CHAPTER 5: INTERNATIONAL TRADE

LEARNING OBJECTIVES

1. Describe the relation between international trade volume and world output and identify overall trade patterns.
2. Describe mercantilism and explain its impact on world powers and their colonies.
3. Explain the theories of absolute advantage and comparative advantage.
4. Explain the factor proportions and international product life cycle theories.
5. Explain the new trade and national competitive advantage theories.

QUICK STUDY QUESTIONS

Quick Study 1 (p. 145)

1. Q: What portion of world trade occurs in (a) merchandise and (b) services?
   A: Merchandise (manufactured goods and other physical products) accounts for about 80 percent of worldwide trade; services account for the remaining 20 percent.

2. Q: What is the relation between trade and world output?
   A: The volume of international trade outstrips growth in world output. The level of world output of any given year influences the level of international trade in that year. Output and world trade move together. If a country is in recession, people make fewer purchases because of uncertainty about the future and a typically weaker currency relative to other currencies.

3. Q: Describe the broad pattern of international trade.
   A: Trade among the world’s high-income economies accounts for roughly 60 percent of total world merchandise trade. Two-way trade between high-income countries and low- and middle-income nations accounts for about 34 percent of world merchandise trade. Intraregional trade accounts for nearly 70 percent of Europe’s exports, 56 percent of Asia’s exports, and 38 percent of North America’s exports. Some economists call this century the “Pacific century,” referring to the expected future growth of Asian economies and the expected shift in trade flows from the Atlantic to the Pacific Ocean.

4. Q: Why is a nation’s level of trade dependence or independence important?
A: Developing and transition nations that share borders with developed countries are often dependent upon their wealthier neighbors. A nation’s level of trade dependence is important because recession or political turmoil in the dominant nation can cause problems for the dependent nation. Countries try to reduce their dependence on other nations. The level of interdependency between pairs of countries is often reflected by the amount of trade that occurs between a company’s subsidiaries in the two nations.

Quick Study 2 (p. 147)


A: Mercantilism states that nations should accumulate financial wealth, usually in the form of gold, by encouraging exports and discouraging imports. Mercantilism was based on colonial powers conducting trade for their own benefit, with colonies being generally treated as exploitable resources. Countries implemented mercantilism by maintaining trade surpluses, active government intervention, and practicing colonization. The three pillars were: (1) trade surpluses, (2) government intervention, and (3) colonialism.

2. Q: What types of policies might a country have in place to be called neo-mercantilist?

A: Today, countries seen as trying to maintain a trade surplus and expanding their national treasuries at the expense of other nations are accused of being neo-mercantilist. Specific policies that can give a nation this label include restrictive import barriers such as quotas and high tariffs, subsidies to domestic companies so they can expand exports, and “dumping” goods in the markets of trading partners, just to name a few.

3. Q: Describe the main flaws of mercantilism. What is meant by the term zero-sum game?

A: One of the main flaws of mercantilism is that it viewed international trade as a zero-sum game—that one nation can benefit only at the expense of others. But if all nations barricaded their markets from imports and push their exports onto others, international trade would be severely restricted. Also, colonial policies kept potential markets poor because they received little money for raw materials but were charged high prices for finished goods. Thus, markets of colonial powers always had limited potential.

Quick Study 3 (p. 151)
1. Q: What is meant by the term absolute advantage? Describe how it works using a numerical example.

A: An absolute advantage is the ability of a nation to produce a good more efficiently than any other nation. The theory emphasizes productivity. Chapter 5 (pp. 147–149) outlines the method that a numerical example should follow with Riceland and Tealand.

2. Q: What is meant by the term comparative advantage? How does it differ from an absolute advantage?

A: A comparative advantage is the inability of a nation to produce a good more efficiently than other nations, but an ability to produce that good more efficiently than it does any other good. This is different from an absolute advantage in that it focuses on production efficiency within nations, not just between nations. [See Chapter 5 (pp. 149–151) for a numerical example of Riceland and Tealand.]

3. Q: Explain why countries can gain from trade even without having an absolute advantage.

A: Trade between two nations can still be beneficial even if one country is less efficient in the production of two goods, so long as it is less inefficient in the production of one of the goods. Even when one country is more efficient at producing both of the goods in question, both nations benefit from trade because of the gains from specialization. The country more efficient at producing both goods still gets more after specialization and trade than it would if it were to produce both goods on its own.

Quick Study 4 (p. 154)

1. Q: What does the factor proportions theory have to say about a nation’s imports and exports?

A: Factor proportions theory says countries produce and export goods that require resources that are abundant and import goods that require resources in short supply.

2. Q: Identify the two categories of national resources in factor proportions theory. What is the Leontief Paradox?

A: The theory states that a nation has two types of resources at its disposal: land on the one hand and labor and capital equipment on the other. The theory
predicts that a country will specialize in products that require labor if the cost of labor is low relative to the cost of land and capital, and vice versa. The Leontief Paradox reflects the gap between the predictions using this theory and the actual trade flows in the world economy.


A: The international product life cycle theory states that a company will begin by exporting its product and later undertake foreign direct investment as the product moves through its life cycle. In the new product stage, high purchasing power and demand of buyers in an industrialized country spurs a company to design and introduce a new product concept and production remains at home. In the maturing product stage, the domestic and markets abroad become aware of the existence of the product and its benefits. Exports rise and some production in markets abroad may begin. In the standardized product stage, competition from other companies selling similar products pressures companies to lower prices in order to maintain sales levels. An aggressive search for low-cost production bases abroad begins and the home market may even begin importing from these other markets.

Limitations include the U.S. bias of the theory, the speed in which firms today create new products, and the fact that today more firms actually are operating internationally since their inceptions.

Quick Study 5 (p. 156)

1. Q: What is the new trade theory? Explain what is meant by the term first-mover advantage.

A: The new trade theory argues that: (1) there are gains to be had from specialization and increasing economies of scale; (2) those companies first to market can create barriers to entry; and (3) government may have a role to play in assisting its home-based companies. A first-mover advantage is the economic and strategic advantage gained by being the first company to enter an industry.

2. Q: Describe the national competitive advantage theory. What is an “advanced” factor?

A: National competitive advantage theory states that a nation’s competitiveness in an industry depends on the capacity of the industry to
innovate and upgrade. An “advanced” factor is indicative of factors such as skill levels of workers and the quality of technology in a nation.

3. Q: What are the four elements and two influential factors of the Porter Diamond?

A: The Porter Diamond consists of four elements that form the basis of competitiveness, plus the roles of government and chance. Factor conditions include a nation’s basic factors (e.g., land, labor, and natural resources) and advanced factors (e.g., skills of the workforce, technological infrastructure). Today, advanced factors are increasingly important to competitiveness. Demand conditions refer to the sophistication of buyers in a market—finicky buyers help a nation to be more competitive. Related and supporting industries that spring up around a competitive industry form geographic clusters of related economic activity that reinforce productivity and competitiveness. Firm strategy, structure, and rivalry also influence competitiveness. Managers committed to producing quality products and an industry structure that intensifies firm rivalry will help improve competitiveness.

Government and chance play roles in fostering the competitiveness of industries. Government policies toward industry and export and import regulations can hurt or help competitiveness. Chance events also can influence national competitiveness.

