PART TWO THE ENVIRONMENT OF INTERNATIONAL BUSINESS


ADDITIONAL BIBLIOGRAPHY


West, Joel, and Graham, John L. "A Linguistic-Based Measure of Cultural Distance and Its Relationship to Managerial Value Management International Review, vol. 44, no. 3 (Third Quarter 2004).

Chapter 6
INTERNATIONAL TRADE

Objectives of the chapter

An understanding of international trade is critical to the study of international business. The primary objective of this chapter is to examine key economic theories that help to explain why nations trade. In addition, the role and importance of a country’s barriers to trade will be studied and discussed. The chapter will focus on why most nations use trade barriers despite vigorous international efforts to eliminate them.

The specific objectives of this chapter are to:

1. Define the term international trade and discuss the role of mercantilism in modern international trade.
2. Contrast the theories of absolute advantage and comparative advantage.
3. Evaluate the importance of international product life cycle theory to the study of international economics.
4. Explain some of the most commonly used barriers to trade and other economic developments that affect international economics.
5. Discuss some of the reasons for the tensions between the theory of free trade and the widespread practice of national trade barriers.

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Active Learning Case

Trade of the triad and China

Over the last three decades, new entrants into the world export market have transformed the economies of industrialized countries and the types of products they export. At the beginning of this time period, the Japanese were a growing force in the international arena. They dominated the 1980s and were able to make substantial gains at the expense of such dominant exporters as the US and the United States. Indeed, between 1980 and 1998, both these countries lost worldwide market share to the Japanese in such industries as automotive products, office machinery, telecommunication equipment, machinery and transport equipment, chemicals, and textiles.

In the late 1980s, however, the world economy began to see major changes. Asia, South Korea, Singapore, Taiwan, Thailand, and China were growing much more competitively on the world stage. South Korea, for example, started expanding its automotive industry, while China’s market share of office and telecom equipment rose from zero to about 1 percent of the market in 1990 to 4.5 percent in 2000. Meanwhile, thanks to NAFTA—which decreased barriers to trade within North America—Mexico and Canada were increasing their market share of automotive products, machinery, and transport equipment. Such competition spurred the United States to radically restructure many of its industries, invest billions in new technology, plant, equipment, and information technology, and introduce improvement programs, such as Six Sigma, that allowed it to match the quality offerings of worldwide competitors. As a result, the US share of the world’s export market in areas such as automotive products, machinery and transport equipment, chemicals, and textiles somewhat recovered. The big loser was Japan, which saw its export market share decline in most of these areas. Today the biggest challenge to the export markets of industrialized countries in China. Between 2003 and 2005, China’s share of the world’s exports merchandise more than doubled—from 4.7 percent to 9.8 percent (see Table 1). This increase comes at the expense of exports by triad countries over the same period. By 2005 the core triad’s share of world exports was 42.3 percent, with the US accounting for over half of this (see Table 2). The United States and Japan were the hardest hit.

China’s expansion is particularly evident in the clothing and textile markets. Today the country holds 26.9 percent and 20.2 percent of each market, respectively (see the first table). More impressive, however, are China’s improvements in exports of office and telecommunication equipment and of machinery and transport equipment, both of which require significant technology know-how.

As can be seen in the tables, China’s rise as a world exporter has decreased the share of the triad’s share of world exports in manufacturers. In response to China’s increased competitiveness, triad countries are trying to balance the need to integrate this new player into the international business arena with the need for short-term effects to their economies.

Japan’s attitude toward China took a turn from protectionism when it realized that this new trade partner could help it overcome some of the problems associated with its rigid economic system. Large amounts of inexpensive, low-skilled labor now allowed Japanese companies to outsource some of their manufacturing operations overseas, within its own region, while more skilled Japanese workers took care of the more specialized areas of the production process. In addition, China eased Japan’s long dependence on the US economy for its industrial and consumer products.

As US and EU companies have also moved operations to Japan, the governments are reacting more aggressively to pressure from special interest groups that see China as a threat to US businesses and jobs. The United States, which runs a large trade deficit with China, has argued that the yuan is undervalued, creating an unfair advantage for Chinese producers. The United States is threatening to impose tariffs on Chinese products. Japan has joined this war and is pressuring China to move to a more flexible exchange rate. Yet, critics argue that this will only know the market value of the yuan and that a fall in its price after deregulation could only cause matters. For its part, the EU has reacted by asking China to curb exports of textiles into the union after exports of clothing increased by 534 percent in less than nine months in 2005.

The increase in imports by any nation does not necessarily mean that other countries are losing out. In terms of trade alone, any new entrant to the world export market, other things being equal, will decrease the share of world exports of all other countries. This, however, does not mean that other countries are exporting less. They could be exporting, in value terms, a significantly higher amount because a new trade partner also means a new market to which they can export. More specifically, however, trade creates losers and winners. Triad economies are being forced to specialize. While those with most to lose pressure their governments to impose trade barriers, those with most to gain—high-skilled industries—are expanding to serve the Chinese market. Further, customers’ real incomes increase when they can purchase the same products at lower prices.

The data on this case help to reinforce an important principle of international trade: specialize in those products in which you can achieve an advantage. Over time, of course, competitors may erode this advantage by developing even better offerings for the export market. In this case, it is important either to counterattack by improving your own offering to win back this market share, or to find other markets where the country’s skills and resources will allow it to compete effectively. In light of the emergence of more and more industrial countries in Asia, the growing competitiveness of Latin America, and the emerging industries of Eastern Europe and the former Soviet Union, triad managers have their work cut out for them.

Table 1. China’s share of the world’s market for exports of manufactures

<table>
<thead>
<tr>
<th>Industry</th>
<th>2000</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>All manufactures</td>
<td>4.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>3.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Chemicals</td>
<td>2.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>3.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Automotive products</td>
<td>0.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Office and telecom equipment</td>
<td>4.5</td>
<td>6.7</td>
</tr>
<tr>
<td>Textiles</td>
<td>10.5</td>
<td>20.2</td>
</tr>
<tr>
<td>Clothing</td>
<td>18.3</td>
<td>24.9</td>
</tr>
</tbody>
</table>

Note: Manufacturing are a subcategory within merchandise exports. These data include intra-regional EU exports.
Source: Authors’ calculations based on data from World Trade Organization, Statistics Database.

Table 2. The triad’s share of merchandise world exports

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>15.3</td>
<td>16.1</td>
<td>11.7</td>
<td>−3.6</td>
</tr>
<tr>
<td>EU</td>
<td>26.2</td>
<td>22.2</td>
<td>22.9</td>
<td>−3.3</td>
</tr>
<tr>
<td>Japan</td>
<td>11.4</td>
<td>8.9</td>
<td>7.7</td>
<td>−3.7</td>
</tr>
<tr>
<td>Triad</td>
<td>53.1</td>
<td>47.2</td>
<td>42.3</td>
<td>−10.8</td>
</tr>
<tr>
<td>Non-triad</td>
<td>46.9</td>
<td>52.8</td>
<td>57.7</td>
<td>10.8</td>
</tr>
</tbody>
</table>

Note: Data are calculated using world trade minus intra-regional EU trade.

1. How does the process of the UK’s finding market niches help illustrate the theory of comparative advantage?
2. How does an EU manager’s desire to buy domestic products illustrate the importance of consumer taste in international markets?
3. In what way could the EU use trade barriers to protect its markets from foreign competitors? Who can be affected by these trade barriers?

**INTRODUCTION**

International trade is the branch of economics concerned with the exchange of goods and services with foreign countries. Although this is a complex subject, we will focus on two particular areas: international trade theory and barriers to trade.

Some international economic problems cannot be solved in the short run. Consider the US balance of trade deficit. US trade with Japan and China heavily affects its overall imbalance. Moreover, this trade deficit will not be reduced by political measures alone; it will require long-run economic measures that reduce imports and increase exports. Other nations are also learning this lesson—and not just those that have negative balances. After all, most countries seem to want a continual favorable trade balance, although this is impossible, since a nation with a deficit must be matched by a nation with a surplus.
International trade has become an even more important topic now that so many countries have begun to move from state-run to market-driven economies. In many cases, unemployment is severe problems for these nations. Fortunately, enhanced international trade is one way to address a weak macroeconomy. International commitment to a free market will bring prosperity to the world economic system. Since the time of Adam Smith in 1790, economists have shown that free trade is efficient and leads to maximum economic welfare. In this chapter, we will discuss the economic rationale for free trade and the political impediments to it.

**INTERNATIONAL TRADE THEORY**

To understand the topic of international trade, we must be able to answer the question, why do nations trade? One of the earliest and simplest answers to this question was provided by mercantilism, a theory that was quite popular in the eighteenth century, when gold was the only world currency. Mercantilism holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports. The result is a positive balance of trade that leads to wealth (gold) flowing into the country.

Neo-mercantilism, like mercantilism, seeks to produce a positive balance of trade but without the reliance on precious metals. Most international trade experts believe that mercantilism is a simplistic and erroneous theory, although it has had followers. For example, under President Mitterand in the late 1970s and early 1980s, France sought to revitalize its industrial base by nationalizing key industries and banks and subsidizing exports over imports. By the mid-1980s the French government realized that the strategy was not working and began denationalizing many of its holdings.

More recently, China has proven to be a strong adherent of mercantilism, as reflected by the fact that it tries to have a positive balance with all of its trading partners. A more useful explanation of why nations trade is provided by trade theories that focus on specialization of effort. The theories of absolute and comparative advantage are good examples.

**Theory of absolute advantage**

The theory of absolute advantage holds that nations can increase their economic well-being by specializing in the production of goods they can produce more efficiently than anyone else. A simple example can illustrate this point. Assume that two nations, North and South, are both able to produce two goods, cloth and grain. Assume further that labor is the only scarce factor of production and thus the only cost.

<table>
<thead>
<tr>
<th>Labor cost [hours] of production for one unit</th>
<th>Cloth</th>
<th>Grain</th>
</tr>
</thead>
<tbody>
<tr>
<td>North</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>South</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

Thus lower labor-hours per unit of production means lower production costs and higher productivity per labor-hour. As seen by the data in the table, North has an absolute advantage in the production of cloth since the cost requires only 10 labor-hours, compared to 20 labor-hours in South. Similarly, South has an absolute advantage in the production of grain, which it produces at a cost of 10 labor-hours, compared to 20 labor-hours in North.

Both countries gain by trade. If they specialize and exchange cloth for grain at a relative price of 1:1, each country can employ its resources to produce a greater amount of goods. North can import one unit of grain in exchange for one unit of cloth, thereby paying only 10 labor-hours for one unit of grain. If North had produced the grain itself, it would have used 20 labor-hours per unit, so North gains 10 labor-hours from the trade. In the same way, South gains from trade when it imports one unit of cloth in exchange for one unit of grain. The effective cost of South for one unit of cloth is only the 10 labor-hours required to make its one unit of grain.

The theory of absolute advantage, as originally formulated, does not predict the exchange ratio between cloth and grain once trade is opened, nor does it resolve the division of the gains from trade between the two countries. Our example assumed an international price ratio of 1:1, but this ratio (Pcloth/Pgrain) could lie between 2:1 (the pretrade price ratio in South) and 1:2 (the pretrade price ratio in North). To determine the relative price ratio under trade, we would have to know the total resources of each country (total labor-hours available per year), and the demand of each for both cloth and grain. In this way we could determine their relative gains from trade for each country.

Even this simple model of absolute advantage has several important implications for international trade. First, if a country has an absolute advantage in producing a product, it has the potential to gain from trade. Second, the more a country is able to specialize in the good it produces most efficiently, the greater its potential gains in national well-being. Third, the competitive market does not evenly distribute the gains from trade within one country. This last implication is illustrated by the following example.

Prior to trade, the grain farmers in North work 20 hours to produce one unit of grain that could be exchanged for two units of cloth. After trade, those who remain can exchange one unit of grain for only one unit of cloth. Thus, the remaining grain producers are worse off under trade. Cloth producers in North, however, work 10 hours, produce one unit of cloth, and exchange it for one unit of grain, whereas previously they received only half a unit of grain. They are better off. If grain producers in North switch to cloth production, then 20 hours of labor results in the production of two units of cloth, which they can exchange for two units of grain. Thus, international trade helps them. As long as North does not specialize completely in cloth, there will be gainers (cloth producers and grain producers who switched to cloth) and losers (those who continue as grain producers).

Because the nation as a whole benefits from trade, the gainers can compensate the losers and there will still be a surplus to be distributed in some way. If such compensation does not take place, however, the losers (continuing grain producers) would have an incentive to try to prevent the country from opening itself up to trade. Historically, this problem has continued to fuel opposition to a free trade policy that reduces barriers to trade. A good example is Japanese farmers who stand to lose their livelihood if the government opens up Japan to lower-priced agricultural imports.

A more complicated picture of the determinants and effects of trade emerges when one of the trading partners has an absolute advantage in the production of both goods. However, trade under these conditions still brings gain, as David Ricardo first demonstrated in his theory of comparative advantage.

**Theory of comparative advantage**

The theory of comparative advantage holds that nations should produce those goods for which they have the greatest relative advantage. In terms of the previous example of two
countries, North and South, and two commodities, cloth and grain, Ricardo’s model can be illustrated as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Cloth</th>
<th>Grain</th>
</tr>
</thead>
<tbody>
<tr>
<td>North</td>
<td>50</td>
<td>190</td>
</tr>
<tr>
<td>South</td>
<td>200</td>
<td>290</td>
</tr>
</tbody>
</table>

In this example North has an absolute advantage in the production of both cloth and grain, so it would appear at first sight that trade would be unprofitable, or at least that incentives for exchange no longer exist. Yet trade is still advantageous to both nations, provided their relative costs of production differ.

Before trade, one unit of cloth in North costs (50/100) hours of grain, so one unit of cloth can be exchanged for half a unit of grain. The price of cloth is half the price of grain. In South, one unit of cloth costs (200/200) hours of grain, or one unit of grain. The price of cloth equals the price of grain. If North can import more than half a unit of grain for one unit of cloth, it will gain from trade. Similarly, if South can import one unit of cloth for less than one unit of grain, it will also gain from trade. These relative price ratios set the boundaries for trade. Trade is profitable between price ratios (price of cloth to price of grain) of 0.5 and 1. For example, at an international price ratio of two-thirds, North gains. It can import one unit of grain in return for exporting one and a half units of cloth. Because it costs only 50 hours of labor to produce the unit of cloth, its effective cost under trade for one unit of imported grain is 75 labor-hours. Under pretrade conditions it costs North 100 labor-hours to produce one unit of grain. Similarly, South gains from trade by importing one unit of cloth in exchange for two-thirds of a unit of grain. Prior to trade, South spent 200 labor-hours producing the one unit of cloth. Through trade, its effective cost for one unit of cloth is 125 (125 x 200, or 133 labor-hours)—cheaper than the domestic production cost of 200 labor-hours. Assuming free trade between the two nations, North will tend to specialize in the production of cloth, and South will tend to specialize in the production of grain.

This example illustrates a general principle. There are gains from trade whenever the relative price ratios of two goods differ under international exchange from what they would be under conditions of no trade. Such domestic conditions are often referred to as autarky, which is a government policy of being totally self-sufficient. Research shows that free trade is superior to autarky. In particular, free trade provides greater economic output and consumption to the trade partners jointly than they can achieve by working alone. By specializing in the production of certain goods, exporting those products for which they have a comparative advantage, and importing those for which they have a comparative disadvantage, the countries end up being better off.

The general conclusion of the theory of comparative advantage is the same as those for the theory of absolute advantage. In addition, the theory of comparative advantage demonstrates that countries jointly benefit from free trade (under the assumptions of the model) even if one has an absolute advantage in the production of both goods. World trade, efficiency and consumption increase.

As with the theory of absolute advantage discussed previously, Ricardo’s theory of comparative advantage does not answer the question of the distribution of gains between the two countries, nor the distribution of gains and losses between grain producers and cloth producers within each country. No country will lose under free trade, but in theory at least all the gains could accrue to one country and to only one group within that country.

Factor endowment theory

A trade theory which holds that nations will produce and export products that use large amounts of production factors that they have in abundance and will import products requiring a large amount of production factors that they lack.

Heckscher–Ohlin theory

A trade theory that extends the concept of comparative advantage by bringing into consideration the endowment and cost of factors of production and helps to explain why nations with relatively large labor forces concentrate on producing labor-intensive goods, whereas countries with relatively more capital than labor specialize in capital-intensive goods.

Leontief paradox

A finding by Nobel Prize-winning economist, Daniel K. Leontief, in the United States, by surprise, where relatively more labor-intensive goods and relatively less capital-intensive goods were exported.

International product life cycle theory

Another theory that provides insights into international theory is Vernon’s international product life cycle (IPLC) theory, which addresses the various stages of a new product’s life cycle. In particular, the theory helps explain why a product that begins as a nation’s export often ends up becoming an import. The theory also focuses on market expansion and technological innovation, concepts that are relatively de-emphasized in comparative advantage.
IPLC theory has two important tenets: (1) technology is a critical factor in creating and developing new products; and (2) market size and structure are important in determining trade patterns.

Product stages
The IPLC has three stages: new product, maturing product, and standardized product. A new product is one that is innovative or unique in some way (see Figure 6.1a). Initially, consumption is in the home country, price is inflexible, and profits are high. The company seeks to sell to those willing to pay a premium price. As production increases and exports reduce local consumption, exporting begins.

As the product enters the mature phase of its life cycle (see Figure 6.1b), an increasing percentage of sales is achieved through exporting. At the same time, competitors in other advanced countries will be working to develop substitute products so they can replace the initial good with one of their own. The introduction of these substitutes and the softening of demand for the original product will eventually result in the firm that developed the product now changing its strategy from production to market protection. Attention will also be focused on tapping markets in less developed countries.

As the product enters the standardized product stage (see Figure 6.1c), the technology becomes widely diffused and available. Production tends to shift to low-cost locations, including less developed countries and offshore locations. In many cases the product will end up being viewed as a generic, and price will be the sole determinant of demand.

