

## **CHAPTER 2**

### **TRADE: RHETORIC AND PRACTICE**

#### **Learning Objectives:**

1. Recognize the emerging trends in global trade
2. Understand why international trade occurs and how it benefits the countries involved in trade
3. Compare and contrast old and new trade theories
4. Explain the rationales behind government intervention in free trade
5. Understand global trade governing systems and the emergence of regional free trade agreements

#### **Key Terms:**

mercantilism, absolute advantage, comparative advantage, factor endowment theory, international product life cycle, new trade theory, first-mover advantage, economies of scale, diamond model, infant industry argument, strategic trade policy, General Agreement on Tariffs and Trade (GATT), Uruguay Round, World Trade Organization (WTO), Doha Round, regional free trade agreement

#### **Lecture Outline**

##### **I. Recent Trends in Global Trade**

###### **A. Largest Global Exporters**

###### **B. Manufacturing vs. Service Trade**

##### **II. Neoclassical Trade Theories**

- A. Absolute Advantage**
- B. Comparative Advantage**
- C. Factor Endowment Theory**
- D. International Product Life Cycle**

### **III. Is Trade Deficit Bad?**

- A. Main Causes of Trade Deficit**
- B. Thriftville vs. Squanderville**

### **IV. New Trade Theory**

- A. First-Mover Advantage**
- B. Economies of Scale**

### **V. Government Intervention in Free Trade**

- A. Political Arguments**
- B. Economic Arguments**

### **VI. Porter's Diamond Model**

### **VII. Global Trade Governing Systems**

- A. General Agreement on Tariffs and Trade (GATT) and Uruguay Round**
- B. World Trade Organization and Doha Round**

### **VIII. Regional Trading Agreement vs. Multilateral Trading Agreement**

#### **Cases:**

Case 2.1: Fast-Track Authority Rendered to President Obama

Case 2.2: U.S. Olympic Uniforms and Comparative Advantage

Case 2.3: The Fight for Flight: Boeing vs. Airbus Trade Dispute

Case 2.4: The Influence of U.S. Foreign Policy toward China on Trade

Case 2.5: Trade Facilitation Deal at the WTO Bali Meeting

### **Questions for Case Discussion (2.1):**

1. What is fast-track authority and why was it important for the U.S. government and former President Barack Obama to have had this privilege?

**The fast-track authority for brokering trade agreements was the authority given to former President Obama to negotiate international agreements that Congress can approve or deny. Fast track authority is instrumental in passing trade agreements that will create economic growth and investments.**

2. What are the expected impacts of providing President Obama with fast-track authority on the negotiation of the TPP?

**The TPP is expected to lower tariffs and create new regulations for diverse sectors such as agriculture, banking, and the pharmaceutical industry. While some labor unions are concerned that the Trans-Pacific Partnership (TPP) could send more jobs to low-wage countries such as Vietnam and Malaysia, the Obama administration says the deal will level the playing field for U.S. workers and raise standards abroad. With fast-track authority, Obama will also be afforded greater flexibility to pursue further trade agreements.**

3. Why do you think that Democrats have recently been opposed to signing another free trade agreement? Do you think that trade politics are necessary to save jobs for the American people?

**Democrats have been concerned about the impact that trade agreements will have on U.S. workers. As Democratic Leader Nancy Pelosi notes, “Any trade agreement must be judged by whether it will create good-paying jobs, whether it will increase the paychecks of American families, and whether it recognizes the fundamental connection between commerce and climate.” Democrats are wary of a repeat of NAFTA, the free trade agreement with Canada and Mexico that concluded in 1994, which many economists argue caused a U.S. Trade deficit resulting in the loss of manufacturing jobs.**

**Yes, trade politics are necessary to save jobs for the American people, as businesses looking to gain a competitive advantage will be looking to outsource labor forces to other countries where wages are lower and regulations are not as standardized or strict as in the United States.**

### **Questions for Case Discussion (2.2):**

1. What is comparative advantage and why is it important in trade?

**David Ricardo's theory of comparative advantage is that countries do best by concentrating on their strengths, and then trading with others for everything else. No one country is going to excel at every industry or product. Comparative advantage allows each country to concentrate its resources and energies on the particular goods and services that it is relatively productive at compared to the rest of the world. The countries then export those abroad, and in exchange import other goods and services produced relatively more efficiently abroad.**

2. Do you think that the U.S., not China, should produce the Olympic uniforms for the U.S. Olympic athletes? If so, please explain your rationale.

