# Chapter 2 — The Dynamic Environment of International Trade

## Teaching Objectives

This chapter has a short history of international trade. Included is a history of GATT and the role of multinationals from the end of World War II through the decade of the nineties and beyond.

The aim of this chapter is to provide a brief overview of the international trade issues that constitute the environment of global business. Issues reflecting the political and economic trade policies that affect how international business is conducted. The teaching objectives are to:

1. Provide some insight into the balance of payments and the relationship of a country's current account and balance of trade.
2. Show the U.S. government's role in helping to ease restrictions on trade through the Omnibus Trade and Competitiveness Act.
3. Explore the provisions and effects of protectionism on world trade and to show that no country, including the United States, has "clean hands" when it comes to protecting home markets.
4. Illustrate the types of trade barriers that may confront a business.
5. Explore how GATT and the new World Trade Organization are designed to eliminate trade restrictions and provide a means for countries to settle trade disputes.
6. The importance of the Internet to global business.

## Comments and Suggestions

1. The discussion on the evolution of the multinational company during the 21st Century and the decade of the nineties may be used as an extension of the discussion of Chapter One since it illustrates the changing role of the U.S. multinational. The focus in this section is how the relative importance of U.S. MNCs after WW II changed from one of dominating world markets to a more competitive world market where U.S. multinationals compete with strong multinationals from Japan, Western Europe, Asia and many developing countries. This competitive environment is forcing MNCs to examine new ways to remain competitive. Some of these changes will be discussed as the course evolves.

2. Besides the discussion of the concept of protectionism and different trade barriers, a class discussion on how markets are protected can be interesting. On the one hand the United States alleges to be for free trade, yet it ignores the WTO in its trade dispute with Japan over opening its markets for U.S. automobile parts. The U.S. also has trade barriers. See, for example, Crossing Borders 2–1.

## Lecture Outline

GLOBAL BUSINESS ENVIRONMENT

I. The 21st Century
   A. World Trade and U.S. Multinationals

II. Balance of Payments
   A. Current Account
   B. Balance of Trade
III. The Omnibus Trade and Competitiveness Act
IV. Protectionism
   A. Protection Logic and Illogic
   B. Trade Barriers
      1. Tariffs
      2. Quotas
      3. Voluntary Export Restraints
      4. Boycott
      5. Monetary Barriers
      6. Standards
V. Easing Trade Restrictions
   A. General Agreement on Tariffs and Trade (GATT)
   B. World Trade Organization
   C. International Monetary Fund

**Discussion Questions**

1. Define:

| | |
|---|---|
| GATT | Protectionism |
| Balance of payments | IMF |
| | Nontariff barriers |
| Current Account | Voluntary export restraint (VER) |
| Tariff | WTO |

2. Discuss the globalization of the U.S. economy.

America's involvement in the global economy has passed through two distinct periods: a development era during which the United States sought industrial self-sufficiency in the eighteenth and nineteenth centuries, and a free-trade in the early and middle twentieth century during which open trade was linked with prosperity. Now America has entered a third, more dangerous era—an age of global economic interdependence.

With surprising swiftness, the United States has shifted from relative economic self-sufficiency to global interdependence. In 1960, trade accounted for only 10 percent of the country's GNP; by the mid-1980s, that figure had more than doubled. American farmers now sell 30 percent of their grain production overseas; 40 percent of U.S. farmland is devoted to crops for export. In fact, more U.S. farmland is used to feed the Japanese than there is Japanese farmland. American industry exports more than 20 percent of its manufacturing output, and one out of every six manufacturing jobs in the U.S. depends on foreign sales. More than 70 percent of American industry now faces stiff foreign competition within the U.S. market.

3. Differentiate among the current account, balance of trade, and balance of payments.

**BALANCE OF PAYMENTS**

When countries trade, financial transactions among businesses/consumers of different nations occur. Products and services are exported and imported, monetary gifts are exchanged, investments are made, cash payments are made and cash receipts received, and vacation and foreign travel occurs. In short, over a period of time, there is a constant flow of money into and out of a country. The system of accounts that records a nation's international financial transactions is called its balance of payments.