TALK IT OVER

1. Q: If the nations of the world were to suddenly cut off all trade with one another, what products might you no longer be able to obtain in your country? Choose one other country, and identify the products it would need to do without.

A: Students should be encouraged to think not just of consumer goods, but industrial products and services that would be unavailable to them and people in other nations. To expand this question, ask students to discuss how the absence of these products would influence their own standards of living, the activities of domestic companies, and, perhaps, the functioning of their own and other governments.

2. Q: Many economists believe that China will soon achieve “superpower” status because of its economic reforms, along with the work ethic and high education of its population. How is the rise of China affecting trade among Asia, Europe, and North America?
A: Reasons for the twenty-first century often being dubbed the “Pacific Century” lie in the economic performance of Asian economies in recent decades. Rapid growth in national output among Asian nations is causing these nations to account for a growing portion of world output and trade. Meanwhile, as personal incomes rise across Asia, products flowing from Canada, the United States, and low-cost production bases in Mexico cross the Pacific Ocean in the opposite direction. Thus, the amount of goods crossing the Pacific is expected to be far greater than the amount of goods crossing the Atlantic Ocean in the twenty-first century.

3. Q: Despite its abundance of natural resources, Brazil was once considered an economic “basket case.” Yet in recent years Brazil’s economy has performed very well. What forces do you think are propelling Brazil’s economic progress?

A: Significant to Brazil’s recent rise is its elimination of hyperinflation. Thus, many consumers are able to afford consumer products such as televisions and refrigerators for the first time in their lives. Hyperinflation had been a persistent problem, holding back any hope of strengthening the nation’s economy. Since then, Brazil has successfully pulled itself through a prolonged economic recession and enjoys low unemployment and inward flowing investment.

TEAMING UP

1. Q: Debate Project. In this project, two groups of four students will debate the advantages and disadvantages of completely free international trade. After the first student from each side has spoken, the second student will question the opponent’s arguments, looking for holes and inconsistencies. The third student will attempt to answer these arguments. A fourth student will present a summary of each side’s arguments. Finally, the class will vote on which team has offered the more compelling argument.

A: Students should be sure to support their arguments with aspects of the theories discussed in this chapter. They should also be prepared to defend their positions, after the debate, if they are called on to give a synopsis of their position in class. It may also be useful to give students some time to do outside research to prepare for the debate.

2. Q: Market Entry Strategy Project. This exercise corresponds to the MESP online simulation. For the country your team is researching, how important is trade (trade as a share of GDP)? What products and services does it export and import? Is there a concerted effort to promote exports to stimulate the economy? With whom does the nation trade? Is it dependent on any particular
nation for trade, or does another nation depend on it? Is outsourcing affecting its trade patterns? Does the nation trade only with high-income countries or with low- and middle-income countries as well? Integrate your findings into your completed MESP report.

A: This may be a good time to get students working on their Market Entry Strategy Project. This exercise gets students to learn more about a country, and to generate interest in countries other than their own. The project focuses on important aspects of each country and the process can begin to develop teamwork in the course.

ETHICAL CHALLENGES

1. Q: You are a research fellow for a Washington, D.C.-based research institute investigating the ethics of restrictions on the international movement of labor. In the practice of international trade, both physical resources and capital cross international borders rather freely, whereas labor is heavily restricted. In fact, it can be extremely difficult for individuals to obtain a permit that allows them to be gainfully employed within many countries. Thus, although companies are free to set up production in markets where labor is cheap, labor cannot move to markets where wages are higher. Some argue that this locks poor people to their poor geographies and gives them little hope for advancement. Why do you think this situation prevails? Is it ethical that of all the components of production, labor is the one most subject to restrictions on its international mobility? Explain.

A: In responding to this ethical question, students should not forget the legal and political issues involved. Many nations restrict entrance to their nation by people who have criminal backgrounds or whose political views do not match that of the government in power. But putting aside these arguments, labor is clearly restricted in its international mobility and students will likely take a wide range of positions on this issue.

2. Q: You are the production manager for a European-based firm that is considering outsourcing its manufacturing to a producer in China. You are asked by your firm’s CEO to prepare a report that outlines the benefits and drawbacks of this potential change. During your research, you find international trade theories that say protectionist actions restrict imports and harm a nation’s standard of living—an argument for free trade. Yet you know that free trade and global competition are driving firms such as your own to move production to cheaper locations abroad, thereby eliminating jobs in their home countries. Clearly, the gains and losses of free trade are not always distributed evenly across the population. As part of your report to the CEO,
argue either for or against the need for measures that protect domestic production and, therefore, jobs at home.

A: Free trade without domestic protection is still the best way. However, job loss is painful and must be handled in an ethical way. When NAFTA was enacted, Americans feared seeing their jobs flee to Mexico. In fact, these fears were justified because of the low wages in Mexico. The U.S. government provided some retraining programs to help individuals reenter the workforce. Now China is the investment darling. For the past two decades, China has seen rising investment from companies around the world, producing everything from refrigerators, calculators, laptop computers, and mobile phones for export. But regions inside China are now experiencing rising wages as investment pours in to take advantage of low-cost labor. But as China’s wages rise, production is moving further inland and to lower-cost Asian nations, even.

3. Q: You are a member of a World Trade Organization task force that is reviewing the recent banana conflict between the United States and the European Union. The European Union and the United States recently ended a nine-year battle over trade in bananas. The European Union was giving preferential treatment to banana exporters from Africa, the Caribbean, and the Pacific island nations. But the United States challenged what it saw as unfair trading practices, and the World Trade Organization agreed. Large global fruit companies such as Dole, Chiquita, and Del Monte—which alone account for nearly two-thirds of the fruit traded worldwide—supported the U.S. action. The European Union argued it was trying to support struggling economies, for which bananas make up a large portion of their income. Discuss the ethics of managing trade in the interests of countries vulnerable in the global economy. Would you have argued on behalf of the United States or the European Union? Why? What are the pros and cons of each side’s arguments?

A: Here is some background on the matter. The United States (backed by Mexico, Guatemala, Ecuador, and Honduras) complained about the EU policy to the WTO, which awarded victory to the plaintiffs in 1997. The EU made amendments to its banana policy, which the EU said brings the policy in line with WTO specifications. However, the United States and its backers said that the amended policy was no better than the old one. The U.S. government notified U.S. importers that they are liable for hefty tariffs on $520 million worth of European luxury goods in retaliation for European barriers on banana imports. Washington said $520 million is the sum that U.S. companies such as Chiquita and Dole lost because of the EU banana quota system. The tariffs affected a range of EU goods, from Belgian biscuits and Scottish cashmere sweaters to Italian cheese and Spanish leather goods.
The British Trade Minister Brian Wilson called the U.S. action “potentially catastrophic” for the British cashmere industry concentrated in Scotland. The French Foreign Ministry also called on the United States to halt what Paris considered an illegal action by Washington. “We strongly deplore that the U.S. has once again acted unilaterally,” the ministry said in a statement. “We are asking them to show good faith and to reconsider this unacceptable decision.”

The World Trade Organization ruled in April 1999 that the European Union’s banana import program violated international trade law and would have to change. Caribbean leaders reacted to the ruling with anger and concern, saying it posed a dire threat to tiny island nations that rely on bananas for their foreign exchange. The Caribbean accounts for 10 percent of the world’s banana trade. Much of the remaining 90 percent is dominated by Latin America’s so-called “dollar banana” producers. Finally, other issues that could be discussed are job creation, setting an international trade precedent, political strategy, and the environment.