**No, China should produce the Olympic uniforms for U.S. Olympic athletes because of China's comparative advantage in producing low-cost uniforms. There are misconceptions over the percentage of products sold in the United States and made in China, and concerns over current economic conditions and unemployment, but the U.S. economy is actually relatively closed. China can make the uniforms less expensively in comparison to the United States, which has a comparative advantage in innovative technology and advanced manufacturing.**

3. What is the general perception about the dominance of "Made in China" products among the American people? Is there any myth about it?

**The majority of American people believe that a double-digit percentage of goods sold in the United States are produced in China. However, goods sold in 2010 labeled "Made in China" accounted for just 2.7% of U.S. personal-consumption expenditures on goods and services. Removing the value that the U.S. businesses transport, sell, and market those Chinese goods, and China imports are just 1.2%. Even adding products that occasionally include "Made in China" components, the final figure of imports increased to just 1.9 percent. The majority of goods and services sold in the United States are produced in the United States.**

### **Questions for Case Discussion (2.3):**

1. What was the ruling of the WTO regarding the trade dispute between Boeing and Airbus?

**The WTO ruled against Boeing as well as Airbus receiving billions of dollars of aid in both 2010 and 2012. While the ruling has been viewed as a victory for both the EU and the United States, new aircraft developments have sparked debates over whether both parties are obeying the WTO case rulings.**

2. How was the form of subsidies received by Airbus different from that received by Boeing? Who do you think has more substantially subsidized the manufacturing of new airplanes and why?

**Airbus has received low-interest loans from the UK, French, German, and Spanish governments to launch new aircrafts. Boeing has enjoyed a Washington State tax break extending over 20 years that partially reduces sales tax on Boeing aircrafts. Boeing would also receive tax benefits after it reinvests profits into growth and development and starts delivering jetliners to customers. An estimated \$8.7 billion in Washington State tax incentives have been paid to the commercial aerospace industry over a period of 16 years. Airbus has more substantially subsidized their manufacturing of new airplanes, with \$15 billion in government loans since 1970. These loans have protected Airbus from market forces that affected Airbus's competitors, including Boeing. Furthermore, Airbus was not required to pay back the loans if the aircraft program proved to be unsuccessful. They were indeed risk-free loans.**

3. Why do think that the EU and the U.S. government have been supporting the production of commercial airplanes?

**The commercial aerospace industry has a larger economy of scale than most other industries and has fewer large competing firms dominating the world market. The industry also has links to military and national security research and development, national pride, the creation of well-paying jobs, technologies that may spill over to other industries, and the contributions of aircraft exports to a positive balance of payments.**

#### **Questions for Case Discussion (2.4):**

1. How does U.S. foreign policy influence its trade policy in East Asia, particularly in the context of U.S.–China relations?

**U.S. foreign policy has shifted toward support for a containment policy against China. The former Australian prime minister believes the United States' proposed trade agenda is "to isolate China, contain it, diminish it, internally divide it and sabotage its political leadership". The Trans-Pacific Partnership (TPP) including the U.S., Vietnam, Australia, and Japan, does not include China. The Obama administration justified this trade agenda by warning that China could pass the U.S. as the global leader in trade and the global economy. The U.S. is hoping that new TPP standards would influence China's behavior, resulting in it being more aligned with U.S. trade policies.**

2. What is China's response to the U.S. suggestion of linking China's foreign policy to its trade policy?

**While the U.S. has encouraged China to be more aggressive in formulating trade policy and cutting tariffs, China has believed that its exclusion from the TPP shows the U.S. is attempting to constrain China. China has joined negotiations for another deal with 16**

**Southeast Asian countries known as the Regional Comprehensive Economic Partnership (RCEP) but results look to be modest compared to the TPP.**

3. How is the U.S. approach to trade expansion different from the Chinese approach?

**The U.S. is focused on “the software of trade” in making the trade rules: determining when tariffs can be imposed on goods, the level of protection for intellectual property and investments, which subsidies and government purchases have been approved, etc. The U.S. has largely set trade rules and persuaded other nations to accept them in regional and global trade pacts. China focuses on the “hardware of trade,” providing financing to developing countries as these countries hire Chinese companies to build the infrastructure that is necessary for global trade.**

### **Questions for Case Discussion (2.5):**

1. What was the trade facilitation deal signed at the Bali WTO meeting in 2013? What is the significance of the implementation of this deal?