Personal computers and the IPLC
In recent years a number of products have moved through the IPLC and are now in the standardized product stage. Personal computers (PCs) are a good example, despite their wide variety and the fact that some versions are in the new product and maturing product phases. For example, the early version of PCs that reached the market in the 1984 to 1991 period were in the standardized product stage by 1995 and sold primarily on the basis of price. Machines that entered the market in the 1990s were in the maturing stage by 1999. PCs with increased memory capability that were in the new product stage in 1999 quickly moved toward maturity, and by 2002 they were being replaced by even better machines with faster processors and more multimedia capabilities. Today, diskettes are standardized and rarely used while standard components include CD writers, DVD ROM.

DSL and wireless Internet controllers, USB ports, advanced graphics and sound, flat LCD monitors, digital photography capabilities, etc.

Desktop computers have been replaced by laptop models that are lighter, faster, more sophisticated, and less expensive than their predecessors. In turn, these machines are being replaced by notebooks with advanced Pentium chips, long-term battery capability, and storage capable of holding billions of bytes complete with wireless equipment and serve as a complete communications center from which the international executive can communicate anywhere in the world. These machines will first be manufactured locally and then in foreign markets. This is largely because IBM (the inventor of the PC) computers became a commodity, and IBM's PC division was sold to the Chinese firm Lenovo in 2005. Lenovo has the benefit of lower labor costs and is better able to manufacture the laptops of today. Thus, computers will continue to move through an IPLC.

The IPLC theory is useful in helping to explain how new technologically innovative products fit into the world trade picture. However, because new innovative products are sometimes rapidly improved, it is important to remember that one or two versions of them may be in the standardized product stage while other versions are in the maturing stage and still others are in the new product phase.

Other important considerations
Many factors beyond those we have considered greatly influence international trade theory. One is government regulation. Countries often limit or restrict trade with other countries for political reasons. For example, despite the benefits of international trade, the EU does not always see eye to eye with the United States on regulatory matters. As a result, there are different government regulations affecting business in Europe, than in North America. For example, EU competition policy differs from US antitrust policy, see the box, International Business Strategy in Action: Microsoft shows the world is not flat. Other important factors include monetary currency valuation and consumer tastes.

Monetary currency valuation
When examining why one country trades with another, we need to consider the monetary exchange rate, which is the price of one currency stated in terms of another currency. For example, from 1995 to 1998 the value of the Japanese yen declined significantly over the value of the US dollar. As a result, many Japanese businesses found their products becoming much more competitive in the US market. Therefore, the Japanese government announced that because the yen was again getting too strong, it wanted to weaken its value, thus ensuring that Japanese businesses could maintain their international competitiveness. Another reason why monetary currency valuation is important is because a foreign firm doing business will report its revenues and profits in home-country currency. So if a British firm sold $10 million of machinery in Canada and the value of the Canadian dollar declined against the British pound, the UK company would report less revenue (in terms of British pounds) than if the Canadian dollar had remained stable, or better yet, increased in value against the pound. In mid-2005, the euro became so strong compared to the dollar that Volkswagen reported a 60 percent decline in pre-tax profits. In the next chapter we will discuss exchange rates in more detail.

Consumer tastes
International trade is not based solely on price; some people will pay more for a product even though they can buy something similar for less money. This willingness to pay more may be based on prestige, perceived quality, or a host of other physical and psychological reasons. Personal tastes dictate consumer decisions.
International Business Strategy in Action

Microsoft shows the world is not flat

The dispute between Microsoft and the European Commission demonstrates that the world is not flat. Microsoft is a company that has seen the wave of worldwide Internet access and software applications. Yet, it has run into a brick wall in Brussels. The European Commission is investigating two separate cases of the company, and it has imposed a fine of $2.2 billion. In January 2008, the European Commission imposed a fine of $2.2 billion on Microsoft for failing to comply with a 2004 antitrust ruling.

This case illustrates that even the world's most successful Internet-based software company does not have unrestricted global market access for its products. Instead, the world is divided into a few regions with strong barriers against entry into the key market segments of the European Union, North America, and Asia-Pacific. Microsoft is simply the latest large MNE to meet the world marketplace. Today, business activity is organized mainly within each region of the world, not globally.

For US firms, going to a foreign market is fraught with peril.

The world's 500 largest firms, on average, sell 72 percent of their goods and services in their home region. Very few firms are truly global, defined as selling a significant portion of their products in each market region. For example, the world's largest firm, Walmart, has 94 percent of its sales in North America. Unfortunately, Microsoft does not reveal the geographic dispersion of its sales, but it is likely that only a majority of them are also in North America. Firms like Walmart and Microsoft need to understand that a business model developed for North America will need to be adapted when going to Europe and Asia.

In the case of Microsoft, the key difference is in the way that the EU regulatory system operates. In Europe, competition policy can be used as a barrier to entry. An individual firm such as Microsoft, has to negotiate with the EU and the individual EU countries. In this process, the EU competes against the foreign firm. In 2001, the US firm General Electric and Microsoft were in a similar situation. The EU nationalized their plans to acquire Honeywell, which was a part of the company.

While the United States has somewhat similar antitrust provisions, the application of those is more business friendly than in Europe. US antitrust enforces agreements that apply internationally.

There is no one-size-fits-all solution to global business expansion. Each country has its own unique set of regulations and standards. Firms must be prepared to adapt their business models when they enter foreign regions of the world. Third, even in high-tech areas such as software Internet applications, the technology itself does not guarantee the flat world of widespread market access. The world is not flat, and there are very strong regional fault lines.

BARRIERS TO TRADE

Why do many countries produce goods and services that could be purchased more cheaply from others? One reason is trade barriers, which effectively raise the cost of these goods and make them more expensive to local buyers.

Reasons for trade barriers
One of the most common reasons for the creation of trade barriers is to encourage local production by making it more expensive for foreign firms to compete there. Another reason is to help local firms export and thus build worldwide market share by doing such things as providing them with subsidies in the form of tax breaks and low-interest loans. Other common reasons include:

1. Protect local jobs by shielding home-country business from foreign competition.
2. Encourage local production to replace imports.
3. Protect infant industries that are just getting started.
4. Reduce reliance on foreign suppliers.
5. Encourage local and foreign direct investment.
6. Reduce balance of payments problems.
7. Promote export activity.
8. Prevent foreign firms from dumping (selling goods below cost in order to achieve market share).
9. Promote political objectives such as refusing to trade with countries that practice apartheid or deny civil liberties to their citizens.
Commonly used barriers

A variety of trade barriers deter the free flow of international goods and services. The following presents six of the most commonly used barriers.

Price-based barriers

Imported goods and services sometimes have a tariff added to their price. Quite often this is based on the value of the goods. As a result, tobacco products coming into the United States carry an ad valorem tariff (see below) of over 100 percent, thus more than doubling their cost to US consumers. Tariffs raise revenues for the government, discourage imports, and make local goods more attractive.

Quantity limits

Quantity limits, often known as quotas, restrict the number of units that can be imported or the market share that is permitted. If the quota is set at zero, as in the case of Cuban cigars from Havana to the United States, it is called an embargo. If the annual quota is set at 1 million units, no more than this number can be imported during the year; once it is reached, all additional imports are turned back. In some cases a quota is established in terms of market share. For example, Canada allows foreign banks to hold no more than 16 percent of Canadian bank deposits.

International price fixing

Sometimes a host of international firms will fix prices or quantities sold in an effort to control price. This is known as a cartel. A well-known example is OPEC (Organization of Petroleum Exporting Countries), which consists of Saudi Arabia, Kuwait, Iran, Iraq, and Venezuela, among others (see Table 6.1). By controlling the supply of oil it provides, OPEC seeks to control both price and profit. This practice is illegal in the United States and Europe, but the basic idea of allowing competitors to cooperate for the purpose of meeting international competition is being ended more frequently in countries such as the United States. For example, US computer firms have now created partnerships for joint research and development efforts.

Non-tariff barriers

Non-tariff barriers are rules, regulations, and bureaucratic red tape that delay or preclude the purchase of foreign goods. Examples include (1) slow processing of import permits, (2) the establishment of quality standards that exclude foreign producers, and (3) a "buy local" policy. These barriers limit imports and protect domestic sales.

Table 6.1 Members of the Organization of Petroleum Exporting Countries (OPEC) 2007

<table>
<thead>
<tr>
<th>Member country</th>
<th>Quotas (barrels per day)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>810</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1,379</td>
</tr>
<tr>
<td>Iran</td>
<td>3,661</td>
</tr>
<tr>
<td>Iraq</td>
<td>5,835</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2,105</td>
</tr>
<tr>
<td>Libya</td>
<td>1,398</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2,164</td>
</tr>
<tr>
<td>Qatar</td>
<td>874</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>8,561</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>2,301</td>
</tr>
<tr>
<td>Venezuela</td>
<td>3,029</td>
</tr>
<tr>
<td>Total</td>
<td>26,380</td>
</tr>
</tbody>
</table>

Source: Adapted from www.opec.org

Financial limits

There are a number of different financial limits. One of the most common is exchange controls, which restrict the flow of currency. For example, a common exchange control is to limit the currency that can be taken out of the country; for example, travelers may take up to only $5,000 per person out of the country. Another example is the use of fixed exchange rates that are quite favorable to the country. For example, dollars may be exchanged for local currency on a 1:1 basis; without exchange controls, the rate would be 1:4. These cases are particularly evident where a black market exists for foreign currency that offers an exchange rate much different from the fixed rate.

Foreign investment controls

Foreign investment controls are limits on foreign direct investment or the transfer or remittance of funds. These controls can take a number of different forms, including (1) requiring foreign investors to take a minority ownership position (49 percent or less), (2) limiting profit remittance (such as to 15 percent of accumulated capital per year), and (3) prohibiting royalty payments to parent companies, thus stopping the latter from taking out capital.

Such barriers can greatly restrict international trade and investment. However, it must be realized that they are created for what governments believe are very important reasons. A close look at one of these, tariffs, helps to make this clearer.

Tariffs

A tariff is a tax on goods that are shipped internationally. The most common is the import tariff, which is levied on goods shipped into a country. Less common is the export tariff, for goods sent out of the country, or a transit tariff for goods passing through the country. These taxes are levied on a number of bases. A specific duty is a tariff based on units, such as $1 for each item shipped into the country. So a manufacturer shipping 1,000 pairs of shoes would pay a specific duty of $1,000. An ad valorem duty is a tariff based on a percentage of the value of the item, so a watch valued at $25 and carrying a 10 percent duty would have a tariff of $2.50. A compound duty is a tariff consisting of both a specific and an ad valorem duty, so a suit of clothes valued at $80 that carries a specific duty of $3 and an ad valorem duty of 5 percent would have a compound duty of $7.

Governments typically use tariffs to raise revenue and/or to protect local industry. At the same time, these taxes decrease demand for the respective product while raising the price to the buyer. This is illustrated in Figure 6.2, which shows how the quantity demanded decreases as the amount of tariff increases.
declines from Q₁ to Q₂ when a tariff drives the price of a good from P₁ to P₂ (the world price plus the tariff). This price increase allows local producers to sell Q₃Q₄ and the new market share away from foreign firms that were exporting Q₄Q₅ into the country. However, the figure shows this is done at the price of charging the consumer more money and reducing the number of buyers who purchase the product. At new price P₂, there are no longer any imports.

There are numerous reasons for using tariffs, such as to protect domestic industries or firms. The US government has used them to prevent foreign companies from selling goods at lower prices in the United States than back home. US auto makers have often accused their overseas rivals of using this tactic. In the case of Japanese car manufacturers, this was particularly troublesome area where the value of the yen rose sharply in the early 1990s, as a result, argued the US car companies, imported parts and cars had to reflect the increased value of the yen or be subjected to tariffs. Others have made similar arguments. Although Kodak, for example, asked the US Commerce Department to impose steep tariffs on the Fuji Photo Film Company, Kodak's argument was partially based on the rising yen. However, it also reflected a concern with dumping, which is the selling of imported goods at a price below cost or below what is in the home country. In this case Kodak argued that Fuji sold color photographic paper for less than 20 cents a square foot in the United States, while charging almost 60 cents a square foot in Japan. For example, a protectionist target the so-called International Business Strategy in Action: The Couriers wars.

Another reason for using tariffs is to raise government revenue. Import tariffs, for example, are a major source of revenue for less developed countries. A third reason is to reduce citizens' foreign expenditures in order to improve the country's balance of payments.

Tariffs continue to be one of the most commonly used barriers to trade, despite the fact that they often hurt low-income consumers and have a limited impact, if any, on upper-income purchasers. In recent years most industrialized countries have tried to reduce or eliminate the use of these trade barriers and to promote more free trade policies. The United States is a good example. (The trade policies of the EU are discussed in Chapter 16 and those of Japan in Chapter 17.)

US trade policy

Despite being a highly protectionist nation in its early years, the United States has a policy today that generally strives to lower tariffs and trade barriers through the use of multilateral agreements. Since the protectionist disaster of the Depression years, the United States has sought to minimize the use of tariffs. It supported the General Agreement on Tariffs and Trade (GATT), and now it supports the 1994 World Trade Organization (WTO), which eliminates most trade restrictions (such as tariffs) among the United States, Canada, and Mexico and extends national treatment to foreign investment, and the Caribbean Basin Initiative, which eliminates tariffs on many imports from the Caribbean and Central American regions. Yet the Trading-with-the-Enemy Act disallows trade with countries judged to be enemies of the United States, including North Korea and Cuba. The US administration has the authority to prevent sales of goods to foreign governments when they are considered to be in the best interests of the United States. These goods can range from computers to chemicals to military weapons.

International Business Strategy in Action

The Couriers Wars

Logistics businesses have many reasons for encouraging their customers to accept restraints to trade. One of the most common is that an industry is not competitive on a world-wide basis and foreign competition could bring about the destruction of local firms. The US steel industry is a good example. The efficiencies of both West European and Japanese steelmakers have brought new challenges to the US steel industry, which asked President George W. Bush to impose tariffs on foreign imports. Furthermore, local firms will seek protection from foreign competition even though they are profitable. Why? Because they don't want to give up any of their local market share—which will happen if more entrants are allowed into the industry. A good example is found in the case of the courier wars that were being fought in the United States. The three firms involved are FedEx, UPS, and DHL. The first two are US companies that collectively control 80 percent of the US market. The other is a German company that holds very little of the market. The total sales in 2006 of UPS are $77.5 billion, for FedEx, $32 billion, while for DHL there are no data except for its parent firm, Deutsche Post, at $79.5 billion.

FedEx operates out of Memphis, Tennessee, where it has a major distribution hub and a large number of aircraft to help meet its commitment of one-day delivery. UPS's main hub is in Atlanta, Georgia, while DHL's hub is near Miami, Florida. All three firms do business in Europe, where they are also profitable. FedEx and UPS have been trying to prevent DHL from building an air fleet business in the United States to deliver packages and mail just like they do. Moreover, the two giant US firms have been receiving support from the Department of Transportation, which has ended their progam to outgrow DHL from getting an air license.

The move away from tariffs does not mean US trade policy is completely open. The US government employs a variety of approaches to promote or discourage international trade. For example, to encourage trade, there is the North American Free Trade Agreement (NAFTA), which eliminates most trade restrictions (such as tariffs) among the United States, Canada, and Mexico and extends national treatment to foreign investment, and the Caribbean Basin Initiative, which eliminates tariffs on many imports from the Caribbean and Central American regions. Yet the Trading-with-the-Enemy Act disallows trade with countries judged to be enemies of the United States, including North Korea and Cuba. The US administration has the authority to prevent sales of goods to foreign governments when they are considered to be in the best interests of the United States. These goods can range from computers to chemicals to military weapons.

with large stakes in DHL's international operations. Critics claimed DHL, tract, with Deutsche Post to be a captive vendor and that in practical terms Deutsche Post owned DHL. The Department of Transportation then forced DHL Aireways to expand its contracts outside of DHL. To this date, however, 90 percent of DHL's business continues to be with DHL.

In 2003, DHL sought to expand its air cargo by integrating Seattle-based Airline's airline fleet. FedEx and UPS once again appealed to the Department of Transportation and to US politicians claiming that the new company being 100 percent owned by public shareholders, would follow the same strategy that DHL Airways always did; working under an exclusive agreement with DHL. The Dutch THT's worldwide sales of $17 billion is emerging in 2007 as another foreign competitor with its US hub in Chicago.

In 2003 John Bartholdi, a Georgia Tech logistics professor, and his 60 students began the annual Great Package Race to determine which carrier is most efficient in delivering packages to worldwide locations. DHL is frequently the winner.


The United States has also used negotiated agreements to limit the type or number of products entering the country. For example, a voluntary agreement with Japan restricts the number of cars imported to the United States. At the same time, exports are encouraged through legislation such as the Foreign Sales Corporation Act, which allows US exporters to establish overseas affiliates and not to pay taxes on the affiliates' income until the earnings are remitted to the parent company. The government also offers trade adjustment assistance to US businesses and individuals who are harmed by competition from imports. This aid takes such forms as loans for retraining and job counseling for those seeking alternative employment.

**Active learning check**

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3. In what way could the EU use trade barriers to protect its markets from foreign competitors? Who can be affected by those trade barriers?

The EU could take a number of steps to protect its markets from foreign competitors. Examples include establishing or increasing ad valorem tariffs, placing quantity limits on various imports, and limiting foreign direct investment. Of course, other countries could retaliate and take similar action against EU-produced goods, so the use of these trade barriers must be selective and should not be undertaken unless efforts at negotiated agreements prove fruitless.

**NON-TARIFF BARRIERS TO TRADE**

The economic effects of non-tariff barriers (NTBs) to trade are roughly similar to those of tariffs. They are inefficient distortions that reduce potential gains from trade. Table 6.2 lists a wide range of NTBs.

NTBs have gained prominence and importance in recent years as nations have begun resorting to them more frequently for protection. Sometimes they are not imposed by countries to interfere deliberately with trade. Rather, they arise out of domestic policy and economic management. Examples include tax breaks to reduce regional income disparities or regulations designed to increase local purchasing or employment. These, in turn, result in a type of indirect export subsidy. Other NTBs are more blatant devices that restrict imports or foster exports.

**Quotas**

The most important NTBs are quotas that restrict imports to a particular level. When a quota is imposed, domestic production generally increases and prices rise. As a result, the government usually ends up losing tariff revenues.