PRACTICING INTERNATIONAL MANAGEMENT CASE

First in Asia and the World

1. Q: As the first to set up an international air express business in 1969, DHL had the first-mover advantage over other companies. Is being a first mover as advantageous for a service company such as DHL, as it is for a manufacturing company such as Boeing? Explain.

   A: In theory, the principle of first-mover advantage is the same for a service firm and a manufacturer. The first-mover advantage is based on economies of scale and strategic benefits of being first. There are economies of scale in services as there are economies of scale in production and the strategic benefits of being first apply to services as well. Expedia is a prime example of this in Internet travel services.

2. Q: When it comes to global expansion and setting up affiliates abroad, how is a service company’s focus different from that of a manufacturing company? What elements are necessary for a service company to achieve global success? What are the obstacles to global expansion?

   A: Key to a service company’s success in markets abroad is the people that represent the company. Because services are provided and consumed simultaneously, a buyer’s impression of the provider is largely based on the experience it has during its interaction with the company. In contrast, a buyer can have an unpleasant purchase experience of a physical product but be so pleased with the product’s performance that repeat purchase is assured. Thus, the most important element or obstacle to a service firm operating
internationally is the training of employees to supply the highest quality service experience as possible to buyers.

3. **Q:** DHL prides itself on having its own staff of more than 300,000 people spread across the globe, instead of relying on local agents. Discuss the merits and drawbacks of this international staffing approach.

   **A:** The potential problems of using this approach rest in effective training and management of employees in markets abroad. This approach can also increase the cost of providing a service, although it is believed that special employee training and oversight allows the company to provide higher quality service.

4. **Q:** Why do you think DHL faltered in the United States? What do you think are the dangers, if any, of being a first mover?

   **A:** DHL largely overreached in its expansion throughout the United States. It underestimated its competition and faced a global recession after launching its expansion strategy. Perhaps the biggest danger of being a first mover is complacency. Companies can easily develop hubris at their rapid growth and dominance of the industry. New, more agile companies may come along and knock them off their pedestal by being more attuned to customers’ needs. Start-ups might also employ a new business model (approach to doing business in the industry) and take market share away from the leader.
CHAPTER 6: BUSINESS-GOVERNMENT TRADE RELATIONS

LEARNING OBJECTIVES

1. Describe the political, economic, and cultural motives behind governmental intervention in trade.
2. List and explain the methods governments use to promote international trade.
3. List and explain the methods governments use to restrict international trade.
4. Discuss the importance of the World Trade Organization in promoting free trade.

QUICK STUDY QUESTIONS

1. Q: What are some political reasons why governments intervene in trade? Explain the role of national security concerns.

   A: (1) Practically every government restricts imports that threaten jobs in the domestic economy. (2) Governments restrict certain imports for national security reasons because the nation must have access to a domestic supply of certain items in the event of war. Agriculture is often protected for national security because a nation importing food could face starvation in war. (3) A government often threatens to restrict imports coming from a nation that restricts its own imports. (4) The largest nations may get involved in trade to gain influence over smaller nations. For example, Japan has influence among many Asian nations because they rely on Japan for a large amount of their imports and exports. (5) Nations restrict exports containing high technology and those with “dual uses.” They also restrict imports to protect domestic sources in case of war.

2. Q: Identify the main economic motives for government trade intervention. What are the drawbacks of each method of intervention?

   A: One economic motive for a nation to intervene in trade is protection of young (infant) industries from competition. According to the infant industry argument, a country’s emerging industries need protection from international competition during their development phase until they become sufficiently internationally competitive. However, drawbacks of this policy include: (1) Governments may not identify industries worth protecting and those not to protect. (2) Protection from international competition can cause domestic companies to become complacent. (3) It can be political suicide to remove protection once it has been given. (4) Consumers can wind up paying more if domestic companies are protected and do not become highly competitive. (5)
A main argument of this policy is that small businesses often cannot obtain financing is less true today than in the past. Another economic motive for intervention is pursuit of a strategic trade policy. The new trade theorists believe government intervention can help companies take advantage of economies of scale and be first movers in their industries. First-mover advantages result because economies of scale limit the number of companies that an industry can sustain. Supporters of strategic trade policy argue that strategic trade policies result in increased national income. However, drawbacks of this strategy are: (1) because it fosters inefficiencies and high costs, following a strategic trade policy can be very damaging to a nation’s economy in hard times; (2) those industries with the best political connections might benefit most from such a policy; and (3) strategic trade policies can spark destructive competition and even trade wars among nations.

3. Q: What cultural motives do nations have for intervening in free trade?

A: The main cultural motive for government intervention in trade is protection of national identity. For example, France has laws that guarantee French artists a minimum amount of airtime on French radio programs and Canada is considering doing something similar. Governments also block imports of products they think might be harmful to the nation’s culture. They also restrict the importation of certain services such as media and entertainment in order to protect budding artists and others in these industries.

Quick Study 2 (p. 172)

1. Q: How do governments use subsidies to promote trade? Identify the drawbacks of subsidies.

A: Governments employ the use of subsidies to assist domestic companies in fending off international competitors. One drawback of subsidies is that they can cause companies to become complacent about increasing efficiency and cutting costs. This can cause companies to overuse resources—an especially difficult problem in developing and emerging countries. Because subsidies are generally funded through tax revenues earned from sales and income taxes, critics charge that they amount to corporate welfare on behalf of consumers.

2. Q: How does export financing promote trade? Explain its importance to small and medium-size firms.

A: Export financing can help a nation increase exports. A government can offer its companies financing to expand their export activities—financing that they would otherwise be unable to obtain. Governments can also offer to
guarantee the loans of its domestic companies that will use the money to expand their exports. Such loans and loan guarantees are often crucial to the export success of small and midsize companies because they often have a far greater need for cash than large, established exporters.

3. **Q: Define the term foreign trade zone. How can it be used to promote trade?**

   **A:** A foreign trade zone (FTZ) is a designated geographic region in which merchandise is allowed to pass through with lower customs duties (taxes) or fewer customs procedures. FTZs promote the most trade when they are established as low-cost assembly points for companies manufacturing products that will then be shipped out to other international markets. An example of an FTZ is the location of Japanese car plants in U.S. states that are administered by the U.S. Department of Commerce.

4. **Q: How can special government agencies help promote trade?**

   **A:** Special government agencies are often created for the purpose of promoting a nation’s exports. They organize trade missions to promising markets for the country’s products to generate contracts for new export business. They may have trade offices in other countries that are designed to promote the home country’s exports and introduce businesses to potential local partners. Such agencies can also identify products abroad that fulfill a current need in the home country.

**Quick Study 3 (p. 175)**

1. **Q: How do tariffs and quotas differ from each other? Identify the different forms each can take.**

   **A:** A **tariff** is a government tax levied on a product as it enters or leaves a country. A **quota** is a restriction on the amount (measured in units or weight) of a good that can enter or leave a country during a certain period of time. An **export tariff** is levied by the government of an exporting country. A **transit tariff** is levied by the government of a country that a product passes through. An **import tariff** is levied by an importing government.

