CHAPTER 2

The Evolution of International Business

Chapter Outline

- Introduction
- Benefits of Trade and Foreign Direct Investment
- Major Theories of International Trade
  - Wealth Accumulation as a Basis for Trade Theory: Mercantilism
  - Specialization as a Basis for Trade Theory: Absolute and Comparative Advantage
    - Theory of Absolute Advantage
    - Theory of Comparative Advantage
  - Factor Endowments as a Basis for Trade Theory: Heckscher-Ohlin and Factor Price Equalization
  - Porter's "Diamond" Model of National Competitive Advantage
    - Factor Conditions
    - Demand Conditions
    - Related and Supporting Industries
    - Firm Strategy, Structure, and Rivalry
- The Practice of Trade Policy
  - Tariffs, Preferential Duties, and Most Favored Nation Status
  - Nontariff Barriers
- Current Practice of "Managed" Trade
  - Socioeconomic Rationale
    - Countertrade
    - Export Cartels
    - Infant Industry Argument
    - Questionable Labor Practices and Environmental Considerations
    - Health and Safety
  - Geopolitical Rationale

- National Security
- Strategic Industries
- Embargoes

Teaching Objectives

After covering this chapter, the student should be able to:

- Briefly explain why trade and foreign investment are good for society as a whole.
- Describe the major international trade theories and how they operate.
- Evaluate trade policy, the main instruments of trade policy, and their impact on business, consumers, and governments.
- Explain the rationale behind a country's choice of managing trade.

COMPREHENSIVE LECTURE OUTLINE

I. Introduction. Business has become increasingly international in nature and has been accelerated by the low cost of communications technology. This chapter discusses the role of international business and how it developed.

CLASS ACTIVITY: *Use the Cultural Perspective case as an opportunity to allow students to explore the impact of international trade and investment on the economies of China and India.***Exhibit 2.1• World's Ten Largest Economies**

II. Benefits of Trade and Foreign Direct Investment.Tradeis the earliest and simplest form of international business.**Exhibit 2.2• World Trade Patterns.**

It benefits consumers by providing:

- A greater choice in the availability of goods and services
- Lower prices
- Higher living standards
- New jobs in the export and import sectors of the economy

At the same time it has a negative impact on economies due to disruptive changes such as:

- Outsourcing of jobs

- Stagnant wages
- Lower or sluggish standard of living in globally uncompetitive industries

Foreign Direct Investment (FDI) brings funds and business culture from abroad, creates new jobs, introduces innovative technologies, and enhances the skills of domestic workers. Emergingcountries tend to attract sizeable amounts of FDI. **Exhibit 2.3• Net Inflows of Foreign Direct Investment by Region and Industrialization.**

DISCUSSION STARTER: REALITY CHECK 1.

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

III. Major Theories of International Trade. No single nation in the world is capable of producing all the goods and services it needs. Neither does any nation have the required resources. Therefore, nations of the world need to trade. Theories of international trade provide an appreciation for the progress made in understanding how trade works. They also present a rationale for why restriction to trade should be minimized.

- **Wealth Accumulation as a Basis for Trade Theory: Mercantilism. Mercantilism** is a theory of international trade that supports the premise that a nation could only gain from trade if it had a trade surplus.
    - It's theoldest trade theory. Mercantilists believed that for a nation to become wealthy, the nation had to export as much as possible, and the value of exports should exceed those of imports, which are viewed as a cost.
    - If every trading nation decided to increase its exports, the surplus of exported goods in the world market would depress prices and decrease earnings of exporting countries.
- **Specialization as a Basis for Trade Theory: Absolute and Comparative Advantage.** Adam Smith argued and proved that free trade without restrictions would increase the wealth of nations.

- **Absolute Advantage** exists when one country can produce a good more efficiently than another.
- **Theory of comparative advantage** is a refinement of Adam Smith's theory and is attributed to David Ricardo. It claims that a country should produce the commodity in which it has the greatest advantage. Resources in the countries are scarce, and countries must choose to produce goods/services that most efficiently use their scarce resources. When all countries follow this approach, resources can be used most efficiently, and the total output and standard of living of the world can be increased.

