

- 59 "Print Me a Stradivarius," *Economist* (February 10, 2011), retrieved February 17, 2011, from [www.economist.com/node/18114327?story\\_id=18114327&fsrc=nwl](http://www.economist.com/node/18114327?story_id=18114327&fsrc=nwl); J. M. Pearce, C. Morris Blair, K. J. Laciak, R. Andrews, R. Nosrat, and I. Zelenika-Zovko, "3-D Printing of Open Source Appropriate Technologies for Self-Directed Sustainable Development," *Journal of Sustainable Development* 3:4 (December 2010): 17–29.
- 60 We wish to thank Mauricio Calero, former manager of two Ecuadoran rose farms, for granting us interviews and supplying additional data. We would also like to thank Tyler Gill, who while an undergraduate student at the University of Miami, worked diligently in gathering information on the world's and particularly Ecuador's export market in roses. Other information came from Jo H. M. Wijnands, Jos Bijman, and Ruud B. M. Huirne, "Impact of Institutions on the Performance of the Flower Industry in Developing Countries," paper presented at the ISNIE Conference, Reykjavik, Iceland, June 21–23, 2007; University of Illinois Extension, "Our Rose Garden: The History of Roses," retrieved December 8, 2010, from <http://urbanext.illinois.edu/roses/history.cfm>; Sector Publications, "The World Cut Flower Industry: Trends and Prospects," retrieved September 12m 2010, from [www.ilo.org/public/english/dialogue/sector/papers/ctflower/139e1.htm](http://www.ilo.org/public/english/dialogue/sector/papers/ctflower/139e1.htm); [www.cia.gov/library/publications/the-world-factbook/geos/ec.html](http://www.cia.gov/library/publications/the-world-factbook/geos/ec.html); International Trade Center (ITC) "Trade Map—International Trade Statistics: List of Importing Markets for a Product Exported by Ecuador," retrieved February 4, 2011, from [www.trademap.org/tradestat/Country\\_SelProductCountry\\_TS.aspx](http://www.trademap.org/tradestat/Country_SelProductCountry_TS.aspx); TransFair Canada, "Hoja Verde: The Flower of Ecuador," retrieved February 3, 2011, from <http://transfair.ca/en/producers/profiles/hoja-verde>.

# Governmental Influence on Trade

## Objectives

1. To explain the rationales for governmental policies that enhance and restrict trade
2. To show the effects of pressure groups on trade policies
3. To describe the potential and actual effects of government intervention on the free flow of trade
4. To illustrate the major means by which trade is restricted and regulated
5. To demonstrate the business uncertainties and business opportunities created by governmental trade policies

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—English proverb

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and antidumping taxes (tariffs) of 64 percent were placed on the importation of the Vietnamese fish. The industry has since petitioned for estimates to be based on higher Philippine costs.

### HEALTH ISSUES: A BOON FROM ADVERSITY

Despite the higher prices, the Vietnamese fish kept increasing their share of the U.S. market. Then, in 2007 the U.S. catfish industry seemed ironically to have found salvation when about 39,000 U.S. dogs and cats were sickened or killed after consuming imported Chinese pet food. This led to an alert and negative attitude toward imported food products in general, especially seafood originating anywhere in Asia. The U.S. catfish farmers have responded quickly with several initiatives. First, they have publicly implied that imported fish may be contaminated. For instance, the Catfish Institute has put out publicity saying, "U.S. farm-raised catfish: Safety you can trust." It has pushed for and gotten several states to require country-of-origin labeling on food and menus by advocating that consumers have the right to know whether the fish and seafood they buy could be contaminated. However, studies on changes in consumer purchases indicate that the labeling had no effect on demand.

Second, catfish farmers have worked through their congresspeople to legislate for increased inspections of fish from Vietnam. Given the food scare, emotions helped gain support. The Food and Drug Administration (FDA) has long been in charge of the safety of overseas food, but has had little budget to check the safety. Less than 2 percent of U.S. imported seafood shipments get inspected, as opposed to about 20 percent in the European Union.) However, during the congressional debates on the safety of food imports, there was a suggestion to upgrade inspection of all types of imported fish from all places. This suggestion was not well received because of the cost, and there was little support to simply single out one kind of fish from only one country. So, the congresspeople representing the catfish industry took a different approach by burying a provision deeply within the \$300 billion farm bill of 2008, which called for the Department of Agriculture—rather than the FDA—to be in charge of catfish safety. Supporters' rationale was that aquaculture is a form of agriculture. Basically, the provision requires inspection at the production source, which is particularly difficult in Vietnam because its highly fragmented production would require an army of inspectors.

### OPPOSITION AND THE FUTURE

As with most regulatory changes, there has been opposition to the effective protection of the U.S. catfish industry. Some have worried about how Vietnam would respond to restrictions on its fish exports. For instance, Montana senator Max Baucus, who hails from a beef-producing state, worried that Vietnam (the third largest export market for U.S. beef) would respond by buying its beef elsewhere.

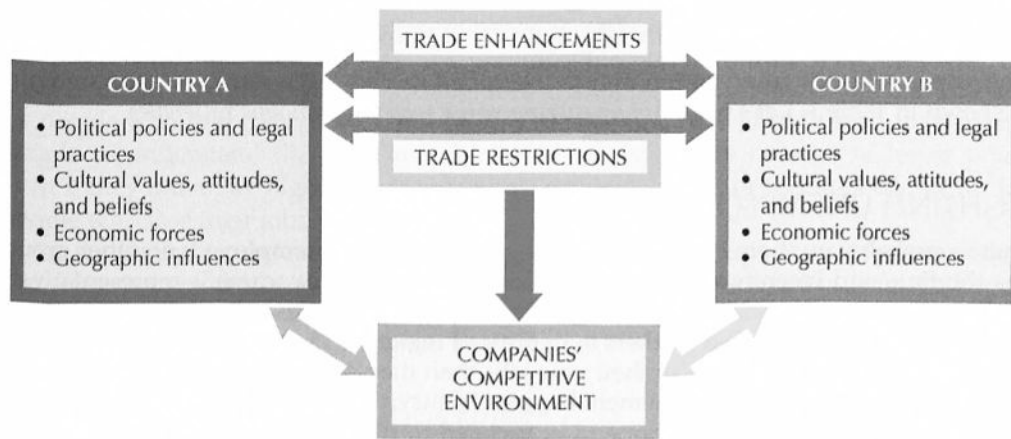
Although the above describes what seems to be a possible means for the U.S. catfish producers to limit foreign competition, a particular problem prevents its implementation. The legislation calls for inspection of imported catfish, but the U.S. industry had earlier been successful in getting a legal ruling that Vietnam was exporting basa, tra, and pangasius rather than catfish. Thus, is a catfish by any other name a catfish?

An old adage is that if you give a man a fish, he will have food for a day. But if you teach him to fish, he will have food for a lifetime. However, the U.S.–Vietnamese catfish controversy illustrates that knowing how to fish is insufficient, especially in international competition. One also needs to know how to influence and maneuver through a maze of government regulations that affect competition.

## Introduction

At some point, you may work for or own stock in a company whose performance, or even survival, depends on governmental trade policies. These policies may affect the ability of foreign producers to compete in your home market. They may limit or enhance your company's ability to sell abroad or acquire needed foreign supplies. Collectively, such governmental restrictions and competitive support are known as protectionism.

The restrictions illustrated in the opening case are common; all countries regulate the flow of goods and services across their borders. Figure 1 illustrates the pressures



**FIGURE 1** Physical and Social Factors Affecting the Flow of Goods and Services

In response to a variety of physical and social factors (i.e., political/legal, behavioral, economic, and geographic), governments enact measures designed to either enhance or restrict international trade flows. These measures invariably affect the competitive environment in which companies operate, either enhancing or hindering their capacity to compete on an international scale. To an extent, of course, the converse is also true: Companies influence government trade policies that affect their activities.

on governments to regulate trade and the subsequent effect of regulation on companies' competitiveness. This chapter reviews the economic and noneconomic rationales for trade protectionism and explains the major forms of trade controls and their effects on companies' operating decisions.

All countries seek to influence trade, and each has economic, social, and political objectives:

- Conflicting objectives.
- Interest groups.

## Conflicting Results of Trade Policies

Despite free-trade benefits, governments intervene in trade to attain economic, social, or political objectives. Officials apply trade policies that they reason will have the best chance to benefit their nation and its citizens—and, in some cases, their personal political longevity. Determining whether and how to influence trade is complicated by uncertain and conflicting policy outcomes. For example, catfish importing was restricted to help workers in depressed areas, but the restrictions forced consumers in those same areas to pay higher prices. In general, governments would also like to help their struggling companies and industries without penalizing those that are doing well. This goal is often impossible, however, especially if other countries retaliate against their protectionist actions by limiting their own imports.

### Concept Check

Specialization (coupled with trade) can increase a country's output of certain products; the theories of both absolute and comparative advantage support the contention that free trade encourages specialization and more efficient output. Here we point out that protectionist policies, though sometimes warranted, can impede the process that revolves around specialization.

## THE ROLE OF STAKEHOLDERS

Proposals on trade regulations often spark fierce debate among people and groups that believe they will be affected—the so-called *stakeholders*. Of course, those most directly affected are most apt to speak out, such as the U.S. stakeholders (workers, owners, suppliers, and local politicians) whose livelihoods depend on growing catfish. Displaced workers see themselves as being unemployed for the long term or forced to take new jobs in new industries, perhaps even in new towns at lower wages. People threatened in this way tend to object often and loudly.

### Concept Check

We define **stakeholders** as all the groups—shareholders, employees, customers, society at large—with which a company must make satisfactory trade-offs if it is to survive.