**The trade facilitation deal that was originally agreed upon by the WTO’s 160 members in Bali was supposed to increase trade and add \$1 trillion to the global economy. The deal was also going to help developing economies implement required standards to improve ports and customs to world-class status. As the agreement was getting finalized, including a decision to renegotiate agricultural subsidy rules in 2017, India’s concern over current procedures caused their veto of the final agreement.**

2. Why did India veto the final agreement on this deal?

**India wanted a solution first to food security issues in regard to their stockpiling and subsidizing of wheat and rice. India buys wheat and rice from farmers at above-market prices, stockpiles the grain, and sells a portion to consumers at much lower prices. While the WTO has rules on food stockpiling and subsidizing, India wants the rules modified so that it can exceed predefined limits. India originally agreed to a reprieve until 2017 but now wants a clearer solution before it approves the trade facilitation package.**

3. What is the likely impact of the failure of the trade facilitation deal on the agreement of the WTO’s Doha Round negotiation?

**The failure to facilitate the agreement of the WTO’s Doha Round negotiation will further erode confidence in the global trading system and will encourage developed nations to pursue more regional and industry-specific trade deals that often leave out smaller and poorer nations.**

### **Review Questions:**

1. What are the major trends in global trade? Are there any particular phenomena to which we need to pay close attention?

World trade seems to have slowed down due to a sluggish economic recovery from the global financial crisis and the changing structure of the Chinese economy. Whereas China used to import raw materials and intermediary products in large volume, Chinese companies now make parts and assemble them themselves, reducing dependence on trade. However, this reduction in international trade has been mainly in manufacturing, as services are accounting for a larger share of GDP than ever before. The trade of services is the future and world trade volumes will be redefined as costs in multiple industries could be reduced and transparency would be key. Open trade agreements in services would reduce costs in shipping, banking, education, and health care, and databases would secure a regulatory framework covering sectors in more than 100 countries.

2. How is comparative advantage theory different from absolute advantage theory? Why do some economists believe that comparative advantage theory may no longer hold in this global economy?

According to absolute advantage theory, a country that specializes in multiple products more efficiently than other countries is supposed to produce those products while the other countries produce nothing. The theory of comparative advantage states that any country can benefit by participating in free trade based on opportunity costs.

Products of almost the same quality as those where they are invented are being made in developing countries with the distribution of innovative technology. An immiserating effect will occur, as multiple countries are capable of producing an identical product, causing the price of exports to drop. This immiserating effect challenges the comparative advantage theory since the countries involved in trade cannot gain from it as export prices get lower and lower.

3. What are the key elements of new trade theory? Are you convinced that new trade theory is more powerful than old trade theory in explaining the current developments in international trade?

New trade theory posits that not all countries will gain the same degree of benefit from trade as the role of government can make significant differences in determining how much benefit is accrued from trade. New trade theory is based on two key concepts: first-mover advantage and economies of scale. The first-mover advantage refers to the benefits that an early entrant into a new industry can enjoy over latecomers, particularly when the industry can accommodate only a few competitors. Economies of scale describes the economic advantage generated when a large scale of output results in substantial savings in unit production cost, mainly by spreading fixed costs over a larger volume. The first-mover advantage often allows a firm to exploit economies of scale, as it usually dominates the market without the existence of competitors.

New trade theory more accurately explains why intra-industry trade occurs. This is because consumers will benefit from free trade as different companies can now produce

**different types of products, even in the same industry, as long as sufficient demand exists for each product to enable the company to attain economies of scale.**

4. Discuss the key political and economic arguments that justify the government protectionism. Identify and explain one most recent case for each of these arguments.