A balance-of-payments statement includes three accounts: the current account, a record of all merchandise exports, imports, and services plus unilateral transfers of funds, the capital account, a record of direct investment, portfolio investment, and short-term capital movements to and from countries; and the official reserves account, records of exports and imports of gold, increases or decreases in foreign exchange, and increases or decreases in liabilities to foreign central banks. Of the three, the current account is of primary interest to international business.

**CURRENT ACCOUNT**

The current account is important because it includes all international trade and service accounts, i.e., accounts for the value of all merchandise and services imported and exported and all receipts and payment from investments.

**BALANCE OF TRADE**

The relationship between merchandise imports and exports is referred to as the balance of merchandise trade or trade balance. If a country exports more goods than it imports, it is said to have a favorable balance of trade; if it imports more goods than it exports, as did the United States, it is said to have an unfavorable balance of trade. Usually a country that has a negative balance of trade also has a negative balance of payments. Both the balance of trade and the balance of payments do not have to be negative; at times a country may have a favorable balance of trade and a negative balance of payments or vice versa. This was the case for the United States during the Korean and Vietnam Wars when there was a favorable balance of trade but a negative balance of payments. The imbalance was caused by heavy foreign aid assistance by the United States to other countries and the high cost of conducting the Korean and Vietnam Wars.

In only three years since 1970 has the United States had a favorable balance of trade. This means that for each year there was an unfavorable balance, the United States imported goods with a higher dollar value than the goods it exported. These imbalances resulted primarily from heavy U.S. demand for foreign petroleum, foreign cars, industrial machinery, and other merchandise. Such imbalances have drastic effects on balance of trade, balance of payments, and therefore, the value of local currency in the world marketplace.

4. Explain the role of price as a free market regulator.

As a free market regulator, price serves as a primary variable in regulating supply and demand and aids in resource allocation. Prices that are too low deplete product supply, and prices that are too high stop consumer purchases.

5. "Theoretically, the market is an automatic, competitive, self-regulating mechanism which provides for the maximum consumer welfare and which best regulates the use of the factors of production." Explain.

   Productivity and market demand are the determinants of the standard of living differentials throughout the world as determined by the market if (theoretically) free competition exists. However, many variables pollute this "best of all possible worlds" model. Government interference, cartels and other monopolistic practices, and market barriers all corrupt this market (free) system.

6. Interview several local businessmen to determine their attitudes toward world trade. Further, learn if they buy or sell goods produced in foreign countries. Correlate the attitudes and report on your findings.

## Independent project.

7. What is the role of profit in international trade? Does profit replace or complement the regulatory function of pricing? Discuss.

   Profit in international trade provides the specific motivation for the traders. It is the catalyst of international trade. Profit complements the regulatory function of pricing in international trade. Out of the differential between cost and price comes profit.

8. Why does the balance of payments always balance even though the balance of trade does not?

   The balance of payments must always balance because the record is maintained on a double-entry bookkeeping system. In the balance of payments, debits must off-set the credits. The balance of trade doesn't have to be in balance. Exports can exceed imports or vice versa or they can be in balance.

9. Enumerate the ways in which a nation can overcome an unfavorable balance of trade.

   A country can overcome an unfavorable balance of trade by increasing exports or decreasing imports. Temporary aid may also result from infusions of capital, loans, or foreign aid.

10. Support or refute each of the various arguments commonly used in support of tariffs.

    Many arguments are commonly used in support of tariffs:

    (1) **Infant industry** – theoretically this argument has a considerable degree of validity. However, practically, the argument is carried too far. How do you determine which particular potential industries would develop a comparative advantage and be able to withstand foreign competition? When protection is a mistake, it is difficult to remove the protection. Unless there is a definite timetable, the incentive to develop increasing efficiency is weakened. This argument for tariffs has validity if it is used very carefully and controlled closely.

    (2) **Protection of the home market –** this argument asserts that low costs of production in other countries pauperizes American labor, and foreign goods would flood the American markets. For example, American producers would be forced to lower wage rates approximating foreign wage rates. This argument is invalid because low money wages do not necessarily mean low wage costs per unit of output. The latter is a function of two elements–money wage rates and the productivity of labor. Therefore, since free trade raised productivity rather than lower it, the above argument is *invalid*.