**The Role of Consumers** In contrast, consumers (who are also stakeholders) typically buy the best product they can find for the price, often without knowing or caring about its origin. They often don't realize how much retail prices rise in aggregate because of import restrictions. Further, because consumer costs are typically spread out among many people, over time, they take little notice. For example, U.S. import restrictions on peanuts and sugar add to the price of peanut butter and confectionary products in the United States.<sup>2</sup> Even if consumers knew about this surcharge, they would likely not see enough incentive to band together and push their government leaders to rectify the situation.

## Economic Rationales for Governmental Intervention

Governmental trade intervention may be classified as either economic or noneconomic, as shown in Table 1. Let's begin by analyzing some leading *economic rationales*.

### FIGHTING UNEMPLOYMENT

There's probably no more effective pressure group than the unemployed; no other group has the time and incentive to protest publicly and contact government representatives. Workers displaced because of imports are often the least able to find alternative work, such as the fairly unskilled catfish workers in depressed regions. When they do find alternative work, they generally earn less in their new jobs than they did before.<sup>3</sup> Moreover, they often need to spend their unemployment benefits to survive in the short term. Further, they put off retraining because they hope to be recalled to their old jobs. When they do seek retraining, many workers, especially older ones, lack the educational background necessary to gain required skills. Or they train for jobs that do not materialize.

**What's Wrong with Full Employment as an Economic Objective?** Although every country desires full employment, using trade policy to achieve it is problematic. From a practical standpoint, gaining jobs by limiting imports may not fully work as expected. Even if successful, the costs may be high and need to be borne by someone.

**The Prospect of Retaliation** One difficulty with restricting imports to create jobs is that other countries, whose production may typically drop as a result, normally retaliate with their own restrictions. Our opening case addressed the concern that Vietnam would respond to U.S. catfish import restrictions by buying less U.S. beef.

However, large trading countries are more important in the retaliation process. If the United States were to limit clothing imports in general, China would have more power to retaliate than, say, Mauritius. And the United States is less apt to retaliate against Mauritian than Chinese trade restrictions because of the lesser effect on the U.S. economy. Even if no country retaliates, the restricting country may gain jobs in one sector only to lose them elsewhere. Why? There are three factors to consider:

1. Fewer imports of a product mean fewer import-handling jobs, such as those in the container-shipping industry.
2. Import restrictions may cause lower sales in other industries because they must incur higher costs for components. (When U.S. import restrictions on steel raised automobile manufacturing costs, auto producers united to convince authorities to remove the restrictions.<sup>4</sup>)
3. Imports stimulate exports, though less directly, by increasing foreign income and foreign-exchange earnings, which foreign consumers then spend on new imports. Thus, restricting earnings abroad will have some negative effect on domestic earnings and employment.

TABLE 1 Why Governments Intervene in Trade

Economic Rationales	Noneconomic Rationales
Fighting unemployment	Maintaining essential industries
Protecting infant industries	Promoting acceptable practices abroad
Promoting industrialization	Maintaining or extending spheres of influence
Improving comparative position	Preserving national culture

The unemployed can form an effective pressure group for import restrictions.

Import restrictions to create domestic employment

- May lead to retaliation by other countries.
- Are less likely retaliated against effectively by small economies.
- Are less likely to be met with retaliation if implemented by small economies.
- May decrease export jobs because of price increases for components.
- May decrease export jobs because of lower incomes abroad.



**Analyzing Trade-Offs** In deciding whether to restrict imports to create jobs, governments must face the difficult task of comparing the costs of limiting imports with the costs of unemployment from freer trade. It is hard to put a price on the distress suffered by people who lose their jobs due to import competition. It is also difficult for working people to understand that they may be better off financially because of lower prices even if they must pay higher taxes to support unemployment or welfare benefits for the people who lose their jobs.

In summary, persistent unemployment pushes many groups to call for protectionism. However, evidence suggests that efforts to reduce unemployment through import restrictions are usually ineffective.<sup>5</sup> Unemployment in and of itself is better dealt with through fiscal and monetary policies.

Possible costs of import restrictions include higher prices and higher taxes. Such costs should be compared with those of unemployment.

## PROTECTING "INFANT INDUSTRIES"

One of the oldest arguments for protectionism, the **infant-industry argument**, holds that a government should shield an emerging industry from foreign competition by guaranteeing it a large share of the domestic market until it can compete on its own. Many developing countries use this argument to justify their protectionist policies, especially if entry barriers are high and foreign competition is formidable.

The infant-industry argument says that production becomes more competitive over time because of

- Increased economies of scale.
- Greater worker efficiency.

**Underlying Assumptions** The infant-industry argument presumes that the initial output costs for an industry in a given country may be so high as to make its output noncompetitive in world markets. Eventual competitiveness is the result of the efficiency gains that take time. Therefore, the industry's government needs to protect it long enough for its fledgling companies to gain economies of scale and their employees to translate experience into higher productivity, enabling efficient production and international competitiveness. The government can then recoup the costs of trade protection through benefits like higher domestic employment, lower social costs, and higher tax revenues.

**Risks in Designating Industries** Although it's reasonable to expect production costs to decrease over time, they may never fall enough to create internationally competitive products. This risk poses two problems.

**Determining Probability of Success** First, governments must identify those industries that have a high probability of success. Some industries grow to be competitive because of governmental protection; automobile production in Brazil is a good example. However, in many other cases, such as automobile production in Malaysia, the protected industries remain inefficient even after years of government aid.

If infant-industry protection fails to reduce costs enough to compete against imports, chances are its owners, workers, and suppliers will constitute a formidable pressure group that may prevent the importation of competing lower-priced products. Also, the security of government protection against import competition may deter managers from adopting the innovations needed to compete globally and to provide their own consumers with high-quality products at a low price.

**Who Should Bear the Cost?** Second, even if policymakers can determine those infant industries likely to succeed, it does not necessarily follow that those companies therein should receive governmental assistance. Some segment of the economy must incur the higher cost when local production is still inefficient, such as consumers paying higher prices for the protected products or taxpayers paying for subsidies. Further, when taxes go to pay subsidies, governments can spend less elsewhere, such as on education and infrastructure, to improve overall competitiveness. There are many examples of entrepreneurs who endured early losses to achieve future benefits, without public help from consumers or taxpayers.

## DEVELOPING AN INDUSTRIAL BASE

Countries seek protection to promote industrialization because that type of production

- Brings faster growth than agriculture.
- Brings in investment funds.
- Diversifies the economy.
- Brings more income than primary products do.
- Reduces imports and promotes exports.
- Helps the nation-building process.

Countries with a large manufacturing base generally have higher per capita GDPs than those that do not. Some, such as the United States and Japan, developed an industrial base while largely restricting imports. Many developing countries try to emulate this strategy, using trade protection to spur local industrialization. Specifically, they operate under the following set of assumptions:

1. Surplus workers can increase manufacturing output more easily than agricultural output.
2. Inflows of foreign investment in the industrial sector promote sustainable growth.
3. Prices and sales of agricultural products and raw materials fluctuate very much, which is a detriment to economies that depend on few of them.
4. Markets for industrial products grow faster than markets for commodities.
5. Industrial growth reduces imports and/or promotes exports.
6. Industrial activity helps the nation-building process.

In the sections that follow, we review each of these assumptions in some detail.

**Surplus Workers** Disguised unemployment is high in many developing countries' rural areas, where people are effectively contributing little, if anything, to the agricultural output. Consequently, many can move into the industrial sector without significantly reducing agricultural output. Like the infant-industry argument, the **industrialization argument** presumes that the unregulated importation of lower-priced products prevents the development of a domestic industry. Although proponents of this argument explain the advantages of developing an inefficient industrial sector, they nevertheless assert that there will be economic growth even if domestic prices do not become globally competitive. In other words, growth occurs because the underemployed gain jobs.<sup>6</sup>

Shifting people out of agriculture, however, can create at least two problems:

1. In rural areas, the underemployed may lose the safety net of their extended families, while many migrating to urban areas cannot find enough suitable jobs, housing, and social services. For example, millions of Chinese have moved to cities and not prospered. In fact, China's urban unemployment rate may run three to five times the officially reported rate.<sup>7</sup>
2. Improved agriculture practices may be a better means of achieving economic success than a drastic shift to industry. Typically, few developing countries farm their land efficiently, losing out on great benefits at low cost.<sup>8</sup> Many developed countries continue to profit from exports of agricultural products and maintain high per capita income with a mix of industry and efficient agricultural specialization.

When a country shifts from agriculture to industry,

- Demands on social and political services in cities may increase.
- Output increases if the marginal productivity of agricultural workers is very low.
- Development possibilities in the agricultural sector may be overlooked.

If import restrictions keep out foreign-made goods, foreign companies may invest to produce in the restricted area.

**Investment Inflows** Import restrictions, applied to spur industrialization, also may increase FDI, which provides capital, technology, and jobs. Barred from an attractive foreign market by trade restrictions, foreign companies may transfer manufacturing to that country to avoid the loss of a lucrative or potential market.

**Diversification** Export prices of many primary products, such as oil and coffee, fluctuate markedly. Price variations due to uncontrollable factors—such as weather affecting supply or business cycles abroad affecting demand—can wreak havoc on economies that depend on the export of primary products. This is especially true for many developing countries that must rely on only a few commodities. Frequently, they are caught in a feast-or-famine cycle, as it were: able to afford foreign luxuries one year but unable to find the funds for replacement parts for essential equipment the next. Contrary to expectations, a greater dependence on manufacturing does not guarantee diversification of export earnings. The population of many developing economies is small; a move to

manufacturing may shift dependence from one or two agricultural commodities to one or two manufactured products, which face competitive risks and potential obsolescence.

**Growth in Manufactured Goods** The quantity of imports that a given quantity of a country's exports can buy—say, how many bananas Country A must sell to Country B to purchase one refrigerator from Country B—is referred to as **terms of trade**. Historically, the prices of raw materials and agricultural commodities have not risen as fast as those of finished products, although they have risen faster during short periods. Over time, therefore, it takes more low-priced primary products to buy the same amount of high-priced manufactured goods.