**Political arguments include saving jobs and industries, protecting consumer health, national security, supporting foreign policy, and human rights protection.**

**As the steel and textile industries in the U.S. continue to lose their comparative advantage, workers can seek governmental protectionist measures to save their jobs.**

**In order to protect consumer health, the EU banned the importation of hormone-treated beef from the U.S. However, this caused a trade dispute as U.S. exports declined from \$231 million in 1988 to \$98 million in 1994. So the U.S. filed a complaint to the WTO in 1995 and the WTO panel ruled that the EU's ban on hormone-treated beef was illegal. As a result, the WTO allowed the U.S. to impose punitive tariffs valued at \$120 million on hundreds of EU products in 1999. In 2012, the EU struck a deal with the U.S. to continue with the ban but to increase its import quota of high-quality non-hormone treated beef from the U.S.**

**Matters of national security are also a justification for government intervention as the U.S. government is concerned with China's cyber campaign to steal trade secrets and intellectual property.**

**Trade policy is also an extension of foreign policy as the U.S. puts sanctions on countries, hoping that economic pressures will change governmental policies. The U.S. government has trade sanctions on Iran, Iraq, and North Korea, hoping that totalitarian government regimes will be replaced by democracy.**

**Human rights protection is used to leverage protectionism as the U.S. government has criticized the Chinese government's lack of effort to improve its domestic human rights situation and has questioned whether it should have its most favored nation status renewed.**

**Economic arguments include infant industry arguments and strategic trade policy.**

**The oldest argument for government intervention is for developing countries to protect its new industry that cannot compete with already well-established competitors from developed countries.**

**The recent trade dispute between Boeing and Airbus reflects strategic trade policy employed by developed countries, in which the country's government can subsidize its domestic companies to gain a first-mover advantage.**

5. What are key remaining issues that the Doha Round needs to deal with to reach an agreement? Do you think that regional free trade agreements such as TPP will continue to increase in the future? If so, please explain your reasoning.



The key unresolved issues that the Doha Round faces are agricultural subsidies that have led to surplus production and dumping, defining and reducing dumping, and developing countries' access to the use of intellectual property rights.

Regional free trade agreements may be more difficult to reach in the future, as developed countries increasingly want to link trade issues to non-trade issues such as labor and environment protection. Member countries will benefit from the regional trade agreements they sign but non-member countries are concerned about discrimination and favor. Still, the number of regional free trade agreements has substantially increased from around 70 in 1990 to more than 270 today.

### **Internet Exercise:**

Please visit the following website ([www.nytimes.com/2016/01/26/business/international/trans-pacific-pact-would-lift-us-incomes-but-not-jobs-overall-study-says.html?\\_r=0](http://www.nytimes.com/2016/01/26/business/international/trans-pacific-pact-would-lift-us-incomes-but-not-jobs-overall-study-says.html?_r=0)) and discuss the key positive and negative impacts of the Trans-Pacific Partnership (TPP) on the US economy.

The key positive impacts of the TPP on the US economy include increases in income, exports, and growth. The agreement makes up 36 percent of global trade and a quarter of all exports, phases out tariffs among trading partners, and includes trade rules governing labor, the environment, goods, services, global investment, and digital commerce. The TPP increases real incomes by \$131 billion annually or 0.5 percent of GDP. Exports would increase by \$357 billion. The U.S. would benefit the most although all members in the agreement gain significant benefits.

However, even with this growth, the TPP is unlikely to add to overall employment. Workers will be displaced by free trade as lasting wage cuts and unemployment may occur based on specific industries, locations, or skill shortages. Manufacturing growth would be reduced by about one-fifth as analysts hope that would mean higher employment in service and primary goods industries. Furthermore, if the TPP is not approved or is delayed it may represent a \$77 billion permanent loss in opportunity costs and create other risks.