   The import tariff can be further subcategorized. (1) An **ad valorem tariff** is levied as a percentage of the stated price of an imported product. (2) A **specific tariff** is levied as a specific fee for each unit (by number or weight) of an imported product. (3) A **compound tariff** is calculated partly as a percentage of the stated price of an imported product, and partly as a specific fee for each unit.
Quotas come in two forms: import quotas and export quotas. There is also a combined tariff-quota.

2. **Q:** Describe how a voluntary export restraint works and how it differs from a quota.

   **A:** A voluntary export restraint (VER) is a unique version of export quota that a nation imposes on its exports usually at the request of an importing nation. It differs from a typical quota because a country normally self-imposes a VER in response to a threat of an import quota or total ban on a product by an importing nation.

3. **Q:** What is an embargo? Explain why it is seldom used today.

   **A:** An embargo is a complete ban on trade (imports and exports) in one or more products with a particular country. It may be placed on one or a few goods or completely ban trade on all goods. Embargoes can be decreed by individual nations or by supranational organizations such as the United Nations. Embargoes are used less frequently today because they are difficult to enforce—some nations will always continue to trade with an embargoed nation.

4. **Q:** Explain how local content requirements, administrative delays, and currency controls restrict trade.

   **A:** A local content requirement is a law that stipulates a specified amount of a good or service be supplied by producers in the domestic market. It’s designed to force foreign companies to employ local resources in production processes—particularly labor.

   Administrative delays are regulatory controls or bureaucratic rules designed to impair the flow of imports into a country. It can include a range of government actions such as requiring: international air carriers to land at inconvenient airports, product inspections that damage the product, understaffing customs offices to cause delays, and special licenses that take a long time to obtain. The central aim is protectionism.

   Currency controls are restrictions on the convertibility of a currency into other currencies. A country can restrict who is allowed to convert the home country currency into others or stipulate an exchange rate that is unfavorable to potential importers. It can be an effective tool for governments because conversion into one of several internationally acceptable currencies is often required for most trade deals.
Quick Study 4 (p. 179)

1. Q: What was the General Agreement on Tariffs and Trade (GATT)? List its main accomplishments.

   A: The GATT was designed to promote free trade by reducing both tariff and nontariff barriers to trade. The GATT was formed in 1947 and early success began to wane in the 1980s. Between 1947 and 1988, it helped to reduce average tariffs from 40 percent to 5 percent and multiply the volume of international trade by 20 times. But by the middle to late 1980s, rising nationalism worldwide and trade conflicts led to a nearly 50 percent increase in nontariff barriers to trade. Also, services (not covered by the original GATT) had become increasingly important—accounting for between 25 and 30 percent of total world trade. It was clear that a revision of the treaty was necessary, and in 1994 a new round of trade talks were concluded.

2. Q: What is the World Trade Organization (WTO)? Describe how the WTO settles trade disputes.

   A: The WTO is the international organization regulating trade among nations. WTO agreements are essentially contracts between member nations that commit them to maintaining fair and open trade policies. The Dispute Settlement Body goes to work as soon as a member nation files a complaint. The rulings of the Body cannot be ignored or blocked by members. Offenders must realign their trade policies according to WTO guidelines or suffer financial penalties and perhaps trade sanctions.

   Dumping occurs when a company exports its product at a lower price than it normally charges in its domestic market. The WTO cannot punish the country in which the company accused of dumping is based. The WTO can only rule on the retaliatory actions of other nations. The WTO allows a country to retaliate if it can show that dumping is actually occurring, calculate the damage to its own companies, and show that the damage is significant. Finally, because countries, not companies, give subsidies, the WTO regulates and rules on the actions of both parties in a dispute over subsidies.

3. Q: Explain the difference between an antidumping duty and a countervailing duty.

   A: An antidumping duty is an additional tariff placed on an imported product that a nation believes is being dumped on its market. A countervailing duty is an additional tariff placed on an imported product that a nation believes is receiving an unfair subsidy.
4. Q: **What efforts have been made to protect the environment from trade and rapid industrialization?**

A: Steady gains in global trade and rapid industrialization in many developing and emerging economies has generated environmental concerns among both governments and special-interest groups. The WTO has no separate agreement dealing with environmental issues. It explicitly states that the WTO is not to become a global environment agency responsible for setting environmental standards. However, its preamble mentions as objectives environmental protection and sustainable development. It also has an internal committee called the Committee on Trade and Environment.

**TALK IT OVER**

1. Q: **Imagine that the people in your country believe international trade is harmful to their wages and jobs and your task is to change their minds. What kinds of programs would you implement to educate your people about the benefits of trade? Describe how each would help change people’s attitudes.**

   A: A nation that takes a very long-term approach to this educational task would begin explaining the very basic need for trade in certain goods already in primary and secondary schools. In fact, Japan is one nation that teaches its students the need for trade with other nations—Japan is a small country with very few of the natural resources it needs to make many of its products. Another potential program is public service messages on television and outdoor signs or in newspapers and magazines.

2. Q: **Most countries create a list of “hostile” countries that require special permission before an exporter will be allowed to proceed. Which countries and products would you place on such a list for your nation, and why?**

   A: This question forces students to consider the inseparable link between trade and international relations among countries. Students should explain the historical reasons for the state of the relations and identify current events that are inflaming or subduing tensions. For each product they identify as one about which they are concerned, students should explain the reasons for their concern in the context of the cultural, political, and economic motives described in this chapter.

3. Q: **Two students are discussing efforts within the global trading system to reduce trade’s negative effects on the environment. One student says, “Sure, there may be pollution effects, but they’re a small price to pay for a higher standard of living.” The other student agrees saying, “Yeah, those ‘tree-**
huggers’ are always exaggerating those effects anyway. Who cares if some little toad in the Amazon goes extinct? I sure don’t.” What counterarguments can you offer to these students?

A: Students should support any counterargument with facts and data. They should realize that protection of the environment does come with a financial burden in terms of monitoring abidance by regulations, and added costs to companies that must install special pollution-control equipment. They must provide reasons for why environmental protection is worth these added costs, which will ultimately be passed on to consumers.

TEAMING UP

1. Q: Research Project. As a group, select a company in your city or town that is involved in importing or exporting, and interview the owner or a top manager. Your goal is to understand how government involvement in international trade has helped or harmed the company’s business activities. Prepare for your appointment by researching the topic of government trade intervention in a business periodical, in print or online, and follow up the interview with additional research. Ask for specific past examples and specific potential impacts of government intervention on the business.

A: Students should be encouraged to find out as many specific examples as possible from their interview. They can also arrange to visit two or more companies to see how intervention can affect companies in different industries differently.

2. Q: Market Entry Strategy Project. This exercise corresponds to the MESP online simulation. For the country your team is researching, to what extent does its government intervene in trade? What are its political, economic, or cultural motives for intervention? What methods, if any, does the government use to: (a) promote exports and (b) restrict imports? Does the nation maintain a free trade zone within its borders? Has the country filed a complaint with the WTO against another member nation? Has it been reported by another nation for unfair trade practices? Integrate your findings into your completed MESP report.