In addition, the quantity of primary products demanded does not rise as rapidly as manufactured products and services, due partly to people spending a lower percentage of income on food as their incomes rise and partly to raw-material-saving technologies. A further explanation is that because commodities are hard to differentiate, producers must compete on price, whereas the prices of manufactured products can stay high because competition is based more on differentiation.

**Import Substitution and Export-Led Development** Traditionally, developing countries promoted industrialization by restricting imports in order to boost local production and consumption of products they would otherwise import. However, if the protected industries do not become efficient—an all-too-frequent outcome—local consumers may have to support them by paying higher prices or taxes. In contrast, some countries, such as Taiwan and South Korea, have achieved rapid economic growth by promoting the development of industries that export their output, an approach known as **export-led development**. In reality, it's not easy to distinguish between import substitution and export-led development. Industrialization may result initially in import substitution, yet export development of the same products may be feasible later.

**Nation Building** There may be a strong relationship between industrialization and aspects of the nation-building process. Industrialization helps countries build infrastructure, advance rural development, and boost workforce skills. Ecuador and Vietnam maintain that industrialization has helped them move from feudal economies suffering chronic food shortages to nations with improved food security and budding export competitiveness.<sup>9</sup>

## ECONOMIC RELATIONSHIPS WITH OTHER COUNTRIES

Every nation monitors its absolute economic welfare, compares its performance to that of other countries, and enacts practices aimed at improving its relative position. Among these many practices, four stand out: making balance-of-trade adjustments, gaining comparable access to foreign markets, using restrictions as a bargaining tool, and controlling prices.

**Balance-of-Trade Adjustments** A trade deficit creates problems for nations with low foreign exchange reserves—the funds that help finance the purchase of priority foreign goods and maintain the trustworthiness of a currency. So if balance-of-trade difficulties arise and persist, a government may act to reduce imports or encourage exports to balance its trade account. Basically, two options affect its competitive position broadly:

1. Depreciate or devalue its currency, which makes basically all of its products cheaper in relation to foreign products
2. Rely on fiscal and monetary policy to bring about lower price increases in general than those in other countries

Terms of trade for emerging economies may deteriorate because

- Demand for primary products grows more slowly.
- Production cost savings for primary products will be passed on to consumers.

### Concept Check

Import substitution is a policy of calling for the local production of goods and services that would otherwise have to be imported. We also demonstrate why this policy failed to achieve certain goals of one country's long-term trade strategy.

Industrialization emphasizes either

- Products to sell domestically or
- Products to export.

### Concept Check

A trade deficit usually indicates that a country's currency—along with its debt—is piling up around the world; a country afflicted with a burgeoning trade deficit needs to reconsider key areas of its economic policy.

Both of these options take time. Furthermore, they aren't selective; for instance, they make both foreign essentials and foreign luxury products more expensive. Thus, a country may use protection more effectively so as to affect only certain products. Doing so is really a stopgap measure that gives the country time to address its fundamental economic situation—the perceived quality, characteristics, and prices of its products—that is causing its residents to buy more abroad than they are selling.

As an example, since the 1970s the United States has run a trade deficit with Japan, largely because of automobile trade. The U.S. government has tried to correct the imbalance by limiting the number of Japanese vehicle imports, persuading Japanese auto companies to locate more production within the United States, and convincing Japan to ease the entry of U.S.-made cars. Nevertheless, the trade deficit continues.

Domestic producers may be disadvantaged if their access to foreign markets is less than foreign producers' access to their market.

**Comparable Access or "Fairness"** Companies and industries often use the **comparable access argument**, which holds that they are entitled to the same access to foreign markets as foreign industries and companies have to their markets. Economic theory supports this idea for industries, such as semiconductors and chemicals, with substantial production cost decreases through economies of scale. Companies that lack equal access to a competitor's market will struggle to gain enough sales to be cost-competitive.<sup>10</sup>

The argument for comparable access is also presented as one of fairness. For instance, the U.S. government permits foreign financial service firms to operate in the United States, but only if their home governments allow U.S. financial service firms equivalent market access. There are, however, at least two practical reasons for rejecting the idea of fairness:

1. Tit-for-tat market access can lead to restrictions that may deny one's own consumers lower prices.
2. Governments would find it impractical to negotiate and monitor separate agreements for each of the many thousands of different products and services that might be traded.

Countries levy trade restrictions to coerce other countries to change their policies.

**Restrictions as a Bargaining Tool** The threat or imposition of import restrictions may be a retaliatory measure for persuading other countries to lower their import barriers. The danger is that each country then escalates its restrictions, creating, in effect, a trade war that has a negative impact on all their economies. To use restrictions successfully as a bargaining tool, you need to be very careful in targeting the products you threaten to restrict. In particular, you need to consider two criteria:

- *Believability:* Either you have access to alternative sources for the product or your consumers are willing to do without it. The EU successfully retaliated against U.S. import restrictions by threatening to impose trade restrictions on U.S.-grown soybeans when Brazil had a surplus.
- *Importance:* Exports of the product you're restricting are significant to certain parties in the producer country—parties influential enough to prompt changes in their own country's trade policy. This consideration was emphasized after the United States had placed restrictions on the importation of steel. The EU threatened to restrict the importation of apples from the state of Washington and oranges from Florida. Given the importance of these two states in a close presidential election, the United States soon removed the steel import restrictions.

Export restrictions may

- Keep up world prices.
- Require more controls to prevent smuggling.
- Lead to substitution.
- Keep domestic prices down by increasing domestic supply.
- Give producers less incentive to increase output.
- Shift foreign production and sales.

**Price-Control Objectives** Countries sometimes withhold goods from international markets in an effort to raise prices abroad. This is most feasible when a few countries hold a monopoly or a near-monopoly control of certain resources and can limit supply so consumers must pay a higher price. However, this policy often encourages smuggling (such as emeralds and diamonds), the development of technology (such as synthetic

rubber in place of natural rubber), or different means to produce the same product (such as caviar from farm-grown rather than wild sturgeons).<sup>11</sup> Export controls are especially ineffective for digital products because they are so easily copied abroad. In addition, if prices are too high or supplies too limited, people will seek substitutes, such as ethanol for petroleum.

A country may also limit exports of a product that is in short supply worldwide to favor domestic consumers. Typically, a greater supply drops local prices beneath those in the intentionally undersupplied world market. Egypt and India have pursued this strategy by limiting exports of rice; Canada has considered doing it with patented prescription drugs.<sup>12</sup> Favoring domestic consumers usually disfavors domestic producers, so they lack an incentive to maintain production when prices are low.

There is also the fear that foreign producers will price their exports so artificially low that they will drive producers out of business in the importing country. If they succeed, there are two potential adverse consequences for the importing economy:

1. The foreign producers may be shifting their countries' unemployment abroad, but their own taxpayers are subsidizing the purchases by consumers abroad.
2. If there are high entry barriers, surviving foreign producers can charge exorbitant prices once their competitors go out of business. However, competition among producers from different countries usually limits anyone's ability to charge exorbitant prices. Low import prices have eliminated most U.S. production of consumer electronics; still, the U.S. has some of the lowest prices in the world for consumer electronics because so many companies make them in so many countries.

**Dumping** Companies sometimes export below cost or below their home-country price—a practice called **dumping**. Most countries prohibit imports of dumped products, but enforcement usually occurs only if the imported product disrupts domestic production. If there is no domestic production, then host-country consumers get the benefit of lower prices. Companies may dump products to introduce them and build a market abroad—essentially, a low price encourages consumers to sample the foreign brand—after which they can charge a high enough price to make a profit. Recall in our opening case that the United States placed antidumping taxes on Vietnamese catfish.

Companies can afford to dump products if they can charge high prices in their home market or if their home-country government subsidizes them. Ironically, exporting-country consumers or taxpayers seldom realize that paying high prices or taxes results in lower prices for foreign consumers. An industry that believes it's competing against dumped products may appeal to its government to restrict the imports. U.S. companies in such industries as shrimp, candles, and furniture have done so in recent years.<sup>13</sup>

However, determining a foreign company's cost or domestic price is difficult because of limited access to the foreign producers' accounting statements, fluctuations in exchange rates, and the passage of products through layers of distribution before reaching the end consumer. The result is that governments allegedly restrict imports arbitrarily through antidumping provisions of their trade legislation and are slow to dispose of the restrictions if pricing situations change. Companies caught by antidumping restrictions often lose the export market they labored to build.

**Optimum-Tariff Theory** The **optimum-tariff theory** states that a foreign producer will lower its prices if the importing country places a tax on its products. If this occurs, benefits shift to the importing country because the foreign producer lowers its profits on the export sales.

Let's examine a hypothetical situation. Assume an exporter has costs of \$500 per unit and is selling abroad for \$700 per unit. With the imposition of a 10 percent tax on the imported price, the exporter may choose to lower its price to \$636.36 per unit, which, with a 10 percent tax of \$63.64, would keep the price at \$700 in the foreign market.

Import restrictions may

- Prevent dumping from being used to put domestic producers out of business.
- Get foreign producers to lower their prices.

**CRN**  
Case Review Note

The exporter may feel that a price higher than \$700 would result in lost sales and that a profit of \$136.36 per unit instead of the previous \$200 is better than no profit at all. Consequently, an amount of \$63.64 per unit has thus shifted to the importing country.

As long as the foreign producer lowers its price by any amount, some shift in revenue goes to the importing country and the tariff is deemed an optimum one. There are many examples of products whose prices did not rise as much as the amount of the imposed tariff; however, it is difficult to predict when, where, and which exporters will voluntarily reduce their profit margins.

## Noneconomic Rationales for Government Intervention

Although noneconomic arguments are used to influence trade, many of these also have economic undertones and consequences. Figure 2 shows this humorously. However, let's look at the major noneconomic rationales:

- Maintaining essential industries (especially defense)
- Promoting acceptable practices abroad
- Maintaining or extending spheres of influence
- Preserving national culture

In protecting essential industries, countries must

- Determine which ones are essential.
- Consider costs and alternatives.
- Consider political and economic consequences.