Historically, the GATT and WTO have prohibited import quotas except on agricultural products, and emergency measures, or when a country has short-run balance of payments problems. Countries have circumvented this regulation most notably for textiles, footwear, and automobiles by negotiating voluntary export restraint agreements that are useful in preventing retaliatory action by the importing country. In general, businesses would rather be protected by quotas than by tariffs. Under quotas, if future domestic demand is known,
borne by the exporter prior to the foreign sale. National governments have the right and duty to protect their citizens by setting standards to prevent the sale of hazardous products. But such standards can also be used to impede trade. For example, at one point Japan excluded US-made baseball bats from the market because they did not meet the country's standard. No product produced outside Japan (even products made by foreign subsidiaries of Japanese MNEs) could bear the certification stamp of the Japanese Industrial Standard (JIS) or the Japanese Agricultural Standard (JAS), and selling in Japan without the JIS or JAS logo was difficult. Similarly, at one time, the new regulations for automobile safety in the United States required that bumpers be above the height practical for imported subcompact cars, thus creating a technical barrier for these car manufacturers. Today the new code on technical barriers to trade requires consultation between trading partners before a standard that impedes trade is put in place. The code also requires that testing and certification procedures treat imports and domestic goods equally and that the importing country accept certification testing conducted in the exporting country.

**Antidumping legislation, subsidies, and countervailing duties**

The GATT and WTO allow importing countries to protect their producers from unfair competition, such as "dumping" goods at extremely low prices in an effort to gain market share and to drive out local competition. Importing countries are allowed to impose additional duties on products that have received export subsidies or are "dumped." Before the duties are imposed, however, the country must show that its domestic industry has suffered "material" injury from dumped or subsidized imports. Although products at these artificially low prices provide consumers in the importing country with a "good buy," such competition is thought to be unfair to domestic producers who object to dumping (and also to subsidized imports that can be offset by "countervailing" duties) if the domestic market of the exporting country is closed to them. A good example is the US auto industry, which claims that some Japanese cars are cheaper in the US market than at home, while Japan continues to impede exports of US cars into Japan.

The GATT and the WTO have developed a code on countervailing duties and antidumping duties that now expedites the process of determining whether exports have been dumped or subsidized and whether the domestic industry has been injured. This subject is exceedingly complex. Here are some examples (and answers):

- If the EU remits value-added taxes on exports by EU producers, is this a subsidy? (No)
- If Canada subsidizes production in a specific sector in one of its depressed regions for domestic purposes, are the exports of a subsidized firm subject to countervailing action? (Yes)
- If the British government subsidizes the British steel industry and its losses incurred by selling at home and abroad at prices below full cost, are its exports subject to antidumping or to countervailing duties? (Maybe, sometimes)

The problem is complex because of the difficulty in determining what material injury is and how it should be measured. This area is likely to be a point of contention for years to come.

**Agricultural products**

Trade in agricultural products is highly regulated by both quotas and fixed and variable tariffs. Domestic producers in most industrialized countries are often highly subsidized both directly and by artificially high domestic prices. Agricultural exports are often subsidized as well. And the EU flatly refused to discuss its Common Agricultural Policy (CAP) at the Tokyo Round. The CAP sets variable tariffs on imports to maintain high domestic prices by excluding or impeding imports. Major reforms in the CAP are now underway that will see continuing support for farmers but independently of production volumes. This is expected to improve the EU's negotiating position at the WTO. The United States is not without guilt in this area, however, since it also subsidizes the export of many agricultural products. The countries most affected by these subsidies are less developed countries with abundant and inexpensive labor and land and thus a competitive advantage in agricultural products. Agricultural subsidies have often stalled trade talks as these countries refused to further liberalize while developed countries continued to subsidize agriculture.

**Export restraints**

Over the vigorous objections of countries exporting natural resources, the GATT (and WTO) rounds have moved to tighten the conditions under which exports could be restrained. In general, world tariffs have increased with the level of processing; for example, import duties increase as copper is processed from concentrate to blister, to refined copper, to copper wire and bars, to copper pots and pans. This tariff structure makes upgrading of natural resources in the producing country difficult. During the Tokyo Round, natural resource-producing countries were largely unsuccessful in their attempts to harmonize tariffs on a sectoral basis in order to increase their ability to upgrade prior to export. However, they did argue successfully for their right to restrict exports to induce further domestic processing.

**OTHER ECONOMIC DEVELOPMENTS**

In addition to the above, other economic developments warrant consideration. These include countertrade, trade in services, and free trade zones.

**Countertrade**

Countertrade is essentially barter trade in which the exporting firm receives payment in terms of products from the importing country. Countertrade is important to the airline industry (for example, the purchase of Boeing 747s by British Airways if Boeing uses Rolls Royce engines) and in defense (for example, the purchase of US jet fighters by Canada if some of the parts are locally sourced in Canada). Barter sometimes takes the form of a buyback in which the exporter agrees to take products that are locally produced.

Countertrade tends to decrease the efficiency of world trade because it substitutes barter for the exchange of goods by the price system. For example, a US exporter of machinery to Indonesia may have to take payment in an "equivalent value" of palm oil or rattan. The exporting firm will then either have to sell these products, in which it has no expertise itself, or sell them through a broker or other firm. Some party to the trade—exporter, importer, or consumer—must bear these additional costs. Despite such obvious inefficiencies, countertrade appears likely to continue as an increasingly important factor in the international trade environment of the twenty-first century.

In one type of situation, however, countertrade may be beneficial. For example, if a US producer of textile machinery exports to China and agrees to take payment in the form of textile products, importers in the United States may perceive a lower risk of variability in product quality and delivery schedules (as a result of US technology and management), and the Chinese may perceive a lower risk of product failure in buying the machinery since the selling firm will not be "paid" unless the machinery performs to specifications.
**Trade in services**

International trade in services has received relatively little attention from government, trade economists during trade negotiations. Reliable statistics are seldom collected; however, as high-income countries move toward a service economy, trade in services has grown and become a significant component of the current accounts of many countries.

In 2006, the United States exported goods worth $1,024 trillion and imported goods worth $1,186 trillion, which left a deficit of $836 billion on merchandise trade. In contrast, it exported $413 billion and imported $342 billion for a trade surplus of $71 billion that partially offset its merchandise trade deficit. And, it had a deficit of $73 billion in the net income receipts from US FDI abroad. Thus, the net deficit on these three accounts for the United States in 2006 was $865.7 billion. Details of the US goods, services, and FDI accounts appear in Table 6.3. (The balance of payments accounts will be explained in the Appendix of this chapter.)

The flow of services across among countries is highly regulated. Internationally trade in services such as banking, investment income, insurance, media, transportation, advertising, accounting, travel, and technology licensing are subject to a host of national and international regulations for economic, social, cultural, and political reasons. In 1995, the General Agreement on Trade in Services (GATS) came into effect. It covers all services except those provided by the government and those related to air traffic. Member countries are not forced to open all their service industries but can choose those areas for which they want to guarantee access to foreigners and, within a framework, how much access they want to provide. For example, a host nation might limit the scope of a foreign bank's operation through the use of licenses or by setting a maximum number of allowable branches. As of January 2000, more than 140 WTO members started negotiating to further liberalize services.

Whatever form is used, negotiating reductions in service trade barriers will be difficult, complex, and lengthy. The barriers are often difficult to list, much less quantify for purposes of negotiation. And the issues are often highly charged and not subject to rational analysis. For example, Canada imposes Canadian content requirements on television, radio, and print media to foster a "national cultural identity," to protect its cultural heritage, and to protect the domestic arts, theater, and movie industries. A government that reduced these trade barriers or even agreed to negotiate them would be in trouble with the (protected) Canadian media, as well as with the general public.

**Free trade zones**

A free trade zone is a designated area where importers can defer payment of customs duty while products are processed further (same as a foreign trade zone). Thus, the free trade zone serves an "offshore assembly plant," employing local workers and using local financing for a tax-exempt commercial activity. The economic activity takes place in a restricted area such as an industrial park, because the land is often being supplied at a subsidized rate by a local host government that is interested in the zone's potential employment benefits.

To be effective, free trade zones must be strategically located either at or near an international port, major shipping routes, or with easy access to a major airport. Important factors in the location include the availability of utilities, banking and telecom services, and a commercial infrastructure.

More than 600 free trade zones exist in the world today, often encompassing entire cities, such as Hong Kong and Singapore. More than two-thirds are situated in developing countries, and most of their future growth is expected to occur there.

The advantages offered by free trade zones are numerous and mutually beneficial to all stakeholders. For private firms, the zones offer three major attractions. First, the firm pays the customs duty (tariff) only when the goods are ready to market. Second, manufacturing costs are lower because no taxes are levied. Third, while in the zone the manufacturer has the opportunity to repackage the goods, grade them, and check for spoilage. Secondary benefits to firms take the form of reduced insurance premiums (since these are based on duty-free values), reduced fines for improperly marked merchandise (since the goods can be inspected in a zone prior to customers' scrutiny), and added protection against theft (resulting from security measures in the bonded warehouses).

At the state and local levels, advantages can be realized in terms of commercial services. On a more global level, free trade zones enable domestic importing companies to compete more readily with foreign producers or subsidiaries of MNEs, thereby increasing participation in world trade. Favorable effects are felt on the balance of payments because more economic activity occurs and net capital outflow is reduced. Finally, the business climate is improved due to reduced bureaucracy and resultant savings to business capital, currently inaccessible because of the delay in paying duties and tariffs. A free-trade zone is a step toward free trade and can be an important signal by government to business that the economy is opening up. Opportunity replaces regulation, and growth of economic activity should result. Before the establishment of more free trade zones becomes too fully accepted and encouraged, governments must be convinced of their economic benefits. Free trade zones are a vital necessity if nations are to remain competitive on an international scale. Not only will existing companies benefit from their use, but new industries will be attracted, keeping up the same benefits of world trade.

The maquiladora industry along the US-Mexican border is an excellent example of a free trade zone. The low wage rate in Mexico and the NAFTA of 1994 make the maquiladora region both accessible and important to labor-intensive firms in the United States and Canada. From only 12 maquiladora plants in 1985, approximately 5,000 existed in 2000. The maquiladora industry has been so successful that only oil earns Mexico more foreign currency today.

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**Table 6.3 Overview of the US balance of current account, 2006, preliminary**

<table>
<thead>
<tr>
<th>Items</th>
<th>Credits (billion of US $)</th>
<th>Debits (billion of US $)</th>
<th>Balance (billion of US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade of goods and services</td>
<td>1,438.6</td>
<td>2,020.1</td>
<td>(681.5)</td>
</tr>
<tr>
<td>Goods, balance of payments basis</td>
<td>1,023.9</td>
<td>1,859.7</td>
<td>(836.0)</td>
</tr>
<tr>
<td>Services</td>
<td>413.8</td>
<td>342.6</td>
<td>71.2</td>
</tr>
<tr>
<td>Direct defense expenditures</td>
<td>16.7</td>
<td>31.2</td>
<td>(14.5)</td>
</tr>
<tr>
<td>Travel</td>
<td>85.7</td>
<td>72.3</td>
<td>13.4</td>
</tr>
<tr>
<td>Passenger fares</td>
<td>21.1</td>
<td>27.3</td>
<td>(6.2)</td>
</tr>
<tr>
<td>Other transportation</td>
<td>48.2</td>
<td>65.6</td>
<td>(17.4)</td>
</tr>
<tr>
<td>Royalties and license fees</td>
<td>62.1</td>
<td>76.5</td>
<td>(14.4)</td>
</tr>
<tr>
<td>Other private services</td>
<td>177.3</td>
<td>114.5</td>
<td>62.8</td>
</tr>
<tr>
<td>US government miscellaneous services</td>
<td>11.1</td>
<td>4.9</td>
<td>6.2</td>
</tr>
<tr>
<td>Income receipts</td>
<td>479.8</td>
<td>479.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Financial accounts</td>
<td>619.1</td>
<td>619.9</td>
<td>(0.8)</td>
</tr>
<tr>
<td>Direct investment receipts/payments</td>
<td>720.5</td>
<td>145.0</td>
<td>575.5</td>
</tr>
<tr>
<td>Other private receipts</td>
<td>308.8</td>
<td>150.3</td>
<td>158.5</td>
</tr>
<tr>
<td>US government receipts</td>
<td>2.4</td>
<td>145.1</td>
<td>(142.7)</td>
</tr>
<tr>
<td>Compensations of employees</td>
<td>6.1</td>
<td>16.3</td>
<td>(10.2)</td>
</tr>
<tr>
<td>Unilateral transfers, net</td>
<td>0.1</td>
<td>0.4</td>
<td>(0.3)</td>
</tr>
<tr>
<td>Total</td>
<td>2,058.8</td>
<td>2,011.5</td>
<td>47.3</td>
</tr>
</tbody>
</table>

Source: Adapted from BEA, Survey of Current Business, June 2007. Table 36 International transactions.
No Mexican taxes are paid on goods processed within the maquiladora. Foreign companies doing such processing can benefit from lower wages and land costs than those of United States as they increase the value added to their products. In return, Mexico must provide plants, create jobs, and collect taxes on any final products and some foreign firms within Mexico. Even though the United States has several hundred trade zones of its own, many near seaports or airfields, these lack the low-wage workforces of their Mexican counterparts.

Canada does not have free trade zones, but the federal government allows duty drawbacks, which arguably offer many of the same advantages. Unfortunately, these drawbacks are repayments of customs duties, apply retroactively and involve enough paperwork to discourage all but the largest or most dedicated organizations. As such, NAFTA and the lower-wage labor in Mexico have attracted Canadian firms producing labor-intensive products. Free trade zones exist in many other parts of the world than North America, and the advantages of these zones are enjoyed by businesses worldwide.19

**KEY POINTS**

1. International economics is the branch of economics concerned with the purchase and sale of foreign goods and services. This includes consideration of areas such as international trade, balance of payments, and barriers to trade.

2. A number of international trade theories help to explain why nations trade. They include the theory of absolute advantage, the theory of comparative advantage, the factor endowment theory, the Leontief paradox, and the international product life cycle (IPLC) theory. While no one theory offers a complete explanation of why nations trade, the collective provides important insights into the area. Other key considerations for explaining why nations trade include monetary currency valuation and consumer expectations.

3. There are a number of barriers to trade. Some of the most common include price-based barriers, quantity limits, international price fixing, non-tariff barriers, financial limits, and foreign investment controls.

4. Although tariffs are often introduced to maintain local jobs and assist infant industries, they are inefficient. This economic inefficiency results in higher prices of imported goods for the consumers. The redistribution of resources from more efficient industries to less efficient industries further adds to the cost of a tariff. Such costs do not occur under free trade.

5. Non-tariff barriers (NTBs) provide similar economic inefficiencies to tariffs. Unlike tariffs, however, NTBs are not imposed by nations to interfere deliberately with trade; they arise out of domestic policy. There are several types of NTBs, including quotas, export restrictions, non-tariff barriers, and technical barriers.

6. Counterrate is a form of barter trade in which the exporting firm receives payments in terms of products produced in the importing country. It is most pronounced in East-West trade, and although it may be beneficial to the trading partners, it increases trade volume.

7. Services are an important but somewhat misunderstood component of trade. Despite the trade of services in the billions of dollars among high-income countries, regulation has been outside the mandate of GATT. As services increase in importance, future discussions will take place concerning whether an international organization like GATT will carry the mandate to regulate this type of trade.

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**Key terms**

- International trade
- Mercantilism
- Neo-Mercantilism
- Theory of absolute advantage
- Theory of comparative advantage
- Factor endowment theory
- Heckscher-Ohlin theory
- Leontief paradox
- International product life cycle (IPLC) theory
- Monetary exchange rate
- Quotas
- Embargo
- Cartel
- Non-tariff barriers
- Exchange controls
- Foreign investment controls
- Tariff
- Import tariff
- Export tariff
- Transit tariff
- Specific duty
- Ad valorem duty
- Compound duty
- Dumping
- Caribbean Basin Initiative
- Foreign Sales Corporation Act
- Trade adjustment assistance
- Countertrade
- Free trade zone
- Maquiladora industry

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**Review and discussion questions**

1. Why is it difficult to solve international economic problems in the short run?
2. What is the supposed economic benefit of embracing mercantilism as an international trade theory? Are there any disadvantages to the use of this theory?
3. How is the theory of absolute advantage similar to that of comparative advantage? How is it different?
4. In what way does factor endowment theory help explain why nations trade? How does the Leontief paradox modify this theory?
5. If an innovating country develops a new technologically superior product, how long will it be before the country begins exporting the product? At what point will the country begin importing the product?
6. Of what value is the international product life cycle theory in helping to understand why nations trade?
7. How does each of the following trade barriers work: price-based barriers, quantity limits, international price fixing, non-tariff barriers, financial limits, and foreign investment controls?
8. What are some of the reasons for trade barriers? Identify and describe five.
9. How does the United States try to encourage exports? Identify and describe two ways.
10. Non-tariff barriers have become increasingly predominant in recent years. Describe a non-tariff barrier, and list four types, explaining how the United States does or could use such a device.
11. How does counterrate work? Is it an efficient economic concept?
CHAPTER 4 INTERNATIONAL TRADE

12 What is a free trade zone? Is it an efficient economic concept?
13 What are two future problems and challenges that will have to be addressed by the international monetary system? Describe each.
14 What is meant by the term balance of payments?
15 What are the three major accounts in the balance of payments?
16 How would the following transactions be recorded in the IMF balance of payments?
   a. IBM in New York has sold an $8 million mainframe computer to an insurance company in Singapore and has been paid with a check drawn on a Singapore bank.
   b. A private investor in San Francisco has received dividends of $80,000 from stock he holds in a British firm.
   c. The US government has provided $60 million of food and medical supplies for a Kurdish refugee camp in Turkey.
   d. The Walt Disney Company has invested $50 million in a theme park outside Paris, France.

Real Case

Job losses and offshoring to China

It was not a difficult choice to make. Over the last 10 years, US imports of manufactured goods from China shot up. Cheap labor—Chinese labor is six times cheaper than Mexican labor—accounts for this. Continued manufacturing operations in the United States and remaining price competitiveness is simply not feasible. When jobs are outsourced across national borders, by the time the US manufacturer ships the goods to the US, this is called offshoring.

