a country that a product is passing through on its way to its final destination. Transit tariffs have been almost

**6.3** Describe the instruments that governments use to restrict trade.

#### tariff

Government tax levied on a product as it enters or leaves a country.

**ad valorem tariff**

Tariff levied as a percentage of the stated price of an imported product.

**specific tariff**

Tariff levied as a specific fee for each unit (measured by number, weight, etc.) of an imported product.

**compound tariff**

Tariff levied on an imported product and calculated partly as a percentage of its stated price and partly as a specific fee for each unit.

**quota**

Restriction on the amount (measured in units or weight) of a good that can enter or leave a country during a certain period of time.

entirely eliminated worldwide through international trade agreements. An *import tariff* is levied by the government of a country that is importing a product. The import tariff is by far the most common tariff used by governments today.

We can further break down the import tariff into three subcategories based on the manner in which it is calculated. An **ad valorem tariff** is levied as a percentage of the stated price of an imported product. A **specific tariff** is levied as a specific fee for each unit (measured by number, weight, etc.) of an imported product. A **compound tariff** is levied on an imported product and calculated partly as a percentage of its stated price and partly as a specific fee for each unit. Let's now discuss the two main reasons why countries levy tariffs.

**PROTECT DOMESTIC PRODUCERS** Nations can use tariffs to protect domestic producers. For example, an import tariff raises the cost of an imported good and increases the appeal of domestically produced goods. In this way, domestic producers gain a protective barrier against imports. Although producers that receive tariff protection can gain a price advantage, in the long run protection can keep them from increasing efficiency. A protected industry can be devastated if protection encourages complacency and inefficiency and it is later thrown into the lion's den of international competition. Mexico began reducing tariff protection in the mid-1980s as a prelude to NAFTA negotiations, and many Mexican producers went bankrupt despite attempts to grow more efficient.

**GENERATE REVENUE** Tariffs are also a source of government revenue, but mostly among developing nations. The main reason is that less-developed nations tend to have less-formal domestic economies that lack the capability to record domestic transactions accurately. The lack of accurate record keeping makes collection of sales taxes within the country extremely difficult. Nations solve the problem by simply raising their needed revenue through import and export tariffs. As countries develop, however, they tend to generate a greater portion of their revenues from taxes on income, capital gains, and other economic activity.

The discussion so far leads us to question who benefits from tariffs. We've already learned the two principal reasons for tariff barriers—protecting domestic producers and raising government revenue. On the surface, it appears that governments and domestic producers benefit. We also saw that tariffs raise the price of a product because importers typically charge a higher price to recover the cost of this additional tax. Thus, it appears on the surface that consumers do not benefit. As we also mentioned earlier, there is the danger that tariffs will create inefficient domestic producers that may go out of business once protective import tariffs are removed. Analysis of the total cost to a country is far more complicated and goes beyond the scope of our discussion. Suffice it to say that tariffs tend to exact a cost on countries as a whole because they lessen the gains that a nation's people obtain from trade.

**Quotas**

A restriction on the amount (measured in units or weight) of a good that can enter or leave a country during a certain period of time is called a **quota**. After tariffs, quotas are the second most common type of trade barrier. Governments typically administer their quota systems by granting quota licenses to the companies or governments of other nations (in the case of import quotas) and domestic producers (in the case of export quotas). Governments normally grant such licenses on a year-by-year basis.

**REASON FOR IMPORT QUOTAS** A government may impose an *import quota* to protect its domestic producers by placing a limit on the amount of goods allowed to enter the country. This helps domestic producers maintain their market shares and prices because competitive forces are restrained. In this case, domestic producers win because their market is protected. Consumers lose because of higher prices and limited selection attributable to lower competition. Other losers include domestic producers whose own production requires the import subjected to a quota. Companies relying on the importation of so-called intermediate goods will find the final cost of their own products increase.

Historically, countries placed import quotas on the textile and apparel products of other countries under the Multi-Fiber Arrangement. This arrangement at one time affected countries accounting for more than 80 percent of world trade in textiles and clothing. When that arrangement expired in 2005, many textile producers in poor nations feared the loss of jobs to China.



A young woman works in a garment factory in Phnom Penh, Cambodia. Across Cambodia and much of the rest of Southeast Asia, small clothing factories have thrived following removal of a worldwide system allowed under the Multi-Fiber Agreement. Under this agreement, wealthy nations guaranteed imports of textiles and garments from poor countries under a quota system. Under what conditions do you think nations should be allowed to impose import quotas?

Dennis Drenner/Alamy Stock Photo

But some countries with a large textile industry, such as Bangladesh, are benefiting from cheap labor and the reluctance among purchasers to rely exclusively on China for all supplies.

**REASONS FOR EXPORT QUOTAS** There are at least two reasons why a country imposes *export quotas* on its domestic producers. First, it may wish to maintain adequate supplies of a product in the home market. This motive is most common among countries that export natural resources that are essential to domestic business or the long-term survival of a nation.

Second, a country may limit the export of a good in order to restrict its supply on world markets, thereby increasing the international price of the good. This is the motive behind the formation and activities of the Organization of Petroleum Exporting Countries (OPEC; [www.opec.org](http://www.opec.org)). This group of nations from the Middle East and Latin America attempts to restrict the world's supply of crude oil in order to earn greater profits.