### MAINTAINING ESSENTIAL INDUSTRIES

Governments apply trade restrictions to protect essential domestic industries during peacetime so the country is not dependent on foreign supplies during war. This is called the **essential-industry argument**. As an example, the U.S. government subsidizes the domestic production of silicon so domestic computer-chip producers will not need to depend on foreign suppliers. Because of nationalism, this argument has much appeal in rallying support for import barriers. However, in times of real (or perceived) crisis or military emergency, almost any product could be deemed essential.

FIGURE 2

While using trade policies to influence acceptable political practices abroad, governments are also concerned about their implications on business.

Source: Mick Stevens/Cartoon Bank



*"My government is very concerned about your government's torture and maiming of potential consumers."*

Because of the high cost of protecting an inefficient industry or a higher-cost domestic substitute, the essential-industry argument should not be (but frequently is) accepted without a careful evaluation of costs, real needs, and alternatives. It is difficult to remove protection, once given, because the protected companies and their employees support politicians who support their continued protection—even when the rationale for the subsidies has long since disappeared. This is why the United States continued to subsidize its mohair producers more than 20 years after mohair was deemed no longer essential for military uniforms.<sup>14</sup>

In addition, governments buy and stockpile supplies of essential raw materials that might be in future short supply. For example, the U.S. military needs weapons, jet engines, high-powered magnets, and other gear that require imported raw materials for their domestic manufacture. It needs lasers and high-powered magnets that require rare-earth elements, and China controls over 90 percent of global production of these elements.<sup>15</sup>

### PROMOTING ACCEPTABLE PRACTICES ABROAD

Governments limit trade to promote changes in foreign countries' political policies or capabilities. For instance, they use national defense arguments to prevent the export, even to friendly countries, of strategic goods that might fall into the hands of potential enemies. For example, the United States prevented exports of data-encryption technology until U.S. high-tech companies and privacy advocacy groups convinced the government to relax the curbs and allow them to export encryption products to various allies.<sup>16</sup>

Export constraints may be valid if the exporting country assumes there will be no retaliation preventing it from securing even more essential goods from the potential importing country. Even then, the latter may find alternative supply sources or develop a production capability of its own, in which case the former is the economic loser. (Our ending case discusses U.S. barriers to trade with Cuba as a means of weakening the Communist nation's economy, and Cuba's shift to imports from other countries.)

**CRN**  
Case Review Note



◀ Although ivory trade is largely illegal, the photo shows that demand continues to stimulate elephant poaching.

Source: © Blueice69caddy/  
Dreamstime.com

Import trade controls also may be used as a foreign policy weapon. When the United States found that nine Chinese companies and an Indian businessman had sold technology that Iran used for its chemical and conventional weapons programs, it imposed sanctions that barred these firms from doing business with the U.S. government and from exporting goods into the United States.<sup>17</sup>

Finally, trade controls are used to pressure foreign governments to alter their stances on a variety of issues ranging from human rights to environmental protection. For instance, many countries restrict importation of ivory to protect elephants.<sup>18</sup> However, the adjacent photo shows that, although restrictions may have slowed elephant slaughter, poaching still continues. A country's trade restrictions may coerce governments to follow certain political actions or punish companies whose governments do not. For example, China delayed permission for Allianz, a German insurance group, to operate in China after Germany gave a reception for the Dalai Lama, the exiled Tibetan spiritual leader.<sup>19</sup>

### Point

**Point Yes** Let's face it: We're now living in a global society where actions in one country can spill over and affect people all over the world. For instance, the development of a nuclear arsenal in one nation can escalate the damage that terrorists can do elsewhere. The failure of a country to protect endangered species can have long-term effects on the whole world's environment. We simply can't sit back and let things happen elsewhere that will come back to haunt us.

At the same time, some pretty dastardly things occur in some countries that most of the world community would like to see stopped: human rights violations in Myanmar, child slaves harvesting cocoa in the Ivory Coast, diamond production in Sierra Leone financing revolutions, to name a few. Even if we can't stop such occurrences, we have a moral responsibility not to participate even if it costs us. I may get some economic benefits by buying from a criminal, and I may not stop his activity by withholding my business. However, I refuse to deal with him because, in effect, that makes me a criminal's associate.

Although not all trade sanctions have been successful, many have at least been influential in achieving their

### Should Governments Impose Trade Sanctions?

**Counterpoint No** Every time I turn around, I see my government imposing a new sanction. Although some don't affect my trade, others do, causing me to lose business that took me years to develop. A few years back, my company had worked hard to develop a market for office machinery in Iraq. Then, suddenly, we could not export there and were left holding inventory we had on the loading dock ready to ship. Thus,

### Should Governments Impose Trade Sanctions?

objectives. These included UN sanctions against Rhodesia (now Zimbabwe), U.K. and U.S. sanctions against the Amin government of Uganda, and Indian sanctions against Nepal.<sup>20</sup> U.S. sanctions against Cuba may have slowed that country's ability to create revolutions elsewhere. The oil export embargo to Iran led to fuel rationing and resultant protests that have weakened the regime.<sup>21</sup>

Finally, when a nation breaks international agreements or acts in unpopular ways, what courses of action can other nations take? Between 1827 and World War I, nations mounted 21 blockades, but these are now considered too dangerous. Military force has also been used, as for the overthrow of the Saddam regime in Iraq, but such measures have little global support. Thus, nations may take such punitive actions as withholding diplomatic recognition, boycotting athletic and cultural events, seizing the other country's foreign property, and eliminating foreign aid and loans. These may be ineffective in and of themselves without the addition of trade sanctions. Moreover, countries may give incentives rather than taking punitive actions. This has occurred with North Korea to curb its nuclear program and has been suggested for Iran for the same purpose.<sup>22</sup>

### Counterpoint

the trade sanctions aimed at hurting the government of Iraq ended up hurting us even though we'd never engaged in any objectionable behavior.

Besides, I really question whether these sanctions even work. When the United States was maintaining its 20-year trade embargo on Vietnam, Vietnamese consumers were still able to buy U.S. products such as Coca-Cola, Kodak film, and Apple computers through other countries that did not

enforce the sanctions.<sup>23</sup> Similarly, the Western oil export embargo you mentioned on Iran simply caused its government to turn to China for supplies. The U.S. trade embargo with Panama only made Panama's Noriega government more adamant in its opposition to the United States, requiring a military invasion to depose him. Oil embargoes against South Africa, because of its racial policies, merely spurred South African companies to become leaders in converting coal to oil.<sup>24</sup>

Even if trade sanctions succeed at weakening the targeted countries' economies, who really suffers? You can bet that the political leaders will still get whatever they need, so the costs of sanctions are borne by innocent people. This occurred in Iraq, where there were widespread reports of

children's deaths because of sanction-induced supply shortages of food and medicine. Moreover, the people adversely affected usually blame their suffering not on their internal regime but on the countries carrying on the sanctions. Despots are very good at manipulating public opinion.<sup>25</sup>

Finally, governments sometimes seem to impose trade sanctions based on one issue rather than on a country's overall record. For instance, some critics have suggested using trade policies to press Brazil to restrict the cutting of Amazon forests, even though its overall environmental record—particularly its limiting of adverse exhaust emissions by converting automobile engines to use methanol instead of gasoline—is quite good.

## MAINTAINING OR EXTENDING SPHERES OF INFLUENCE

Governments also use trade to support their spheres of influence. Governments give aid and credits to, and encourage imports from, countries that join a political alliance or vote a preferred way within international bodies. The EU and the 77 members of the African, Caribbean, and Pacific Group of States signed the Cotonou Agreement to formalize preferential trade relationships that also strengthened political ties.<sup>26</sup> Venezuela has exported oil at low cost and with long-term financing to targeted Latin American countries to gain influence in the region.<sup>27</sup>

## PRESERVING NATIONAL CULTURE

Countries are held together partly through a unifying sense of identity that sets their citizens apart from those in other nations. To sustain this collective identity, they prohibit exports of art and historical items that they deem to be part of their national heritage. In addition, they limit imports of certain foreign products and services that may either conflict with their dominant values, such as morality, or replace domestic sources of production that uphold these traditional values. The relevance of culture has been confirmed through several UNESCO conventions aimed at preserving cultural diversity, and the concern has been largely focused, but not entirely, on media (print, visual, and audio).<sup>28</sup> For many years, Japan, South Korea, and China maintained an almost total ban on rice imports, largely because rice farming has been a historically cohesive force in each nation.<sup>29</sup> Canada relies on a "cultural sovereignty" argument to prohibit foreign ownership or control of publishing, cable TV, and bookselling.<sup>30</sup> South Korea requires theaters to show Korean films a certain number of days per year.<sup>31</sup>

## Instruments of Trade Control

Governments use many rationales and seek a range of outcomes when they try to influence exports or imports. The choice of trade-control instrument is crucial because each type may incite different responses from domestic and foreign groups. One way to understand trade-control instruments is by distinguishing between two types that differ in their effects:

- Those that indirectly affect the amount traded by directly influencing the *prices* of exports or imports
- Those that directly limit the *amount* of a good that can be traded

Let's review these instruments.

### Concept Check

A primary function of culture is to support a nation's sense of its uniqueness and integrity. We also explain that—especially in developing countries—many people fear that the escalation and influence of global business interaction is a prelude to another era of **cultural imperialism** in which weaker nation-states will be weakened even further. Finally, we note that similar concerns are raised by the prospect of cultural diffusion—a process by which elements of a foreign culture may infiltrate themselves into a local culture.

## TARIFFS

Tariffs may be levied

- On goods entering, leaving, or passing through a country.
- For protection or revenue.
- On a per unit or a value basis.