(3) **Keep money at home –** this fallacious reasoning is based on the mercantilist identity of money and wealth. A higher volume of money makes no direct contribution to the real income and wealth of a country. If a country is experiencing monetary problems, central bank and fiscal policies are much more potent weapons of monetary control than is manipulation of trade balance. Therefore, this argument is *invalid*.

(4) **Capital accumulation –** a country indeed does increase capital accumulation by imposing tariffs, but this gain is at the expense of other countries and retaliation soon follows which in the end leaves everybody losing, including the original tariff imposer. Therefore, this argument is *invalid*.

(5) **Standard of living and real wage –** this argument is parallel to number (4), except that the imposition of tariffs eventually leads to a lower national income and wage level due to retaliation. This argument is self-defeating and *invalid*.

(6) **Conservation of natural resources –** tariffs tend to cause extreme dependence on national resources and, therefore, our economy actually depletes its resources more quickly than if free trade existed and other countries bought our resources. Instead of conservation, there is depletion of natural resources; therefore, this argument is *invalid*.

(7) **Industrialization of low wage nation –** quite pertinent to underdeveloped countries. However, many times the foreign competition isn't the problem, but the paucity of capital and technical knowledge are problems. The danger of tariffs for this argument lies in the fact that the wrong kind of industries will be created. The types of industries which the underdeveloped areas can economically create and maintain are generally those which don't require protection on any large scale because they are based on natural advantages. Again, this argument is valid if it is used very carefully and closely controlled.

(8) **Maintain employment and reduce unemployment –** this argument becomes useless upon retaliation of other countries. The problem compounds itself. Also, if countries don't retaliate, there is still a gross inefficient allocation of resources in the tariff-setting country. Alternative policies are available which would relieve unemployment at home while encouraging greater employment abroad and a larger volume of international trade. Therefore, this argument is *invalid*.

(9) **National defense –** in particular instances there may be merit to this argument, but it becomes *invalid* if applied indiscriminately. We must trade to get the proper resources and conserve ours. (See #6). If the economy weakens, the military strength weakens. "National Security depends upon many factors, not the least of which is a community of economically healthy nations devoted to living in harmony and tied together by mutually beneficial trade."[1]

(10) **Increase business size –** with fully employed resources, aggregate domestic production can't be expanded by protective tariffs; expansion in one area of the economy must be at the expense of reduced output in other fields. Tariffs tend to draw resources away from previous employments into protected industries; hence, an inefficient allocation of resources. Also some of these reallocated resources are likely to be drawn away from production of export goods. Domestic expansion would be at the expense of the export market. Therefore, this argument is *invalid*.

[1] U.S. Senate, "Foreign Economic Police: Report No. 2629 (84$^{th}$ Cong. 2nd session), 1956, p.28

(11) **Retaliation and bargaining –** retaliation doesn't recover the losses that are suffered due to foreign tariffs. Retaliation further reduces the volume of trade. Bargaining as a reciprocal tool; i.e., tariffs are raised and then offered to be lowered if the other countries will lower theirs. If the reciprocal agreement isn't reached, then the tariffs usually remain. These arguments are sometimes a front for other reasons for erecting tariffs. Therefore, most of the time, this argument is *invalid*.

11. France exports about 18 percent of its GDP, neighboring Belgium exports 46 percent. What areas of economic policy are likely to be affected by such variations in exports?

12. Does widespread unemployment change the economic logic of protectionism?

    Increased validity is being granted to the argument that it is better to have workers employed even if the consumer must pay more. Many economic trade models assume full employment but the "real world" does not necessarily reflect the theory.

13. Review the economic effects of major trade imbalances such as those caused by petroleum imports.

    Trade imbalances cause shifting balance of payments patterns, unstable monetary exchange rates, wage and employment levels. Eventually a nation's economic base is significantly modified. As money value is depreciated, imports become more expensive and exports less expensive so an automatic adjustment process is set into motion.

14. Discuss the main provisions of the Omnibus Trade and competitiveness Act of 1988.

    Just as its name implies, the Omnibus Trade and Competitiveness Act is many faceted, focusing on assisting businesses to be more competitive in world markets as well as correcting perceived injustices in trade practices. Congressional concern centered around the issue that the United States, the world's largest economy, was open to Japan, Western Europe and the newly industrializing countries of Asia but was closed out in parts of their markets. Some see the trade bill as a protectionist measure, but the government sees it as a means of providing stronger tools to open foreign markets and to help U.S. exporters be more competitive. The bill covers three areas considered critical in improving the U.S. trade position: improving access to foreign markets, assisting U.S. exporters to be more competitive, and providing relief to U.S. businesses affected by unfair trade activities.