**VOLUNTARY EXPORT RESTRAINTS** A unique version of the export quota is called a **voluntary export restraint (VER)**—a quota that a nation imposes on its own exports, usually at the request of another nation. Countries normally self-impose a voluntary export restraint in response to the threat of an import quota or a total ban on the product by an importing nation. The classic example of the use of a voluntary export restraint is from the 1980s when Japanese carmakers were making significant market-share gains in the United States. The closing of US carmakers' production facilities in the United States was creating a volatile anti-Japan sentiment among the population and the US Congress. Fearing punitive legislation if Japan did not limit its automobile exports to the United States, the Japanese government and its carmakers self-imposed a voluntary export restraint on cars headed for the United States.

Consumers in the country that imposes an export quota benefit from lower-priced products (due to their greater supply) as long as domestic producers do not curtail production. Producers in an importing country benefit because the goods of producers from the exporting country are restrained, which may allow them to increase prices. Export quotas hurt consumers in the importing nation because of reduced selection and perhaps higher prices. Yet export quotas might allow these same consumers to retain their jobs if imports were threatening to put domestic producers out of business. Again, detailed economic studies are needed to determine the winners and losers in any particular export quota case.

**TARIFF-QUOTAS** A hybrid form of trade restriction is called a **tariff-quota**—a lower tariff rate for a certain quantity of imports and a higher rate for quantities that exceed the quota. Imports entering a nation under a quota limit of, say, 1,000 tons are charged a 10-percent tariff. But

#### **voluntary export restraint (VER)**

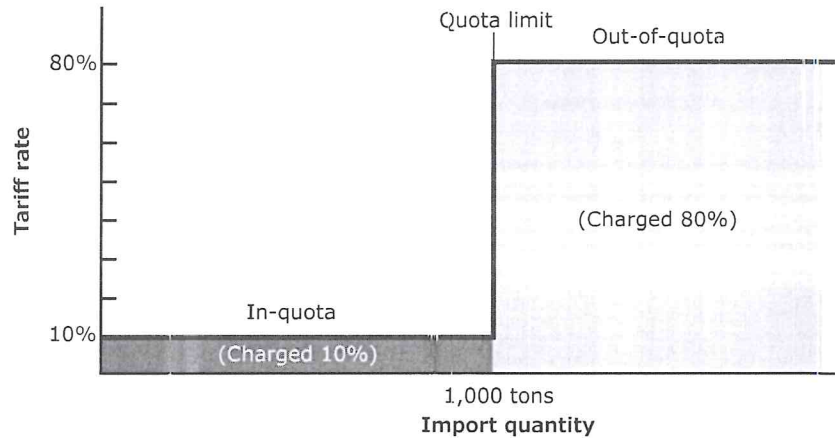
Unique version of export quota that a nation imposes on its exports, usually at the request of an importing nation.

#### **tariff-quota**

Lower tariff rate for a certain quantity of imports and a higher rate for quantities that exceed the quota.

**Figure 6.1**  
**How a Tariff-Quota Works**

Source: World Trade Organization Website  
 (www.wto.org).



subsequent imports that do not make it under the quota limit of 1,000 tons are charged a tariff of 80 percent. Figure 6.1 shows how a tariff-quota actually works. Tariff-quotas are used extensively in the trade of agricultural products. Many countries implemented tariff-quotas in 1995 after their use was permitted by the World Trade Organization, the agency that regulates trade among nations.

### Embargoes

#### embargo

Complete ban on trade (imports and exports) in one or more products with a particular country.

A complete ban on trade (imports and exports) in one or more products with a particular country is called an **embargo**. An embargo may be placed on one or a few goods, or it may completely ban trade in all goods. It is the most restrictive nontariff trade barrier available, and it is typically applied to accomplish political goals. Embargoes can be decreed by individual nations or by supranational organizations such as the United Nations. Because they can be very difficult to enforce, embargoes are used less today than they have been in the past. One example of a total ban on trade with another country is the US embargo on trade with Cuba.

After a military coup ousted elected President Aristide of Haiti in the early 1990s, restraints were applied to force the military junta either to reinstate Aristide or to hold new elections. One restraint was an embargo by the Organization of American States. Because of difficulties in enforcing the embargo and after two years of fruitless United Nations diplomacy, the embargo failed. The United Nations then stepped in with a ban on trade in oil and weapons. Despite some smuggling through the Dominican Republic, which shares the island of Hispaniola with Haiti, the embargo was generally effective and Aristide was eventually reinstated.

### Local Content Requirements

Recall from Chapter 4 that *local content requirements* are laws stipulating that producers in the domestic market must supply a specified amount of a good or service. These requirements can state that a certain portion of the end product must consist of domestically produced goods or that a certain portion of the final cost of a product must come from domestic sources.

The purpose of local content requirements is to force companies from other nations to use local resources in their production processes—particularly labor. Similar to other restraints on imports, such requirements help protect domestic producers from the price advantage of companies based in other, low-wage countries. Today, many developing countries use local content requirements as a strategy to boost industrialization. Companies often respond to local content requirements by locating production facilities inside the nation that stipulates such restrictions.

For example, although many people consider music to be the universal language, not all cultures are equally open to the world's diverse musical influences. To prevent Anglo-Saxon music from invading French culture, French law requires radio programs to include at least 40-percent French content. Such local content requirements are intended to protect both the French cultural identity and the jobs of French artists against other nations' pop culture that may wash up on French shores.

#### administrative delays

Regulatory controls or bureaucratic rules designed to impair the flow of imports into a country.

### Administrative Delays

Regulatory controls or bureaucratic rules designed to impair the flow of imports into a country are called **administrative delays**. This nontariff barrier includes a wide range of government