*Tariff barriers* directly affect prices, and *nontariff barriers* may affect either price or quantity. A **tariff** (also called a **duty**), the most common type of trade control, is a tax that governments levy on a good shipped internationally. That is, governments charge a tariff on a good when it crosses an official boundary—whether it be that of a nation or a group of nations that have agreed to impose a common tariff on goods crossing the boundary of their bloc.

Tariffs collected by the exporting country are called **export tariffs**; if they're collected by a country through which the goods pass, they're **transit tariffs**; if they're collected by importing countries, they are called **import tariffs**. Because import tariffs are by far the most common, we discuss them in some detail.

**Import Tariffs** Unless they're *optimum tariffs* (discussed earlier in the chapter), import tariffs raise the price of imported goods by placing a tax on them, thereby giving domestically produced goods a relative price advantage. A tariff may be protective despite no domestic production in direct competition if the tariff raises the price of some foreign production in order to curtail overall demand for imports.

**Tariffs as Sources of Revenue** Tariffs also serve as a source of governmental revenue. Import tariffs are of little importance to developed countries, usually costing more to collect than they yield.<sup>32</sup> However, in many developing countries they are a major source of revenue, potentially giving the governments more control over determining the amounts and types of goods crossing their borders and collecting a tax on them than over determining and collecting individual and corporate income taxes. Although revenue tariffs are most commonly collected on imports, some countries charge export tariffs on raw materials.<sup>33</sup> Transit tariffs were once a major source of countries' revenue, but governmental treaties have nearly abolished them.

**Criteria for Assessing Tariffs** A government may assess a tariff on a per unit basis, in which case it is applying a **specific duty**. A tariff assessed as a percentage of the item's value is an **ad valorem duty**. If both types are assessed on the same product, the combination is a **compound duty**. A specific duty is more straightforward for customs officials to assess because they do not need to determine a good's value on which to calculate a percentage tax.

A tariff controversy concerns developed countries' treatment of manufactured exports from developing countries that seek to add manufactured value to their raw material exports. Raw materials frequently enter developed countries free of duty (say, coffee beans); however, if they are processed (instant coffee), developed countries then assign an import tariff. Because an ad valorem tariff is based on the total value of the product (say, \$5 for a jar of instant coffee), meaning the raw materials and the processing combined (\$2.50 for the coffee beans and \$2.50 for the processing), developing countries argue that the **effective tariff** on the manufactured portion turns out to be higher than the published tariff rate. In other words, a tariff rate of 10 percent is effectively 20 percent on the manufactured portion. This anomaly further challenges developing countries to find markets for their manufactured products. At the same time, the governments of developed countries cannot easily remove barriers to imports of developing countries' manufactured products, largely because these imports are more likely to displace workers who are least equipped to move to new jobs.

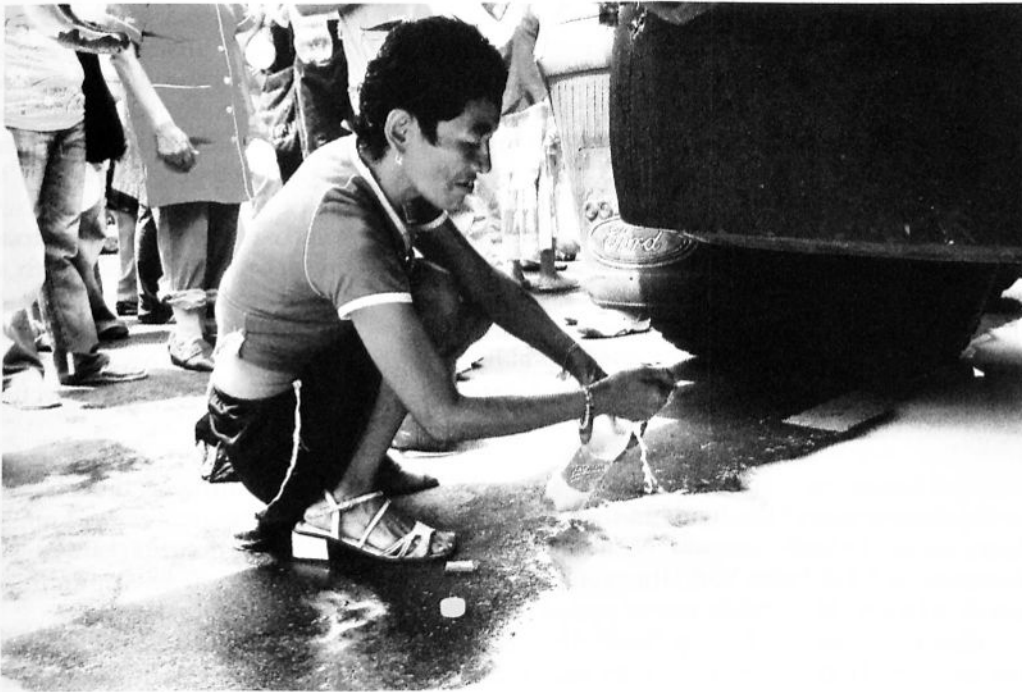
## NONTARIFF BARRIERS: DIRECT PRICE INFLUENCES

Now that we've shown how tariffs raise prices and limit trade, let's turn to a discussion of other ways that governments alter product prices to limit their trade.

**Subsidies** Subsidies are direct assistance to companies to make them more competitive. (The photo shows a Colombian protest against subsidized European milk imports.)

Governmental subsidies may help companies be competitive,

- Especially to overcome market imperfections because they are least controversial.
- But there is little agreement on what a subsidy is.
- But agricultural subsidies are difficult to dismantle.



◀ A woman collects milks spilled under a truck that was handing out milk during a protest against the signature of a 2010 free trade agreement with the European Union in Medellin, Colombia. Colombian milk producers argue that the local dairy industry will be unable to compete with the heavily-subsidized European dairy producers.

Source: AP Photo/Luis Benavides

Although this definition is straightforward, disagreement on what constitutes a subsidy causes trade frictions. In essence, not everyone agrees that companies are being subsidized just because they lose money, nor that all types of government loans or grants are subsidies. One long-running controversy involves commercial aircraft. Airbus Industrie and the EU claim that the U.S. national and state governments subsidize Boeing respectively through R&D contracts for military aircraft that also have commercial applications and tax breaks to secure employment from Boeing's facilities. Meanwhile, Boeing and the U.S. government claim that the EU subsidizes Airbus Industrie through low-interest government loans.<sup>34</sup>

An area that may well raise future questions about subsidies is governmental support to shore up floundering companies and industries during the global recession. For instance, several countries have bailed out banks and acted on behalf of their automobile industries with help such as generous loans and support for consumers to replace their old cars. Other countries have eliminated taxes on their companies' export earnings.<sup>35</sup> In turn, these actions are altering international competitiveness.<sup>36</sup>

**Agricultural Subsidies** The one area in which everyone agrees that subsidies exist is agricultural products in developed countries. The official reason for granting subsidies to farmers is that food supplies are too critical to be left to chance. Although subsidies lead to surplus production, surpluses are argued to be preferable to the risk of food shortages. The question of food shortages came to the forefront during 2010 droughts when a number of countries limited or banned exports of such agricultural commodities as rice and wheat in order to maintain supplies for their own consumers.<sup>37</sup>

Although this official reason seems compelling, it does not explain agricultural subsidies for non-food products, such as U.S. subsidies for cotton that have disadvantaged Brazilian production.<sup>38</sup> There is an unofficial reason as well. Within the EU, Japan, and the United States, rural areas have a disproportionately high representation in government decision making. In the United States, for instance, there is one senator per 300,000 people in Vermont, a state with a 68 percent rural population, and one senator per 18 million in California, which is 93 percent urban. The result is that internal politics effectively

prevents the dismantling of such instruments as price supports for farmers, government agencies to improve agricultural productivity, and low-interest loans to farmers.

What is the effect? Developing countries are disadvantaged in serving the developed markets with competitive agricultural products. Further, much of the surplus production from developed countries is exported at prices below those in the products' domestic markets, thus distorting trade and disadvantaging production from developing countries.<sup>39</sup>

**Overcoming Market Imperfections** Another subsidization area is less contentious. Most countries offer potential exporters many business development services, such as market information, trade expositions, and foreign contacts. From the standpoint of market efficiency, these sorts of subsidies are more justifiable than tariffs because they seek to overcome, rather than create, market imperfections. There are also benefits to disseminating information widely because governments can spread the costs of collecting information among many users.

**Aid and Loans** Governments also give aid and loans to other countries. If the recipient is required to spend the funds in the donor country, which is known as *tied aid* or *tied loans*, some products can compete abroad that might otherwise be noncompetitive. For instance, tied aid helps win large contracts for infrastructure, such as telecommunications, railways, and electric power projects.

However, there is growing skepticism about the value of tied aid, because it requires the recipient to use suppliers in the donor country who are shielded from competition and may not be the best. Tied aid can also slow the development of local suppliers in developing countries. These concerns led OECD members to untie financial aid to developing countries, no longer obliging aid-recipient countries to purchase equipment from suppliers in the donor country.<sup>40</sup> However, China is using tied aid for nearly all its foreign projects.<sup>41</sup>

**Customs Valuation** Tariffs for imported merchandise depend on the product, price, and origin. The temptation exists for exporters and importers to declare these wrongly on invoices to pay less duty. Generally, most countries have agreed to use the invoice information unless customs officers doubt its authenticity. Agents must then assess on the basis of the value of identical goods. If not possible, agents must assess on the basis of similar goods arriving in or about the same time.