Competition in quality, which can shelter domestic manufacturing from outsourcing to developing countries, was not an alternative because Chinese products for export are usually as good (although not in terms of Mattel found in 2007). When high labor intensity is tied to quality, the Chinese can easily substitute Western industrialized countries.

Another factor is that the Chinese have a combination of highly skilled management and low-skilled labor, ensuring that production is efficient and that quality standards are met. This ability to produce high-quality goods is also what allows China to move into export markets of Westerners. New Mexico and Mississippi, reducing its US workforce to less than half, and expanded its production in China. By 2003, all significant products marketed by the company were made in China.

Like many other US, European, and Japanese companies, National Presto uses an agent in Hong Kong to sub-contract production to manufacturing plants in mainland China. Larger companies like Metelona, Philips, IBM, Toshiba, and BE have more control over their manufacturing plants in China. Ryozen of Japan, for example, invested $90 million in the early 2000s to construct a high-tech industrial park in Shizouka Prefecture. Only 20 years ago, Shizouka was dominated by paddy fields, today it is China's largest manufacturing cluster.

Proponents of free trade argue that political rhetoric against trade with China is meant to appease US fears of job losses. Yet, as seen in the following table, under 3 percent of all job losses in the United States in the first quarter of 2007 were due to the result of overseas relocation. While some argue that this percentage in international business is very low, other studies show that even if new jobs in China were to be created, these new jobs in the United States if offshoring to China had not already been a possibility.

| Job losses and job losses in the United States, first quarter of 2007 |
|---------------------------|-----------------|-----------------|-----------------|-----------------|
| Non-farm job losses | 1,830 | 1.6 |
| High skill relocation | 5,506 | 5.4 |
| Low skill relocation | 11,152 | 20.9 |
| Total private and different sectors | 101,079 | 10.8 |

China has become the world's largest manufacturer, first of the United States, Japan, and Germany. It has surpassed Japan to become the country having the largest trade surplus with the United States. US politicians and managers blame Chinese protectionist practices for the growing trade deficit between the two nations, which in 2007 was estimated at $124 billion. Among the barriers, United States claims prevent a free flow of its goods to China are import barriers, unclear legal provisions applied in a discriminatory manner against US imports, and an undervalued yuan. The last one has generated the most controversy in the last few years. The Chinese yuan has been fixed at 6.8 to the dollar since 1994, a rate that critics argue is up to 40 percent undervalued. Yet economists do not all agree that the yuan is undervalued. Some fear that a sharper devaluation would hurt not only the Chinese economy but also those trading partners that are most heavily dependent on Chinese imports.


17 How is the theory of comparative advantage contrary to China's trade with industrialized countries? How does this factor induce the theory to apply to China's trade with industrialized countries? Are any of the countries mentioned operating in this way? How can distribution of gains from free trade cause much of the political debate regarding trade with China?

Real Case

Dumping on trade complaints

The biggest problems in international trade is the ability of domestic producers to lobby their home government to protect their industry from Chinese dumping. In the past, the textile, apparel, and shoe industries were able to obtain protection from Chinese imports through tariffs, quotas, and special procurement tied to multilateral trade agreements such as GATT and WTO (land also regional and bilateral agreements such as NAFTA and the emerging Asian Pacific Economic Cooperation (APEC) which outlaw such blatant instruments of protection. However, these agreements have been replaced by more subtle ones.

In contrast to what a free trade economist would expect the dumping of goods would not only inhibit trade, but also lead to the development of a new Chinese export industry. So far, however, Chinese goods have not been able to challenge traditional US markets. In 2005, the United States collected $100 billion in Chinese anti-dumping duties. A variety of studies have found that the bureaucrats who administer AD and CVD laws are subject to corruption. The AD and CVD cases are decided by three judges, three years, and that the rate of rejection for AD cases has been as high as 80 percent.

A study by the US-China Business Council found that US AD and CVD cases have been decided in favor of US producers 80 percent of the time, and that there is a "disconnect" between the US and Chinese legal systems. US courts are more likely to grant AD and CVD orders, while Chinese courts are more likely to grant partial or preliminary AD and CVD orders. A study by the US-China Business Council found that US AD and CVD cases have been decided in favor of US producers 80 percent of the time, and that there is a "disconnect" between the US and Chinese legal systems. US courts are more likely to grant AD and CVD orders, while Chinese courts are more likely to grant partial or preliminary AD and CVD orders.
of the unresolved problems is how smaller countries can secure access to the protected markets of tried economies such as the United States and the EU. In Japan’s case, there are similar arguments including those from its triad rivals, but it has entry barriers in place preventing market access.

Website: miscenaga.org


1 Why are AD and CVD measures brought and imposed?
2 What is the impact on a firm from a non-tariff country if it faces on AD or CVD case in its major market?
3 What is the solution to the abusive use of AD and CVD measures by tried economies?

ENDNOTES
5 For additional insights into trade theory, see Nicolaus Schmidt, “New International Trade Theorists and Euroweak: Some Results Relevant for EU Countries,” Journal of Common Market Studies, September 1990, pp. 53-64.
16 As an example, see Clyde H. Farnsworth, “US Steel Company for Brazil,” International Herald Tribune, April 13-14, 1991, p. 3.
PART TWO THE ENVIRONMENT OF INTERNATIONAL BUSINESS

CHAPTER 6 INTERNATIONAL TRADE

APPENDIX TO CHAPTER 6: BALANCE OF PAYMENTS

How well do we keep track of the millions of transactions that take place annually among exporters and importers, international banks, and multinational companies? The bureaus who tabulate the foreign exchange dealings of their own banks are only a part of the picture. How well can we account for the part of direct investment that occurs through overseas borrowing, yet affects the home country's international economic position? Even more simply, how well can we measure "international" transactions that are simply transfers of funds from the account of an importer to the account of a foreign exporter in the same bank?

The realistic answer to these questions is: not very well. National governments continue to account for the transactions between their residents and foreign residents, but it is often very difficult to obtain full and accurate information. Putting that problem aside for the moment, let us consider the methods that governments use to record each country's international transactions.

The most widely used measure of international economic transactions for any country is the balance of payments (BOP). This record attempts to measure the full value of the transactions between residents of one country and residents of the rest of the world for some period of time, typically one year. The balance of payments is a flow concept, in that it records flows of goods, services, and capital transfers across borders. It is a statistical concept, in that all the items recorded receive a monetary value, denominated in the given country's currency at the time of those transactions. The balance of payments thus is a record of the value of all the economic transactions between residents of one country and residents of other countries during a given time period.

Why do we worry about measuring these transactions? We do so because a country records a substantial imbalance between inflows and outflows of goods and services for an extended period of time, some means of financing or adjusting away the imbalance must be found. For example, if a country experiences a persistent trade deficit, it may find itself in a situation where its currency is being sold in the foreign exchange market.

Balance of payments accounting

There is no such thing as the balance of payments, since the accounts are organized into a double-entry bookkeeping system, and for every debit entry there is a credit entry of equal value. There are half a dozen BOP measures, which group some international transactions together and leave others in a second, "everything else" category. In each case the intent is to place the fundamental economic causes of transactions in the first group and leave the payments for them in the second group. In the actual accounts, the former transactions are listed "above the line," and the payments are left "below the line."

Current account

The current account consists of merchandise trade, services, and unilateral transfers. (See Table 6.1, parts A and B.)

Table 6.1 Balance of payments: IMF presentation

<table>
<thead>
<tr>
<th>Balance of payments account</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Goods, services, and income:</td>
<td>Imports from foreign sources (acquisition of goods)</td>
<td>Receipts of foreign obligations (provision of goods)</td>
</tr>
<tr>
<td>1. Merchandise</td>
<td>Payments to foreigners for freight and insurance on international shipments; for ship repair, stores, and supplies; and international passenger fares</td>
<td>Receipts by residents from foreigners for services rendered</td>
</tr>
<tr>
<td>B. Unilateral transfers</td>
<td>Payments to foreigners for merchandise, payments to foreign governments, and foreign official transfers</td>
<td>Receipts by residents for goods and services (including transportation) paid to foreign travelers and government officials</td>
</tr>
<tr>
<td>C. Financial flows</td>
<td>Payments to foreign governments and official agencies for transfers received by residents from foreign governments and official agencies</td>
<td>Receipts by residents for management fees, royalties, and license fees</td>
</tr>
<tr>
<td>D. Investment income</td>
<td>Profits of foreign direct investments in reporting country, including reinvested earnings; income paid to foreigners as interest, dividends, etc.</td>
<td>Receipts by residents for goods and services (including transportation) paid to foreign travelers and government officials</td>
</tr>
<tr>
<td>E. Other official payments</td>
<td>Profits of foreign direct investments in reporting country, including reinvested earnings; income paid to foreigners as interest, dividends, etc.</td>
<td>Receipts by residents for goods and services (including transportation) paid to foreign travelers and government officials</td>
</tr>
<tr>
<td>F. Private</td>
<td>Payments to foreign governments and official agencies for transfers received by residents from foreign governments and official agencies</td>
<td>Receipts by residents for goods and services (including transportation) paid to foreign travelers and government officials</td>
</tr>
<tr>
<td>G. Services, and Income balance</td>
<td>Payments to foreign governments and official agencies for transfers received by residents from foreign governments and official agencies</td>
<td>Receipts by residents for goods and services (including transportation) paid to foreign travelers and government officials</td>
</tr>
</tbody>
</table>

value.
Table 6A (Continued)

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Increased investment in foreign enterprises by residents, including reinvestment of earnings</td>
<td>(a) Increased investment in foreign enterprises by residents</td>
</tr>
<tr>
<td>(b) Decreases in investment in private enterprises by foreigners</td>
<td>(b) Decreases in investment in domestic enterprises by foreigners</td>
</tr>
<tr>
<td>2 Portfolio investment</td>
<td></td>
</tr>
<tr>
<td>(a) Increases in investment by residents in foreign securities</td>
<td>(a) Decreases in investments by residents in foreign securities</td>
</tr>
<tr>
<td>(b) Decreases in investment by foreigners in domestic securities such as bonds and corporate equities</td>
<td>(b) Increases in investment by foreigners in domestic securities</td>
</tr>
<tr>
<td>3 Other long-term, official</td>
<td></td>
</tr>
<tr>
<td>(a) Loans to foreigners</td>
<td>(a) Foreign loan syndications</td>
</tr>
<tr>
<td>(b) Redemption or purchase from foreigners of government securities</td>
<td>(b) Sales to foreigners of government securities</td>
</tr>
<tr>
<td>4 Other long-term, private</td>
<td></td>
</tr>
<tr>
<td>(a) Long-term loans to foreigners by resident banks and private parties</td>
<td>(a) Long-term loans by foreigners to resident banks or private parties</td>
</tr>
<tr>
<td>(b) Loan repayments by residents in foreign banks or private parties</td>
<td>(b) Loan repayments by foreigners to residents</td>
</tr>
<tr>
<td>5 Other short-term, official</td>
<td></td>
</tr>
<tr>
<td>(a) Short-term loans to foreigners by central government</td>
<td>(a) Short-term loans to resident central government by foreigners</td>
</tr>
<tr>
<td>(b) Purchase from foreigners of government securities, decrease in liabilities constituting reserves of foreign authorities</td>
<td>(b) Foreign rates of short-term resident government securities, increases in liabilities constituting reserves of foreign authorities</td>
</tr>
<tr>
<td>6 Other short-term, private</td>
<td></td>
</tr>
<tr>
<td>(a) Increases in short-term foreign assets held by residents</td>
<td>(a) Decreases in short-term foreign assets held by residents, increase in foreign liabilities of residents</td>
</tr>
<tr>
<td>(b) Decreases in domestic assets held by foreigners, such as bank deposits, currencies, debts in banks, and commercial claims</td>
<td>(b) Increase in domestic short-term assets held by foreigners or decrease in short-term domestic liabilities to foreigners</td>
</tr>
<tr>
<td>III Reserves</td>
<td></td>
</tr>
<tr>
<td>0 Reserves</td>
<td></td>
</tr>
<tr>
<td>1 Monetary gold</td>
<td></td>
</tr>
<tr>
<td>2 Special drawing rights (SDRs)</td>
<td></td>
</tr>
<tr>
<td>3 IMF reserve position</td>
<td></td>
</tr>
<tr>
<td>4 Foreign exchange assets</td>
<td></td>
</tr>
<tr>
<td>E Net errors and omissions</td>
<td></td>
</tr>
<tr>
<td>Balances</td>
<td></td>
</tr>
<tr>
<td>Balances on merchandise trade</td>
<td></td>
</tr>
<tr>
<td>Balance on goods, services, and income</td>
<td></td>
</tr>
<tr>
<td>Balance on current account</td>
<td></td>
</tr>
</tbody>
</table>

| A-1 Merchandise imports                                               | $600,000                                                               |
| C-6b Increase in domestic short-term assets held by foreigners       | $600,000                                                               |

The result of this purchase is that the United States has transferred currency to foreigners and thus reduced its ability to meet other claims.

Services

The services category includes many payments such as freight and insurance on international shipments (A-3); tourist travel (A-3); profits and income from overseas investment (A-4); personal expenditures by government, civilians, and military personnel overseas (A-5); and payments for management fees, royalties, film rental, and construction services (A-6). Purchases of these services are recorded as debits, while sales of these services are similar to exports and are recorded as credits. For example, extending the earlier example of Nissan and GM, assume that the US auto maker must pay $125,000 to Nissan to ship sales to the United States. The transaction would be recorded this way:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-2</td>
<td>$125,000</td>
</tr>
<tr>
<td>C-6b</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

GM purchased a Japanese shipping service (a debit to the current account) and paid for this by increasing the domestic short-term assets held by foreigners (a credit to the capital account).

Unilateral transfers

Unilateral transfers are transactions that do not involve repayment or the performance of any service. Examples include the American Red Cross sending $10 million in food to refugees in Somalia; the United States paying military pensions to residents of the Philippines who served in the US Army during World War II; and British workers in Kuwait shipping money home to their families in London. Here is how the American Red Cross transaction would appear in the US BOP:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>D-1</td>
<td>Unilateral transfers, private $10 million</td>
</tr>
<tr>
<td>A-1</td>
<td>$10 million</td>
</tr>
</tbody>
</table>
Capital account

Capital account items are transactions that involve claims in ownership. Direct investment (C-1) involves managerial participation in a foreign enterprise along with some assets that involve degree of control. The United States classifies direct investments as those investments that give the investor more than 10 percent ownership. Portfolio investment (C-2) is investment designed to obtain income or capital gains. For example, if Exxon shipped $20 million of equipment to an overseas subsidiary the entry would be:

Debit Credit
C-1 Direct investment $20 million $20 million
A-1 Exports

"Other long-term" capital accounts are differentiated based on whether they are government (C-3) or private (C-4) transactions. These transactions have a maturity of over one year and involve either loans or securities. For example, Citibank may have loaned the government of Poland $50 million. "Other short-term" capital accounts are also differentiated based on whether they are governmental (C-5) or private (C-6). Typical short-term government transactions are short-term loans in the securities of other governments. Private transactions often include trade bill acceptances or other short-term claims arising from the financing of trade and movements of money by investors to take advantage of interest differentials among countries.

Official reserves

Official reserves are used for bringing BOP accounts into balance. There are four major types of reserves available to monetary authorities in meeting BOP deficits (D1 through D4 in Table 6A). These reserves are analogous to the cash or near-cash assets of a private firm. Given that billions of dollars to transactions are reported in BOP statements, it should come as no surprise that the amount of recorded deficits is never equal to the amount of credits. This is why there is an entry in the reserve account for net errors and omissions. If a country's reporting system is weak or there are a large number of clandestine transactions, this discrepancy can be quite large.

US BOP

The official presentation of the US BOP is somewhat different from the IMF format presented in Table 6A. Because the United States plays such a dominant role in the world economy, it is important to examine the US system. Table 6B presents US international transactions for two recent years. A number of select entries in Table 6B help to highlight the US BOP Lines 2 and 19 show that in 2006 exports of goods and services were $765.3 billion (Line 73) less than imports. This trade deficit was greater than that in 2003 when it stood at $521.7 billion, and 2003 when it was $496.5 billion, showing that the United States continues to have trade deficit problems.

To assess the trade situation accurately, however, we need to examine the data in more depth. This information is provided in Table 6C. The table shows that although US exports are strong in areas such as capital goods and industrial supplies and materials, the country also imports a large amount of these products. In addition, the United States is a net importer of foods, feeds, and beverages, automotive vehicles and parts, consumer goods, and petroleum and products.