    **Market Access** There has been growing concern that U.S. business does not have the same access to foreign markets that foreign business has to U.S. markets. There are many barriers restricting or prohibiting goods from entering a foreign market: unnecessarily restrictive technical standards, compulsory distribution systems, customs barriers, tariffs, quotas, and restrictive licensing requirements are just a few. The Act gives the President authority to deal with countries where specific barriers unfairly keep U.S. products from entering those countries' markets. If a country violates a trade agreement, the President can retaliate by restricting the country's products in U.S. markets.

    Two other issues addressed under the market access section of the law are government procurement procedures and market access to telecommunications markets. Foreign government procurement procedures must not discriminate against U.S. firms; if they do, the President has the authority to impose a ban on U.S. Government procurement of goods and services from that country.

Deregulation and the divestiture of American Telephone and Telegraph assured foreign telecommunications suppliers full access to the American market. By contrast, U.S. companies enjoy limited access to the major foreign telecommunications markets, most notably in Europe. The 1988 Act clearly indicates that the United States regards telecommunications market access a top priority of U.S. trade policy and, when negotiation fails to open foreign markets, the government will take retaliatory action.

**Export Expansion** In addition to making foreign markets more accessible to U.S. goods, the 1988 Act reflects on awareness that some problems with U.S. export competitiveness stemmed from impediments on trade imposed by U.S. regulations and export disincentives. Export controls, the Foreign Corrupt Practices Act (FCPA), and export promotion were specifically addressed. The new regulations make it easier and speed up the process for obtaining export licenses for products on the export control list. Much of the ambiguity in the FCPA was removed by clarifying the legality of most types of payments. In addition, the act reaffirmed the government's role in the promotion of export trade in general, agricultural trade in particular, and the continued financial assistance to small businesses engaged in exporting.

**Import Relief** Export trade is a two way street; that is, we must be prepared to compete with imports in the home market if we force foreign markets to open to U.S. exports. The Act provides a menu of remedies for U.S. businesses adversely affected by imports; it recognizes that foreign penetration of U.S. markets can cause serious competitive pressure, loss of market share and, occasionally, severe injury. Measures dealing with antidumping, countervailing duty and intellectual property protection laws are designed to redress competitive advantages obtained by foreign companies through unfair trade practices. The Act also provides temporary relief from competition to firms injured by fairly traded imports.

15. The Tokyo Round of GATT has emphasized the reduction of nontariff barriers. How does the Uruguay Round differ?

Nontariff barriers are all the restrictions imposed on the importation of goods by a host government with the exception of tariffs. Such things as standards, quotas, import licenses, countervailing duties, border taxes can be classified as nontariff barriers. The Tokyo Round considered nontariff barriers as having become one of the major deterrents to international trade. Earlier rounds of negotiations by GATT members had been successful in reducing tariffs but nontariff barriers are considered to be insidious protectionist devices and the Tokyo Round focused on the reduction of nontariff barriers.

The Tokyo Round made a good start at addressing a number of nontariff barriers that have become more serious in recent years. Despite the success of these past rounds, high tariffs have not disappeared entirely and nontariff barriers are still widely used. There are also areas that, until now, GATT has not addressed such as services, intellectual property rights, and investment. Specifically, GATT negotiations in this round are to address key areas of importance in international trade which are not now under the scope of GATT rules. For example, GATT rules do not apply to the international trade of services which represent an increasing percentage of international trade flows. Similarly, GATT rules have little influence over government investment policies affecting international trade or on policies concerning the protection of intellectual property rights such as patents, trademarks, and copyrights. Agricultural trade is another area where GATT rules either do not apply or are not effective. Finally, the dispute settlement mechanism is seen to be increasingly ineffective at resolving conflicts among GATT members.

