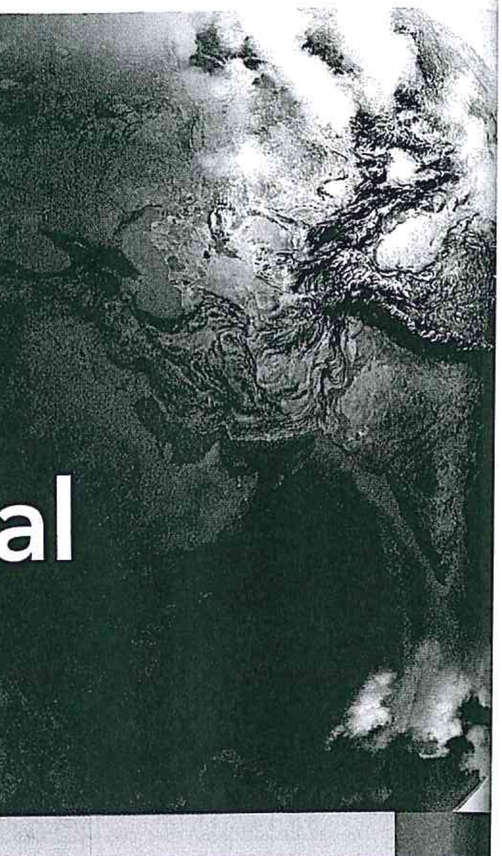

2
The Evolution of International Business

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After studying this chapter, you should be able to:

LO-1 **Briefly explain why trade and foreign investment are good for society as a whole.**

LO-2 **Describe the major international trade theories and how they operate.**

LO-3 **Evaluate trade policy, the main instruments of trade policy, and their impact on business, consumers, and governments.**

LO-4 **Explain the rationale behind a country's choice of managing trade.**

Asia's Century: The Reemergence of China and India

During the early 19th century, the world's two largest economies in terms of national income were China and India.[1] Because of foreign invaders and rule by various domestic feudal factions and foreign colonial powers, these two countries restricted free enterprise and open trade while increasing the government's role in commerce. After its independence from Britain in 1947, India, under the leadership of Prime Minister Jawaharlal Nehru, adopted the practice of democratic socialism.[2] In 1949, China's move to communism with Chairman Mao Zedong at the helm led to a command, or government-directed, economic system. As a result, China's and India's economic systems stifled domestic entrepreneurship as well as business growth, which left both countries relatively poor.

In 1978, recognizing the economic failure of the communist system, China, under the leadership of Deng Xiaoping, decided to jump-start its economy by encouraging private enterprise—capitalism with communist roots—as well as opening the economy to foreign trade and investment. India's socialist economic policies led the country to near bankruptcy in 1991, when Finance Minister Dr. Manmohan Singh (with economic policy advice and financial assistance of the International Monetary Fund in Washington, DC) agreed to change the country's economic strategy through systematic deregulation, privatization, and implementation of freer trade and foreign investment policies.

These changes in economic policies have led both China and India to grow rapidly. For example, during 2005–2013, China's economy grew by an average of 10.2 percent each year while India's economy grew by an average of 7.5 percent a year during the same period. This compares with U.S. annual growth of 1.7 percent and Japan's 0.7 percent for that period. Thus, by 2013, China had become the world's second largest economy after the United States; India became the third largest economy followed by Japan[3] (see Exhibit 2.1).

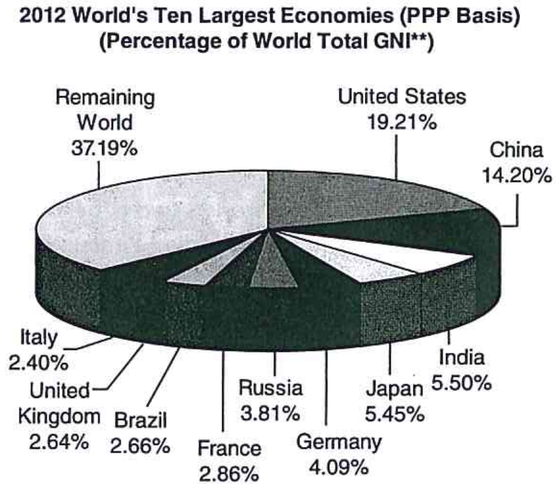
Interestingly, while both China and India have unleashed their pent-up domestic consumption and competitive advantage in the global marketplace, their paths to economic success have been different.[4] China has followed the traditional route by becoming a global center for manufacturing and exporting of consumer goods like apparel, small appliances, and consumer electronics including smartphones and laptop computers—items that can be found every day in stores such as Walmart and Target in the United States. India, on the other hand, has focused more on using its large English-speaking labor force to provide business process outsourcing services, such as call centers, medical transcription, data and mortgage processing, and software development for companies worldwide.

Based on current economic trends, analysts believe that by 2020 China will become the world's largest economy, followed by the United States and India (see Exhibit 1.2). China has recently been expanding its manufacturing capabilities by producing greater value-added goods, such as automobiles, aircraft, high-speed trains, and semiconductor chips. India has also been expanding the

EXHIBIT 2.1 WORLD'S TEN LARGEST ECONOMIES: PURCHASING POWER PARITY (PPP) BASIS* (U.S.$ 2012)

*PPP conversion factor is the number of units of a country's currency that is required to buy the same amount of goods and services in the domestic market that a U.S. dollar would buy in the United States.

Source: *World Development Indicators 2014*, The World Bank.



service value chain by becoming a center for information technology services, research and development, and biomedical sciences. Over time, economists believe that India's approach may work better because the wealth of nations eventually depends more on services than manufacturing.

Introduction

The growth trends in China and India[5] today illustrate the impact that **international business** has on blue-collar and white-collar workers in wealthy countries (such as the United States and in Europe) as relatively low-skill factory jobs as well as high-skill service profession jobs migrate overseas. Business has become increasingly international in nature and has been accelerated by low-cost communications technology. What is international business? And, how did all this development happen?

One could trace international business to a story from fertile Mesopotamia (present-day Iraq).[6] In 3000 B.C., Sumerian farmers realized that the grain surplus they produced could be used as barter for things they did not have. Therefore, the Sumerians obtained copper from Sinai Desert traders who were located several hundred miles to the west in order to make weapons and repel nomadic raiders. Thus, international trade yielded to the Sumerian farmers not only a bounty of material goods (copper and armaments for security) but also an understanding of the culture of their neighbors and a mutual desire to sell things to other groups rather than to annihilate them.

international business
all commercial transactions, both private and public between nations of the world

LO-1
Explain briefly why trade and foreign investment are good for society as a whole.

2-1 Benefits of Trade and Foreign Direct Investment

The earliest and simplest form of international business is **trade**, which can be defined as the sale (exports) and purchase (imports) of goods (textiles, wine, spices, smartphones, etc.) and services (banking, transportation, education, consulting, etc.) across national borders. International trade benefits consumers in three major ways by providing:

trade
the two-way flow of exports and imports of goods (merchandise trade) and services (service trade)

- A greater amount of choice in the availability of goods and services.
- Lower prices for goods and services consumed.
- Higher living standards.

Foreign Inflow of Capital: *The New York Stock Exchange (NYSE), like other stock exchanges, attracts foreign capital.*

Largely for better, but sometimes for worse, trade has affected our world. Trade has influenced culture, shaped history, raised living standards, and expanded knowledge to include new ways of thinking.[7] In fact, one could ask: Where would the history of civilization be without trade? Yet, even today, policymakers in some countries continue to question the benefits of trade by asking whether to open national borders to freer trade and **foreign direct investment (FDI)**, foreign inflow of capital, technology, and skills to enhance domestic investment and economic growth.

Open trade and investment does create winners and losers and, as discussed later, the gains from open trade and investment are always greater than the losses.[8] The right to export and import freely enhances the quality of life and living standards of people in the countries involved in trade. In addition, trade brings with it cultural and technological riches; it can also make the world a more peaceful place because of national interdependence.