## Sample Exam Questions

**Multiple Choice Questions** (The correct answers are in green)

1. Which of the following has come about as a result of the growth of services in international trade?
  - a. Reduced shipping costs
  - b. More accessible workers' rights
  - c. The same testing regimes for pharmaceuticals
  - d. All of the above
2. Which of the following best describes absolute advantage theory?
  - a. One country gains at the expense of the other country
  - b. Any country can find a product that it can produce more efficiently
  - c. A country should produce based on factors it has in abundant supply
  - d. A country can produce multiple products more efficiently than other countries
3. Mercantilism is based on the premise that trade is a \_\_\_\_\_ sum game in which only those exporting countries benefit from it while importing countries do not gain anything.
  - a. Zero
  - b. Positive
  - c. Win-win
  - d. Negative
4. Which of the following is not among neoclassical (old) trade theories?
  - a. Absolute advantage
  - b. Comparative advantage
  - c. Factor endowment theory
  - d. Economies of scale
5. Which of the following best describes comparative advantage?
  - a. One country gains at the expense of the other country
  - b. Any country can find a product that it can produce more efficiently
  - c. A country should produce based on factors it has in abundant supply
  - d. A country can produce multiple products more efficiently than other countries
6. If multiple countries are capable of producing an identical product in terms of quality and function, the price of exports will drop. This phenomenon is known as:
  - a. Economies of scale
  - b. Immiserating effect
  - c. Strategic trade policy
  - d. Opportunity cost
7. Which of the following most accurately describes the maturity stage of the International Product Life Cycle?
  - a. The product is introduced to other developed countries
  - b. A new product will replace the existing product as it gets old
  - c. Developing countries can produce the same product the developed country invented

- d. A product is invented and introduced in a developed country
8. Which of the following is not a key source of the United States' trade deficit?
- a. Low savings rate in the private sector
  - b. Large spending in the government sector
  - c. China's large trade surplus
  - d. None of the above
9. Which of the following best describes first-mover advantage?
- a. A firm can enjoy benefits like efficient cost structures
  - b. A firm can enjoy large profits and a monopoly status
  - c. A firm can exploit economies of scale with no competitors
  - d. All of the above
10. Which of these is not a political argument for government protectionism of free trade?
- a. Saving jobs and industries
  - b. Protecting consumer health
  - c. Supporting foreign policy
  - d. Strategic trade policy
11. An example of government protectionism of free trade for national security is:
- a. Prohibiting the trade of products that contain confidential information
  - b. Banning the importation of hormone-treated beef
  - c. Trade sanctions against a country for their totalitarian government practices
  - d. All of the above
12. Which of the following is a pitfall for using infant industry arguments for government protectionism of free trade?
- a. It is not always easy to accurately predict the industry that is most likely to succeed in the future
  - b. Finding the right timing to remove the protection is difficult
  - c. All of the above
  - d. None of the above
13. Which of these trade models explains why a certain country continues to sustain a competitive advantage in a particular industry?
- a. Porter's Five Forces
  - b. Diamond Model
  - c. Comparative Advantage
  - d. New Trade Theory
14. Which of the following is not a factor in the trade model described above?
- a. Domestic rivalry
  - b. Demand conditions
  - c. National security
  - d. Firm strategy

15. An example of a supporting industry that would help a firm gain a competitive advantage in the auto industry is:
- a. Computer
  - b. Steel
  - c. Rubber
  - d. All of the above
16. The Japanese inventing miniature consumer electronic appliances to accommodate small living spaces is an example of a country's response to:
- a. Demand conditions
  - b. Factor conditions
  - c. Supporting Industry
  - d. Comparative advantage
17. Which of the following was created after World War II to promote free trade and sponsored multiple rounds of multilateral trade negotiations?
- a. World Trade Organization
  - b. General Agreement on Tariffs and Trade
  - c. Most Favored Nation
  - d. All of the above
18. Which of the following was not a key achievement in the Uruguay Round of multilateral trade negotiations?
- a. Creation of the WTO
  - b. Adequate protection of intellectual property rights
  - c. Reducing trade barriers in financial services
  - d. Reduction of agricultural subsidies
19. Which of the following is not a negative impact of Regional Free Trade Agreements (RFTA)??
- a. Incentives for other nations to join the RFTA or negotiate their own agreements
  - b. RFTA members would lose interest in multilateral free trade agreements
  - c. RFTA members would discriminate against non-members
  - d. None of the above
20. Which of the following is still an issue that remains between developing and developed nations in the Doha Round?
- a. Agricultural subsidies
  - b. Anti-dumping issues
  - c. Intellectual property rights
  - d. All of the above

### Short Questions

1. What are the recent trends in global trade?

World trade has slowed down as economies have recovered from the global financial crisis and there have been shifts in the Chinese economy. Whereas China used to import raw materials and intermediary products in large volume, Chinese companies now make parts and assemble them themselves, reducing dependence on trade. While the slow growth has been in trading for manufacturing, services are accounting for a larger share of GDP than ever before. The trade of services continues to grow and free trade agreements would reduce costs in shipping, banking, education, and health care.