For example, there is no sales invoice when imported goods enter for lease rather than purchase. Customs officials must then base the tariff on the value of identical or similar goods. If this basis cannot be used, officials may compute a value based on final sales value or on reasonable cost. Similarly, agents sometimes use their discretionary power to assess the value too high, thereby preventing the importation of foreign-made products.<sup>42</sup>

**Valuation Problems** The fact that so many different products are traded creates valuation problems, especially since new products are coming on the market all the time and must be classified within existing tariff categories. It is easy (by accident or intention) to misclassify a product and its corresponding tariff. Administering more than 13,000 categories of products means a customs agent must use professional discretion to determine, say, if silicon chips should be considered "integrated circuits for computers" or "a form of chemical silicon." In our opening case, we saw the controversy of whether the Vietnamese fish are catfish or whether they are basa, tra, or pangasius. The classification will become even more complex as both U.S. and Vietnamese scientists develop fish hybrids that combine, for example, fast-growing with good-tasting fish. The differences among products in tariff schedules are also minute. For example, the United States has a different tariff on athletic footwear than on sports footwear, and these are further categorized by whether the sole overlaps the upper part of the shoe or not. Each type of accessory and reinforcement of the shoes' uppers have different tariffs.

Because it is difficult for customs officials to determine the honesty of import invoices,

- They may arbitrarily increase value.
- Valuation procedures have been developed.
- They may question the origin of imports.

Although classification differences may seem trivial, the disparity in duties may cost companies millions of dollars. Some contentious examples are whether the French company Agatec's laser leveling device would be used primarily indoors or outdoors as well,<sup>43</sup> whether Marvel's X-Men Wolverines were toys or dolls, and whether sport utility vehicles—such as the Suzuki Samurai and the Land Rover—were cars or trucks. Because of a much higher U.S. tariff on trucks than on automobiles, Ford imports autos from Turkey and then removes the rear seats and replaces the rear windows with solid metal in order to turn them into trucks.<sup>44</sup>

Because countries treat products from different countries differently, customs must also determine products' origins. This is neither cheap nor easy. However, officials have uncovered many instances of transshipping products—shoes, cigarette lighters, garlic, lightbulbs—from China through Cambodia to overcome quantity limitations and higher duties.<sup>45</sup>

**Other Direct-Price Influences** Countries use other means to affect prices, including special fees (such as for consular and customs clearance and documentation), requirements that customs deposits be placed in advance of shipment, and minimum price levels at which goods can be sold after they have customs clearance.

## NONTARIFF BARRIERS: QUANTITY CONTROLS

Governments use other nontariff regulations and practices to affect the quantity of imports and exports directly. Let's take a look at the various forms these typically take.

**Quotas** The **quota** is the most common type of quantitative import or export restriction, limiting the quantity of a product that can be imported or exported in a given time frame, typically per year. *Import quotas* normally raise prices for two reasons: (1) to limit supply and (2) to provide little incentive to use price competition to increase sales. A notable difference between tariffs and quotas is their effect on revenues. Tariffs generate revenue for the government. Quotas generate revenue only for those companies that are able to obtain and sell a portion of the intentionally limited supply of the product. (Sometimes governments allocate quotas among countries, based on political or market conditions.)

To circumvent quotas, companies sometimes convert the product into one for which there is no quota. For instance, the United States maintains sugar import quotas that result in its sugar prices averaging about double the world market price. As a result, many U.S. candy producers have moved plants to Mexico where they can buy lower-cost sugar and import the candy duty-free to the United States.<sup>46</sup>

Finally, import quotas are not necessarily imposed to protect domestic producers. Japan has maintained quotas on many agricultural products from outside the country. It has then allocated import rights to competing suppliers as a means of bargaining for sales of Japanese exports and preventing excess dependence on any one country for essential foods.

**Voluntary Export Restraint** A variation of an import quota is the so-called **voluntary export restraint (VER)**. Essentially, Country A asks Country B to voluntarily reduce its companies' exports to Country A. The term *voluntarily* is somewhat misleading; typically, either Country B volunteers to reduce its exports or else Country A may impose tougher trade regulations. Procedurally, VERs have unique advantages. They are much easier to switch off than an import quota, and the appearance of a "voluntary" choice by a particular country to constrain its shipments can do less damage to political relations than an import quota.

A country may establish *export quotas* to assure domestic consumers a sufficient supply of goods at a low price, to prevent depletion of natural resources, or to attempt to raise export prices by restricting supply in foreign markets. To restrict supply, some

A quota may

- Set the total amount to be traded.
- Allocate amounts by country.

countries band together in various commodity agreements, such as OPEC for petroleum, which then restrict and regulate exports from the member countries.

**Embargoes** A specific type of quota that prohibits all trade is an **embargo**. As with quotas, countries or groups of countries may place embargoes on either imports or exports, on whole categories of products regardless of origin or destination, on specific products with specific countries, or on all products with given countries. Governments impose embargoes in an effort to use economic means to achieve political goals. As we explain in our closing case, the U.S.-imposed embargo on Cuba was conceived to weaken the Cuban economy and thus induce a demoralized populace to overthrow the Communist regime.



Through “buy local” laws

- Government purchases give preference to domestically made goods.
- Governments sometimes legislate a percentage of domestic content.

**“Buy Local” Legislation** Another form of quantitative trade control is so-called *buy local legislation*. Government purchases are a large part of total expenditures in many countries; typically, governments favor domestic producers. Sometimes they specify a domestic content restriction—that is, a certain percentage of the product must be of local origin. For example, the U.S. economic stimulus package of 2009 to counter the economic recession required any funded project to use only U.S.-made steel, iron, and manufactured goods.<sup>47</sup> Sometimes governments favor domestic producers through price mechanisms, such as permitting an agency to buy a foreign-made product only if the price is at some predetermined margin below that of a domestic competitor. Sometimes governments favor domestic purchases indirectly, such as the U.S. prohibition of foreign Medicare payments for elderly Americans except in emergency situations, a regulation that limits U.S. foreign purchases in the fast growing area of medical tourism.

Other types of trade barriers include

- Arbitrary standards.
- Licensing arrangements.
- Administrative delays.
- Reciprocal requirements.
- Service restrictions.



**Standards and Labels** Countries can devise classification, labeling, and testing standards to allow the sale of domestic products but obstruct foreign-made ones. Consider product labels. The requirement that companies indicate on a product where it is made informs consumers who may prefer to buy products from certain nations. In our opening case, we saw that the U.S. catfish industry sought country-of-origin labeling on fish. Countries also may dictate content information on packaging that is not required elsewhere. These technicalities add to a firm’s production costs, particularly if the labels must be translated for different export markets. In addition, raw materials, components, design, and labor increasingly come from many countries, so most products today are of such mixed origin that they are difficult to sort out.

The professed purpose of standards is to protect the safety or health of the domestic population. However, some companies argue that standards are just another means to protect domestic producers. For example, some U.S. and Canadian producers have contended that EU regulations and labeling requirements on genetically engineered corn and canola oil are merely means to keep out the products until their own technology catches up.<sup>48</sup> In another case, following U.S. publicity about contaminated Chinese foods, China upped its rejection of foodstuffs from the United States, citing contamination with drugs and salmonella.<sup>49</sup>

In reality, there’s no way of knowing to what extent products are kept out of countries for legitimate safety and health reasons rather than arbitrarily to protect domestic production. Nevertheless, the U.S. FDA publishes a monthly summary of rejected food import shipments by country, a list that is substantial. For example, in April 2011 it rejected over a thousand shipments from 73 different countries. Most of the rejections, in order, were from China, India, and Mexico.<sup>50</sup>

**Specific Permission Requirements** Some countries require that potential importers or exporters secure permission from government authorities before conducting trade transactions. This requirement is known as an **import or export license**. A company may have to submit samples to government authorities to obtain such a license. The procedure can restrict imports or exports directly by denying permission or indirectly because of the cost, time, and uncertainty involved.

A **foreign-exchange control** is similar. It requires an importer to apply to a government agency to secure the foreign currency to pay for the product. As with an import license, failure to grant the exchange, not to mention the time and expense of completing forms and awaiting replies, obstructs foreign trade.

**Administrative Delays** Closely akin to specific permission requirements are intentional administrative delays or those caused by inefficiency, which create uncertainty and raise the cost of carrying inventory. Competitive pressure, however, moves countries to improve their administrative systems. Chinese trade authorities, for example, cut the time from one week to one day for goods manufactured by Hong Kong firms in Guangdong to pass through internal customs checks. Improved processes, such as electronic submission of cargo manifests, affected 68,000 non-mainland firms and reduced administrative costs more than US\$70 million.<sup>51</sup>

**Reciprocal Requirements** Because of government regulations in the importing countries, exporters sometimes must take merchandise or buy services in lieu of receiving cash payment. This requirement is common in the aerospace and defense industries—sometimes because the importer does not have enough foreign currency. For instance, Indonesia bought Russian jets in exchange for commodities such as rubber.<sup>52</sup>

**Countertrade** Countertrade or offsets are government requirements in the importing country whereby the exporter, usually in sales (especially military ones) to a foreign government must provide additional economic benefits such as jobs or technology as part of the transaction. When McDonnell Douglas sold helicopters to the British government it had to equip them with U.K.-made Rolls Royce engines as well as transfer much of the technology and production work to the United Kingdom.<sup>53</sup> Countertrade has been criticized because large defense contractors usually keep their own sales in tact while transferring their purchases from smaller domestic contractors to those in foreign countries, thus weakening domestic defense capabilities.<sup>54</sup>

Reciprocal requirements often mean that exporters must find markets for goods outside their lines of expertise or engage in complicated organizational arrangements that require them to relinquish some operating control. All things being equal, companies avoid these transactions. However, some have developed competencies in these types of arrangements in order to gain competitive advantages.

**Restrictions on Services** Service is the fastest-growing sector in international trade. In deciding whether to restrict service trade, countries typically consider four factors: *essentiality, not-for-profit preference, standards, and immigration.*

**Essentiality** Countries judge certain service industries to be essential because they serve strategic purposes or provide social assistance to citizens. Governments may prohibit private companies, foreign or domestic, in some sectors because they feel the services should not be sold for profit. In other cases, they set price controls or subsidize government-owned service organizations that create disincentives for foreign private participation. Some essential services in which foreign firms might be excluded are media, communications, banking, utilities, and domestic transport.