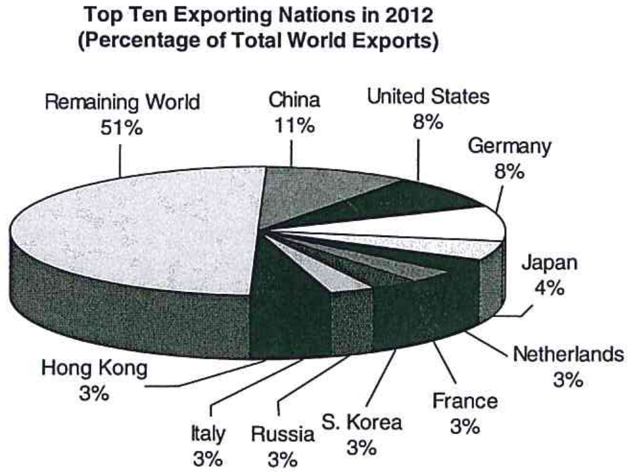
Trade generates jobs in both the export and import sectors of an economy. For example, it is estimated that for every billion dollars worth of exports from the United States 20,000 domestic jobs are created. As seen in Exhibit 2.2, U.S. exports in 2012 were about 8 percent of the world's total ($1.55 trillion), which would imply creating some 31 million jobs in the export sector of the country. In addition, 2012 U.S. imports of approximately $2.3 trillion also created more U.S. jobs, for example, at imported car dealerships.[9]

Despite the deep global recession in 2009, world trade in 2013 increased by some 13 percent over the pre recession 2008 level of $33 trillion, thereby improving the income of all those involved in trade. One could also argue that the living standard of people in the developed countries of Europe, Japan, and North America has been enhanced because of the low-cost goods and services imported from China and India that were mentioned in the opening vignette. At the same time, trade has given an astonishing boost to China's and India's economies as millions of Chinese and Indian workers move from subsistence farming and clerical work into more comfortable middle-class prosperity. As the income of Chinese and Indian workers increases, they will purchase more imported goods and services, thereby giving a boost to the global economy.

foreign direct investment inflows of capital from abroad for investing in domestic plant and equipment for the production of goods and/or services as well as for buying domestic companies

EXHIBIT 2.2 WORLD TRADE PATTERNS: TOP TEN EXPORTING NATIONS IN 2012 (PERCENTAGE OF TOTAL WORLD EXPORTS)

Source: The World Bank. *World Development Indicators, 2014.*



Open trade increases competition, and, like rivalry from new domestic companies, it does have a negative impact on some because of this disruptive change. In the case of the United States, the "losers" include workers in some manufacturing as well as service sectors who lose jobs or are forced to accept reduced or stagnant wages (and a lower or sluggish standard of living) for working in globally uncompetitive industries. This generally happens when assembly-line jobs in uncompetitive manufacturing sectors (e.g., microwave ovens) migrate to countries like China and Vietnam, or when service sector jobs (e.g., call centers, software development) are **outsourced** abroad to countries like India or the Philippines. In general, countries in the developed world try to soften the disruptive nature of trade by retraining and re-educating their workforce and enabling those workers to learn new skills in order to become more productive and gainfully employed.

Foreign direct investment (FDI) in a country brings funds and business culture from abroad, creates new well-paying jobs, introduces innovative technologies, and enhances the skills of domestic workers. Because of the largely positive impact that FDI has on countries, governments all over the world try to create a business-friendly environment to attract such investments. In addition, emerging countries like Brazil, Russia, India, and China (BRIC) that have large populations, an expanding middle class, and a combination of relatively low wage-rates and rapidly growing economies (as indicated in Exhibit 2.1) tend to attract sizeable amounts of foreign investment.

Exhibit 2.3 summarizes net (inflow minus outflow) foreign direct investment inflows during 1990–2012 based on national income levels and geographic regions of the world. It is important to note that 59 percent of net inflows of foreign investment in 2012 went to high-income countries in Europe and North America; the United States has been almost consistently the largest recipient of FDI in the world through 2011 and China took the lead in 2012.[10] This to an extent reflects the decoupling of the world economic order and the move to a multipolar world discussed in Chapter 1.

Foreign investors have always had great faith in the mature high-income economies listed in Exhibit 2.3. However, since the bursting of the dotcom bubble in 2000 and the global financial crisis of 2008, global investors have been keeping a watchful eye on the rise of emerging economies, especially BRIC (Brazil, Russia, India, and China). Foreign investment flows are generally based on long-term global or country outlook. For example, the largest increase in the world FDI flows in 2000 reflects the euphoria of the dot-com era with approximately $321 billion in net inflows of FDI to the United States. Soon after the dot-com bubble burst in late 2000, net inflows of FDI to the United States fell by

outsourcing
the corporate practice of acquiring or producing quality goods or services abroad at a lower cost thereby eliminating domestic production

EXHIBIT 2.3 NET INFLOWS OF FOREIGN DIRECT INVESTMENT BY REGION AND INDUSTRIALIZATION

Foreign Direct Investment by Region and Industrialization (billions of U.S. dollars)*

	1990	1995	2000	2005	2010	2011	2012
World Total	**205**	**328**	**1518**	**1050**	**1430**	**1654**	**1510**
High Income	**181**	**230**	**1358**	**773**	**916**	**1007**	**893**
Belgium	8	11	215	34	73	102	-2
Canada	8	9	66	29	24	40	43
France	13	24	42	81	34	45	28
Germany	3	12	210	35	46	39	27
United Kingdom	34	22	122	196	53	36	56
United States	48	58	321	109	236	258	204
Low and Middle Income	**24**	**99**	**161**	**276**	**514**	**648**	**617**
East Asia and Pacific	**11**	**51**	**45**	**104**	**231**	**275**	**314**
China	3	36	38	79	185	220	254
Indonesia	1	4	–5	8	13	18	20
Malaysia	2	4	4	4	9	12	10
Singapore	6	12	16	15	39	64	57
Thailand	2	2	3	8	10	8	11
Vietnam	0	2	1	2	8	7	8
Europe and Central Asia	**3**	**10**	**20**	**63**	**87**	**119**	**65**
Kazakhstan		1	1	2	11	13	15
Poland	0	4	9	10	9	15	7
Russia		2	3	13	43	53	51
Turkey	1	1	1	10	9	16	13
Latin America & Carib.	**8**	**30**	**80**	**70**	**117**	**162**	**150**
Argentina	2	6	10	5	7	9	12
Brazil	1	5	33	15	49	72	76
Chile	1	3	5	7	15	17	30
Columbia	0	1	2	10	7	14	16
Mexico	3	10	18	20	20	21	16
Middle East & N. Africa	**1**	**1**	**5**	**14**	**26**	**16**	**23**
Yemen	0	0	0	0		1	
South Asia	**1**	**3**	**4**	**10**	**28**	**36**	**27**
India	0	2	4	7	24	32	24
Sub-Saharan Africa	**1**	**5**	**7**	**15**	**25**	**40**	**37**
Nigeria	1	1	1	2	6	9	7

* Net inflows of investment to acquire or establish an enterprise in another country.

Source: World Bank: World Development Indicators database and 2012, 2013, 2014 World Development Indicators, pp. 88–92.

almost two-thirds. Among middle-income countries, China, as we discussed earlier, has been consistently attracting the largest amount of FDI because of its well-developed infrastructure and its strategic position as the low-cost manufacturing center of the world. Singapore, a regional center for global companies, continues to attract sizable amounts of foreign investment given its strategic location, world-class infrastructure, and productive workforce. India, as mentioned earlier, is a major player in the service sector and has recently witnessed a significant increase in FDI inflow. Oil- and gas-rich Colombia, Russia, Kazakhstan, and Nigeria have been attracting foreign investment primarily in the energy sector. Because of NAFTA, Mexico consistently draws a significant amount of investment from the United States and Canada. Brazil, rich in natural resources and also a manufacturing powerhouse in the Western Hemisphere, will continue to draw significant amounts of foreign investment.

REALITY CHECK LO-1

Visit the retail store where you purchase everyday necessities and pick out ten items that you regularly use. Now, look at the labels and find out how many of them come from abroad. Can you imagine what your life would be like if we did not have international trade?

LO-2

Describe the major international trade theories and how they operate

2-2 Major Theories of International Trade

No single nation in the world is capable of producing and consuming all the goods and services that its citizens want or need. Neither does any nation have the required resources—minerals, agricultural land, skilled labor, machinery, technology, and the like—to produce the wide range of goods and services that people in our modern economy desire. Therefore, nations of the world need to trade.

