Chapter Six

The Political Economy of International Trade
Opening Case

• Since 1974, international trade in the textile industry has been governed by a system of quotas known as the Multi-Fiber Agreement
  - Designed to protect textile producers in developed nations from foreign competition
• The World Trade Organization agreed to let the MFA expire on December 31, 2004
  - In 2003 China was making 17% of the world’s textiles
  - By 2007 the WTO expects that China may make up to 50% of the world’s textiles
Opening Case

- Trade associations from more than 50 textile-producing nations signed the ‘Istanbul Declaration’ in 2004
  - Requested that the WTO delay the removal of quotas
  - The request was denied
- The result of the removal of quotas is that China’s increased production could cripple the economies of countries like Bangladesh
- Even though China has increased export tariffs, many see this as a token gesture
- In the first three months of 2005, imports of Chinese textiles into the US surged 62% compared with the same period in 2004
Instruments of Trade Policy: Tariffs

- Tariffs are the oldest form of trade policy; they fall into two categories
  - **Specific tariffs** are levied as a fixed charge for each unit
  - **Ad valorem** tariffs are levied as a proportion of the value of the imported good
- Tariffs are good for government because they generate revenue
- Tariffs protect domestic producers but they reduce efficiency
- Tariffs are bad for consumers because they increase the cost of goods
Instruments of Trade Policy: Subsidies

- Government payment to a domestic producer
  - Cash grants
  - Low-interest loans
  - Tax breaks
  - Government equity participation in the company
- Subsidy revenues are generated from taxes
- Subsidies encourage over-production, inefficiency and reduced trade
Instruments of Trade Policy: Quotas

- **Import quota**
  - Restriction on the quantity of some good imported into a country

- **Voluntary export restraint (VER)**
  - Quota on trade imposed by exporting country, typically at the request of the importing country
Hypothetical Tariff Rate Quote

- **Tariff Rate %**
  - 80%
  - 10%

- **Quota Limit**
  - **In quota**
  - **Out of quota**

- **Tons of Rice Imported**
  - 0
  - 1 million
  - 2 million
Instruments of Trade Policy:
Local Content

- Requires some specific fraction of a good to be produced domestically
  - Percent of component parts
  - Percent of the value of the good
- Initially used by developing countries to help shift from assembly to production of goods.
- Developed countries (US) beginning to implement
- For component parts manufacturer, LCR acts the same as an import quota
- Benefits producers, not consumers
Instruments of Trade Policy: Administrative Policies

- Bureaucratic rules designed to make it difficult for imports to enter a country
  - France – video tapes
- Japanese ‘masters’ in imposing rules
  - Tulip bulbs
  - Federal Express
Instruments of Trade Policy: Antidumping Policies

• Defined as
  - Selling goods in a foreign market below production costs
  - Selling goods in a foreign market below fair market value

• Result of
  - Unloading excess production
  - Predatory behavior

• Remedy: seek imposition of tariffs
Political Arguments for Intervention

- Protecting jobs and industries
  - CAP (Europe) and VER
- National security
  - Defense industries - semiconductors
- Retaliation
  - Punitive sanctions
Political Arguments for Intervention

• Protecting consumers
  - Genetically engineered seeds and crops
  - Hormone treated beef

• Furthering foreign policy objectives
  - Helms-Burton Act
  - D’Amato Act

• Protecting human rights
  - MFN
Economic Arguments for Intervention

- Infant industry
  - Oldest argument - Alexander Hamilton, 1792
  - Protected under the WTO
  - Only good if it makes the industry efficient
  - Brazil auto-makers - 10th largest - wilted when protection eliminated
  - Requires government financial assistance
    - Today if the industry is a good investment, global capital markets would invest
Economic Arguments for Intervention

- Strategic trade policy
  - Government should use subsidies to protect promising firms in newly emerging industries with substantial scale economies
  - Governments benefit if they support domestic firms to overcome barriers to entry created by existing foreign firms
Development of the World Trading System

- Intellectual arguments for free trade
  - Adam Smith and David Ricardo
- Free trade as government policy
  - Britain’s (1846) repeal of the Corn Laws
- Britain continued free trade policy
  - Fear of trade war
Development of the World Trading System

- Great Depression
  - US stock market collapse
  - Smoot-Hawley tariff (1930)
    - Almost every industry had its “made to order tariff”
    - Foreign response was to impose own barriers
    - US exports tumbled
Development of the World Trading System

• GATT - multilateral agreement established in 1948 under US leadership
  - Objective is to liberalize trade by eliminating tariffs, subsidies, and import quotas
  - 19 original members grew to 120
Development of the World Trading System

- Used ‘rounds of talks’ to gradually reduce trade barriers
- Uruguay Round GATT 1986-93
  - Mutual tariff reductions negotiated
  - Dispute resolution only if complaints were received
Disturbing Trends in the World Trading System

- Pressure for greater protectionism due to
  - Increase in the power of Japan’s economic machine and closed Japanese markets
  - US trade deficit
  - GATT circumvented by many countries
    - Through use of VER
GATT Criticisms

• Economic theories don’t fit the ‘real world’ model
• US global preeminence has declined
• Shift from cutting tariffs to eliminating non-tariff barriers angered countries
• ‘National Treatment’ or ‘Most Favored Nation’ status results in inequalities
The World Trade Organization

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

- 145 members in 2003
- Represents 90% of world trade
- 9 of 10 disputes satisfactorily settled
- Tariff reduction from 40% to 5%
- Trade volume of manufactured goods has increased 20 times
The WTO

- Policing organization for:
  - GATT
  - Services
  - Intellectual property

- Responsibility for trade arbitration:
  - Reports adopted unless specifically rejected
  - After appeal, failure to comply can result in compensation to injured country or trade sanctions
WTO at Work

- 280 disputes brought to WTO between 1995 and 2003
- 196 handled by GATT during its 50 year history
- US is biggest WTO user
  - Big wins: beef - bananas
  - Big loss: Kodak
The WTO - Achievements

- **Telecommunications (1997)**
  - 68 countries - 90% of world telecommunications revenues
  - Pledged to open their market to fair competition

- **Financial Services (1997)**
  - 95% of financial services market
  - 102 countries will open their markets to varying degrees
WTO in Seattle

- Millennium round was aimed at further reduction of trade barriers in agriculture and services
- WTO meeting disrupted by
  - Human rights groups
  - Trade unions
  - Environmentalists
  - Anti globalization groups
- No agreement was reached
Doha Agenda - WTO

- Cutting tariffs on industrial goods and services
- Phasing out subsidies
- Reducing antidumping laws
- WTO regulation on intellectual property should not prevent members from protecting public health
  - TRIPS agreement
Looking Ahead to Chapter 7

- Foreign Direct Investment in the World Economy
- Horizontal Foreign Direct Investment
- Vertical Foreign Direct Investment
- Implications for Managers