<table>
<thead>
<tr>
<th>Line</th>
<th>Credits (+) or debits (−)</th>
<th>2006 in millions of US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exports of goods and services and income receipts</td>
<td>$2,065,824</td>
</tr>
<tr>
<td>2</td>
<td>Exports of goods and services</td>
<td>$1,346,816</td>
</tr>
<tr>
<td>3</td>
<td>Goods, balance of payment basis</td>
<td>$923,000</td>
</tr>
<tr>
<td>4</td>
<td>Services</td>
<td>413,127</td>
</tr>
<tr>
<td>5</td>
<td>Transfers under US military agency sales contracts</td>
<td>16,482</td>
</tr>
<tr>
<td>6</td>
<td>Travel</td>
<td>85,497</td>
</tr>
<tr>
<td>7</td>
<td>Passenger fares</td>
<td>72,060</td>
</tr>
<tr>
<td>8</td>
<td>Other transportation</td>
<td>48,708</td>
</tr>
<tr>
<td>9</td>
<td>Royalties and license fees</td>
<td>62,851</td>
</tr>
<tr>
<td>10</td>
<td>Other private services</td>
<td>177,284</td>
</tr>
<tr>
<td>11</td>
<td>US government miscellaneous services</td>
<td>1,145</td>
</tr>
<tr>
<td>12</td>
<td>Income receipts</td>
<td>622,020</td>
</tr>
<tr>
<td>13</td>
<td>Income receipts of US-owned assets abroad</td>
<td>619,385</td>
</tr>
<tr>
<td>14</td>
<td>Direct investment receipts</td>
<td>275,894</td>
</tr>
<tr>
<td>15</td>
<td>Other private receipts</td>
<td>330,796</td>
</tr>
<tr>
<td>16</td>
<td>US government receipts</td>
<td>2,405</td>
</tr>
<tr>
<td>17</td>
<td>Compensation of employees</td>
<td>2,935</td>
</tr>
<tr>
<td>18</td>
<td>Imports of goods and services and income payments</td>
<td>2,911,367</td>
</tr>
<tr>
<td>19</td>
<td>Goods, balance of payment basis</td>
<td>2,202,083</td>
</tr>
<tr>
<td>20</td>
<td>US-owned assets abroad, net (increase/financial inflow)</td>
<td>1,869,465</td>
</tr>
<tr>
<td>21</td>
<td>Direct defense expenditures</td>
<td>342,428</td>
</tr>
<tr>
<td>22</td>
<td>Direct defense expenditures</td>
<td>31,190</td>
</tr>
<tr>
<td>23</td>
<td>Travel</td>
<td>73,299</td>
</tr>
<tr>
<td>24</td>
<td>Services</td>
<td>37,306</td>
</tr>
<tr>
<td>25</td>
<td>Passenger fares</td>
<td>45,611</td>
</tr>
<tr>
<td>26</td>
<td>Other transportation</td>
<td>26,923</td>
</tr>
<tr>
<td>27</td>
<td>Compensation of employees</td>
<td>114,485</td>
</tr>
<tr>
<td>28</td>
<td>Other private services</td>
<td>4,024</td>
</tr>
<tr>
<td>29</td>
<td>US government miscellaneous services</td>
<td>629,584</td>
</tr>
<tr>
<td>30</td>
<td>Income payments</td>
<td>619,862</td>
</tr>
<tr>
<td>31</td>
<td>Direct investment payments</td>
<td>145,441</td>
</tr>
<tr>
<td>32</td>
<td>Other private payments</td>
<td>329,231</td>
</tr>
<tr>
<td>33</td>
<td>US government payments</td>
<td>145,070</td>
</tr>
<tr>
<td>34</td>
<td>Compensation of employees</td>
<td>9,424</td>
</tr>
<tr>
<td>35</td>
<td>Unilateral current transfers, net</td>
<td>84,122</td>
</tr>
<tr>
<td>36</td>
<td>Unilateral current transfers, net</td>
<td>1,045,760</td>
</tr>
<tr>
<td>37</td>
<td>Foreign-owned assets in the US, net (increase/financial inflow)</td>
<td>1,394,109</td>
</tr>
<tr>
<td>38</td>
<td>Balance on goods lines 15 and 18</td>
<td>829,996</td>
</tr>
<tr>
<td>39</td>
<td>Balance on credits (Lines 2 and 19)</td>
<td>70,499</td>
</tr>
<tr>
<td>40</td>
<td>Balance on goods and services lines 2 and 19</td>
<td>165,267</td>
</tr>
<tr>
<td>41</td>
<td>Balance on income lines 24 and 27</td>
<td>71,466</td>
</tr>
<tr>
<td>42</td>
<td>Unilateral current transfers, net (Lines 25)</td>
<td>84,122</td>
</tr>
<tr>
<td>43</td>
<td>Balance on current account Lines 21 and 35 or Lines 74, 77, and 79</td>
<td>285,658</td>
</tr>
</tbody>
</table>


In the early 1980s US trade deficits were offset by large amounts of income generated by direct investments abroad. Later in the decade massive international borrowing offset these deficits. More recently the situation has improved somewhat, and dollar devaluation has helped to generate stronger demand for US exports, thus partially reducing the growth rate of its annual trade deficit. However, more concerted action will be needed if the United States is to continue on this course. One way is to continue to increase US competitiveness.
in the international market. Another way is to get other countries to reduce their trade barriers and to make international markets more open.

When a country suffers a persistent balance of trade deficit, the nation will also suffer from a depreciating currency and will find it difficult to borrow in the international capital market. In this case there are only two choices available. One is to borrow from the IMF and be willing to accept the restrictions that the IMF puts on the country, which are designed to introduce austerity and force the country back on to the right economic track. The other approach is for the country to change its fiscal policy (tariffs and taxes), resort to exchange and trade controls, or devalue its currency. To prevent having to undertake austerity steps, the United States will have to continue working very hard to control its trade deficit.
America’s Mega-Regional Trade Diplomacy: Comparing TPP and TTIP

Daniel S. Hamilton

The United States is currently negotiating two massive regional economic agreements, one with 11 Asian and Pacific Rim countries and the other with the 28-member European Union. The Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) herald a substantial shift in US foreign economic policy as Washington turns its focus from the stalemated Doha Round of multilateral trade negotiations and scattered bilateral trade agreements to ‘mega-regional’ trade diplomacy. As the only party to both negotiations, Washington seeks to leverage issues in one to advance its interests in the other, while reinvigorating US global leadership.

Keywords: trade, investment, services, TPP, TTIP, United States, European Union, Japan, China, foreign policy

Since becoming US Secretary of State in 2013, John Kerry has become fond of saying that “foreign policy is economic policy”. The Obama administration is trying to translate that phrase into substantial advantage for the United States as it negotiates two massive regional economic agreements, one with 11 Asian and Pacific Rim countries and the other with the 28-member European Union. These two negotiations – the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) – herald a substantial shift in US foreign economic policy as Washington turns its focus from the stalemated Doha Development Round of multilateral trade negotiations and successful ratification of scattered bilateral trade agreements with Columbia, Panama and the Republic of Korea, to ‘mega-regional’ trade diplomacy.

If both deals are successful, the US and its partners will have opened trade and investment across both the Atlantic and the Pacific with countries accounting for two-thirds of global output. As the only party to both initiatives, the negotiations give the US a distinct advantage in leveraging issues in one forum to advance its...
interests in the other, while potentially reinvigorating US global economic leadership and supporting a number of broader US goals.

Comparing TPP and TTIP

The Trans-Pacific Partnership, or TPP, includes 12 Pacific Rim countries (the United States, Australia, New Zealand, Canada, Mexico, Peru, Chile, Singapore, Brunei, Vietnam, Malaysia, and Japan). Together they account for about one-third of international trade and produce about USD 28 trillion annually, about 37 percent of global output. TPP negotiating partners accounted for 40 percent of US goods trade in 2012. A significant portion of this is a ‘North American’ story rather than a ‘Pacific’ story, since Canada and Mexico are by far the largest US trading partners among TPP countries in goods, and both are significant US services trade and investment partners. Japan is the third largest US–TPP goods trade partner, and second largest services trade and investment partner. The 12 TPP countries are all members of the 21-member Asia-Pacific Economic Cooperation (APEC) forum.\(^1\)

Leaders have stated explicitly that TPP could expand to include more APEC countries, which together account for 45 percent of the world’s people, over half of global production, over 60 percent of overall US trade and about one-quarter of the stock of foreign direct investment (FDI) into and out of the United States.\(^2\)

The Transatlantic Trade and Investment Partnership, or TTIP, includes the US and the 28 member states of the European Union, represented in negotiations by the European Commission. Together the US and EU account for three-quarters of global financial markets, 50 percent of world GDP in terms of value and 41 percent in terms of purchasing power, 40 percent of world trade in services and one-third of global trade in goods. The dynamic interaction between investment and trade distinguishes the transatlantic economy from all others. Together the US and EU account for 57 percent of the inward stock of FDI worldwide and a whopping 71 percent of outward stock of FDI globally. In addition, they have investments of more than USD 3.7 trillion in each other’s economies, and each allots over half of its outward foreign investment to the other. Transatlantic investment flows of nearly USD 2.7 trillion dwarf those between any other continents. On a historic

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\(^1\)APEC consists of Australia, Brunei, Canada, Chile, China, Hong Kong (officially Hong Kong, China), Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, South Korea, Taiwan (officially, Chinese Taipei), Thailand, the United States and Vietnam.

cost basis, the US investment position in Europe was nearly 4 times larger than in all of Asia at the end of 2011. In 2012, US affiliate income from Europe – USD 160 billion – was more than the combined US affiliate income from Latin America (USD 67 billion) and Asia (USD 57 billion). Foreign affiliate sales of services, or the delivery of transatlantic services by foreign affiliates, are far more important than cross-border trade in services, and have exploded on both sides of the Atlantic over the past few decades, topping more than USD 1 trillion.\(^3\) Under new WTO/OECD ‘value-added’ calculations, the US in 2009 was the major customer and supplier for Germany, the UK, France and Italy. Germany followed only Canada as the most important export market for the United States, ahead of Mexico, China and Japan.\(^4\)

Varying impact

While it is practically impossible to quantify the economic impact of successful TPP or TTIP negotiations, some attempts have been made. Petri and Plummer estimate that a successful TPP agreement could generate USD 295 billion in annual global income gains by 2025. They estimate that Japan would gain USD 119 billion annually and the United States would gain USD 78 billion annually.\(^5\) Benefits from a full APEC agreement would be even higher. Regarding TTIP, an independent study by the Centre for Economic Policy Research forecasts that an ambitious and comprehensive agreement could generate USD 159 billion in annual economic gains for the EU, USD 127 billion a year for the United States, and boost global income by almost USD 134 billion.\(^6\) Members of either TPP or TTIP would enjoy larger benefits than those expected from the World Trade Organisation’s (WTO) Doha Development Agenda.\(^7\)

These calculations may be underestimating the full impact of such agreements because of a relatively new, and potentially revolutionary development – America’s rise as an energy power. Surging domestic oil and gas production, driven in large part by hydraulic fracturing and horizontal drilling techniques that have unlocked previously inaccessible reserves of oil and gas, is transforming the North American – and potentially global – energy landscape and has positioned the United States

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\(^3\)Hamilton and Quinlan, The Transatlantic Economy 2013.
\(^5\)Petri and Plummer, Trans-Pacific Partnership and Asia-Pacific Integration, http://www.iie.com/publications/pb/pb12-16.pdf. Hufbauer, Schott and Foong (Figuring Out the Doha Round) estimated the benefits from a Doha Development Agenda agreement in the USD 63 billion to USD 283 billion range, although these estimates are not directly comparable to Petri and Plummer’s estimated results from TPP because they are not scaled to the economy of 2025.
\(^6\)Francois et al., Reducing Trans-Atlantic Barriers to Trade and Investment.
to export natural gas abroad. Key partners in Europe as well as Pacific partners such as energy-dependent Japan are looking to the US as a new energy source. US law, however, currently limits natural gas exports to countries with which the United States has a free trade agreement. This gives some partners considerable motivation to move quickly to such an agreement with the United States. A surge in transatlantic and transpacific energy trade would generate even greater benefits than most calculations have shown.

**TPP, TTIP, and US economic statecraft**

As both an Atlantic and a Pacific power, the US is in a unique position to leverage one set of negotiations to support its interests in the other, while using each to advance a number of broader US goals.

First, the two mega-deals reflect US interest in continuing a strategy of ‘competitive liberalisation’ in which free trade agreements with some countries spur others to engage in trade liberalisation as well, thus leading to overall expansion of trade globally.\(^8\) The US conducts this strategy not only through the TPP and the TTIP but via other plurilateral negotiations as well, for instance ongoing talks on the International Services Agreement and negotiations to expand the WTO’s Information Technology Agreement.

Second, the TPP and TTIP reflect a frustration by Washington and its partners with the stalemated WTO Doha Development Round of multilateral trade negotiations. The WTO was created in 1995 as the primary forum for liberalising global trade, but it has foundered, and countries have rushed to conclude bilateral and regional trade deals – more than 250 since the WTO was created, and 319 now in force worldwide.\(^9\) In Washington’s view, successful TPP and TTIP negotiations might create momentum that could in fact push Doha forward. In addition, if TPP and TTIP partners went even further and codified and aligned their existing free trade agreements with all others with whom they have such free trade agreements, such a step would be a major boost to the global trading order. The feasibility of such a step, however, is subject to considerable debate.

Third, TPP and especially TTIP negotiations extend far beyond traditional free trade agreements. Each has a free trade component, but each also includes

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\(^8\)The United States now has FTAs in force with 19 countries, including Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, South Korea and Singapore. Cooper et al., *The Trans Pacific Partnership Negotiations*; Williams, *Comparative Trade and Economic Analysis*, http://fpc.state.gov/documents/organization/203883.pdf.

\(^9\)An agreement on trade facilitation was in fact reached by WTO members in Bali in December 2013, but the overall Doha Round has been underway for over 12 years with no agreement in sight. See http://www.wto.org; also Bergsten and Cline, *Trade Policy in the 1980s*. 
negotiations over additional disciplines, as well as standards, norms and regulatory coherence. The TPP and TTIP offer the US an opportunity to influence the formulation of standards and the establishment of norms among very diverse economies in the Asia-Pacific, while deepening shared US-EU norms as a core for global standards. In many cases, the standards being negotiated are intended to be more rigorous than comparable rules found in the WTO. Agreement on such issues as intellectual property, services, discriminatory industrial policies or state-owned enterprises could strengthen the normative underpinnings of the multilateral system by creating benchmarks for possible future multilateral liberalisation under the WTO.10 “Our goal,” US Vice President Joe Biden announced in April 2013, “is for high standards ... to enter the bloodstream of the global system and improve the rules and norms.”11

In Washington’s view, TPP and TTIP also create economic partnerships that can lock in commitments made by individual countries such as Vietnam to domestic reforms and open commerce, or to provide additional impetus to partners to implement commitments they have made yet not fulfilled, such as the EU’s intention to create a single market in services.

Greater trade and investment opportunities and alignment on high standards and norms are important not only in terms of how the US and its partners relate to each other, but how they together might best relate to rising powers, especially emerging growth markets, whose leaders are still debating their role in the international system. Whether those powers choose to challenge the current international economic order and its rules or promote themselves within it depends significantly on how the US and its partners engage, not only with them but also with each other. The stronger those bonds, the better the chances that rising partners will emerge as responsible stakeholders in the international trading system. The looser or weaker those bonds, the greater the likelihood that rising powers will challenge this order.

Each agreement is also important to Washington in its own regional context. The TPP provides a significant underpinning to the Obama administration’s ‘rebalance’ to Asia, including efforts to avoid being marginalised from a region in which China’s influence is growing and rival trade pacts are gathering momentum. Asia-Pacific countries have concluded more than 180 preferential trade agreements, most of which do not include the United States.12 The most significant perhaps is a parallel ‘Asian’ cluster of agreements centred on the Association of Southeast Asian Nations (ASEAN). Japan, South Korea and China have also initiated free trade talks, though current political issues among the three have slowed progress.

10 Cooper et al., The Trans Pacific Partnership Negotiations; Williams, Trans-Paciﬁc Partnership Countries; Akhtar and Jones, Proposed Transatlantic Trade and Investment Partnership.
11 Vice President Joseph P. Biden, 5 April 2013, cited in Cooper et al., ibid.
ASEAN’s Regional Comprehensive Economic Partnership, known as the RCEP, which is being negotiated by Australia, China, India, Japan, South Korea and New Zealand, is intended as a traditional free trade agreement focused on reducing trade tariffs. It excludes the US and it excludes provisions important to US interests, such as services, investment or intellectual property rights. The TPP, in contrast, is far more ambitious and offers the US a mechanism through which it can help shape the economic – and political – architecture of the Asia-Pacific region. Former US National Security Adviser Thomas Donilon called the TPP “the centerpiece of our economic rebalancing... . We always envisioned the TPP as a growing platform for regional economic integration.”

Although the TPP has been portrayed as an effort to contain China, it does not preclude Chinese entry since China, like any other APEC economy, has the right to request participation in the TPP. In this regard, the TPP is less about excluding China than defining the terms of its integration into the regional and global economy. Currently, China does not meet some basic criteria of TPP negotiating partners in terms of such issues as government controls, labour standards, intellectual property protection and currency conversion. The question is whether the TPP will be a strong enough inducement in terms of potential benefits to the Chinese economy to prompt Beijing to accelerate domestic reforms so that it can accede to the TPP and adhere to its negotiated disciplines. Deutsche Bank estimates that China’s TPP accession could increase the country’s real GDP by 2.0 percent due to trade liberalisation alone. Other TPP requirements, including liberalisation of investment regimes and capital accounts, freer competition and protection of intellectual property rights, would have significant additional effects on China. In the end, the degree to which TPP participants are prepared to include China, as well as China’s willingness or interest in participating in a comprehensive, high-standard agreement, will help determine if the TPP truly has the potential to become the basis of a far wider Asia-Pacific free trade agreement. Thus far, Beijing has reacted by promoting its own trade initiatives in Asia, although it is joining the plurilateral talks on the International Services Agreement and there are some indications that it may be considering joining the TPP.

The TTIP is similarly important in terms of US relations with Europe. The TTIP is about more than trade. At its core, it is about generating regulatory coherence and breaking down barriers to transatlantic commerce in ways that can generate growth and jobs without piling on debt. It is also about creating a more strategic, dynamic and holistic US–EU relationship that is better positioned with regard to third countries to open markets and strengthen the ground rules of the

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13Petri and Plummer, Trans-Pacific Partnership and Asia-Pacific Integration.
international order. There is also a reassurance element to the TTIP. Many view NATO as wobbly, and many Europeans are worried that the US rebalance to Asia will translate into less US attention and commitment to Europe. Creation of what would essentially be a Euro-American market of over 800 million people from Hawaii to the Baltic and Black Seas, together with a commitment to work together to advance core Western norms and standards, would offer reassurance that Europe is in fact America’s ‘partner of choice’. In this regard, TTIP has the potential to serve as a new binding element for the transatlantic partnership. It is not an ‘economic NATO’ – a term that can easily be misinterpreted – but it could be a second transatlantic anchor, rooted in deep and growing transatlantic economic integration. TTIP could be both a symbolic and a practical assertion of Western renewal, vigour and commitment, not only to each other but to high rules-based standards and core principles of international order. It is an initiative that can be assertive without being aggressive, and that challenges fashionable notions about a ‘weakened West’.

**Key differences**

While US goals for the TPP and TTIP are similar in some respects, there are also important distinctions. The first has to do with timing. The two negotiations are at different stages. There have been over 20 TPP negotiating rounds, whereas the United States and the European Union launched the TTIP only in early 2013 and conducted just three rounds of negotiations in 2013. TPP is thus further along, although Japan’s recent entry into the talks may slow them down. Since the TPP is likely to be concluded and considered for legislative approval ahead of the TTIP, it – more than the TTIP – is likely to be the lightening rod for US domestic debates about the value of additional trade agreements. US domestic stakeholders traditionally concerned about such agreements – including labour, consumer and environmental groups, each important to the Democratic Party – have been vocal in expressing concerns, and in some cases opposition, to the TPP. Such stakeholders have been relatively less vocal, however, with regard to the TTIP, largely because the EU upholds high protection for labour, as well as consumer and environmental standards.