An understanding of how major trade theories have evolved is important. First, these theories provide an appreciation for the progress made in understanding how trade (and gains from trade) really works in an open economy. Second, these theories present a rationale why restriction to trade should be minimized even when domestic economic and business conditions seem awful. If policy-makers ignore trade theory, they are likely to repeat past mistakes, which could then lead to trade retaliation and lower global living standards.

mercantilism
a theory of international trade that supports the premise that a nation could only gain from trade if it had a trade surplus

factors of production
endowments used to produce goods and services: land (quantity, quality, and mineral resources beneath it), labor (quantity and skills), capital (cost), and technology (quality)

trade surplus
when the value of exports exceeds the value of imports; the opposite of a trade deficit

2-2a Wealth Accumulation as a Basis for Trade Theory: Mercantilism

Mercantilism is a theory of international trade that supports the premise that a nation could only gain from trade if it had a trade surplus, that is, more exporting than importing. Mercantilism is the oldest form of trade theory; it was practiced during the 1500–1750 period as Europe emerged from the feudal systems of the Middle Ages and moved toward nationalism. During this period, money consisted almost exclusively of gold and silver coins; bank notes were rarely used, largely because of a lack of trust in them. Wealth, at a personal or national level, was largely determined by the amount of precious metal (gold and silver) to which one had access. Land and labor were considered less important, because they were primarily **factors of production** that were needed to generate wealth—gold and silver.

Mercantilists believed that for a nation to become wealthy, that nation must export as much as possible and, in turn, import as little as possible. Their objective was to see that, as a nation, the value of exports must always exceed those of imports so that the country would have a **trade surplus**. Their rationale was simple: exports generate income, causing gold or silver to flow into the country. On the other hand, imports were determined to be a cost, as gold or silver must leave the country to pay for them. Therefore, when countries have a trade surplus, the inflow of gold and silver will exceed the outflow of gold and silver; the result will be a net gain of gold and silver, hence the wealth of the nation will be enhanced. National wealth was seen as the foundation of national power and global influence. Mercantilists also believed that accumulation of gold and silver by way of exportation was the only way that countries without gold and silver mines could become wealthy.

Mercantilists did not want, or care, to see the big picture. If every trading nation decided to increase its exports and decrease its imports, there would be a surplus of exported goods in the world market. This would lead to two unpleasant results. First, the surplus of exports in the world market would depress prices and, therefore, earnings for exporting countries (in the form of gold and silver) would drop. This decrease in wealth would result in lower wages in the export sector, meaning that exporters would become poorer, not richer. Second, as the demand for exports drops, competitors in the export market would want to undersell each other by further lowering their prices in order to get rid of their exports. This would further depress wages in those countries.

To keep labor costs low, mercantilists encouraged their people to produce large families by providing bounties for children and penalties for the unmarried. The inflow of gold and silver to the nation—hence national wealth—was what mattered, not the prosperity of its citizens. Mercantilists championed this short-sighted view of wealth.

2-2b Specialization as a Basis for Trade Theory: Absolute and Comparative Advantage

During the mid-18th century, British economist Adam Smith, who came to be known as the father of free market and open trade systems, recognized the absurdity of mercantilism. He argued and proved that free trade without restrictions would increase the wealth—in

Specialization as a Basis for Trade Theory: *The United States has a comparative advantage in corn production.*

terms of rising real income—of all those who participated in free, unrestricted trade. At the heart of Adam Smith's international trade theory was his belief that free trade encourages countries to specialize in the production of those goods and services that they most efficiently produce. There are two basic theories that explain this behavior: the theory of absolute advantage in production and the theory of comparative advantage in production. These theories are best explained with the help of examples.

2-2b-(i) Theory of Absolute Advantage As a hypothetical example, consider two countries, Brazil and the United States, and try to determine what each of these countries would export if each opened their countries to free trade. Assume that because of soil and climatic conditions, Brazil is more efficient (measured in pounds of coffee beans produced per acre of farmland) in the production of coffee than the United States. Also assume that for the same reasons (soil and climate), the United States is more efficient than Brazil in the production of corn. It would make more sense for Brazil to concentrate on producing coffee rather than corn; part of the coffee produced would be kept for domestic consumption and the remainder exported to the United States. The United States could do the same by concentrating on corn production, saving some for domestic consumption and exporting the rest to Brazil.

The gains from trade are quite significant. Citizens from both Brazil and the United States would enjoy the benefits of lower-cost coffee and corn because of trade. If these two countries did not trade, the United States would need to produce its own coffee and Brazil would need to grow its own corn, which in both cases would be inefficient and at a high cost to citizens. Using terminology of international trade, Brazil has an **absolute advantage** in coffee production and the United States has an absolute advantage in corn production. An absolute advantage exists when one country can produce a good—such as coffee or corn—more efficiently than another.

2-2b-(ii) Theory of Comparative Advantage Now suppose that one country has an absolute advantage over another in the production of two (or more) products. Should trade between these two countries occur? The answer is yes. This approach is a refinement of Adam Smith's theory of absolute advantage and can be attributed to another great British economist, David Ricardo.[11] Let's analyze the rationale behind this assertive answer.

Continue with the Brazil–U.S. case that was just explored. *Assume* two small changes: that Brazil can produce both coffee and corn more efficiently than the United States (measured in terms of pounds of coffee or corn per acre of farmland) and that Brazil can produce five times more coffee than the United States but only two times more corn than the United States, using the same quantity of resources (land and labor). Therefore, Brazil has an absolute advantage over the United States in the production of both coffee and corn. In which commodity, coffee or corn, does Brazil have a greater production advantage than the United States? It is in coffee production, because Brazil can produce five times as much, compared with only twice as much corn. What should Brazil do? The answer is that Brazil should produce the commodity in which it has the greatest advantage: coffee.

You will notice that Brazil not only has an absolute advantage in coffee production, it also has a **comparative advantage** in coffee production over corn production. Despite the fact that Brazil has an absolute advantage over the United States in the production of both coffee and corn, free trade will ensure that both countries will have a higher standard of living if Brazil concentrates its efforts on producing coffee and the United States concentrates on producing corn.

It is important to remember that resources (land, labor, and capital) in all countries are scarce, which is why countries must choose the most efficient use of their scarce resources. When all countries follow this approach, resources can be used most efficiently, and the total output and standard of living of the world can be increased.

absolute advantage
the ability of one country to produce a good or service more efficiently than another

comparative advantage
the ability of one country that has an absolute advantage in the production of two or more goods (or services) to produce one of them relatively more efficiently than the other

2-2c Factor Endowments as a Basis for Trade Theory: Heckscher–Ohlin and Factor Price Equalization

2-2c-(i) Factor Endowment In the 1930s, two Swedish economists, Eli Heckscher and Bertil Ohlin, refined David Ricardo's theory of comparative advantage and showed that nations primarily export goods and services that intensely use their abundant factors of production. The next two theories described use the concept of factor intensity as the basis of trade.

The **Heckscher–Ohlin (H–O) theory** attributes the comparative advantage of a nation to its factor endowments: land (quantity, quality, and mineral resources beneath it), labor (quantity and skills), capital (cost), and technology (quality). By implication, a country rich in minerals, such as Australia, would have global competitive advantage in the production and exports of minerals, such as iron and uranium ore, and coal.

Similarly, Saudi Arabia, with the world's largest reserve of easily extractable crude oil, will export crude oil to other nations. The key assumptions for the H–O theory to work are (1) perfect competition in the marketplace and (2) perfect immobility of factors of production among countries. As indicated in the opening vignette, China's abundant factor has been relatively low-wage workers, who migrate from villages to large cities for assembly line work. The H–O theory, therefore, helps explain why the export of manufactured goods is China's competitive advantage. On the other hand, India's abundant factor has been relatively well-educated, English-speaking labor that provides a low-cost gateway to global services exports. The two key requirements of H–O are met, because the markets for labor in both China and India are very competitive and severe external restrictions prevent labor from moving abroad.