- **Factor Endowments as a Basis for Trade Theory: Hecksher-Ohlin and Factor Price Equalization.**
  - Eli Heckscher and Bertil Ohlin showed that nations primarily export goods and services that intensely use their abundant factors of production.
  - The **Heckscher-Ohlin (H-O) Theory** attributes the comparative advantage of a nation to its factor endowments. The key assumptions for the H-O theory to work are:
    - Perfect competition
    - Perfect immobility of factors of production
  - **Factor price equalization theory** states that when factors are allowed to move freely among trading nations, efficiency increases, and leads to superior allocation of production of goods and services among countries.
- **Porter's "Diamond" Model of National Competitive Advantage.**In 1990 American economist Michael Porter found that trade theories broadly explained the basis upon which countries exported certain goods. Porter looked more closely at the theory of firm and industry specifics to identify characteristics that made firms and industries in countries "winners" or "losers" in international trade. Porter explains this hybrid model in terms of a "diamond" that consists of four groups of company-specific and country-specific characteristics.
  - **Factor Conditions**. Porter's model looks more closely at the quality of the factor endowments described in the Hecksher-Ohlin theory.

- **Demand Conditions**. Porter stresses the importance of domestic demand for goods and services. When domestic demand is high, domestic competition will intensify and lead to lower prices and sophisticated new products.
- **Related and supporting industries**. The presence of supporting industries and companies in a country will always be important for its competitive advantage.
- The final set of characteristics relate to **firm strategy, structure, and rivalry.**

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

DISCUSSION STARTER: REALITY CHECK 2.

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

IV. The Practice of Trade Policy. Despite the benefits of the free trade individuals, firms, and lobby groups pressure governments to impose barriers to imports or subsidize exports of goods and services. Their efforts are aimed at saving good-paying jobs and preventing increased competition in their industries at home. **Trade policy** refers to all government actions that seek to alter the free flow of merchandise or services between countries.

- **Tariffs, Preferential Duties, and Most Favored Nation Status. Tariffs** are taxes on imports. They generate revenues for governments. Tariffs come in two forms:
  - **Specific tariff** – an import tax that assigns a fixed dollar amount per physical unit.
  - **Ad valorem tariff** – an import levied as a constant percentage of the monetary value of one unit of the imported good.

- **Preferential duties** refer to low tariff rates applied to specific imports coming from certain countries. Under this system, the same good imported from a country outside of a preferred group will be subject to higher tariff. For example, in the **Generalized System of Preferences**, a large number of developed countries have agreed to permit duty-free imports of a selected list of products that originate from specific developing countries.
- Some countries interfere with the free flow of exports by enforcing **export subsidies, or export taxes**, meant to encourage or discourage exports.
- The**General Agreement on Tariffs and Trade (GATT)** was established in 1948 by 22 member countries, who committed to lower approximately 45,000 tariff rates within rules laid down by that organization.
- GATT was renamed the **World Trade Organization (WTO)** in 1995, which now sets rules of trade among nations on a near-global basis. The WTO's objective is to extend tariff reduction to agriculture and services, and to settle trade disputes among member countries. By June 26, 2014, 160 nations had become members of the WTO.
- Under the **most favored nation (MFN)** principle, any tariff concession granted by one member to any other country will automatically be extended to all other WTO member countries.