The two arrangements also differ in that Washington is negotiating with only one party in TTIP (although in the end the European Commission will need support from 28 member states), with which it does not have a free trade agreement, whereas in TPP it is negotiating with 11 other parties, six of which already have free trade agreements with the US – Canada, Mexico, Australia, Chile, Peru and Singapore. But the negotiations also include five countries with which the US does not have a free trade agreement – Brunei, Malaysia, New Zealand, Vietnam and, most importantly, Japan, the world’s third largest economy, which accounted for 6
percent of all US goods trade in 2012 and 7 percent of all US services trade in 2011.\textsuperscript{16} This means that while the US and the EU share one overarching agenda for negotiations, TPP negotiations are divided in focus and content depending on the country, with the US negotiating market access for goods, services and agriculture with its ‘non-FTA’ countries.

The TPP’s diversity in trade partners is further enhanced by the fact that it includes a far more disparate set of countries than the TTIP, including advanced industrialised, middle income, and developing economies, which creates its own set of challenges in achieving a comprehensive and high standard agreement. This diversity has led the Asian Development Bank to express concern that the TPP could degenerate “into a series of loosely tied bilateral deals”\textsuperscript{17}. The US and the EU, in contrast, are far more homogenous; they account for two-thirds of the world’s high-income countries and each has generally strong protections for investors, intellectual property rights, labour and the environment – although those differences that do exist have proven tough to align in the past.

Another important distinction between the TPP and TTIP relates to the use of the term ‘living agreement’. The TPP has been envisaged as a living agreement with two components. First, TPP leaders have declared that a TPP agreement will not necessarily be concluded with a final document, but will “evolve in response to developments in trade, technology or other emerging issues”.\textsuperscript{18} This means that various mechanisms are likely to be set in place to address the regulatory impact of new innovative technologies for instance, or changing domestic rules among its members.

Second, leaders have used the term ‘living agreement’ to mean that the TPP is an open agreement, and can be expanded “to include other economies from across the Asia-Pacific region”.\textsuperscript{19} The TPP has in fact expanded already from an original group of four to the current membership of twelve. While leaders’ statements have charted the TPP’s future as an expansive trans-Pacific agreement, activities to date have focused on attracting other APEC countries. In December 2013 South Korea expressed interest in joining; other potential candidates include Taiwan, Thailand and the Philippines, and perhaps China and even Russia. Non-APEC countries such as Colombia and Costa Rica have also expressed interest, and it is conceivable that even non-Pacific countries could accede to the agreement, once negotiated, in the future. The TPP’s ‘open architecture’ could give it powerful leverage over other

\textsuperscript{17}S. Adam, “TPP Trade Pact Risks Degenerating into Bilateral Deals, ADB Says”, Bloomberg, 23 October 2013, \url{http://www.bloomberg.com/news/2013-10-24/tpp-trade-pact-risks-degenerating-into-bilateral-deals-adb-says.html}; Hufbauer, Schott and Wong (Figuring Out the Doha Round) argue that the lack of such symmetry helps to explain why the Doha Development Agenda received little support in advanced economies.
\textsuperscript{18}TPP Leader’s Statement, Honolulu, Hawaii, 12 November 2011.
\textsuperscript{19}Ibid.
countries seeking to share the benefits of expanded trade and investment and higher standards, and over leaders who would come to understand that if they wanted to reap the TPP’s benefits, they would have to create the domestic conditions that could make future accession possible.

US and EU officials, in contrast, have used the term ‘living agreement’ only in the context of creating a process to address new issues as they evolve; they have thus far been silent as to whether the TTIP, once negotiated, would be open to others willing and able to accede to its provisions. TTIP is unlikely to realise its strategic potential unless and until the US and the EU announce that, like the TPP, can be expanded to encompass others. Framing the TTIP as an ‘open architecture’ accessible to others could give the West tremendous leverage in terms of ensuring ever broader commitment to the high standards and basic principles governing modern open economies, much as the ‘Open door’ principle guided NATO and EU enlargement and gave the West significant leverage over transitional democracies in central and eastern Europe. The US and the EU have stopped short of that, however, generating considerable uncertainty and concern among other countries – Turkey in particular – whether TTIP is about trade creation or trade diversion.

Once reason why many Turks are interested in TTIP is that it represents a ‘transatlantic form of governance’ as opposed to other models being debated in Turkey, and thus is important as a means to influence Turkey’s own modernisation. Yet the US and EU have not been clear whether Turkey could in fact accede at some point. Turkey has a customs union with the EU, but nothing similar with the US, which means that, under a TTIP, US goods could flow via the EU into the Turkish market without Turkish engagement on the terms. Switzerland and Norway face related issues. NAFTA member Mexico has a rudimentary free trade agreement with the EU, and the EU and Canada are in the process of ratifying their own Comprehensive Economic and Trade Agreement, or CETA, but questions remain whether and how to align such arrangements with the TTIP.

The issue of open architecture could have even greater resonance for eastern European countries with whom the EU is negotiating deep free trade agreements, and even for Brazil and other rising economies.

The TPP and TTIP negotiations also differ in terms of the relative weight and focus given by the US on particular issues, reflecting the distinct nature of US commercial ties with each region. A comprehensive review of all issues in the negotiations exceeds the scope of this article, but a brief survey of a few important areas illuminates how Washington is approaching both negotiations, including how it seeks to use one set of negotiations to help advance US interests in the other.

Simply stated, US commercial ties with the Asia-Pacific region are driven primarily by trade in goods, whereas US commercial ties with Europe are driven primarily

20Kirisci, *Turkey and TTIP*.
by both investment and trade in services. That does not mean that transpacific investment or services, or transatlantic goods trade are not important. But it does indicate where the greatest benefits are to be had from each negotiation.

**Goods Trade**

The major immediate gains from a TPP agreement would come from dismantling ‘at-the-border’ trade tariffs across an ever-wider space in the Asia-Pacific region, which is likely to make such trade even more of a driver of transpacific commerce. Transatlantic tariffs on goods, in contrast, are relatively low, although there are exceptions in some areas. Eliminating such tariffs can still be important, however, given the size of the US and EU markets. According to the European Centre for International Political Economy, a Transatlantic Zero Tariff Agreement would lead to USD 120 billion in added growth in the US and the EU within five years of signing the agreement. US exports to the EU would increase by USD 53 billion – five times more than under the 2012 US–South Korea free trade agreement.

Tough market access issues remain, however, particularly in agriculture, which is critical for both the TPP and the TTIP. Although such US industries as dairy and sugar are wary of additional market concessions, in each negotiation the US is pressing hard to open agricultural markets. In fact, unless the TPP and the TTIP offer significant new market access to US agriculture, the US Congress is unlikely to agree to either deal.

In 2012, two-way US agricultural trade with the other 11 TPP countries totalled USD 108 billion, with the US recording a USD 10 billion surplus. This represented 44 percent of the combined total of US agricultural exports and imports with the world. Within TPP, NAFTA countries Canada and Mexico once again rank as the most important US partners, followed by Japan. Washington is seeking to use the TPP to open agricultural markets in Malaysia, Vietnam and Japan, the three commercially-significant countries with which the United States does not yet have an FTA. Of the three, Japan is the clear prize. Though Japan currently is the fourth largest US agricultural export market, it protects its producers with very high tariffs and restrictive quotas. Japan has agreed to abolish tariffs on up to 89 percent of trade items with some TPP members, but that is still far below the trade liberalisation rate of around 95 percent needed to conclude a successful agreement.

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22 Cooper et al., *The Trans Pacific Partnership Negotiations*.
Historically, agriculture has been the big sticking point to a US-EU trade agreement. Studies generally show that the average EU tariff is two to four times the average US tariff for agricultural products. Most US free trade agreements have no product exclusions – “all tariffs go to zero” is the US mantra on tariff negotiations in free trade agreements. When exceptions have been negotiated, it is for just one or two products, and in many cases these products may avoid a tariff cut but still have to provide new access through expanded tariff-rate quotas. In contrast, in its trade negotiations the European Union has excluded a large number of agricultural products from tariff elimination, and in many cases from any tariff cut at all.\(^{24}\)

**Services**

The United States is particularly competitive in services, which provide 83 percent of non-agricultural jobs and over 65 percent of US GDP. In fact, the US has a collective trade surplus both with its TPP partners and with the EU. Moreover, services are provided increasingly through US corporate affiliates based in these countries, rather than by trade, which underscores the importance the US attaches to open flows of foreign direct investment.

Services are the sleeping giant of the transatlantic economy. Most American and European jobs are in the services economy, which accounts for over 70 percent of US and EU GDP. The US and EU are each other’s largest and most profitable commercial partners when it comes to services trade and investment. Deep transatlantic connections in services industries, powered by mutual investment flows, are also the foundation for the global competitiveness of US and European services companies. Yet protected services sectors on both sides of the Atlantic, for example, account for about 20 percent of combined US-EU GDP – more than the protected agricultural and manufacturing sectors combined. Removing barriers in these sectors would be equivalent to 50 years’ worth of GATT and WTO liberalisation of trade in goods.\(^{25}\) Even modest progress could lead to substantial gains for both sides.

Cross-border trade in services, and provision of services through foreign affiliates, are much less developed across the Pacific Basin than trade in goods, and far less developed than transatlantic services trade and investment. Even within TPP, the majority of US services trade and investment is conducted not with partners across the Pacific but with North American partners Canada and Mexico. For instance, Canadian affiliates based in the United States account for up to three-fourths of all services supplied in the US from TPP countries.\(^{26}\) Opening protected services markets and reducing barriers to investment that would enable provision of services in


\(^{26}\)Williams, *Trans-Pacific Partnership Countries*. 
TPP markets by US foreign affiliates would offer significant opportunities to US companies and enhance considerably the overall impact of a deal.

In addition, the TPP offers the US some potential leverage with the EU within TTIP. TPP countries have agreed to use the US approach of negotiating services on a ‘negative list’ basis, meaning that all types of services would be included in an agreement unless specifically excluded. Such provisions already are included in US free trade agreements with six of its TPP partners. This approach is generally considered to be more comprehensive than the ‘positive list approach’ used in the GATS and usually used by the EU in the vast majority of its trade agreements.\textsuperscript{27} The US is likely to use TPP ‘negative list’ commitments to leverage its negotiations on services-related issues with the EU in the TTIP.

**Investment**

Investment is a primary driver of transatlantic commerce. The United States and EU member states generally have open investment regimes, though certain restrictions remain. The United States has investment treaties with many of the EU’s 27 member states, but has no agreement with the EU itself. Yet in the 2009 Treaty of Lisbon, EU member states relinquished to the European Commission their authority to negotiate investment treaties, thus creating the potential for future legal uncertainty for US companies, absent a US–EU agreement on investment. Such an agreement on investment should be structured around the elimination of ownership restrictions and other investment barriers, alignment of bilateral investment competences, and common approaches to restrictions on investment in third countries. A US–EU investment agreement as part of the TTIP could also strengthen international investment law, and serve as a model for investment agreements worldwide.\textsuperscript{28}

Investment is less of a driver of commercial activity between the US and its Pacific TPP partners than between the US and the EU. As with services, over half of TPP FDI flows both into and out of the United States are actually with North American partners Canada and Mexico.\textsuperscript{29} US free trade agreements with six of the TPP countries include investment provisions and already cover the countries responsible for the majority of TPP–US FDI flows. However, no other bilateral investment treaties exist between the United States and the remaining TPP countries. Investment provisions in the US–South Korea free trade agreement are likely to serve as a template for US goals with other TPP partners. It requires the parties to treat foreign investors the same way they treat domestic investors (‘national

\textsuperscript{27}Cooper et al., *The Trans Pacific Partnership Negotiations*.


\textsuperscript{29}Australia is the other significant FDI partner in the TPP.
treatment’); bans the expropriation or nationalisation of foreign investments unless they serve a ‘public purpose’; and establishes investor-state dispute settlement provisions designed to resolve disputes between foreign investors and governments. Except for the agreement with Australia, US free trade agreements have included an investor-state provision. The US has also sought to use TPP ‘negative list’ commitments to leverage its negotiation with the EU within the TTIP. The EU did in fact reverse its position and adopted a ‘negative list’ approach in the EU–Canada CETA, and EU negotiators pointed to this switch in their efforts to convince US officials to start the TTIP negotiations.

**Regulatory coherence**

Since ‘at-the-border’ tariff barriers between the US and the EU are generally so low, the biggest overall gain from a TTIP would be to tackle ‘behind-the-border’ regulatory differences. For instance, *The Economist* estimates although EU chemical exports to America face a modest 1.2 percent tariff rate, non-tariff barriers to chemicals result in a tariff equivalent of 19.1 percent.30 “Our main ambition,” EU Commissioner Karel de Gucht has stated, “beyond simply reducing tariffs across the board – is to make the EU and the US regulatory systems more compatible and to help shape global rules in trade since this is where the economic and political benefits of a deal lie.”31 Estimates indicate that 80 percent of the overall potential wealth gains resulting from TTIP will come from cutting costs imposed by bureaucracy and regulation, as well as from liberalising trade in services and public procurement.32 The goal is to build a more integrated transatlantic marketplace, while respecting each side’s right to regulate in a way that ensures the protection of health, safety and the environment at a level it considers appropriate. Regulatory coherence is likely to consist of a number of mechanisms, including mutual recognition agreements in which officials on each side agree to accept products or services from the other side based on a ‘tested once’ criterion for specific sectors and products. Where harmonisation or mutual recognition of existing regulations and standards cannot be achieved, then the TTIP seeks to create other forward-looking mechanisms to head off conflicts, including early consultations, impact assessments and regulatory reviews.

There are challenges, and a number of seemingly intractable issues remain. Some regulatory differences relate to divergent public preferences and values, for instance

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31Statement by EU Trade Commissioner Karel De Gucht on the Transatlantic Trade and Investment Partnership (TTIP) prior to the second round of negotiations, Brussels, 30 September 2013.

attitudes towards genetically-modified foods. In the face of high levels of concern in some EU countries that the TTIP may open the door to such US foods in Europe, EU officials have been adamant that the TTIP will not force the EU to change laws intended to protect human life and health, animal health and welfare, and that environment and consumer interests will not be part of the negotiations. This includes genetically-modified organisms. The intent, rather, is to improve US–EU exchange of information on policy, regulations and technical issues without affecting safety assessment and risk procedures carried out by the European Food Safety Authority.

Regulatory talks in the TPP are less ambitious than in the TTIP, although in some areas such as human health and animal/plant safety they are intended to secure commitments beyond those found in the WTO. In essence, the US is seeking to lift and align regulatory mechanisms among TPP countries, for instance through the creation of domestic regulatory structures similar to the US Office of Information and Regulatory Affairs in the Office of Management and Budget and similar approaches to regulatory impact assessments; use of cost-benefit analysis and procedures for assessing alternatives to regulation; and introduction of transparency in regulatory processes. The more compatible the regulatory systems of TPP countries, the more seamlessly US companies can operate in TPP markets.

Since the US and the EU already have high regulatory standards, the TTIP is not just about regulatory coherence across the Atlantic. Both sides hope that by aligning their domestic standards, they will be able to set the benchmark for developing global rules in ways that avoid lowest-common denominator outcomes when dealing with rising powers that may not necessarily share the same such standards with regard to health and safety or consumer, worker and environmental protection.

In this sense, a successful TTIP would actually be a TPP-plus agreement with regard to regulatory coherence. Its impact would stretch beyond transatlantic markets and would have considerable impact on countries in Asia and elsewhere. Since TTIP regulatory standards could be higher in many areas than TPP standards, Asian companies – and others – would have to orient to these higher standards if they wish to engage with the US and EU markets, which account for two-thirds of the world’s high-income economies.

33Cooper et al., *The Trans Pacific Partnership Negotiations*.
Government procurement

On all the issues outlined so far, the United States is using one negotiation to help advance its interests in the other. In the case of government procurement, however, the EU and TPP partners are seeking to squeeze Washington.

The United States is a member of the plurilateral WTO Government Procurement Agreement (GPA), and US agreements with Canada and Mexico through NAFTA and US FTAs with Australia, Peru, Chile, and Singapore include chapters on government procurement, which provide opportunities for firms of each nation to bid on a reciprocal basis on certain government contracts over a set monetary threshold. Similar chapters have been proposed by US negotiators in the TPP and TTIP talks. This market potentially could be quite large. According to the WTO, government procurement accounts for 15-20 percent of a country’s GDP and the size of the government procurement market among GPA members was USD 1.6 trillion in 2008.36 Successful TTIP and TPP agreements would provide US companies access to the EU single market and open up some TPP markets, since among TPP partner countries only Japan and Singapore are members of the GPA, although New Zealand has announced that it will seek to join the agreement.

The US has a problem, however, due to resistance among some US states in providing access to their procurement markets. US states must voluntarily opt in to government procurement commitments in free trade agreements; the federal government cannot impose an agreement on them. The number of US states joining such agreements, however, is going down, not up. Whereas 37 of 50 US states signed up to the GPA, only 8 US states acceded to commitments under the most recent US bilateral free trade agreements with South Korea, Panama and Colombia. Because of this issue, the US approach has been to propose that negotiating partners agree on access commitments for central government procurement before addressing sub-federal or state level commitments.

The EU, in contrast, has a single public procurement framework for the single market, and thus has significant interest in using the TTIP to press the US to open up entirely. In fact, establishing a precedent for opening sub-national procurement to foreign bidders was arguably the EU’s main goal in its successful CETA talks with Canada, under which Canadian provincial procurement contracts will be open to EU companies. The EU hopes to use the CETA arrangement to push the US in the TTIP. Similarly, Canada is using the TPP to address US ‘buy American’ exclusions concerning state and municipal projects funded by the federal government, pressing for a TPP agreement that would obligate sub-federal entities to open procurement projects funded by a central government to competition from firms in TPP countries. In this case, TPP and TTIP partners are seeking to squeeze

36Cited in Cooper et al., The Trans Pacific Partnership Negotiations.
the US, rather than the US leveraging each set of negotiations to its own advantage.