A related theory, **factor price equalization theory**, states that when factors (labor, for example) are allowed to move freely among trading nations, efficiency further increases, which leads to superior allocation of the production of goods and services among countries. For example, when Poland entered the European Union—where there is free movement of labor across member countries—some of the abundant Polish plumbers migrated to the United Kingdom to fill the shortage there. The net result was that wages for plumbers in the United Kingdom stabilized or softened and wage rates for plumbers in Poland increased. As the U.K. consumer of plumbing services benefited from this development, one could argue that the real income of the British consumer was, therefore, enhanced.

The Polish plumber's real income received a boost as well, because earnings in Britain were higher than what would have been earned in Warsaw. In Poland, wages of plumbers will gradually rise because of a decrease in the supply of plumbers (when some plumbers migrated to Britain). The real income of all Polish plumbers will increase over time. As is shown, free mobility of factors will lead to the efficient reallocation of resources (factors of production) until price equilibrium is reached. That is, over time the wage rates for plumbers doing similar work in Britain and Poland will be the same. Then, **factor price equalization** would have been attained.

A similar scenario is happening in the United States as well. Software and IT engineers from India are allowed to enter the United States on H-1B visas, which enable Indian engineers to work in the United States for up to five years. Because of factor price equalization, wages for software and IT specialists (with similar educational background and work experience) in the United States have stabilized at a lower level than during the dot-com days of 2000. At the same time, wages for software and IT engineers in India have considerably gone up. Over time, wages for software and IT engineers in India and the United States (adjusted for cost of living) will move toward equilibrium.

factor endowment
the quantity and quality of factors of production (land, labor, capital and technology) that a country owns

Heckscher-Ohlin (H–O) theory
a theory that attributes the comparative advantage of a nation to its factor endowments. A capital-abundant country will, therefore, export capital-intensive goods, while a labor-abundant country will export labor-intensive goods

factor price equalization theory
the theory (attributed to Paul A. Samuelson) that when factors of production are allowed to move freely among nations as a result of international trade, the prices of identical factors of production will be equalized across said nations

factor price equalization
when the prices of identical factors of production (e.g. labor) are equalized across international borders

2-2d Porter's "Diamond" Model of National Competitive Advantage[12]

In 1990, American economist and Harvard Business School professor Michael Porter published his seminal work, *The Competitive Advantage of Nations*, which reported the results of his four-year study of ten nations on why some countries excel in certain industries and markets. Porter found that trade theories broadly explained the basis upon which countries exported certain goods, services, or commodities. However, Porter believed that the trade theories did not explain enough. For example, why did some countries export certain products and import similar products? Also, he argued that firms and not countries conduct most trade. Therefore, Porter looked more closely at the theory of firm and industry specifics to identify characteristics that made firms and industries in countries "winners" or "losers" in international trade.

Porter's model of National Competitive Advantage is based upon the trade theories discussed earlier in this chapter. The robustness of Porter's model can be attributed to his integration of the theory and structure of a firm's behavior to trade theory. Porter's hybrid model was designed to operate within an environment of government actions and unforeseen external events—shocks, positive or negative. Porter neatly explains his model in terms of a "diamond" that consists of four groups of company-specific and country-specific characteristics positioned at the edge of a diamond. Porter's model also explains that the interaction of these four groups of characteristics will determine a country's competitive advantage in the global arena. Hence, the success or failure of firms can be attributed to how country- and company-specific characteristics are nurtured. Each group of characteristics is discussed next.

2-2d-(i) Factor Conditions The theory of comparative advantage in production and the Heckscher–Ohlin theory provide factor endowments as a basis for international trade. Porter's model looks more closely at the quality of the factor endowments (i.e., land, labor, capital, and technology). For example, how can the quality of labor in a specific country be described—skilled, unskilled, highly technical? Can the quality of educational systems and research institutions be determined? Are schools and institutions aimed at producing a significant number of quality engineers and scientists or musicians and artists? Regarding the earlier example of land, Porter's model would focus upon the quantity of land, as well as upon its quality, management, and development. With regard to capital, the availability and ability to raise capital at a low cost will be an important characteristic. Technology becomes crucial in a knowledge-based economy, therefore, the prevalence and quality of technology and telecommunications are crucial factor characteristics.

Porter exemplifies Japan as a powerhouse for consumer electronics because of the quality and quantity of its engineers and the ability and willingness of Japanese consumers to try out new electronic products that are perfected and later exported. Porter found that Japan has more engineers per capita than any other country in the world. When we analyze current emerging economies, Porter's model would explain why R&D and IT services are moving to India: the availability of quality English-speaking engineers and scientists at very competitive wage rates. Similarly, the supply of skilled, productive factory workers coupled with modern infrastructure makes China a global manufacturing hub.

2-2d-(ii) Demand Conditions Porter stresses the importance of domestic demand for goods and services when determining a nation's competitive advantage. When domestic demand remains high, the number of suppliers will also be high. With sizable demand, domestic competition among suppliers will intensify and result in lower prices as well as sophisticated, innovative new products. This could lead to product specialization. In the United States, which has a sophisticated marketing and distribution network, the demand for smartphones and related items (the iPhone, iPod, iPad, etc.) has been strong and rapidly growing. As a result, the United States has become a global leader for these products, which are also in strong demand in other high-income countries. In the emerging economies of China and India, which have a fast-growing middle class, the demand for automobiles has been strong; China became the world's largest market for automobiles in 2009. Because of this fact, domestic competition among automobile companies in these countries has increased considerably, spurring the development of such innovative cars as India's $3,000 four-seat Tata "Nano," which will likely enter the global market for low-cost cars by 2015.

Porter's "Diamond" Model: *India's factor conditions make the $3,000 Tata Nano possible.*

2-2d-(iii) Related and Supporting Industries The presence of supporting industries and companies in a country will always be important for its competitive advantage. The quality and competitive nature of supplier industries will determine how successful a country will be. Silicon Valley, California, where there are numerous world-class suppliers that provide semiconductors to the IT hardware industry, posits a good example. The availability of a full range of world-class supporting industries makes Silicon Valley the envy of the world. China's southern province of Guangdong has become the center for textile and apparel production, and the province teems with textile industry supporting industries, including manufacturers of textile machinery, yarn manufacturers, and sources of dyes and related chemicals. Similarly, India's southern coastal city of Chennai houses the country's automotive, truck, and motorcycle industry. The large cluster of supporting supply companies create a highly competitive environment, enabling Chennai to put out quality products at reasonable prices, with automobile exports going to East Asia, Africa, and Europe.

2-2d-(iv) Firm Strategy, Structure, and Rivalry The final set of characteristics in Porter's diamond relate to a firm's strategy, structure, and rivalry. Firm strategy deals with the way companies in an industry manage their operations as well as the structure of the organization. Management style—top down, bottom up, or consultative—has a large impact on a firm's performance. Also, the background of top managers holds great importance, as Porter points out in the case of Japanese and German companies versus American companies. Japanese and German firms often employ engineers to run manufacturing companies, hence their emphasis on product and product quality and the reason why German and Japanese companies are generally known for their machinery and engineering goods. American firms are often run by finance and marketing professionals with an emphasis on sales and short-term profits that may not be too helpful in the long term.

Firm structure and rivalry address the competitive structure of industries in a nation. Monopolistic industrial structures are unlikely to create innovative or dynamic firms willing to compete abroad or have the capability of competing abroad. However, a competitive industry will foster innovative, cost-efficient, aggressive firms that can adjust to changing economic conditions at home and will be well prepared to compete abroad.

According to Porter's "diamond" model, the success or competitive advantage of a nation at the global stage would crucially depend upon the interaction of the four groups of characteristics identified above. Yet, Porter also identified two other crucial variables outside the diamond that play an important role in the competitiveness of nations: chance and government.

Chance refers to an external shock or development that could drastically change or hasten the course of economic development. Innovation in information technology, for example, has, to a considerable extent, made some countries very competitive all of a sudden. Innovation in IT has increased efficiency all over the world and has increased connectivity among citizens globally. IT has propelled economic growth in some countries, India, for example, has recently become a major supplier of IT services worldwide (see a more detailed discussion in Chapter 1).