ECONOMIC PERSPECTIVES: Predatory Trade Practices: A Game of Chicken?*Use the Economic Perspectives case as an opportunity to discuss the impact of predatory trade practices on national economies and the role of the government in resolving trade disputes between countries.*
Suggestion: You could ask studentsto do this case as individuals or in teams as a class activity. Have the students read the case presented in the text and answer the questions at the end of the case.
Questions:

1. *Is China practicing fair trade? Explain in detail what China is trying to achieve, and the implications on the result for the rest of the world.Answer:China is not practicing fair trade. The value of Chinese currency is kept artificially low. Since their currency is not market-determined, itprovides unfair competitive advantage for all Chinese exporters. In addition, cheap credit, subsidized land, low cost energy, and controlled wages enhance China's competitiveness compared to the countries that use market mechanisms in determining the prices of their currencies and factors of production.*
2. *Why did the U.S. impose a "sliding-scale" tariff on China's tires? And why only for a three-year period? What was the net result?Answer:The sliding-scale tariff on tires imported from China gave time to the U.S. manufacturers to restructure and increase their efficiency. The three-year period presumably will be sufficient to achieve this goal.*

Chinese tire exports have caused market disruption in the U.S. tire manufacturing industry. China's share of the U.S. tire market increased from 3% to 11% over the 4 year period and has led to plant closing and redundancies.

- **Nontariff Barriers.** Since 1948 GATT and later the WTO managed to significantly lower tariffs. During that period countries have resorted to various forms of non-tariff barriers such as quality and environmental standards to restrict trade.
- **Import quotas or quantitative restrictions (QR)** limit the amount of products that can be imported into a country. They are generally worse than import tariffs because when the quota is reached, that particular product can no longer be imported.
- **Voluntary export restraint (VER)** occurs when an efficient exporting nation agrees to temporarily limit exports of a product to another country to allow competitors in the importing country to become more efficient within a set period of time.
- **Domestic content provisions** are another form of non-tariff barrier. Countries may require that a certain percentage of the value of an import be domestically sourced.

DISCUSSION STARTER: REALITY CHECK 3.

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

V. Current Practice of "Managed" Trade. Global trade cannot be completely based upon the economics of free trade, but encompasses a response to geopolitical and socioeconomic factors. **Managed trade** refers to agreements between countries that aim to achieve certain trade outcomes for the countries involved.

- **Socioeconomic Rationale.** Socioeconomics explores the relative negative impact of free trade upon society's welfare, as well as government policy measures that are implemented to minimize the negative outcomes to society. Several forms of managed trade are part of this category:

- **Countertrade.** In countertrade an exporter of goods or services commits to import goods or services of corresponding value. The terms of export and import exchange are predetermined through negotiations. Countertrade can be inefficient. Countries participate in countertrade especially when they do not have adequate amounts of foreign currencies to pay for imports.
- **Export Cartels.**Several developing countries depend upon non-renewable natural resources for economic growth. Since business cycles cause fluctuations in export volume and prices, some of these countries form export cartels to control prices and export revenues. For export cartels to be successful, all cartel members must agree not to cheat on the agreement, substitutes for the good in question must not exist, and demand for a particular product must be relatively inelastic.
- **Infant Industry Argument.** At times when a country gets a "late start" in a particular industry where it has a potential to become a world class competitor, short-term protection is justified. The infant industry argument implies that economies of scale and the comparative advantage of an industry can only be exploited by providing temporary protection. During this period, the firm or industry will strive to become globally competitive.
- **Questionable Labor Practices and Environmental Considerations.** Developed countries often resort to managed trade for reasons of unethical labor practices and violation of basic human rights. Developed countries may restrict imports from developing countries that implement such policies.
- **Health and Safety.** Every country has the right to protect the health and physical safety of its citizens from contaminated imports.

ETHICAL PERSPECTIVES: Stabilizing Sierra Leone's Devastated Economy.*Use the Ethical Perspectives case as an opportunity to discuss the socioeconomic impact of banning the trade of "blood diamonds" on the economies of West African countries.*

Questions:

1. *Who are the various stakeholders who have benefited from the socioeconomic move away from the sale of "blood diamonds" to legal commercial diamond operations in Sierra Leone? Answer:Profit-sharing arrangements implemented in the diamond mines will benefit the local population, as soon as the mines become profitable. Small-time miners*

will have to pay 3 % tax on their diamond sales, while .75% of the tax will be returned to the local government to develop social infrastructure. These measures are intended to benefit the local community and bring peace and stability to the region.