**Conclusion**

Beyond these illustrative areas, negotiators face a host of other issues, including the extent to which financial services should be included; whether new rules on geographical indications will be made; or how to engage on intellectual property rights and data protection. These tough issues are further reasons why there should be no illusions about the difficulties involved in achieving a TPP or TTIP agreement. Remaining tariff barriers, especially in agriculture, often reflect the most politically difficult cases. Regulatory differences can be extremely difficult to broker. Issues such as food safety or environmental standards can be extraordinarily sensitive. Investment barriers, especially in terms of infrastructure and transport sector ownership, will be very difficult to change.

In addition, the greatest challenge to US goals for the TPP and TTIP may actually be at home. Despite the Obama administration’s great ambitions for both the TPP and TTIP, each may suffer because, as of this writing, the administration does not yet have Trade Promotion Authority. In the United States the constitutional authority to “regulate commerce with foreign nations” lies with the Congress, not the executive branch. To preserve the constitutional role of Congress yet enable the executive branch to negotiate trade agreements without fear that their provisions would be picked apart by legislators, a mechanism known as Trade Promotion Authority (TPA) – previously called ‘fast track’ – was devised. TPA provides for expedited legislative procedures (limited debate, no amendments, up-or-down vote) for the consideration of the implementing bill for a trade agreement. TPA expired in 2007, however, and has not yet been renewed, which means that neither the TPP nor the TTIP negotiation is being conducted under TPA, although the administration is informally following its most recent procedures. TPA will need to be approved before TPP or TTIP is considered by the Congress, otherwise each will be subjected to potentially debilitating amendments.

In sum, both the TPP and the TTIP are highly ambitious but potentially risky endeavours. The potential payoff of such initiatives is high, however, and their geostrategic impact could be as profound as the direct economic benefits they may convey.

**References**


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that the EEC already emphatically pleaded for eastern enlargement. See European Round Table, Reshaping Europe (Brussels: ERT, 1991). Several reports specifically on enlargement followed in 1999 and 2001. Most recently the EEC has expressed its support for a continuing enlargement process to create a yet bigger single market.


Suggested Readings


Websites

- Gateway to the European Union: http://europa.eu.int/index_en.htm
- History of European Integration, Leiden University: www.en-history.leidenuniv.nl/
- The European Roundtable of Industrialists: www.ert.be/

Chapter 22

The North American Free Trade Agreement

Tony Porter

In 1994, amid much controversy, Mexico, the US, and Canada joined together in the North American Free Trade Agreement (NAFTA), a dramatic change from their wary relationships in earlier periods. By 2004 NAFTA included 430 million people and US$11.4 trillion in economic activity, constituting a formidable economic bloc. This chapter will discuss, in turn, the reasons for NAFTA, its key features, its effects, and its significance. Although NAFTA is often seen primarily as an economic arrangement, this chapter stresses, consistent with one of this book’s overall themes, that politics has played a key role in its negotiation and implementation. I argue that political initiatives are needed in response to the failure of NAFTA to improve the well-being of citizens in its three member countries in the way that its supporters claimed it would.

Why Was NAFTA Created?

For much of the post-World War II period few people would have imagined that Canada, Mexico, and the US would sign an agreement such as NAFTA. A growing Canadian nationalism, associated with fears about the negative consequences of Canada’s increasing dependence on US investment and trade, reached a high point during the 1970s with new government initiatives, such as the Foreign Investment Review Agency, which sought to shape incoming investment in ways that were more beneficial to Canadians, and efforts to establish closer economic links with Europe and Japan. The Canada-US Free Trade Agreement (CUTA), which came into effect in 1989, and NAFTA, which went beyond that agreement by including Mexico and by adding new issues, marked a remarkable turn away from the earlier, more nationalist period.

In Mexico nationalism had even stronger roots than in Canada. Anger at foreign influence had helped fuel the Mexican Revolution of 1910 and had contributed to the strongly nationalist Constitution of 1917. In the post-World War II period Mexico had been a leading advocate of the right and duty of governments to build economic sovereignty through such measures as controls over cross-border capital and trade flows and the nationalization of important industries. Government spending as a share of GDP increased from 13.1 per cent in 1970 to 39.6 per cent in 1976. In 1973 Mexico enacted two major laws to regulate foreign investment and the transfer of technology. Even in 1982 the Mexican government’s response to the debt crisis was to take over the privately owned banks, adding them to more than a thousand other state-run enterprises. Yet by 1986 Mexico had signalled its commitment to free trade by joining the General Agreement on Tariffs and Trade, and then, in 1990 by initiating talks with the United States on NAFTA.

While the turn towards regional free trade could be traced through domestic political factors that were specific to each of the three countries, the simultaneous upsurge in enthusiasm for it in all three countries suggests that systemic factors were at work, and it is these that this chapter will stress.

One systemic factor, which is frequently cited, especially by supporters of NAFTA, is the worldwide expansion of markets and the opportunities and
constraints this expansion presents to policymakers. Opportunities reside in the capacity of market exchanges to generate growth through allowing people to specialize in the economic activities they can do best, in allowing capital to flow to the activity in which it is most productive as measured by the highest rate of return, and in forcing uncompetitive firms and individuals to modify their behaviour if they wish to survive, a point that also highlights the constraints imposed by markets. These considerations might suggest that NAFTA is simply an expression of the recognition by governments and citizens of these opportunities and constraints, perhaps stimulated by technological advances that have increased the fluidity of international trade and capital flows.

There are three clues, however, that such an explanation is inadequate. First, these countries' earlier policies, for most of the post-World War II period, were associated not with stagnation but rather with unprecedented growth—indeed, with higher growth rates than those that have followed NAFTA. Second, the advantages of market exchange cannot alone explain the regional character of NAFTA. Third, the timing of NAFTA is difficult to explain on the basis of an ongoing expansion of market exchanges alone.

An explanation that accounts for these issues must highlight the impact of historically specific international political structures on the three countries, and most particularly the changing fortunes of the United States as the hegemonic leader of the West during the Cold War. In the aftermath of World War II, the United States was unvexillated, in part due to the damage inflicted on its major competitors, including the division of Europe, as a result of the war and in part due to the superiority of its productive capacity. In constructing a post-war order with itself as the centre, the United States found it was willing and able to support the arrangements within which international markets flourished, including the trade and monetary regimes, as well as bilateral arrangements with key allies in which political and ideological allegiance was exchanged for relatively free access to US markets. These political arrangements were accompanied by a particular set of production arrangements: the rapidly expanding manufacturing industries upon which the United States had built its ascendancy were organized by US-based multinational corporations and spread to other countries through those corporations' branch plants and subsidiaries.

Canada's and Mexico's integration into these arrangements was given their proximity to the United States, a particularly distinctive feature of their post-war political economies. US direct foreign investment poured into Canada in the 1950s and 1960s, dominating both the extraction of natural resources destined for the US market and manufacturing industries catering to the Canadian market. These economic ties were facilitated by close and informal political ties, symbolized by phrases such as 'special relationship' and 'quiet diplomacy' as a trusted ally Canada had privileged access for its diplomats in Washington, allowing it to manage tensions and promote integration in the economic relationship. Close economic ties also were associated with a strengthening of the Canadian state, allowing it to cushion its citizens from the negative effects of economic dependence through access to raw materials and to invest in the creation of strong industries. Similarly, Mexico experienced huge inflows of US capital during the 1960s, and, by the end of the 1970s, 70 per cent of direct foreign investment and foreign debt originated from the United States and 70 per cent of Mexican exports were to the United States. Beginning in World War II, in which hundreds of thousands of Mexicans were recruited into the US army and brought into the country to replace mobilized US workers, migration from Mexico to the United States strengthened economic ties. Like Canada, Mexico tried to offset the negative effects of its close economic relationship to the United States by strengthening state intervention in the Mexican economy.

During the 1970s these arrangements began to change. In response to US fears about its diminishing economic lead over the rest of the world, US indulgence began to be replaced by more aggressive unilateralism, evident for instance in the United States ending its support of the Bretton Woods monetary regime and its unexpected imposition of a new duty on imports in August 1971. There were direct negative effects for Canada and Mexico, such as increased trade frictions, but indirect effects as well. For instance, the United States took measures with regard to global finance that, due to the size and centrality of its financial markets, enhanced its own position but left smaller countries, including Canada and Mexico, vulnerable. This was evident in the early 1980s in its contribution to the Mexican crisis of high US interest rates, government deficits, and massive inflows of capital to the United States, and the related contribution of the overvalued US dollar to raising the Canadian dollar and making Canadian exports to the rest of the world less competitive.

Given the constraints facing Canada and Mexico during the 1980s the political balance in both countries began to shift towards support for free trade with the United States. Washington was in favour of negotiations on free trade as well, but this was far from a passive recognition of the mutual benefits that could be obtained by allowing markets freer play. The United States had key goals related to its competitive position in the world as a whole to offset the negative effects of the United States of the high oil prices of the 1970s and to alleviate US anxiety about the long-run implications for its economic strength and political power of its dependence on oil imported from outside North America. There were, in addition, goals specific to Mexico. The United States aimed to obtain a nearby low-wage location in which the labour costs of US corporations could be reduced (and their competitiveness thereby enhanced) by shifting parts of production to Mexico. Low-wage export-oriented manufacturing in Mexico was more likely to use US inputs and be controlled by US firms than would similar manufacturing in Asia. Allowing freer access for products made in Mexico to US markets was also seen as a way to stem the tide of illegal immigration from Mexico as the work done by these immigrants could be shifted back south of the border.

While economic arguments can be made for strengthening rules governing investment, intellectual property, and financial services, these arguments lack decisive empirical confirmation and tend to obscure the political factors contributing to the US enthusiasm for them. In each case such rules facilitated internationalization in areas in which the US saw itself as having a competitive advantage that would offset its diminished lead in manufacturing. This would be accomplished by establishing new rights that were traceable more directly to the political process of threat and negotiation than to a generalized recognition of their economic or ethical merits. In the case of investment many countries, including Canada and Mexico, had, at various times, argued that the state had a legitimate and useful role in play in seeking to offset the economic and organizational capacity of multinational corporations and that the state should monitor and control the process of economic and social development in an effort to enhance benefits and minimize costs for their own citizens. Intellectual property rights establish a temporary monopoly in knowledge, and it is far from clear that the resulting benefits of the increased incentives to produce new knowledge outweigh the costs from the barriers to the free flow of knowledge that this monopoly creates. The financial sector, because of its centrality to the economy as a whole and the intangible and interdependent nature of the transactions on which it is based, is filled with externalities—social costs and benefits not captured by the prices of particular transactions, which have traditionally been a reason for strong state regulation—and it is not clear that the efficiency gains from greater international competition in financial services outweigh the losses from a diminished capacity for regulation. These three areas were ones for which Washington had been campaigning in bilateral negotiations and at the
Uruguay Round of trade negotiations and their inclusion in NAFTA would enshrine previous efforts more comprehensively and boldly in a major trade agreement, as well as providing the global negotiations with an explicit US threat to withdraw into a hemispheric alternative.

In short, NAFTA did not simply come about as a result of a sudden recognition by the three governments of the mutual benefits they would enjoy from a generalized expansion of market exchange. Each government came to the table influenced by constraints and power associated with their particular role in the evolving structure of the international political economy. For the United States, NAFTA was merely one element in a larger effort to promote, in a restricted form, the continuation of the leadership role it had played since World War II, and to promote the interests of powerful US firms. Canada and Mexico, by contrast, constrained by the restructuring of the international political economy, had to focus more narrowly on obtaining more secure access to the US market, and to substitute negotiated rules governing their relationship with the United States for previous informal understandings and independent deployment of their states’ capacity.

**Key Features of NAFTA**

While the final text of NAFTA runs to more than 2,000 pages and is impossible to review comprehensively here, it is useful to discuss its most significant provisions. The agreement is striking in its blending of an unprecedented level of legal detail on international trade obligations with very weak collaborative institutions, as compared, for instance, to the European Union. Politically this is consistent with the great disparities in power between the United States and the other two NAFTA partners. The United States wanted to preserve its traditional independence from international institutions, and Canada and Mexico were wary of creating a set of US-dominated continental political arrangements that would go too far in weakening their decision-making autonomy.

The NAFTA rules include greater market access in a variety of sectors, investment rules, intellectual property rights, dispute settlement, and side agreements on environmental and labour rights. These will be examined in turn, emphasizing especially the political significance of the Agreement’s provisions.

On energy, NAFTA reproduced the controversial measures agreed between Canada and the United States in CUSFTA—a prohibition, except under specified circumstances such as national security reasons, on restrictions on energy trade, foreclosing export taxes and other measures that had been used in the past to support nationalist economic policies. The Mexican government did not go that far, but did agree to open up procurement by PEMEX, its oil company, to foreign participation, although it retained control of PEMEX in Mexican hands.

On automobiles, NAFTA included provisions for the elimination, over a 10-year period, of tariffs between the three countries for vehicles meeting requirements for substantial regional content. The regional content rules, which deviate from pure free trade principles, are to degree to which these provisions were designed to improve the prospects of firms engaged in North American-based auto manufacturing by allowing them to produce at a more efficient scale, shifting key manufacturing processes to low-wage locations in Mexico, while protecting these firms from competitors from other regions. Mexico’s interest in these rules is to the extent that they promote productive foreign investment, by assuring investors that they will be protected from discriminatory or arbitrary treatment. For critics the ability of investors to seek judgements against states in secret, binding arbitration processes provides excessive rights to investors and undermines democracy, especially since some firms have used the process to claim that environmental regulations are a form of expropriation for which they should be compensated by governments. Chapter 11 provides to both long-term direct foreign investments and portfolio investments (where there is no direct control by the investor of the enterprise) and prohibit interference, except under certain restricted circumstances, with investors’ transfer of capital or profits across borders. Many governments have been reluctant to eliminate controls on portfolio investments because they are more likely to be short-term and speculative. Arguably these rules, by stimulating volatile inflows and outflows before adequate prudential financial regulations were established in Mexico, contributed to the 1994 peso crisis. Overall, the investment provisions of NAFTA went well beyond any other multilateral agreements, including those being negotiated through the GATT.

The intellectual property provisions are also striking. Governments are obligated to protect copyrights on computer programs, to prosecute decoding of encrypted satellite transmissions (such as telemiic programs), and to protect new sound recordings for 50 years, new trademarks for 10 years, and new patents for 20 years. Such levels of protection, as noted previously, are controversial because critics see them as giving producers of new technologies excessive profits as a result of the monopoly they are given and because this protection is seen as interfering with the flow of knowledge to places where it is needed. Supporters argue that the increased profits are a justifiable necessary incentive if new knowledge is to be produced.

Canada, in a political process that generated a great deal of domestic political conflict, reworked its patent regulations for pharmaceuticals to bring them in line with NAFTA obligations. A thriving Canadian generic drug industry had developed as a result of compulsory licensing provisions that were prohibited by NAFTA, despite the support of many Canadians for generic producers on public policy and economic grounds. Multinational pharmaceutical companies, however, were determined in NAFTA to overturn these provisions, in part due to the increased revenues that could be obtained from the Canadian market, and in part to eliminate Canada as a negative example for other countries. NAFTA’s consolidation of previous efforts by the United States to strengthen Mexico’s rules on intel-
lectual property was also seen by the United States as an important precedent for future negotiations with developing countries.

Canada and Mexico hoped that NAFTA would reduce what they saw as the frequent arbitrary use by Washington of two types of trade measures, anti-dumping and countervailing duties, which are supposed to be used only when an exporter engages in predatory flooding of a foreign market with products sold below their real cost, CUSFTA had put in place a dispute resolution mechanism that, in its first five years, had led to two-thirds of Canadian appeals of US decisions being successful, twice the success rate of appeals by other countries using the non-CUSFTA procedures provided by the United States, perhaps creating a deterrent to the initiation of trade actions by the United States against its partners. While the reduced rate of US trade actions against its NAFTA partners relative to trade actions against other countries could be taken as evidence that this deterrent was at work with the NAFTA panel mechanism, it may also be due to other factors, such as the contrasts between robust North American and weak Latin American and East Asian crisis in the late 1990s. Indeed, a World Bank study found that the overall number of trade actions taken by the United States against its NAFTA partners does not appear to have been affected by NAFTA. Overall, the process yields leeway to the reality of the Parties’ power asymmetry by its reliance on self-help rather than on judicial mechanisms. The use of sanctions in the trade process became more prevalent and the use of sanctions in the labour process became less frequent. The fact that the United States is restricted to the implementation of such country’s own laws. This deficiency would become glaringly apparent in the softwood lumber dispute in which, despite favourable panel decisions, Canada was successfully pressured by threats from Washington to impose restrictions on its exports to the United States and then was subjected to punitive US duties.

Faced with strong concerns on the part of US citizens that NAFTA would allow US firms to avoid US standards by moving production to a lightly regulated location in Mexico, and then to freely export manufactured goods back into the United States, US President Bill Clinton decided to negotiate a side accord on environmental standards and one on labour standards. These established a Commission for Environmental Co-operation and a Commission for Labour Co-operation, each with a council composed of the relevant ministers from the respective countries, who would meet once a year, and a secretariat, the members of which are expected to remain independent of their governments and which is responsible for ongoing administrative and technical support for the commission. The commission for Labour Co-operation, being more of the active participation of non-governmental organizations in its negotiation, has in addition a 15- member Joint Public Advisory Committee, which can be composed of scientific experts or others active on environmental issues.

The labour agreement establishes national administrative offices in each country that play an important role in receiving and initially considering complaints lodged by either individuals or NGOs.

The agreements both focus on monitoring and enforcing national standards rather than establishing and enforcing common international standards. There are, however, general statements regarding the desirability of standards, the making of joint recommendations, and the need for a good faith attitude on the part of the parties to implementing the agreement. All of the parties commit themselves to promoting 10 ‘labour principles’, including, for example, the right to organize and to be compensated for injury. Most complaints are envisioned as being resolved by consultation and arbitration without the threat of sanctions. There is a strong emphasis on the maintenance of existing levels of environmental and labour standards; any complaints are made about the well-being of citizens has improved.