In contrast, some external shocks could have negative effects on countries. For example, the Icelandic volcano eruption of 2010 disrupted air travel in northern Europe for six days at an estimated cost of $200 million per day to the airlines alone.[13] The massive 2011 earthquake off Sendai in Japan led to an unprecedented tsunami, several hundred billion dollars in damages, and severe global supply chain disruptions in the auto industry. The global nuclear power industry also came under great scrutiny because of the crippling effect on Japan's Fukushima–Daichi nuclear power plant. Human-caused shocks, such as terrorist attacks, could also result in negative business affects by raising the cost of conducting business because of security-related outlays.

The second and even more important variable outside Porter's "diamond" is the role of *government*. Government institutions and policies could help or hurt competitiveness of nations (as discussed in Chapter 1), due to the fact that government institutions and policies have the potential to affect all four sets of characteristics associated with Porter's diamond. For example, in the case of factor conditions, if government policy does not support or provide incentives for higher education, the quality and quantity of a labor force will be detrimentally impacted with corresponding loss in the nation's global competitiveness. Similarly, inflationary monetary policies would lead to high cost of capital and diminished competitiveness. Also, inadequate investment in physical infrastructure will increase business cost and lower competitiveness.

Government policy could also stifle demand through excessive taxation or perverse incentive programs. Such policies will stifle rational investment and innovation and hence, national competitiveness. Government policies could also stunt the growth of related and supporting industries through the implementation of programs that divert resources to sectors in which companies do not have core competencies.

Finally, government policies could impact market structure or the level of competitiveness in an industry. For example, privatization of public enterprises will have a major positive impact on economic growth, economic efficiency, and competitiveness. Furthermore, the institution of antitrust policies, for example, could also lead to increased competition, growth of supporting industries, and overall competitiveness of nations.

From the above analysis, one can conclude that Porter's model of national competitive advantage provides a neat, comprehensive framework with which to analyze global trade patterns in industrial subsectors. The predictability of the model will depend on how well the four clusters of characteristics (i.e., factor conditions, demand conditions, related and supporting industries, and firm strategy, structure and rivalry) interact within the external framework of chance and government. Therefore, a company that exhibits relatively positive characteristics in all four diamonds will be an exporter of certain types of goods or services. And a country that exhibits relatively negative characteristics will be a net importer of goods or services.

REALITY CHECK LO-2

Have you witnessed any changes in international business activity in your hometown over the past five years? Which of the above discussed theories can you attribute to that business development?

2-3 The Practice of Trade Policy

LO-3

Evaluate trade policy, the main instruments of trade policy, and their impact on business, consumers, and governments.

Trade theory clearly shows how free trade has had a positive effect on the economic well-being of all trading partners. This can be achieved through improvements in the living standards of people in those countries due to a greater amount of choice in goods and services and lower prices to the consumer. Equally important, free trade also creates jobs in the exports and imports sectors of economies. Despite these benefits, individuals, firms, and lobby groups continue to pressure government policymakers to impose barriers to imports or subsidize exports of goods and services. Special interest groups primarily attempt to save good-paying jobs and prevent increased competition in their industries at home—at least for the short term—thereby preventing companies from reorganizing their businesses quickly. **Trade policy** refers to all government actions that seek to alter the free flow of merchandise or services from or to a country.[14] A look at daily business newspapers will show that governments do not adhere to free trade principles. A country's trade policy will, therefore, have a direct impact on the value and volume of their exports and imports. Historically, the main instrument of trade policy has been import tariffs; however, more recently, nontariff barriers and export subsidies have become equally important in international business. Some of the main instruments of trade policy that countries use to interfere with free trade are described next.

2-3a Tariffs, Preferential Duties, and Most Favored Nation Status

Tariffs are taxes on imports; they are also known as **custom duties** in some countries. Like domestic taxes, import tariffs generate revenues for governments. In many developing countries, import tariffs are a major source of government revenue. Tariffs come in two forms: specific and ad valorem.

A **specific tariff** describes an import tax that assigns a fixed dollar amount per physical unit. Until January 1, 2012,[15] the price for ethanol consumers in the United States was higher than world free-market price by $0.54 per gallon because of the $0.54 per gallon tariff imposed by the U.S. government on ethanol imports. This also implied that domestic (U.S.) producers of ethanol could domestically sell ethanol at a price not exceeding the world price by $0.54.

An **ad valorem tariff** describes a tax on imports levied as a constant percentage of the monetary value of one unit of the imported good. For example, the ad valorem tariff on passenger cars imported into the United States has been around 2.5 percent.[16] Thus, the tariff bill will depend upon the cost of the car being imported into the United States. If the car dealer imports a $50,000 BMW from Germany, the tariff that the dealer must pay the U.S. government that will be passed on to the customer is $1,250.

Preferential duties refer to low tariff rates applied to specific imports coming from certain countries, especially from the developing world. Under this system, the same good imported from a country outside the preferred group will be subject to a higher tariff. Preferential duties are, therefore, geographically discriminatory as certain countries receive

trade policy
all government actions that seek to alter the size of merchandise and/or service flows from and to a country

tariffs
taxes on imports; also known as custom duties in some countries

custom duties
taxes on imports that are collected by a designated government agency responsible for regulating imports

specific tariff
an import tax that assigns a fixed dollar amount per physical unit

ad valorem tariff
a tax on imports levied as a constant percentage of the monetary value of one unit of the imported good

preferential duties
an especially advantageous or low import tariff established by a nation for all or some goods of certain countries and not applied to the same goods of other countries

different or preferential treatment. The **Generalized System of Preferences (GSP)**, where a large number of developed countries have agreed to permit duty-free imports of a selected list of products that originate from specific countries provides a good example. GSP could be based on colonial relationships or based upon helping developing countries succeed in trade—trade could be better than aid. Countries that are part of a free-trade area allow duty-free entry of imports. (This type of regional trade agreement will be discussed in Chapter 3, "Regional Economic Integration.")

Finally, in addition to imposing import tariffs, some countries also interfere with the free flow of exports by enforcing **export subsidies**, or **export taxes**. Export subsidies are aimed at protecting certain groups within their economy, such as agriculture. An export subsidy refers to a negative tariff or tax break aimed at boosting exports by lowering export prices. On the other hand, export taxes are meant to discourage exports and to keep production at home. For example, when food grain prices shot up dramatically in late-2008, governments in several rice exporting countries, such as India and Thailand, imposed export tariffs to reduce rice exports and increase the domestic supply of rice in order to keep local rice prices under control.

At the end of World War II, three major international organizations were established to accelerate trade and economic growth among countries of the world. The Bretton Woods conference of 1944 instituted the International Monetary Fund (IMF) and the World Bank, and the General Agreement on Tariffs and Trade (GATT), an offshoot of a conference held at Geneva, was established in 1948. (Details about these three institutions were discussed in Chapter 1). When GATT was established, 22 member countries committed to lower approximately 45,000 tariff rates within rules laid down by that organization. GATT was renamed the World Trade Organization (WTO) and was formally established on January 1, 1995, to set rules of trade among nations on a near-global basis. The WTO's primary objectives were (and still is) to extend tariff reductions to agriculture and services and also to settle trade disputes among member countries (as in the example on Chinese tire exports). By June 26, 2014, 160 nations had become members of the WTO and a further 23 countries were in negotiations to join the organization[17].

Under the **most favored nation** (MFN) principle, any tariff concession granted by one member to any other country will automatically be extended to all other countries of WTO—nondiscrimination in tariff policy. WTO members are *obligated* to apply the MFN principle only to other WTO members, but they can apply MFN to nonmember countries as well. WTO members periodically assemble to discuss major trade negotiations with the prime objective of lower tariffs and increased trade and economic growth among member nations.

generalized system of preferences (GSP)
an agreement where a large number of developed countries permit duty-free imports of a selected list of products that originate from specific countries

export subsidy
a negative tariff or tax break aimed at boosting exports

export taxes
taxes meant to raise export cost and divert production for home consumption

most favored nation (MFN)
an agreement among WTO countries in which any tariff concession granted by one member to any other country will automatically be extended to all other countries of WTO

2-3b Nontariff Barriers

Since 1948, GATT (and later, the WTO) has been able to significantly lower tariffs. During that same time period, however, countries have resorted to various forms of nontariff barriers to restrict imports and, hence, trade. Some of the important forms of nontariff barriers are described next.