2. What is the difference between absolute advantage and comparative advantage?

Absolute advantage argues that any country can find a product and produce it more efficiently than any other country. This corrected the mercantilism assumption that trade is a zero-sum game in which only one country gains at the expense of the other country. Comparative advantage builds on absolute advantage by answering the question, “what if a country can produce multiple products more efficiently than other countries?” Based on the concept of opportunity cost, any country can benefit from trade by importing the products in which they don’t have an absolute advantage and exporting the products in which they do have an absolute advantage.

3. Explain the misconception of the U.S. trade deficit in relation to China’s trade surplus.

Because China is the second largest economy in the world and has a trade surplus, many Americans believe that China is the principal culprit of the U.S. trade deficit. However, the root cause of the trade deficit is a low savings rate and high government spending. The U.S. does not have a high enough domestic savings rate to finance investments for economic growth, so they must borrow money from other countries or attract foreign direct investment to bring in capital.

## Essay Questions

1. What are government arguments for intervening in free trade?

Government protectionism is often driven by political and economic arguments.

Political arguments include saving jobs and industries, protecting consumer health, national security, supporting foreign policy, and human rights protection.

Politicians typically use the argument of saving jobs to seek political support in exchange for keeping jobs in industries where comparative or competitive advantages are diminishing. Governments seek to protect consumer health in their intervention of free trade as biotechnology has advanced to produce genetically modified agricultural and meat products. National security is a concern, as certain items are not barred from being exported or imported due to their confidential information. Governments also use international free trade to support their foreign policies; the U.S. has maintained trade sanctions against Iran, Iraq, and North Korea, hoping that economic pressure will result in the downfall of totalitarian governments and replacement with democratic governments.

The government may also cite human rights issues to leverage their protection until domestic human rights policies are installed.

Economic arguments include infant industry arguments and strategic trade policy. Governments may intervene in free trade in order to protect their new industry that cannot compete with already well-established competitors in developed countries. However, it is difficult not only to predict the successful industry but also to know the right time to remove the government protection. Governments may also look to use strategic trade policy to help their domestic companies gain a first-mover advantage.

2. What is the purpose of Porter's Diamond model? Describe the four elements of the model.

Porter's Diamond model explains why a certain country continues to sustain a competitive advantage in a particular industry. The four factors of the diamond model are Factor Conditions, Demand Conditions, Supporting and Related Industry, and Firm Strategy, Structure, and Rivalry.

Porter refined the factor endowment theory to classify factors into basic factors consisting of natural endowment such as labor, land, and climate, and advanced factors created by the provision of quality education and effective training.

Demand conditions have driven companies to sustain their competitive advantage as the conditions are shaped by the specific physical countenance and unique environment in which they are living and the pressure to keep improving existing products to satisfy customers.

Supporting and related industry highlights the importance of having an industry cluster that creates both forward and backward linkages. A heavy reliance on imported parts and components would hamper successful growth.

Firm strategy, structure, and rivalry are important for maintaining competitive advantage as top management influences strategy and structure with their expectations and profitability, and competition puts pressure on companies to deliver high-quality products at reasonable prices.

3. Explain the key issues still remaining in the conclusion of the Doha Round.

The three key issues still remaining in the Doha Round are agricultural subsidies, anti-dumping issues, and intellectual property rights.

Developed countries have provided a significant amount of subsidies for their farmers, allowing them to produce a surplus that has led to dumping and lower prices. These depressed prices negatively affect producers in developing countries, who are losing revenue. Agricultural products also decrease as developing countries overproduce agricultural products to feed their large population in poverty.

Developing countries are asking for clarification about what constitutes dumping and ways in which they can reduce dumping. Developing countries have blamed the U.S. and other

developed countries for penalizing companies who allegedly market their products below production costs or a fair market price.

While developed countries want to protect their intellectual property rights, developing countries want to get more access to public use of intellectual property rights. For example, in the case of AIDS treatments that are more readily available to developed countries, developing countries want to produce generic products as substitutes.

The Doha Round also faces new issues, as developed countries want to link trade issues to non-trade issues such as labor and environment protection. While the outcome of the 2013 meeting in Bali looked promising, the Indian government refused the implementation and the conclusion of the Doha Round remains uncertain.