A: This may be a good time to get students working on their Market Entry Strategy Project. This exercise gets students to learn more about a country, and to generate interest in countries other than their own. The project focuses on important aspects of each country and the process can begin to develop teamwork in the course.
ETHICAL CHALLENGES

1. **Q:** You are the president of a sugar company based in southern Florida. Your firm is struggling lately to meet demand because of poor harvests in the Caribbean Islands where your firm sources much of its raw product. Because of the Helms-Burton Act and the U.S. embargo on Cuba, your firm is not allowed to trade with Cuba. If the embargo were dropped, your firm would have an excellent source of cheap sugar, and profits would improve significantly. A U.S. senator from your state of Florida serves on an influential committee in Washington, D.C., that is reviewing the status of the embargo on Cuba. What arguments would you provide your senator that could help eliminate this trade barrier?

   **A:** Indeed there are many arguments on both sides of this issue. As a representative of a sugar firm, you could argue that dropping the embargo would help bring down the price of sugar, and therefore many consumer goods could be manufactured at a lower cost. This, in turn, could help create more jobs due to rising profits in the food and beverage industry. You could also argue that dropping the embargo would also allow more U.S. firms to sell to the Cuban market which should also help increase revenues and potentially create jobs. Tourism in Cuba has expanded significantly in the past decade with an onslaught of Europeans and Canadians and this could be a fruitful market for U.S. goods. The problem that remains is the human rights record in Cuba with a number of major violations in recent years.

2. **Q:** You are a consultant advising the World Trade Organization (WTO) on the U.S. Supreme Court decision regarding the State of Massachusetts and the country of Myanmar. A nonprofit trade and industry group, the National Foreign Trade Council (NFTC), based in Washington, D.C., won a court battle recently against the State of Massachusetts. In a unanimous decision, the U.S. Supreme Court sided with the NFTC and struck down a Massachusetts law that was designed to deny state contracts to any company doing business in Myanmar. The Court ruled that the Massachusetts law intruded on the federal government’s authority and was preempted by federal law regarding Myanmar. In fact, the U.S. Constitution states that, “foreign policy is exclusively reserved for the federal government.” The NFTC says it shares concern over human rights abuses occurring in Myanmar, but believes that a coordinated, multinational effort would be most effective at instilling change in the nation.

   Do you think companies should be penalized in their domestic business dealings because of where they do business abroad? Should the World Trade Organization get involved in these types of political matters? Why or why not? How might domestic firms be affected if each state were allowed to punish firms based on its individual foreign policy ideals?
A: Students will likely have strong opinions on this question because of the human rights issue. Probably the biggest problem with such a policy is the cost of monitoring the activities of companies around the world and making sure that deals are not just restructured so as to hide their involvement. Even then, companies could create holding companies in offshore locations that have strict secrecy laws so that home governments would be unable to find out whether they are dealing with countries having questionable human rights records. Finally, if the WTO were to involve itself in such political issues of nations, charges of political favoritism for powerful industrialized countries would likely increase.

PRACTICING INTERNATIONAL MANAGEMENT CASE

Down with Dumping

1. Q: “You can’t tell consumers that the low price they are paying on that fax machine or automobile is somehow unfair. They’re not concerned with the profits of some company. To them, it’s just a great bargain and they want it to continue.” Do you agree with this statement? Do you think that people from different cultures would respond differently to this statement? Explain your answers.

A: Many people would agree with the sentiment expressed in this statement. The attitude would likely change dramatically, however, if the person were to suddenly find his or her own job threatened by a cheap import being dumped on the domestic market. People from individual-oriented cultures would probably be more likely to agree with the statement than would people from very group-oriented cultures. For example, many Japanese would probably disagree with the statement because they would see the dumping as a threat to many people in their nation with whom they are inextricably linked and with whom they feel obligated to assist if possible.

2. Q: As we have seen, currently the WTO cannot get involved in punishing individual companies—its actions can only be directed toward governments of countries. Do you think this is a wise policy? Why or why not? Why do you think the WTO was not given authority to charge individual companies with dumping? Explain.

A: The task of investigating the actions of individual companies would no doubt overwhelm the resources of an organization the size of the WTO even. Investigating each company against which a complaint was brought would be very time consuming and expensive. Besides, the members of the WTO are not individual companies but the governments of nations in which companies are based. Also, if the WTO had authority to charge individual companies with
offenses, charges of political favoritism would probably increase over that which already occurs at the governmental level.

3. **Q:** Identify a recent antidumping case that was brought before the WTO. Locate as many articles in the press as you can that discuss the case. Identify the nations, product(s), and potential punitive measures involved. If you were part of the WTO dispute settlement body, would you vote in favor of the measures taken by the retaliating nation? Why or why not?

**A:** Students should probably be advised to stay with large countries and prominent cases so that enough information is available to complete the assignment. Students might also be asked to work in small groups so that they can do more in-depth analysis in an expedient manner. Presenting their findings in front of the class would also benefit students in the audience by exposing them to a wide array of cases and the reasoning of students rendering decisions on the cases.
CHAPTER 7: FOREIGN DIRECT INVESTMENT

LEARNING OBJECTIVES

1. Describe worldwide patterns of foreign direct investment and reasons for these patterns.
2. Describe each of the theories that attempt to explain why foreign direct investment occurs.
3. Discuss the important management issues in the foreign direct investment decision.
4. Explain why governments intervene in the free flow of foreign direct investment.
5. Discuss the policy instruments that governments use to promote and restrict foreign direct investment.

QUICK STUDY QUESTIONS

Quick Study 1 (p. 191)

1. Q: What is the difference between foreign direct investment and portfolio investment?

   A: Foreign direct investment is the purchase of physical assets or a significant amount of the ownership (stock) of a company in another country to gain a measure of management control. It differs from portfolio investment—an investment that does not involve obtaining a degree of control in a company.

2. Q: What factors influence global flows of foreign direct investment?

   A: Three main reasons for the large increases in FDI flows over the past couple of decades are: (1) globalization, (2) mergers and acquisitions, and (3) increasing FDI on the part of entrepreneurs and small businesses.

3. Q: Identify the main destinations of foreign direct investment. Is the pattern shifting?

   A: Highly industrialized countries are the destination for most FDI inflows, with the EU, United States, and Japan attracting the vast majority of world FDI inflows. But highly developed nations are attracting a declining share of global FDI. Developed countries account for about 57 percent of global FDI inflows and developing countries account for about 37 percent of global FDI inflows. For developing nations, China attracts the most FDI in Asia and India
attracts the most on the subcontinent. Newly industrialized and emerging markets (particularly in Asia) are also a growing source of FDI.

Quick Study 2 (p. 193)

1. Q: Explain the international product life cycle theory of FDI.

   A: The international product life cycle theory says that a company will invest in production facilities in other countries as a product moves through its life cycle. In the new product stage, the production of a good remains in the home country because of uncertain domestic demand and to keep production close to the research department that developed the product. In the maturing product stage, the company directly invests in production facilities in those countries where demand is great enough to warrant its own production facilities. In the final standardized product stage, increased competition creates pressures to reduce production costs. In response, the company builds production capacity in low-cost developing nations to serve its markets around the world.