Import quotas, also known as Quantitative Restrictions (QRs), limit the amount or number of units of products that can be imported to a country. Import quotas are generally worse than import tariffs because when a quota is reached, that particular good can no longer be imported or purchased. In the case of an import tariff, the price of imports can only increase by the amount of the tariff. But under an import quota, with high demand, the price of goods will increase to extremely high levels.

Voluntary export restraint (VER) occurs when an efficient exporting nation agrees to temporarily limit exports of a product to another country to allow competitors in the importing country to become more efficient within a set period of time. For example, in

import quotas
also known as Quantitative Restrictions (QRs) are regulations that limit the amount or number of units of products that can be imported to a country

voluntary export restraint (VER)
a nontariff barrier in which an efficient exporting nation agrees to limit exports of a product to another country for a temporary period

ECONOMIC PERSPECTIVES Predatory Trade Practices: A Game of Chicken?

In September 2009, U.S. President Barack Obama imposed a three-year, sliding-scale tariff on tires imported from China starting at 35 percent for the first year and decreasing to 25 percent in the final year. Critics noted that this decision seemed hypocritical considering that the president had accused China of unfair trade practices. China decided to challenge the U.S. decision by deferring the matter to the World Trade Organization's dispute resolution branch. China retaliated by initiating an investigation regarding the United States' possible violation of WTO sanctions by unfairly dumping chicken feet and auto parts into China's market. Global concerns were raised about how a tit-for-tat trade war could lead to rapid contraction of global trade, economic growth, and accelerating unemployment, thereby deepening the global recession.

China has been accused of predatory trade practices on several counts, and many believed the Chinese should be held accountable for their actions. First, the value of the Chinese currency, the yuan, has not been market determined, but rather managed and kept artificially low (some economists claim by as much as 15 to 20 percent), thereby providing an unfair competitive advantage for all Chinese exporters. In addition, cheap credit, subsidized land, low cost energy, and controlled wages add to China's competitiveness to the detriment of nations that practice fair trade worldwide. These actions have led China to accumulate some $4 trillion in foreign exchange reserves in 2014 that are available for investment abroad.

Until the Obama decision, the United States had been generally unwilling to impose broad trade sanctions on China lest they curtail buying U.S. Treasury securities that finance the United States' large federal deficits. If that were to happen, U.S. interest rates would need to rise, leading to rising debt service, increasing the cost of capital to U.S. firms, and slowing economic growth in the United States.

Why impose tariffs on Chinese tires? The U.S. used a trade law against Chinese tire exports because their unfair exchange rate could "cause or threaten to cause market disruption"[18] in the domestic tire-manufacturing industry. China's share of the U.S. tire market increased from 5 percent to 17 percent over the 2004–2008 period; during this time four U.S. tire plants were closed, and approximately 5,200 workers were laid off. In 2013, the first full year since the 25 percent tariff on passenger and light truck tires imported from China expired, a record 51.2 million tires were imported from China—10 percent higher than the 2008 figure of 46.5 million units—the year before the tariff went into effect. And, three new tire plants opened in the United States during the 2014–2015 period because of improving economic conditions in the country. In 2010, China imposed tariffs on certain imported chicken products from the United States including chicken feet, which are considered a delicacy in China. China accused the United States of selling chicken parts at below market prices. On August 2, 2013, the WTO ruled that by enacting those tariffs, China violated international trade regulations, which was welcome news to American poultry processors.

QUESTIONS:

1) Is China practicing fair trade? Explain in detail what China is trying to achieve and the implications of the result for the rest of the world.
2) Why did the United States impose a "sliding-scale" tariff on China's tires? And why only for a three-year period? What was the net result?

Source: "The China Conundrum: Using Tires to Send a Message," *Newsweek*, September 28, 2009, p. 24.

the early 1980s, soon after the second oil shock of 1979 that quadrupled the world price of crude oil, U.S. consumer demand for small cars significantly increased. However, the bulk of small, fuel-effective cars available in the world market were built in Japan. The Detroit "Big Three" faced severe financial strain because they could not compete against the Japanese automakers. The Japanese and U.S. governments negotiated a VER whereby Japan's automobile manufacturers voluntarily agreed to limit their export of cars to the United States to approximately 1.6 million units a year for three years. This gave the American automobile firms three years to retool and become relatively efficient and competitive; at the end of this period the VER was removed.

Domestic content provisions are another form of nontariff barrier. Countries may require that a certain percentage of the value of the import be domestically sourced. For example, the U.S. government may require that apparel imported into the United States should use U.S. cotton, or use a certain amount of American labor. Domestic content provisions aim to protect jobs in the home country.

REALITY CHECK LO-3

Visit your local foreign car dealer and find out what type of tariff or nontariff barriers they face when importing cars from abroad. If tariffs are imposed on imported cars, find out whether it is ad valorem or specific, and for how much.

LO-4

Explain the rationale behind a country's choice of managing trade.

2-4 Current Practice of "Managed" Trade

This text has, so far, evaluated arguments for free trade and protection, examined multilateral trade negotiations and agreements under GATT (WTO), and analyzed tariff and nontariff barriers to trade. Remember that global trade today cannot be completely based upon the economics of free trade, but also encompasses a response to geopolitical and socioeconomic factors. **Managed trade** refers to agreements, sometimes temporary, between countries (or a group of countries) that aim to achieve certain trade outcomes for the countries involved.[19] Managed trade aims to replace global market or economic forces with government actions to determine trade outcomes. Under a managed trade regime, policymakers may use various socioeconomic or geopolitical rationales to protect specific companies or industries and achieve particular strategic objectives.

2-4a Socioeconomic Rationale

In general terms, socioeconomics addresses the study of the relationship between business or economic activity and the social life of residents in a nation. In the context of international trade, socioeconomics explores the relative negative impact of free trade upon society's welfare, as well as government policy measures that are implemented to minimize the negative outcomes to society in a country. Several forms of managed trade are part of the socioeconomic category; these include countertrade, export cartels, the infant industry argument, and considerations of ethics and safety.

2-4a-(i) Countertrade In **countertrade**, an exporter of goods or services to another country commits to import goods or services of corresponding value from that country. The terms of export and import exchange are predetermined through negotiations. However, most countertrade transactions are still paid through the banking system; relatively few are done through outright barter (e.g., Iranian crude oil exports for imports of Chinese goods and infrastructure services). During the Cold War period (and even today in several countries of the former Soviet bloc,[20] as well as some developing countries) the Soviet bloc countries practiced countertrade.

As you can imagine, countertrade can be extremely inefficient. Countries participate in countertrade, especially when they do not have adequate amounts of foreign currencies (U.S. dollars, euros, etc.) to pay for their imports. Countries may also pursue countertrade because they may not be capable of producing goods of international quality or because a banking embargo has been imposed on them. For example, during the Soviet days, the government of India imported Soviet fighter jets and other defense hardware in exchange for Indian-made consumer goods such as soaps, detergents, and copy machines.

domestic content provisions
regulations requiring that a certain percentage of the value of imports be sourced domestically

managed trade
agreements, sometimes temporary, between countries (or a group of countries) that aim at achieving certain trade outcomes

countertrade
agreement in which an exporter of goods or services to another country commits to import goods or services of corresponding value from that country

2-4a-(ii) Export Cartels Rich, developing countries dependent upon certain nonrenewable natural resources have generally seen their export earnings and economic growth widely fluctuate. Commodity price changes caused by business cycles, as well as a limited number of countries competing with one other in the same market cause this to happen. In order to maintain stable economic growth, natural-resource-rich countries have tried to join together to form **export cartels**, which could control export volume and prices. The Organization of Petroleum Exporting Countries (OPEC), which has considerable influence over crude oil supply and prices throughout the world, exemplifies an export cartel.

There are certain requirements for export cartels to be successful; all cartel members must agree not to cheat on the agreement, substitutes for the good in question must not exist, and demand for a particular product must be relatively inelastic.