2. *Evaluate the impact of Koidu Holding's corporate social responsibility practices in Sierra Leone.Answer:Koidu Holding's practices are socially responsible. They bring economic prosperity and political stability to the region.*

- **Geopolitical Rationale.** The geopolitical objective is to sacrifice some economic efficiency for the greater good of the country in terms of national security, protection of critical industries, and international commerce.
    - **National Security.** For national security reasons, U.S. exports of certain types of high-technology defense equipment are generally restricted to allies and friendly countries. Because the need to receive government approval prevents the affected firms from openly competing and increasing sales, these firms receive special treatment and protection.
    - **Strategic Industries.**Some countries provide protection to strategic industries that have a significant employment impact on certain sectors of an economy.
    - **Embargoes.** When trade sanctions are imposed upon a country for political reasons, an embargo is in force, and trade will be restricted with that country. Embargoes, which may not be universally enforced, are meant to punish a country for perceived unacceptable international behavior.

DISCUSSION STARTER: REALITY CHECK 4.

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

Assignments

End-of-Chapter Discussion Questions

1. How would you make a convincing case that open trade in goods and services as well as free flow of foreign direct investment will enhance the well-being of (a) consumers, (b) producers, and (c) the government of countries? Give specific examples to prove your position. Answer: Free trade and investment results in more competition in the market and leads to greater choice in the availability of goods and services, lower prices, higher living standards for consumers, higher tax revenues for governments, and technological and skill transfer to producers.

2. What trade theories support the recent rise of China and India on the global stage? Explain your views in detail. Answer: The theory of comparative advantage and H-O theory suggest that China and India possess an abundant supply of skilled human resources. They have a comparative advantage in labor-intensive industries. The difference between China and India lies in the English language, historically predominant in India. Knowledge of English allowed Indian workers to specialize in providing services to English-speaking countries, while the Chinese had to focus on manufacturing.

3. Some believe there is adisconnect between trade theory and trade policy. What rationale could the United States use to support its trade policies? Give specific examples.Answer: Employment and environmental law and employee health and safety legislation are very stringent in the U.S. To compete with the countries that have lower standards in these areas, the U.S. has to manage international trade in a way that levels the playing field and allows American companies that follow the ethical and legal standards of the ILO to compete with their counterparts from the developing countries, where such regulations are not enforced or are missing.

4. When would a country such as France use socioeconomic rather than geopolitical reasons to support its trade policy? Can you provide some examples? Answer: Socioeconomics focuses on the impact free trade has on society's welfare, while a geopolitical rationale argues in favor of sacrificing economic efficiency for the purpose of achieving a country's political goals. Therefore, a developed country such as France will be more likely to use socioeconomic reasons to support its trade policy when the issue concerns the well-being of French consumers and workers.

Mini-Case Synopsis and Questions

The ideology of economic nationalism seeks to implement trade policies that help to keep jobs and investment at home. Such protectionism may violate international trade rules, and retaliation from other countries may follow.

Questions:

1. *Is economic nationalism justified?* No. Although in the short run economic nationalism can help keep jobs at home, in the long run it leads to loss of international competitiveness, curtails international business activity, and makes the country inefficient.

2. *Is the Smoot-Hawley plan better or worse than "Buy American"? "Buy Spanish"? Or "British jobs for British workers"? Explain fully.* The recent attempts at protectionism differ fromthe Smoot-Hawley act in form, but not is substance. The Smoot-Hawley bill raised import tariffs, while this time the focus is on inserting nontariff barriers. The "Buy American" provision in the American Recovery and Reinvestment Act of 2009 was matched by similar policies in other countries, which has resulted in a downward trend in international trade, hurting all exporters and economies.

Point/Counterpoint, *Interpreting Global Business News*, and *Portfolio Projects*

Students' answers to these assignments will vary widely. Their writing should reflect an understanding of the chapter's basic concepts, thorough research, and logic and critical thinking skills.