2. Q: How does the theory of market imperfections (internalization) explain FDI?

   A: Market imperfections theory states that when an imperfection in the market makes a transaction less efficient than it could be, a company will undertake FDI to internalize the transaction and thereby remove the imperfection. Two important market imperfections are trade barriers and specialized knowledge, such as technical expertise of engineers or the special marketing abilities of managers. Companies can eliminate the inefficiency of trade barriers (they increase the cost of getting a product to market) by developing production facilities within the market. Sometimes the only way a company can exploit the specialized knowledge of its employees is to engage in FDI—the knowledge simply cannot be licensed to another firm. Firms also can undertake FDI when they want to lessen the risk of giving away a competitive advantage to other companies through licensing agreements.

3. Q: Explain the eclectic theory, and identify the three advantages necessary for FDI to occur.

   A: The eclectic theory states that firms undertake foreign direct investment when the features of a particular location combine with ownership and internalization advantages to make a location appealing for investment. A location advantage is the advantage of locating a particular economic activity in a specific location because of the characteristics (natural or acquired) of that location. These advantages have historically been natural resources but can also be acquired advantages such as a productive workforce. An ownership
advantage is the advantage that a company has due to its ownership of some special asset, such as a powerful brand, technical knowledge, or management ability. An internalization advantage is the advantage that arises from internalizing a business activity rather than leaving it to a relatively inefficient market. The theory states that when all these advantages are present, a company will undertake FDI.

4. Q: How does the theory of market power explain the occurrence of FDI?

A: The market power theory states that a firm tries to establish a dominant market presence in an industry by undertaking foreign direct investment. The benefit of market power is greater profit because the firm is far better able to dictate the cost of its inputs or the price of its output.

Quick Study 3 (p. 197)

1. Q: Why is control important to companies considering the FDI decision?

A: When many companies invest abroad, they are greatly concerned with controlling their companies’ activities in the local market for a variety of reasons. They may want to be certain that its product is being marketed the same in the local market as it is at home. They may also want to ensure that the selling price remains the same in both markets. Some companies try to maintain ownership of a large portion of the local operations, say even up to 100 percent, in the belief that greater ownership gives them greater control. But even complete ownership does not guarantee control. For example, the local government might intervene and require a company to hire some local managers rather than bring them all in from the home office. Governments might also require that all goods produced in the local facility be exported so they do not compete with products of the country’s domestic firms.

2. Q: What is the role of production costs in the FDI decision? Define rationalized production.

A: Production cost can be very important in the FDI decision. Labor regulations can increase the hourly cost of production several times. Companies can be required to offer benefits packages that are over and above hourly wages. The time required to train workers and increase productivity can be expensive. The soaring cost of R&D is leading multinationals to engage in cross-border alliances and acquisitions.

Rationalized production is when each of a good’s components is produced where the cost of producing that component is lowest. A potential problem
with this production model is that a work stoppage in one country can bring the entire production process to a standstill.

Q: Explain the need for customer knowledge, following clients, and following rivals in the FDI decision.

A: Obtaining customer knowledge can be a motivator for FDI. A local presence might help companies gain valuable knowledge about its customers that it cannot obtain by remaining in the home country. Firms also commonly engage in FDI when doing so puts them close to firms for whom they act as suppliers. This reduces lead times in getting products to customers because the distance from which goods must be shipped can be just a few miles rather than halfway around the world. Finally, when a few large firms dominate an industry, FDI decisions frequently resemble a “follow the leader” scenario in which not making a parallel move to that of the “first mover” might result in being shut out of a potentially lucrative market.

Quick Study 4 (p. 201)

1. Q: What is a country’s balance of payments? Briefly explain its usefulness.

A: A country’s balance of payments is a national accounting system that records all payments to entities in other countries and all receipts coming into the nation. The balance of payments helps a country monitor the flows of goods, services, income, and transfer of assets between itself and other nations. The balance of payments position sends warning signals about trade deficits with other nations. The main question surrounding the persistent U.S. trade deficit is whether the deficit is borrowing to finance consumption or borrowing to purchase equipment that will have productivity payoffs.

2. Q: Explain the difference between the current account and the capital account.

A: The current account is a national account that records transactions that involve the import and export of goods and services, income receipts on assets abroad, and income payments on foreign assets inside the country. The capital account is a national account that records transactions that involve the purchase or sale of assets. These assets include financial assets such as stocks and bonds and physical assets such as investments in plants and equipment.

3. Q: For what reasons do host countries intervene in FDI?
A: One reason host governments intervene in FDI is to control their balance of payments. (1) Countries get a balance-of-payments boost from initial FDI flow into their economies. (2) Local content requirements can lower imports, thereby providing a balance-of-payments boost. (3) Exports generated by production resulting from FDI can help the balance-of-payments position.

Another reason for intervening in FDI is to obtain resources and benefits. (1) They may want access to technology. Nations encourage the import of technology because it tends to increase the productivity and competitiveness of nations. (2) They may want to obtain management skills and increase employment levels. By encouraging FDI, nations can allow in talented managers to train local managers in how to operate the local facilities—particularly important for former communist nations that lack skilled managers. (3) Some of these managers will go on to establish their own businesses, thereby expanding the economy and employment opportunities within the nation.

4. Q: For what reasons do home countries intervene in FDI?

A: There are generally fewer concerns regarding the outflow of FDI among home nations because they tend to be prosperous, industrialized nations. FDI outflows do not drastically affect the domestic economy. Nevertheless, there are reasons why home countries discourage outward FDI. (1) Investing in other nations sends resources out of the home country. (2) Outgoing FDI may ultimately damage a nation’s balance of payments by reducing exports that would otherwise be sent to international markets. (3) Jobs resulting from outgoing investments may replace jobs at home.

Home countries also promote outgoing FDI. (1) They may do so because outward FDI can increase long-run competitiveness. (2) Nations may encourage FDI in industries that they have determined to be “sunset” industries.

Quick Study 5 (p. 202)

1. Q: Identify the main methods host countries use to promote and restrict FDI.

A: Host countries promote FDI by giving tax incentives, low-interest loans, and infrastructure improvements. Host nations restrict FDI through ownership restrictions and performance demands.

2. Q: What methods do home countries use to promote and restrict FDI?
A: To promote FDI, home countries can offer insurance, low-interest loans, tax breaks, and apply political pressure. Home countries may try to restrict FDI by using differential tax rates and sanctions.

TALK IT OVER

1. **Q:** You overhear your superior tell another manager in the company, “I’m fed up with our nation’s companies sending manufacturing jobs abroad and off-shoring service work to low-wage nations. Don’t any of them have any national pride?” The other manager responds, “I disagree. It is every company’s duty to make as much profit as possible for its owners. If that means going abroad to reduce costs, so be it.” Do you agree with either of these managers? Why or why not? Now step into the conversation and explain where you stand on the issue.

A: By this point in the course, students should be able to give a detailed response to why they agree or disagree with either of these managers. They should understand the role of culture, politics, and law in international business and have examined how different economic systems function. They also should have a grasp of the theories of international trade and foreign direct investment and why governments intervene in their free flow. Thus, students should include in their response a rational discussion of how culture, politics, law, and economics influence their own opinion. The opinions of most students will likely lie somewhere in-between those of the two managers quoted.

2. **Q:** The global carmaker you work for is investing in an automobile assembly facility in Costa Rica with a local partner. Explain the potential reasons for this investment. Will your company want to exercise a great deal of control over this operation? Why or why not? In what areas might your company want to exercise control and in what areas might it cede control to the partner?