For most people, a key factor in their well-being is the number and quality of jobs available. NAFTA supporters in all three countries argued that it would have a major positive impact on employment through the exports that it would generate. However, it is misleading to point to just exports created from exports, as for instance the US President did in his 1997 report to Congress on NAFTA, without subtracting jobs lost from imports. The US Department of Labor’s NAFTA-Transitional Adjustment Assistance Program had recorded, by the end of 2001, 415,371 workers certified to receive adjustment benefits, a rough estimate of US job losses. The Economic Policy Institute has concluded that the impact of both imports and exports on US employment and has estimated that NAFTA resulted in a loss of 879,280 US jobs between 1993 and 2002. Others have been sceptical of the ability of this method of separating the effect of NAFTA on US jobs from other factors, such as technological change, cycles of expansion and recession, or world trade. During the mid 1990s, a vigorous debate added millions of jobs to the US economy, suggesting at a minimum that NAFTA did not have the disastrous effect on jobs that US presidential candidate Ross Perot had ominously labelled the ‘great sucking sound’, even if more than two million jobs were subsequently lost between 2001 and 2004. A Carnegie Foundation study concludes that the effect of NAFTA on US unemployment was probably minimal relative to other factors shaping the huge US economy.

Supporters of NAFTA claimed that it would lead to an expansion of high-quality jobs as the United States specialized in high-value-added industries in which it had comparative advantage. Critics suggested instead that there would be downward pressure on the quality of jobs as US workers were forced to compete with Mexican workers. A 2004 report from the World Market Trends found a dramatic decline in US job quality between 2001 and 2004 as high-pay jobs were replaced by low-pay jobs that Simeon was regarded as dangerous for the safety of all workers. A development that could be taken as lending support to the critics’ contentions. Critics point also to the toll taken on individuals of having their factory threaten to move to Mexico, as has been the case with a large number of unionized firms, or actually closed down. A post-NAFTA study by Bronfman et al. found that half of US firms facing North American environment drivers, threatened the market in the maquiladora region in Mexico, the NAFTA-related weakness of North
American labour plays an important part in the widening gap between productivity and wages and in growing inequality in all three countries, as fewer workers produce more without benefiting from that improved effort.

For Canada, like the United States, separating non-trade factors, such as the decline in the value of the Canadian dollar over the 1990s, from NAFTA is difficult. One plausible assessment is that there was a significant increase in the first decade after NAFTA and that modest improvements. A growing productivity gap with the US—from 17 per cent in 1995 to 33 per cent in 2001—and persistently higher unemployment rates in Canada as compared to the United States, however, might suggest that Canada's relative position in the continent had been weakened rather than strengthened by NAFTA, contrary to what liberal economic theory had predicted.

Of the three countries, Mexico's experience in the post-NAFTA period was the most negative: the real minimum wage lost 23 per cent of its value between 1993 and 1999 and labour income as a share of GDP fell from over 40 per cent in the 1980s to 18.7 per cent in 2000, while profits as a share of GDP jumped from 31 per cent to 68 per cent over the same period. Employment fell drastically after the peso crisis, grew strongly for several years, but then stagnated. In the decade after NAFTA, the size of manufacturing and construction in Mexico averaged 1 per cent, as compared to 3.2 per cent from 1948 to 1973, or to the South Korean growth over the same period of 4.3 per cent, despite the East Asian crisis. There is, however, sharp disagreement about the relationship of this performance to NAFTA. Some argue that Mexico's problems were due to the 1994 peso crisis and that NAFTA was important in helping Mexico recover from that crisis. Yet, as noted above, NAFTA should also share some blame for the peso crisis, since it encouraged volatile cross-border flows of capital without ensuring that the prudential regulations and other policy tools needed to avoid and manage financial crises were in place.

A major problem in Mexico has been massive agricultural unemployment created by huge NAFTA-related inflows of both US agricultural and other US agricultural products, destroying an estimated 1.5 million livelihoods as prices paid to Mexican farmers dropped by 70 per cent. (Ironically, this has occurred in the land where corn was first domesticated several thousand years ago.) The connection of many Mexican NAFTA-related inflows of low-skilled workers and other US agricultural and other US agricultural products, destroying an estimated 1.5 million livelihoods as prices paid to Mexican farmers dropped by 70 per cent. (Ironically, this has occurred in the land where corn was first domesticated several thousand years ago.) The connection of many Mexican employers with the replacement of redistributive communal landholding policies dating back to the Mexican Revolution with private landownership as part of the neo-liberal economic restructuring with which NAFTA was associated.

Liberal economic theory might lead one to expect that these workers have been absorbed into rapidly expanding NAFTA-related export-oriented employment. Unfortunately, such increases in employment did not keep pace with job losses. Employment generated in the maquiladora region failed to lead to linkages or lasting transformations of the Mexican economy more generally. This failure was in part to the degree to which the foreign firms manufacturing in Mexico were treating their operations as merely one dispensable link in a processing chain starting and ending elsewhere and in part due to the Mexican government not investing sufficiently in infrastructure, legal reform, or the upgrading of the skills of their population through training. As one report noted, "Mexico's old role as a low-skilled, low-wage producer is now played by other countries, and Mexico has been slow to move on to the next step in the production process." The inability of poorly represented Mexican workers to demand their share of the wealth generated by productivity increases further inhibited their ability to upgrade their own living standard. As a Federal Reserve Bank report noted, an estimated 1.2 million manufacturing jobs were lost from Mexico to lower-wage countries from 2000 to 2003, including, for instance, 1,200 jobs at a $250 million Mitsubishi computer monitor plant, created in 1999 and closed a few years later when it could not compete with flat-screen monitors produced in East Asia.

China has been particularly worrisome for Mexico, after the former increased its connection with the US market by joining the World Trade Organization in 2001.

Contrary to the expectations of its supporters, NAFTA did not reduce immigration to the United States by creating employment in Mexico. On the contrary, the number of Mexican-born residents in the United States increased by more than 80 per cent between 1990 and 2000, and the pace of illegal border crossings grew despite huge American investment in border controls, with the greater danger of the crossings reflected in the 1,600 deaths of migrants between 1999 and 2004. A decade after NAFTA's launch it was estimated that one in five Mexicans lived in the United States.

In assessing NAFTA's performance it is also important not to rely only on aggregate figures that obscure important differences. In all three countries social inequality has increased significantly since NAFTA and the growth of a relatively small number of very high incomes at the upper levels can hide growing poverty and distress among the population more generally. The differences across industries are also an important part of the NAFTA story. One study found substantial variation across the 39 sectors it examined. For instance, the experience of electronics has been positive while the experience of apparel and textiles has been negative. A study of NAFTA lobbying patterns similarly found that its strongest supporters were in those industries for which economies of scale and high amounts of intra-firm trade would allow firms to reap considerable competitive advantages from being able to operate on a continental basis.

NAFTA's effects on the environment have been a major concern. While some of these effects have been positive they appear to be outweighed by the negative effects. The positive environmental effects are primarily related to the North American Agreement on Environmental Co-operation (NAECC), the environmental side agreement, and the Commission for Environmental Co-operation (CEC), which it created. NAFTA itself is path-breaking in the way in which it went beyond previous trade agreements in acknowledging and seeking to address institutionally the links between trade and environment. The structure of the institutions, in which the Secretariat and the Joint Policy Advisory Committee have been able to operate with substantial autonomy from the member states and with a significant degree of participation from non-state actors, has contributed to the strengthening of a continent-wide environmental policy network. The NAECC can take credit for some important accomplishments, including its intiative to create a "polluter pays" rule by having parties sign penalties paid by polluters to non-juridical bodies. This initiative resulted in the North American Development Bank, which was supposed to play a large role in cleaning up severe environmental problems around the US-Mexican border, has played a disappointingly small role, with only $17 million in funding of its $3 billion total lending capacity dispersed by 2001.

Critics of NAFTA feared that it would lead Mexico to become a pollution haven for firms wishing to escape environmental regulation in the United States and Canada, and that the ability of these firms to export back into the United States and Canada would put downward pressure on those countries' regulatory standards. One study found no evidence that dirtier industries shifted to Mexico in higher proportions than clean industries, a shift one might expect if these fears were realized. However, this may be because some of the dirtier industries, including steel and chemicals, are highly capital-intensive, with massive fixed investments in plants and infrastructure, and are not easily moved, and it is possible that the cleaner industries may still produce serious pollution problems. The environmental degradation of the maquiladora area and the growth of infection and cancers have been horrifying. Studies have estimated that in 1997 only 12 per cent of 8 million tons of hazardous wastes generated in that area were treated and that the average annual cost in Mexico of environmental damage...
of US$36 billion exceeds the growth from trade and the economy as a whole. This suggests that many of the measurements of the benefits of economic growth from NAFTA are overstated because they do not take into account the associated environmental and social costs.

The CCES citizen submission process by 2004 had involved 43 complaints, of which nine resulted in ‘actual records’ (CCES reports), 10 remained active, two were dropped because they were being pursued elsewhere, and 22 were rejected or dropped because they did not, in the CCES judgment, meet its criteria. The procedure is innovative in allowing citizens to engage in whistle-blowing and in providing a means of spotlighting violations, but the CCES has been careful to restrict the scope of the process, and its outcomes remain very modest relative to the severity of the environmental problems in the continent.

One of the most troubling environmental effects of NAFTA has been the use of the Chapter 11 investor dispute mechanism by firms seeking compensation from governments for restrictions imposed on them by environmental regulations. Critics have pointed out that this mechanism is similar to the earlier failed proposal of the right wing of the Republican Party to have the US government provide such compensation to US firms. The Chapter 11 mechanism has raised concerns in general because its deliberations are secret, and it is not clear that its panelists, many of whom have worked in the private sector, are independent from industry as they should be. There are also no mechanisms for ensuring that environmental expertise will be brought to bear in the judgments made by the panel. Sometimes critics overtaste the dangers. For instance, the panels have rejected some of the claims of the firms, and governments may be able to avoid future complaints by being more careful to devise regulations that are strong but not vulnerable to charges that they are really designed to discriminate against foreign firms and support domestic firms, a problem associated with the Canadian government’s effort to prohibit the export of toxic PCBs from Canada by a US-owned firm while allowing similar activities by a Canadian-owned firm. The NAFTA governments also agreed in 2001 to narrow somewhat the conditions under which investors can claim damages.

Nevertheless, serious concerns remain. The award to Metalclad of $16 million when it was not allowed to open a toxic chemical processing operation in Mexico, for example, is portrayed in superficial accounts as a case in which a local authority acted arbitrarily to undermine a commitment made by the Mexican government to Metalclad, and thus a case of Chapter 11 working as it should. Careful and detailed examination reveals, however, that Metalclad must have been aware of a history of intense local opposition to the illegal burial at the dumpsite in question of 20,000 tons of toxic materials, which resulted in extensive contamination of the local environment and suspected links with birth defects; that Metalclad made questionable payments to government officials in its efforts to get permission to operate; and that it would seem reasonable that those in the neighbourhood of the prospective toxic processing operation should have some say over whether it should be permitted to proceed. All this suggests that the critics are correct in saying that the integration process is a secret process that is biased towards giving foreign firms the ability to pre-empt local democratic rights.

The North American Agreement on Labor Cooperation, the labour side agreement, has been less effective than the environmental side agreement. As of 2003, 28 submissions had been filed, 13 of which have dealt with the manufacturing industry. Inspection has dramatically increased Mexican spending on the enforcement of labor standards since NAFTA. The Commission has had some modest positive impact in publicizing complaints about violations, promoting cross-border co-operation among labour rights advocates, and affecting the treatment of some of the workers concerned. A 2001 article by Compas lists nine cases brought to the Commission that resulted in concrete, positive outcomes for labor.

A development that stands up is the free trade area of the Americas negotiations, which once had seemed like a logical and inexorable outgrowth of the successful negotiation of NAFTA, provides a further indication of the political problems that have developed in the years since the launch of NAFTA. Initiated in 1994, the FTAA languished in the late 1990s when US Presidents Clinton and Bush were denied fast-track negotiating authority by a US Congress concerned about the political fallout from free trade dislocations. Fast track had restricted congressional involvement to acceptance or rejection of any trade deal negotiated by the executive branch and without US trading partners were reluctant to negotiate because they feared Congress would make modifications in the legislation implementing the agreement. Bush was able to gain fast-track authority, renamed ‘Trade Promotion Authority’, in 2002, but only a small number of aggressive actions to protect US economic interests, such as protection and financial support for steel and agriculture, were undertaken. With the Bush administration distracted from the FTAA by the war on terror and displaying aggressively unilateralist and protectionist economic policies, it is not surprising that by 2004 the FTAA negotiations had lost their momentum, with expectations reduced to, at most, an ‘FTAA lite’ in which the most important issues would be set aside and a series of bilateral agreements would be made between the United States and other countries, the line of which was Chile. Indeed, it was not clear that the negotiators would be successful in concluding any FTAA agreement at all.

Conclusion

The political character of NAFTA is evident in both the process leading to its negotiation and in its effects and evolution since it was established. The provisions of most concern to important interests in the United States and to the long-range strategy of the US government—the investment, intellectual property rights, and financial services provisions—are the ones that were most innovatively and strongly developed. The dispute resolution mechanism for other matters, by contrast, remains subject to power politics and the mechanisms in the labour and environmental agreements are especially weak.

NAFTA helps consolidate a strongly market-oriented regime for North America, weakening pre-existing national political instruments that had been developed to offset the negative effects of markets, without developing alternative international instruments. In contrast to the European
Union, for instance, where a great deal of effort has been devoted to developing an institutional solution to regional inequality and exchange rate problems, such issues in North America are dealt with by individual government initiatives on an ad hoc basis. This market-oriented regime poses more challenges for Canada and Mexico than for the United States, in part because of the latter's size and in part because it matches more closely the traditional relationship between state and market in the United States than does it in the other countries. Mexico's failure to translate NAFTA-related rapid export growth of the mid-1990s into long-range development, its vulnerability to lower-wage jurisdictions such as China, and the growing inequality across the continent all reinforce the importance of government initiatives in promoting the capacities of their citizens, in fostering innovation, in helping them bear trade-related dislocations, and in ensuring that the costs and benefits of trade are fairly distributed. Without such initiatives the negative effects of trade agreements can outweigh the benefits, and political opposition will prevent further trade agreements. In short, NAFTA, as with other issues in international political economy, reveals the intensely political nature of the evolving international system.

Notes

1. Research assistance by Diana Cacic is gratefully acknowledged.
5. The figures in this and the previous sentence are from George W. Grayson, The North American Free Trade Agreement: Regional Community and the New World Order (Lanham Md: University Press of America, 1999), 30.
7. See George W. Grayson, The United States and Mexico: Patterns of Influence (New York: Praeger, 1984), 27–31. Mexico's criticisms of excessive US influence in Latin America were tolerated by the United States, which was grateful for its anti-communism, evident for instance in Mexico's support of the US blockade during the Cuban Missile Crisis.
9. Bhagwati, a leading economist in favour of free trade, has commented with regard to intellectual property: 'As it now widely conceded among economists ... there is no presumption of mutual gain, world welfare itself may be reduced by any or more IPR protection, and there is little empirical support for the view that "adequate" IPR protection impedes the creation of new technical knowledge significantly. Jagdish Bhagwati, 'Regionalism Versus Multilateralism', World Economy 15, 5 (September 1992): 553.
11. Although many critics feel that NAFTA went too far and in effect created a new constitution for the rights of foreign corporations, see, for instance, Stephen Clarkson, 'Canada's Secret Constitution: NAFTA, WTO and the End of Sovereignty? (Ottawa: Canadian Centre for Policy Alternatives, Oct. 2002). Available at: <www.policyalternatives.ca>.
17. NAFTA also sets up the Border Environmental Cooperation Commission, designed to address problems along the US-Mexico border, and the North American Development Bank, designed to fund environmental infrastructure and cleanup projects. For a critical account, see Andrew Wheat, 'Troubled NAFTA Waters', Multinational

19. For instance, a 10-year assessment by the partners' three trade ministers has a full page of data about trade and investment but only a sentence on standards of living. Lower tariffs mean that families pay less for the products they buy and they have a greater selection of goods and services, which increases their standards of living. NAFTA: A Decade of Strengthening a Dynamic Relationship, at: <www.dfait-maeci.gc.ca/nafta-alexen/nafta10-en.asp>.
20. The number may underestimate total losses because of the sentigency of the criteria for receiving such assistance and because they do not account for jobs lost because of imports, but they may also overestimate losses because not all certified workers actually lose their jobs. M. Angeles Villarreal, Industry Trade Effects Related to NAFTA, Report for Congress (Washington: Congressional Research Service, 21 Oct 2003). See also Earl H. Fry and Jared Baere, 'NAFTA 2002: A Cost/Benefit Analysis for the United States, Canada and Mexico', Canadian-American Public Policy 49 (Jan. 2002): 1. The NAFTA adjustment assistance program was folded into a more general program in which it is not possible to distinguish jobs lost specific to NAFTA, and thus more recent figures are not available.


27. Ibid.

28. Standing Committee on Foreign Affairs and International Trade, Partners in North America: Advancing Canada's Relations with the United States and Mexico (Ottawa: House of Commons, 2002).


35. Jeff Faux, "How NAFTA Failed Mexico: Immigration: Is Not a Development Policy", American Prospect 14, 7 (3 July 2003), at <www.ourprotect.org>. In NAFTA's first decade the budget of the US Immigration and Naturalization Service more than tripled and more than twice agents were authorized to carry guns but were those of any other federal law enforcement agency. See Peter Andreas, A Tale of Two Borders: The US-Canada and US-Mexico Lines After 9-11, in Andreas and Biersteker, eds, The Redevelopment of North America, 1-24.


40. "Ten Year Track Record".


43. "Ten Year Track Record"; Audley et al., NAFTA: Promise and Reality, 6.

44. Calculated from list at <www.ce.org/citizen/smart/index.cfla>.


Suggested Readings


Web Sites

Free Trade Area of the Americas: <www.fta-ala.org>

NAFTA, Chapter 11 cases: <www.naftaslaw.org>

NAFTA Secretariat: <www.nafta-scc-ala.org>

North American Agreement on Environmental Cooperation: <www.cec.org>

Stop the FTA: <sofpia.org>.