**Not-for-Profit Services** Mail, education, and hospital health services are often not-for-profit sectors in which few foreign firms compete. When a government privatizes these industries, it customarily prefers local ownership and control.

**Standards** Some services require face-to-face interaction between professionals and clients. At the same time, governments limit entry into many service professions to ensure practice by qualified personnel. The licensing standards for these personnel vary by country and include such professionals as accountants, actuaries,

Three main reasons for restricting trade in services are

- Essentiality.
- Preference for not-for-profit operations
- Standards.
- Immigration.

architects, electricians, engineers, gemologists, hairstylists, lawyers, medical personnel, real estate brokers, and teachers.

At present, there is little reciprocal recognition in licensing from one country to another because occupational standards and requirements differ substantially. This means that an accounting or legal firm from one country might face obstacles in another, even to serve its domestic clients' needs. The firm must hire professionals within each foreign country or else try to earn certification abroad. The latter option can be difficult because the professionals may have to take examinations in a foreign language and study materials different from those in their home country. There also may be lengthy prerequisites for taking an examination, such as internships, time in residency, and coursework at a local university.

### Concept Check

The effect of the increasing reliance on people as an internationally mobile production factor. In addition, we observe that most countries hand out immigration papers only sparingly and that many others allow workers to enter only for short periods of time.

When facing import competition, companies can

- Move abroad.
- Seek other market niches.
- Make domestic output competitive.
- Try to get protection.

**Immigration** Satisfying the standards of a particular country is no guarantee that a foreigner can then work there. In addition, governmental regulations often require an organization—domestic or foreign—to search extensively for qualified personnel locally before it can even apply for work permits for personnel it would like to bring in from abroad.<sup>55</sup>

## Dealing with Governmental Trade Influences

Government intervention in trade affects the flow of imports and exports of goods and services among countries. When companies face possible losses because of import competition, they have several options, four of which stand out:

1. Move operations to another country.
2. Concentrate on market niches that attract less international competition.
3. Adopt internal innovations, such as greater efficiency or superior products.
4. Try to get governmental protection.

There are costs and risks with each option. Nevertheless, the records of many companies show that they undertake different ones. For example, competition from Japanese imports spurred the U.S. automobile industry to move some production abroad (such as subcontracting with foreign suppliers for cheaper parts), developing niche markets through the sale of minivan and sport utility vehicles (SUVs) that initially had less international competition, and adopting innovations such as lean production techniques to improve efficiency and product quality. General Motors and Chrysler eventually received substantial government funding to survive.

## Tactics for Dealing with Import Competition

Granted, these methods are not realistic for every industry or every business. Companies may lack the managerial, capital, or technological resources to shift their own production abroad, and finding qualified foreign suppliers may be problematic. They may not be able to identify more profitable product niches. Even if they manage to develop niches or improve efficiency, foreign competitors may quickly copy their innovation. In such situations, companies often ask their governments to restrict imports or open export markets. As our opening case shows, U.S. catfish farmers have successfully gained government support to limit import competition, such as changing the name of the imported competitive fish.



### CONVINCING DECISION MAKERS

Governments cannot try to help every company that faces tough international competition. Likewise, helping one industry may hurt another. Thus, as a manager, you may

propose or oppose a particular protectionist measure. Inevitably, the burden falls on you and your company to convince officials that your situation warrants particular policies. You must identify the key decision makers and convince them by using the economic and noneconomic arguments presented in this chapter. In any situation, companies must convey to public officials that voters and stakeholders support their position.<sup>56</sup>

## INVOLVING THE INDUSTRY AND STAKEHOLDERS

A company improves the odds of success if it can ally most, if not all, domestic companies in its industry. Otherwise, officials may feel that its problems are due to its specific inefficiencies rather than the general import challenges or difficulty in gaining export sales. Similarly, involving other stakeholders can help, such as the taxpayers and merchants in the communities where it operates. Finally, it can lobby decision makers and endorse the political candidates who are sympathetic to its situation.

## PREPARING FOR CHANGES IN THE COMPETITIVE ENVIRONMENT

Companies can take different approaches to deal with changes in the international competitive environment. Frequently, their attitudes toward protectionism are a function of the investments they have made to implement their international strategy. Those that depend on freer trade and/or have integrated their production and supply chains among countries tend to oppose protectionism. In contrast, those with single or multidomestic production facilities, such as a plant in Japan to serve the Japanese market and a plant in Taiwan to serve the Taiwanese market, tend to support protectionism.

Companies also differ in their self-perception of being able to compete against imports. In nearly half the cases over a 60-year period in which U.S. firms proposed protecting a U.S. industry, one or more companies in that industry opposed it, typically commanding competitive advantages in terms of scale economies, supplier relationships, or differentiated products. Thus, they reasoned that not only could they successfully battle international rivals, they also stood to gain even more as their weaker domestic competitors failed to do so.<sup>57</sup>

### Concept Check

Although representative democracies tend to share many features, the process whereby citizens select representatives to make decisions on their behalf varies from country to country, especially when it comes to the centralization or decentralization of authority. Among other things, the task of locating decision makers for business purposes thus differs from one country to another.

### Looking to the



### Future Dynamics and Complexity

When trade restrictions change, there are winners and losers among countries and among companies and workers within them. So it's probably safe to say that we'll see mixtures of pushes for freer trade and greater protection.

In addition, gains to consumers from freer trade may be at the expense of some companies and workers—people who see themselves as big losers. They are not apt to lose without a struggle; they'll garner as much support for protection as they can, and they may win. This support may well come from alliances that cross national borders, such as clothing companies in various developing nations uniting to push governments to enact quota agreements to protect

their markets in developed countries against Chinese and Indian competition. Thus, if you are a manager in an industry that may be affected by changes in governmental protection, you must watch closely to predict how the politics may affect your own economic situation.

Finally, the international regulatory situation is becoming more, rather than less, complex—a situation that challenges companies to find the best locations in which to produce. New products are coming onto the market regularly, thus making the task of tariff classification more complex. Services available over the Internet, such as international online gambling, challenge governments to find means of regulation and

(continued)

tax collection. Heightened concerns about terrorism and product safety compound considerations of what should or should not be traded and with whom.

Every time countries negotiate a trading agreement (and these agreements are proliferating), there is the possibility that a new optimum production location emerges. When the United States and Mexico negotiated a free trade pact, it caused some U.S. imports to

shift from Taiwan to Mexico. However, with an additional free trade agreement between the United States and Central America, some of the production that developed in Mexico shifted to Central American countries. Another free trade agreement might cause another shift in the future. All of this creates uncertainties and dynamics for companies' operations. ■

## CASE



### U.S.–Cuban Trade: When Does a Cold War Strategy Become a Cold War Relic?

The U.S. embargo of Cuba has been a resilient foreign policy, able to weather a variety of political leaders, economic events, and historical eras for over 50 years.<sup>58</sup> In 2011, the Obama administration rescinded earlier restrictions by allowing licensed organizations to grant U.S. citizens permission to make purposeful (academic, cultural, and humanitarian) travel to Cuba. In addition, the Cuban government announced in 2011 that it was easing restrictions on Cubans' ability to buy and sell houses and automobiles and to travel abroad. On the one hand, these moves led to speculation that commercial relations would grow between the two countries. On the other hand, 2010 U.S. mid-term elections gave more power to hard-liners in the U.S. House of Representatives and Senate, who want stricter restrictions on U.S.-Cuban relations, such as by limiting the number of flights between the United States and Cuba and revoking visas for executives from non-U.S. companies doing business in Cuba. Many U.S. observers want normal commercial relations with Cuba and many do not. The opposing positions are straightforward and similar to those that have prevailed for over five decades. On the one hand, proponents of normal relations argue that the long embargo has not worked and that U.S. companies have been forced to lose business to competitors from other countries. On the other hand, opponents of normal relations argue that a demoralized Cuban population will overthrow the regime if economic conditions deteriorate just a little more. Further, they argue that there is a moral obligation not to do business with a regime that has been so economically and politically repressive. For instance, Cuba is on the official U.S. list of countries sponsoring terrorism and the list refusing to do enough to prevent child prostitution. Let's first look at the history of the situation.

#### Before and After the Revolution

Since Cuba's independence from Spain in 1899, it has depended on a succession of "sugar daddies." Until Fidel Castro overthrew the Batista government in 1959, more than two-thirds of Cuba's foreign trade took place with the United States. The U.S. bought Cuban sugar at a price well above the world market price, which was a disguised form of foreign aid that extended the U.S. sphere of political influence. Later, the Soviet Union poured aid into Cuba and Venezuela has followed by subsidizing oil exports to Cuba.

After Castro came to power in 1959, he threatened to incite revolutions elsewhere in Latin America. The United States countered by canceling its agreements to buy Cuban sugar, and

Cuba retaliated by seizing U.S. oil refineries. The oil companies refused to supply Cuba with crude oil. Cuba then turned to the Soviet Union for replacement supplies.

### The Cold War Sets In

This conflict occurred at the height of the Cold War tension between the United States and the Soviet Union. In 1962, the United States severed diplomatic relations and initiated the full trade embargo of Cuba. In 1963, the Treasury Department set forth regulations that prohibited all unlicensed financial transactions, forbade direct or indirect imports from Cuba, and imposed a total freeze on Cuban government assets held in the United States. Trade between the United States and Cuba stopped.

The incidents that strained relations during the next decades are too numerous to detail. Some threatened peace; others bordered on the absurd. They included the U.S. sponsorship of an invasion by Cuban exiles at the Bay of Pigs, the placement and removal of Soviet missiles in Cuba, the deployment of Cuban forces to overthrow regimes the United States supported (such as in Nicaragua and Angola), and exposés claiming the CIA had tried to air-lift someone to assassinate Castro and had tried to develop a powder to make his beard fall out. Figure 3 gives a time line of major events in U.S.-Cuban relations.