16. Discuss the impact of GATS, TRIMS, AND TRIPS on global trade.

    An important objective of the United States in the Uruguay Round was to reduce or eliminate barriers to international trade in services. While there is still much progress to be made before free trade in services will exist throughout the world, the General Agreement on Trade in Services (GATS) is the first multilateral, legally enforceable agreement covering trade and investment in services sector. It provides a legal basis for future negotiations aimed at eliminating barriers that discriminate against foreign services trade and deny them market access. For the first time, comprehensive multilateral disciplines and procedures covering trade and investment in services have been established. Specific market-opening concessions from a wide range of individual countries were achieved and provision was made for continued negotiations to further liberalize telecommunications and financial services.

    Equally significant were the results of negotiations in the investment sector. Trade-Related Investment Measures (TRIMs), established the basic principle that investment restrictions can be major trade barriers and therefore are included, for the first time, under GATT procedures. An initial set of specific practices were prohibited including: local content requirements specifying that some amount of the value of the investor's production must be purchased from local sources or produced locally; trade balancing requirements specifying that an investor must export an amount equivalent to some proportion of imports or condition the amount of imports permitted on export levels; and, foreign exchange balancing requirements limiting the importation of products used in local production by restricting its access to foreign exchange to an amount related to its exchange inflow. As a result of TRIMs, restrictions in Indonesia which prohibit foreign firms from opening their own wholesale or retail distribution channels can be challenged. And so can investment restrictions in Brazil that require foreign-owned manufacturers to buy most of their components from high-cost local suppliers and that affiliates of foreign multinationals maintain a trade surplus in Brazil's favor by exporting more than they sell within.

    Another objective of the United States from the Uruguay Round was achieved by an agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). The TRIPs agreement establishes substantially higher standards of protection for a full range of intellectual property rights (patents, copyrights, trademarks, trade secrets, industrial designs, and semiconductor chip mask works) than are embodied in current international agreements and it provides for the effective enforcement of those standards both internally and at the border.

17. Discuss the evolution of world trade that has led to the formulation of the WTO.

    Since the inception of GATT, there have been eight "rounds" of intergovernmental tariff negotiations. The most recently completed was the Uruguay round which built on the success of the Tokyo Round, the most comprehensive and far-reaching round undertaken by GATT up to that time. The Tokyo Round resulted in tariff cuts and set new international rules for subsidies and countervailing measures, anti-dumping, government procurement, technical barriers to trade (standards), customs valuation, and import licensing. While the Tokyo Round addressed non-tariff barriers, there were some areas not covered by that round which continued to impede free trade. In addition to market access, there were issues of trade in services, agriculture, and textiles; intellectual property rights; and investment and capital flows.

18. Visit http://hts.usitc.gov/ (U.S. Customs tariff schedule) and look up the import duties on leather footwear. You will find a difference in the duties on shoes of different value, material composition, and quantity. Using what you have learned in this chapter, explain the reasoning behind these differences. Do the same for frozen and/or concentrated orange juice.

    This exercise is designed to familiarize the student with the Internet and the information available from the U.S. Customs tariff schedule. There are various reasons why there will be different import duties on leather footwear and orange juice. The student should relate some of the issues discussed in the text as reasons for the different tariffs.

19. The GATT has had a long and eventful history. Visit http://www.wto.org/ and write a short report on the various Rounds of GATT. What were the key issues addressed in each round?

    This exercise is designed to familiarize the student with the Internet and issues GATT as well as the WTO. In addition to the various Rounds of GATT, this site is a complete discussion of WTO. The discussion of this question could include a broader discussion of WTO.

**GATT trade rounds**

| Year | Place/name | Subjects covered | Countries |
|---|---|---|---|
| **1947** | **Geneva** | Tariffs | 23 |
| **1949** | **Annecy** | Tariffs | 13 |
| **1951** | **Torquay** | Tariffs | 38 |
| **1956** | **Geneva** | Tariffs | 26 |
| **1960-1961** | **Geneva (Dillon Round)** | Tariffs | 26 |
| **1964-1967** | **Geneva (Kennedy Round)** | Tariffs and anti-dumping measures | 62 |
| **1973-1979** | **Geneva (Tokyo Round)** | Tariffs, non-tariff measures, “framework” agreements | 102 |
| **1986-1994** | **Geneva (Uruguay Round)** | Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc | 123 |
| 2001-present | Doha Round | incomplete | |