A: Students might be better equipped to answer this question if given time between class periods to do some research on the structure of the car industry and its global nature. But students should be able to suggest answers even if they are not given time to prepare. First, the company might be investing in the Costa Rican market with a partner in order to get a foothold there. Second, the (fictitious) local partner could control a good portion of the local car market with a successful model or two. Third, the local market could represent great potential as a production base for one component in the global carmaker’s global production network—an example of the rationalization concept.
One area in which the global carmaker might want to maintain control is in strategy so that the local operation fits well with the company’s activities in other nations. Another is in local R&D if any is to be done in Costa Rica. The reason for this is so that the global company can incorporate special knowledge from other markets into the new product development efforts in Costa Rica. However, the global partner might want to cede control in the area of human resource management to the local company—it likely better understands the culture and the needs of the local workforce.

3. **Q:** This chapter presented several theories that attempt to explain why firms undertake foreign direct investment. Which of these theories seems most appealing to you? Why is it appealing? Can you think of one or more companies that seem to fit the pattern described by the theory? In your opinion, what faults do the alternative theories have?

A: This question probably is best suited to advanced undergraduates and MBA students. To arrive at more informed answers to this question, students could be asked to research the theories in more depth. They could go to the original work(s) that advanced the theory and trace the major research that has been done to test or update it.

**TEAMING UP**

1. **Q:** Research Project. In a small group, locate an article in the business press that discusses a cross-border merger or acquisition within the past year. Gather additional information on the deal from any sources available. What reasons did each company give for the merger or acquisition? Was it a marriage of equals or did a larger partner absorb a far smaller one? Do the articles identify any internal issues managers had to deal with following the merger or acquisition? What is the current performance of the new company? Write a two- to three-page report of your group’s findings.

A: As with many projects that require outside research of articles in the business press, it is probably best to stick with companies that are fairly large and covered regularly in the media. This way, the students will have far less difficulty locating two or more articles covering the merger or acquisition.

2. **Q:** Market Entry Strategy Project. This exercise corresponds to the MESP online simulation. For the country your team is researching, does it attract large amounts of FDI? Is it a major source of FDI for other nations? What is the nation’s balance-of-payments position? What is its current account balance? List some possible causes for its surplus or deficit. How is this surplus or deficit affecting the nation’s economic performance? What is its
capital account balance? How does the government encourage or restrict trade with other nations? Integrate your findings into your completed MESP report.

A: This may be a good time to get students working on their Market Entry Strategy Project. This exercise gets students to learn more about a country, and to generate interest in countries other than their own. The project focuses on important aspects of each country and the process can begin to develop teamwork in the course.

ETHICAL CHALLENGES

1. Q: You are a sales manager working in international sales for a major U.S. beef distributor. Your firm is attempting to sell a large quantity of beef to a developing market in northern Africa where U.S. beef is a rarity. The vice president for new business development has instructed you to sell the beef well below the market price quickly. Standing at the coffee machine, you overhear two quality assurance managers discussing “the potentially tainted beef heading for Africa.” You are aware that, in the past, your firm has come across small traces of typhoid in some of its products. What do you do? Do you go through with the northern Africa deal? Do you first contact someone inside or outside the company? If additional information would be helpful to you, what would it be?

A: This exercise addresses the issue of applying U.S. standards to international markets. The dilemma here is providing potentially tainted food to an impoverished market, versus applying rigid standards to ensure that no harm is caused. Although people would receive a low-cost food staple, they may become ill. One option is to conduct a thorough investigation to eliminate the possibility of typhoid. Another, if possible, may be to treat the beef to eliminate any contaminants. Discussing the various stakeholders involved and the financial status of the firm is also important. For instance, how would you act if the firm was on the verge of bankruptcy and the sale could save jobs? It may be a good idea to introduce “moral relativism” versus “moral universalism” at this time.

2. Q: You are the U.S. senator deciding whether to vote up or down on a new piece of legislation. The potential new law places restrictions on the practice of outsourcing work to low-wage countries and is designed to protect U.S. workers’ jobs. These days it is increasingly common for companies to promise manufacturing contracts to overseas suppliers in exchange for entry into that country’s market. Labor union representatives argue that these kinds of deals are made at the expense of jobs at home. After all, if a company can have parts made in China at lower wages, why keep factories going at home? They
also are concerned that the transfer of technology will breed strong competitors in other nations and thereby threaten even more domestic jobs in the future. But others argue that increased sales abroad actually help create more jobs at home. Discuss the ethics of companies contracting out production to factories abroad in exchange for sales contracts. How would you vote on the pending legislation? What other issues must you consider?

A: Students approach this issue from a variety of perspectives ranging from a total free-market ideology to a protectionist one. Students must balance the short-term gains of new business and greater profits against the short-term loss of jobs and potential long-term loss of creating future competitors. One key issue here is whether companies are transferring cutting-edge technologies or those that are a generation or more old. Students must also consider social issues of lost jobs due to manufacturing going abroad and the strong competitors arising from transferring technologies abroad.

3. Q: You are the U.S. Ambassador to Malaysia. In order to become a major export platform for the semiconductor industry, Malaysia’s government not only offered tax breaks but also guaranteed that electronics workers would be prohibited from organizing independent labor unions. The government decreed that the goal of national development required a “union-free” environment for the “pioneers” of semiconductors. Under pressure from U.S. labor unions, the Malaysian government offered a weak alternative to industry unions—company-by-company “in-house” unions. Yet as soon as workers organized one at a Harris Electronics plant, the 21 union leaders were fired and the new union disbanded. In another instance, when French-owned Thomson Electronics inherited a Malaysian factory with a union of 3,000, it closed the plant and moved the work to Vietnam. Newly industrialized nations such as Malaysia feel that their futures depend on investment by multinationals. Yet their governments are acutely aware that in the absence of incentives such as a “union-free” workforce, international companies can easily take their investment elsewhere. Discuss the problems that these governments face in balancing the needs of their citizens with the long-term quest for economic development. As the ambassador, what advice do you give Malaysian business and government leaders? Can you think of examples from other nations that can help you make the case for local unions?

A: As ambassador, you must wear many hats. More trade with Malaysian firms would be a positive development for the United States. Because the United States tends to honor the rights of workers to unionize, Malaysian work standards must be acceptable to U.S. firms, especially because they are image conscious when operating abroad. Ethical issues include a fear of lost jobs, MNCs causing small firms to fail, worker exploitation, lost control over the domestic economy, and consumer and environmental protection. Most students will agree that MNCs should not have completely free rein in FDI
activities. Perhaps phase policies in over time with individual governments retaining a say over the types of allowable FDI and their circumstances. An organization similar to the WTO for international trade could be created to monitor the FDI activity of nations.

All nations industrialized by exploiting workers to some degree. European workers lived in squalid conditions, which laid the foundation for communist ideas. U.S. companies exploited new immigrants who could not form unions (slavery represented the nation’s most immoral practice). Thus, poor nations should not be viewed as immoral or unenlightened. Developing nations that allow or promote unions may see international companies invest elsewhere, where labor is abundant and unions nonexistent.

PRACTICING INTERNATIONAL MANAGEMENT CASE

World Class in Dixieland

1. Q: What do you think were the chief factors involved in Mercedes’ decision to undertake FDI in the United States rather than build the M-class in Germany?