2-4a-(iii) Infant Industry Argument Economists have successfully argued that at times when a country gets a "late start" in a particular industry where it has a potential to become a world-class competitor, short-term protection for that industry or firm may be justified. This **infant industry argument** expects that economies of scale and the comparative advantage of an industry can only be exploited by providing temporary protection. During this period, the firm or industry will grow and become globally competitive, thereby enhancing society's gains from trade for the long term. For example, in the past, several South Korean firms in the semiconductor and automotive sectors have been provided protection under the infant industry premise.

2-4a-(iv) Questionable Labor Practices and Environmental Considerations Developed countries often resort to managed trade for reasons of unethical labor practices and violation of basic human rights. International Labor Organization (ILO) standards does not accept the use of child labor, unusually long work hours, below subsistence-level wages in the production of exports (e.g., the case of Nike in Vietnam), or working under dangerous conditions with toxic chemicals (e.g., manufacture of fire crackers in Sivakasi, India). Developed countries may restrict imports from developing countries that implement such policies. For instance, environmental degradation brought about through slash-and-burn policies in the Brazilian Amazon region in order to grow sugar cane for ethanol can be one reason why the European Union imposes a tariff on Brazilian ethanol of €0.19 per liter. The European Union hopes that this measure will force Brazil to change its environmental and labor practices.

2-4a-(v) Health and Safety Every country has the sovereign right to protect the health and physical safety of its citizens from contaminated imports. *Food safety measures* introduced to prevent the entry of harmful pests and diseases via imported foods, animals, and plants are a justifiable means to protect human life and physical health. For Japan, the world's largest net importer of agricultural products, food safety has been of particular concern. For example, when the first case of BSE-infected cattle was discovered in the United States in 2003, Japan's government quickly moved to halt U.S. beef imports. The two countries held several rounds of talks before Japan lifted the ban on U.S. beef in 2005. Similarly, the European Union has banned imports of genetically modified (GM) crops and processed goods from the rest of the world.

2-4b Geopolitical Rationale

There are several geopolitical and strategic reasons why nations practice managed trade. The geopolitical objective is to sacrifice some economic efficiency for the greater good of the country in terms of national security, protection of critical industries, and international commerce.

2-4b-(i) National Security For national security reasons, U.S. exports of certain types of high-technology defense equipment, instruments, devices, and components are generally restricted to allies and friendly countries; this applies to dual-purpose equipment (items that

export cartels
a group of countries that could effectively control export volume to keep their export prices, revenues, and economic growth stable or high

infant industry argument
temporary provision of protection to nascent industries that have good prospects of becoming globally competitive in the medium term

ETHICAL PERSPECTIVES

Stabilizing Sierra Leone's Devastated Economy

Sierra Leone, a small country in West Africa, sandwiched between Liberia and Guinea, has a population of six million. The end of Sierra Leone's civil war in 2002 brought much hope to this mineral-rich, but fiscally poor nation. With a gradual return to democracy and the rule of law, Sierra Leone's economy has slowly grown and has been diversifying away from the export of "blood diamonds," which illicitly finance civil wars for more commercial production of diamonds, gold, bauxite, and rutile (a mineral used as a whitening agent in the production of paint, paper, etc.). Blood diamonds, mined by poor panhandlers at the mercy of local militias, will not fetch international market price because they have been banned (by the Kimberley Process set up in 2003) in global trade and can only be sold illegally.

As the country's civil war ended, South Africa-based Koidu Holdings, a major global commercial mining operator, replaced local freelance panhandlers in Sierra Leone's Kano district (in the east of the country), which was known for its diamonds. As part of the deal with Sierra Leone's government, Koidu Holdings negotiated profit-sharing arrangements that would benefit the local population as soon as the mines became profitable. In addition, local small-time miners who were competing with the "mining majors" have been required to pay a 3 percent tax on their diamond sales. Approximately 0.75 percent (a quarter of the sales tax) will be returned to the local government to develop social infrastructure (e.g., education, health, sanitation, and roads). This trickle-down effect aims to economically benefit the local community and also bring peace and stability in the once militia-infested region.

Since the end of 2002, Sierra Leone's diamond exports have almost quadrupled from some $26 million to $99 million in 2008. However, the recession in 2009 caused diamond exports to fall to $79 million that year, which also created a fall in diamond prices. Some of the laborers who were laid off from Koidu Holdings' mines have begun farming because food prices have sharply risen. Furthermore, other miners are following Koidu Holdings' profit-sharing example and investing in Sierra Leone's other mineral operations, such as gold, bauxite, and rutile. Hopefully these commercial operations will lead to diversification of the country's exports, raising incomes, better working conditions, social welfare for local labor, and greater political stability in the country.

QUESTIONS:

1) Who are the various stakeholders who have benefited from the socioeconomic move away from the sale of "blood diamonds" to legal commercial diamond operations in Sierra Leone?
2) Evaluate the impact of Koidu Holdings' corporate social responsibility practices on Sierra Leone.

Source: "Digging in the Dumps," *The Economist*, May 30, 2009, pp. 49–50.

could be used for civilian and military purposes) as well. American firms that seek to tap China's huge market for these products can do so only if the U.S. government removes export controls and if the firms guarantee that the sale of these products will not jeopardize U.S. national security. Because the need to receive government approval prevents the affected firms from openly competing and increasing sales, these firms receive special treatment and protection. They include companies like Raytheon, General Dynamics, and Boeing in the United States, and EADS (European Aeronautics and Defense Systems) in Europe.

2-4b-(ii) Strategic Industries Some countries provide protection to *strategic industries* that have a significant employment impact on certain sectors of an economy—the so-called "national champions"—when these champions are unable to compete globally. In 2009, France and also the United States evoked this concept to protect their automotive sectors. Also, in 2011, legislation was introduced in Italy to designate some Italian companies as strategic in order to prevent their foreign takeovers, just as France invoked a similar sentiment in protecting Groupe Danone in 2007. The severe recession that began in 2008 with the collapse of the United States investment bank Lehman Brothers, led several financial firms in the United States to seek massive federal bailout capital to survive and compete in the global marketplace.

embargoes
trade sanctions that are imposed upon a nation to restrict trade with that country

2-4b-(iii) Embargoes When trade sanctions are imposed upon a country for political reasons, an embargo is in force, and trade will be restricted with that country. Embargoes, which may not be universally enforced, are meant to "punish" a country for perceived unacceptable international behavior. Trade embargoes have been used against several countries over time. Most recently in 2014, the United States, the European Union, and Australia imposed various trade sanctions on Russia because of that country's annexation of Crimea and incursion in east Ukraine. Also, the United States has maintained a trade embargo against Cuba for almost 50 years. The United States wants to put pressure on the Cuban government to move toward democratization and bring greater economic and political freedom to its citizens. The United States maintains trade embargoes on Iran because of the country's alleged nuclear weapons program.

REALITY CHECK LO-4

Boeing is the single largest exporter for the United States, yet it is restricted from exporting sensitive military equipment to all countries. What specific restrictions does the U.S. government impose upon defense contractors such as Boeing?

SUMMARY

Trade has influenced culture, shaped history, affected living standards, and opened society to new ways of thinking. Open trade and investment creates "winners" and "losers," but the gains from open trade and investment are always greater than the losses. Trade enhances the quality of life of consumers, brings with it cultural and technological riches, and makes the world a more peaceful place because of national interdependence. Trade generates jobs both in the export and import sectors of an economy. The disruptive nature of trade can be softened by retraining and reeducating the negatively affected workforce and enabling workers to learn new skills in order to become more productive and gainfully employed.

Three major economic ideas comprise trade theory. Mercantilism, the oldest, was based upon the idea of wealth accumulation (i.e., countries striving to generate trade surpluses so that their holdings of gold and silver would increase, making them rich and powerful). Second, theories based on specialization in the production of goods and services include the theories of absolute and comparative advantage. Finally, H–O and factor price-equalization theories emphasize factor abundance as the fundamental reason behind exports and trade.

Porter's model of National Competitive Advantage is based upon the trade theories mentioned above. The robustness of Porter's model can be attributed to his integration of the theory and structure of a firm's behavior to trade theory. Porter looked more closely at the theory of firm and industry specifics to identify characteristics that made firms and industries in countries "winners" or "losers" in international trade. Porter's hybrid model was designed to operate within an environment of government actions and unforeseen external events—external shocks, positive or negative.