### Enacting the Embargo

During this period, the U.S. trade embargo endured as originally set. Despite the collapse of communism in most of the world in the early 1990s, the U.S. Congress passed the Cuban Democracy Act in 1992. This policy codified the ban on American travel to Cuba and extended the embargo to the foreign subsidiaries of U.S. companies operating abroad—there would be no trade, direct or otherwise, between the United States and Cuba. The act also required Cuba to hold democratic elections before the U.S. executive branch could repeal the embargo.

### Shifting Sympathies

Over time, the U.S. role in the Cuban drama has played to a less sympathetic audience worldwide. Initially, many countries supported the U.S. embargo. All members of the Organization of American States (OAS) except Mexico agreed in 1964 to endorse it. Gradually, countries began trading with Cuba anyway. In 2011, the United Nations voted 186 to 2 against the U.S. embargo. Only Israel voted with the United States. In 2009, the OAS lifted a 47-year suspension of Cuba as a member, basically by redefining democracy to include Marxist-Leninist ideology and not requiring property rights, transparent elections, and free speech as part of the definition.

### The Cold War Thaws

Events increasingly created questions about the rationale for continuing the embargo. The fall of the Berlin Wall and the end of the Cold War in the early 1990s triggered many changes.

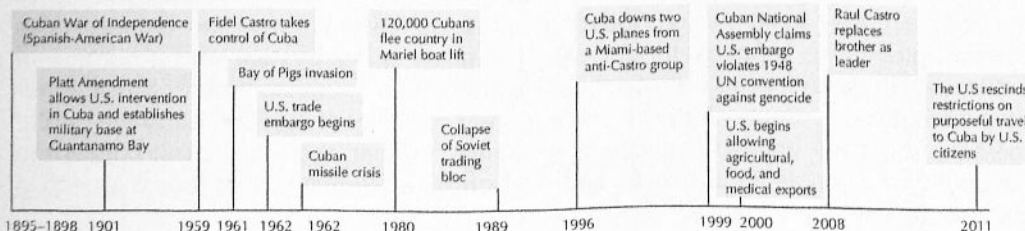


FIGURE 3 The Saga of U.S.-Cuba Relations

Relations between the United States and the island nation of Cuba have been embroiled in the vicissitudes of international politics for more than a century—and especially since Fidel Castro took power in 1959.

The attendant collapse of the Soviet Union deprived Cuba of annual subsidies that sustained its feeble economy. Before long, the export of revolution from Cuba seemed less of a threat. In 2000, congressional legislation allowed certain exports of U.S. agricultural, food, and medical products. After the passage of this act, the United States has become the fourth largest exporter to Cuba after Venezuela, China, and Spain.

### **The Argument for Policy Change**

Those in favor of establishing diplomatic relations with Cuba argue that hard-liner policies caused adversity for over 11 million Cubans without weakening either Fidel Castro's or Raúl Castro's political power. (Raúl replaced his older brother in 2008 and turned 80 in 2011.) In fact, they point to the Cuban government's past actions against the Cuban people in retaliation for new, stringent U.S. economic policies. These have included the raising of prices in Cuba for foreign-produced goods and the elimination of the U.S. dollar as an official currency.

Moreover, they warn that Cuban economic problems merely aggravate U.S. immigration tensions with Cuba. A growing number of leaders in the United States (including heads of major firms, Democratic and Republican members of Congress, and labor leaders) have publicly favored normalization of U.S.–Cuban trade. In essence, they believe that increasing exposure to the United States, not the embargo, would be a more promising force of change.

### **Are There U.S. Business Advantages in Cuba?**

Repealing the embargo might help many U.S. industries and companies inasmuch as companies from other countries have already found advantages in tapping Cuba's highly qualified workforce and near-perfect literacy rate. (The Cuban government has announced elimination of a half million state jobs, thus creating a substantial labor supply.) Further, there is a Cuban demand for foreign products and services.

Groups in the United States have noted Cuba's market potential for U.S. companies within the tourism and transportation sectors. Cuba received over 2.5 million international arrivals in 2010. Even with travel bans, there were about 300 sanctioned flights per month between Miami and Cuba. Further, many Americans defied U.S. travel bans by entering Cuba from non-U.S. embarkation points. There are also some bright spots for the Cuban economy. Venezuela has been supplying Cuba with about 100,000 barrels per day of petroleum products at preferential terms, paid for in part by receiving about 30,000 Cuban medical professionals. Further, there are estimates of large oil reserves off the north Cuban coast only 65 miles from the United States. U.S. companies are currently not allowed to bid for exploration rights, and environmentalists worry that the use of Chinese-made rigs by the Spanish company Repsol may increase dangers of spills that enter U.S. waters. In addition, Cuba receives substantial remittances from its citizens working abroad and from relatives of Cuban residents.

At the same time, many argue that the potential for business with Cuba is highly limited. Cuba's per capita GDP is low, which when coupled with its small population (a little over 11 million) does not amount to much purchasing power. This is evident by the prevalence of 1950s U.S.-made cars in Cuba even though European and Asian auto companies face no embargoes on their sales.

In addition, Cuba has to export enough to pay for imports. Cuba depends heavily on commodity exports—sugar, nickel, tobacco, citrus, coffee—for which the United States has ample alternative supplies. In fact, the U.S. sugar quota system with a number of countries would surely cause a political backlash in those countries if part of their sugar quotas were given to Cuba. Certainly, there is the possibility of tourism, but there is disagreement about the unused capacity of its hotels. Further, there has been concern in some countries, such as the Bahamas and the Dominican Republic, that tourist growth in Cuba would be at their expense.



◀ US autos from the 1950s are commonly seen in Havana because funds are lacking to import new vehicles.

Source: © Roxana Gonzalez/iStockphoto.com

### Is the Embargo a Cold War Relic?

Finally, there has been debate over the basis for the pro-embargo position. Some argued that, in an age when China is a member of the WTO and nations like Vietnam are trading with the United States, the Cuban embargo looked like a Cold War relic. Moreover, the Cuban embargo is the longest and harshest embargo by one state against another in modern history.

However, a change in U.S. commercial policy toward Cuba does not necessarily mean that Cuba would welcome or accept it. For example, U.S. trade actions have given the Cuban government something other than inept policies to blame for economic blunders. Further, when the OAS allowed Cuba's reentry, Cuba rejected the overture by calling the OAS "totally anachronistic." Fidel Castro has said that the OAS will end up "in the garbage dump of history." Further, Raúl Castro purged Cuba's political leadership in 2009 by referring to former aides as foreign lackeys and indicating that he would not allow any cozying up to foreigners. ■

### QUESTIONS

- ✓ 1. Should the United States seek to tighten the economic grip on Cuba? If so, why?
- ✓ 2. Should the United States normalize business relations with Cuba? If so, should the United States stipulate any conditions?
- ✓ 3. Assume you are Cuba's leader. What kind of trade relationship with the United States would be in your best interest? What type would you be willing to accept?
4. How does the structure and relationships of the U.S. political system influence the existence and specification of the trade embargo?
5. Much U.S. tourism, especially via cruise ships, goes to the Caribbean. Do you think that the end of U.S. travel restrictions to Cuba will add or displace tourism going to other Caribbean countries?

Now that you have finished this chapter, go back to [www.myiblab.com](http://www.myiblab.com) to continue practicing and applying the concepts you've learned.

## SUMMARY

- Despite the documented benefits of free trade, no country permits an unregulated flow of goods and services across its borders.
- It is difficult to determine the effect on employment from protecting an industry due to the likelihood of retaliation and the fact that imports as well as exports create jobs.
- Policymakers continue to struggle with the problem of income redistribution due to changes in trade policy.
- The infant-industry argument for protection holds that governmental prevention of import competition is necessary to help certain industries evolve from high-cost to low-cost production.
- Government interference is often argued to be beneficial if it promotes industrialization, given the positive relationship between industrial activity and certain economic objectives.
- Trade controls to improve economic relations with other countries include objectives of improving the balance of payments, raising prices to foreign consumers, gaining fair access to foreign markets, preventing foreign monopoly prices, assuring that domestic consumers get low prices, and shifting revenue from foreign producers to domestic tax receipts.
- Considerable government interference in international trade is motivated by political rather than economic concerns, including maintaining domestic supplies of essential goods and preventing potential enemies from gaining goods that would help them achieve their objectives.
- Trade controls that directly affect price and indirectly affect quantity include tariffs, subsidies, arbitrary customs valuation methods, and special fees.
- Trade controls that directly affect quantity and indirectly affect price include quotas, VERs, "buy local" legislation, arbitrary standards, licensing arrangements, foreign-exchange controls, administrative delays, and reciprocal requirements.
- A company's development of an international strategy will greatly determine whether it will benefit more from protectionism or from some other means for countering international competition.

## KEY TERMS

ad valorem duty  
comparable access argument  
compound duty  
countertrade  
dumping  
duty  
effective tariff  
embargo  
essential-industry argument

export-led development  
export tariffs  
foreign-exchange control  
import (or export) license  
import tariff  
industrialization argument  
infant-industry argument  
offsets  
optimum-tariff theory

protectionism  
quota  
specific duty  
subsidy  
tariff (or duty)  
terms of trade  
transit tariff  
voluntary export restraint  
(VER)

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# Cross-National Cooperation and Agreements

## Objectives

1. To identify the major characteristics and challenges of the World Trade Organization
2. To discuss the pros and cons of global, bilateral, and regional integration
3. To describe the static and dynamic impact of trade agreements on trade and investment flows
4. To define different forms of regional economic integration
5. To compare and contrast different regional trading groups
6. To describe other forms of global cooperation such as the United Nations and OPEC

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*Marrying is easy, but housekeeping is hard.*

—German proverb

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