Trade policy refers to government actions that seek to alter the free flow of merchandise or services from and to a country. The primary instruments of trade policy include tariffs (specific, ad valorem, and GSP) and export subsidies; however, nontariff barriers, such as import quotas, voluntary export restraint, and domestic content provisions, have become equally important.

Managed trade aims to replace free global-market forces with government actions to determine trade outcomes. Policymakers may use various socioeconomic or geopolitical rationales to protect specific companies, industries, or countries to achieve certain strategic objectives. Socioeconomic rationale may include countertrade, export cartels, the infant industry argument, or ethical considerations, such as labor and environmental practices and health and safety issues. Geopolitical justification could include considerations of national security, strategic industries, and embargoes.

KEY TERMS

international business, p. 36
trade, p. 36
foreign direct investment (FDI), p. 37
outsourcing, p. 38
mercantilism, p. 40
factors of production, p. 40
trade surplus, p. 40
absolute advantage, p. 42
comparative advantage, p. 42
factor endowment, p. 43
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managed trade, p. 50
countertrade, p. 50
export cartels, p. 51
infant industry argument, p. 51
embargoes, p. 52

CHAPTER QUESTIONS

1. How would you make a convincing case that open trade in goods and services as well as free flow of foreign direct investment will enhance the well-being of (a) consumers, (b) producers, and (c) the government of countries? Give specific examples to prove your position.
2. What trade theories support the recent rise of China and India on the global stage? Explain your views in detail.
3. Some believe there is a disconnect between trade theory and trade policy. What rationale could the United States use to support its trade policies? Give specific examples.
4. When would a country, such as France, use socioeconomic rather than geopolitical reasons to support its trade policy? Can you provide some examples?

MINI CASE: ECONOMIC NATIONALISM

Buy American! Buy Spanish! British jobs for British workers! The ideology of economic nationalism seeks to implement trade policies that help to keep jobs and investment at home, while ignoring the advantages of open international trade and investment. Economic nationalism was popular during the Great Depression of 1929–1933, when it served to protect domestic firms from international competition. However, this led to curtailing international business activity, making the global economic slowdown worse. Widely recognized as a myopic policy, economic nationalism nevertheless reemerged during the global financial crisis that originated in the United States in 2008, prompting many analysts to wonder whether the public has learned anything from international business history.

Soon after the U.S. stock market crash of 1929, Willis Hawley and Reed Smoot, two Republicans in the U.S. Congress, sponsored a bill to raise import tariffs to the highest level in U.S. history.[21] Given the high rate of U.S. unemployment at that time, the bill was passed in order to keep jobs at home. This resulted in retaliation from other nations as they raised tariffs on exports from the United States and other countries. The net result was a ruinous fall in global trade and a worldwide depression.

In late 2008 and early 2009, when the United States faced the worst recession since the Great Depression, the call for a new round of trade barriers was being debated. However, this time the focus was upon inserting nontariff barriers on items in the American Recovery and Reinvestment Act of 2009, which was meant to give

(continued)

the floundering U.S. economy a boost. This legislation, commonly known as the "stimulus package," included a "Buy American" provision that restricted government spending to U.S. companies. As a result, public works such as infrastructure projects were required to use commodities, such as iron and steel, that was domestically sourced, despite that these products cost more than imports from countries such as China. Similarly, the development and delivery of computerized medical records would be restricted to domestic IT firms, even if such services could be sourced at a much lower cost from India.

Some experts argued that such protectionism may violate international trade rules, and U.S. exporters feared retaliation against their goods and services. Canada, in fact, soon threatened retaliation. Meanwhile, other countries moved in similar directions. The British prime minister talked of "British jobs for British workers," the French president urged French car companies to invest at home rather than elsewhere in the European Union, the government of Spain launched a "Buy Spanish" campaign. It may not be Smoot-Hawley, but the global implications could be the same.

QUESTIONS:

1) Is economic nationalism justified?
2) Is the Smoot-Hawley plan better or worse than "Buy American"? "Buy Spanish"? Or "British jobs for British workers"? Explain fully.

Should "Carbon Tariffs" Be Imposed upon Greenhouse Gas-Producing Traded Goods?.

POINT COUNTERPOINT

In the aggregate, China is the world's largest emitter of greenhouse gases, primarily carbon dioxide, while the United States is the largest emitter of carbon dioxide on a per capita basis. The countries of the European Union fall somewhere in between. To control global warming and climate change, there has been a worldwide movement to regulate greenhouse gases caused by energy-intensive industries, such as the manufacturing of aluminum and other metals, paper, chemicals, and cement. The question is: Will the imposition of "carbon tariffs" (i.e., dollars per ton of carbon dioxide emitted by, for instance, aluminum production) in a particular country lead to unfair competition?

POINT If an agreement can be reached on a global basis without exceptions, a WTO-negotiated carbon tariff could lead to a reduction in worldwide demand for carbon dioxide-intensive materials as well as a move from coal-fired power plants to greener alternative-energy sources for electric power. Carbon tariffs could also lead to greater investment in research and development to conserve energy and to find more efficient ways in the manufacturing process so as to minimize greenhouse gas emissions.

COUNTERPOINT By imposing a carbon tariff on the exports of greenhouse gas-emitting industries, one would be exposing these firms to unfair competition from those that do not emit carbon dioxide. Also, the output of these industries (steel, paper, cement, etc.) is so basic (inelastic) for life that the net reduction in their demand may not have much impact on greenhouse gas emissions. Finally, a carbon tariff may be hard to implement. Customs officials would either need to assess the emissions embedded in imports or make arbitrary assumptions—the latter being a recipe for trade war.

What Do You Think?

Which viewpoint do you support, and why? Use the Internet to learn more about this issue and come up with your own argument.

INTERPRETING GLOBAL BUSINESS NEWS

The following relate to Chapter 2.

1) Health care costs, especially in the United States, have been skyrocketing in the recent past. This has led to a new trend, "internationalization of health care services." Countries as diverse as India, China, Thailand, and Cuba have developed strategies to supply health care services to patients in wealthy countries. What are the implications of this development to both the developing and developed economies of the world? Describe who will benefit and who will lose from this growing trend.

2) Because of the rising price of food grains in the global market, the Argentine government introduced a new sliding scale of export tariffs in early 2008—up to 44 percent on grains and cereals—which they say protects local prices from following record rises on international markets. Argentine farmers staged a 21-day strike in March 2008 in protest. Why? Who are the beneficiaries and the disenchanted?

3) In pursuit of ethical international business practices, western retailers are trying to ensure that suppliers in the developing world meet international labor and environmental standards. Yet, critics argue that this approach risks marginalizing those most in need of jobs. Explain what each side of this argument means.

4) As the global recession continues, China's exporters are looking homeward and threatening multinational enterprises operating in the country. What do you think is the likely outcome?

PORTFOLIO PROJECTS

Explore Your Own Case in Point: Understanding the Nature of Your Company

After reading this chapter you should be prepared to find the answers to some basic questions about your favorite company.

1) Determine whether your company is a producer of goods or services. What are the major products and/or services provided by your company? Are those outputs sold only domestically or are they also exported?

2) If some or all of the output is exported, how much of it is exported? To where are they exported, and why?

3) Do these products and services face tariff or nontariff barriers in the target export markets? What are the tariff rates or nontariff barriers imposed on these items?

4) Does your chosen company fall within the framework of "managed trade" in the export market? If so, on what basis? How is the company trying to overcome this challenge?

Develop an International Strategy for Your Own Small Business: Your Idea for Exporting

Using the data sources listed earlier, as well as other sources you may find on your own, develop a strategy and make a convincing case for why you would like to produce a particular product or service and export it to a target country. It is important that you identify in detail the comparative advantage of sourcing the product or service in your home country. You should look into supply as well as demand for your product or service. You should focus sales to one target country and its currency. The following questions will help you define your objectives:

1) What product or service do you plan to produce at home and sell abroad? What is your rationale and what competitive advantages do you have?
2) What foreign country do you plan to target and why? What is its demand for your product or service?
3) Identify factors such as tariffs and quotas that can affect trade in goods or services between your home and the target country. Explain how they could affect the demand for your product or service and how you could overcome those challenges.

CHAPTER NOTES

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