   A: First, Mercedes undertook FDI to learn about the U.S. market. They needed to fully understand consumers to produce cars that they would want. Second, Mercedes chose the U.S. south over Germany because U.S. labor costs were lower. Third, Alabama offered attractive tax refunds and other incentives to gain jobs that the plant would create in and around Vance, Alabama. Fourth, the company chose the U.S. market to develop an ultra-modern plant that would be a model for its future international facilities.

2. Q: Why do you think Mercedes decided to build the plant from the ground up in Alabama rather than buying an existing plant in, say, Detroit? List as many reasons as you can and explain your answer.

   A: First, Mercedes probably chose to build from the ground up because existing facilities would not supply the cutting-edge environment it wanted for its latest efforts in car-manufacturing technology, organizational design, and HRM techniques. Second, it probably chose Alabama because of the mix of economic factors, including low wages, a rural setting with a strong work ethic, and financial incentives. Third, it wanted to create a unique work setting and environment that reflected the firm’s values.

3. Q: Do you think Mercedes risks diluting its “Made in Germany” reputation for engineering quality by building its M-class outside Germany? Why or why not?
A: “Made in Germany” transcends individual products and applies to all products made in Germany that therefore incorporate German expertise in engineering. If Mercedes can successfully implement its effort in changing “Made in Germany” to “Made by Mercedes,” they will not dilute the value of its brand. However, in doing so, it will need to publicize the fact that the M-class incorporates German engineering and the German reputation for attention to quality.

4. Q: What do you see as the pros and cons of Mercedes’ approach to managing FDI—abandoning the culture and some of its home country practices?

A: Time will tell whether Mercedes’ decision to adapt certain of its practices to the local market was wise. But it appears Mercedes has so far avoided culture clashes of the type some Japanese carmakers experienced when they applied Japanese management practices in the U.S. market with little adaptation. By considering local culture when developing operations at its Vance plant, Mercedes did not offend the local workforce and developed good labor–management relations from the start.
CHAPTER 8: REGIONAL ECONOMIC INTEGRATION

LEARNING OBJECTIVES

1. Define regional economic integration and identify its five levels.
2. Discuss the benefits and drawbacks of regional economic integration.
4. Discuss regional integration in the Americas and analyze its future prospects.
5. Characterize regional integration in Asia and how it differs from integration elsewhere.
6. Describe integration in the Middle East and Africa and explain the slow progress.

QUICK STUDY QUESTIONS

Quick Study 1 (p. 214)

1. Q: What is the ultimate goal of regional economic integration?

A: Regional economic integration is the process whereby countries in a geographic region cooperate with one another to reduce or eliminate barriers to the international flow of products, people, or capital. The ultimate goal is to raise living standards by expanding cross-border trade and investment.

2. Q: What are the five levels, or degrees, of regional integration? Briefly describe each one.

A: The first (and lowest) level of regional integration is a free trade area—economic integration whereby countries remove all barriers to trade between themselves but each country determines its own barriers against nonmembers. Each country is able to maintain whatever policy it sees fit against nonmember countries. These policies can differ widely from country to country. The second level of regional integration is a customs union—economic integration whereby countries remove all barriers to trade among themselves, but erect a common trade policy against nonmembers. What makes it different from a free trade area is that members treat all nonmembers similarly.

The third level of regional integration is a common market—economic integration whereby countries remove all barriers to trade and the movement of labor and capital between themselves, but erect a common trade policy against nonmembers. Common markets integrate the elements of free trade
areas and customs unions while adding the free movement of important factors of production such as people and cross-border investment.

The fourth level of regional integration is an *economic union*—economic integration whereby countries remove barriers to trade and the movement of labor and capital, erect a common trade policy against nonmembers, and coordinate their economic policies. Economic union requires that member countries harmonize their tax, monetary, and fiscal policies, create a common currency, and concede a certain amount of sovereignty to the supranational organization to which they belong.

The fifth (and highest) level of regional integration is a *political union*—economic and political integration whereby countries coordinate aspects of their economic and political systems. A political union requires member nations to accept a common stance on economic and political policies regarding nonmember nations.

3. **Q:** Identify several potential benefits and several potential drawbacks of regional integration.

**A:** One main benefit of regional integration is *trade creation*—the increase in the level of trade among nations that results from regional economic integration. It gives consumers and industrial buyers in member nations a wider selection of goods and services, and lowers the cost of imported goods and services following the lowering of trade barriers such as tariffs. Another potential benefit is *greater consensus on trade issues* relative to that experienced in the WTO. A third potential benefit is *greater political cooperation* that can reduce the potential for military conflict among member nations.

There also are several potential drawbacks of regional integration. First, formation of regional trading blocs can result in *trade diversion*—the diversion of trade away from nations not belonging to a trading bloc and toward member nations. It can actually result in reduced trade with a more efficient nonmember nation in favor of trade with a less efficient member nation. A second potential drawback is *shifts in employment* or dislocations in labor markets—some jobs are lost while others are gained. This can occur because the formation of trading blocs results in the producer of a particular good or service being decided by relative productivity. A third potential drawback is *loss of national sovereignty*. Because successive levels of integration require that nations surrender more of their national sovereignty, higher levels of integration are more difficult to achieve.
4. Q: What is meant by the terms trade creation and trade diversion? Why are these concepts important?

A: *Trade creation* is the increase in the level of trade among nations that results from regional economic integration. *Trade diversion* is the diversion of trade away from nations not belonging to a trading bloc and toward member nations.

These two concepts are important because trade creation gives consumers and industrial buyers in member nations a wider selection of goods and services, and lowers the cost of imported goods and services following the lowering of trade barriers. This increases efficiency among members of the regional trading bloc. However, trade diversion can result in reduced trade with a more efficient nonmember nation in favor of trade with a less efficient member nation. Thus, the significance of trade diversion is that it works against the rationale for the formation of trading blocs.

Quick Study 2 (p. 221)

1. Q: Why did Europe initially desire to form a regional trading bloc?

A: First, Europe needed to rebuild itself in the mid-1900s after another devastating war and to avoid further conflict. Nations saw cooperation as a way to interweave their economies and make military confrontation very costly to all. Second, Europe needed to increase its industrial strength to stay competitive with an increasingly powerful United States. A regional trading bloc would let a united Europe reduce cross-border inefficiencies (such as tariffs and long waits at border crossings for goods transport) and increase the competitiveness of its companies.

2. Q: Describe the evolution of the European Union. What are its five primary institutions?

A: The members of the European Coal and Steel Community signed the Treaty of Rome in 1957, creating the *European Economic Community (EEC)*, which outlined a future common market. In 1967, the Community’s scope was broadened to include additional industries, notably atomic energy. It changed its name to the *European Community*. Enlargement occurred, and in 1994 the bloc changed its name to the *European Union (EU)*. Two important milestones contributed to the EU: the *Single European Act* and the *Maastricht Treaty*. Today the 27-member European Union has a population of about 500 million people and a GDP of around $15 trillion.
The five main institutions that play important roles in monitoring and enforcing economic and political integration are as follows:

- The **European Parliament** is composed of nearly 736 members who are elected by popular vote within each member nation every 5 years. Parliament acts as a consultative rather than legislative body by debating and amending legislation proposed by the European Commission.

- The **Council of the European Union** is the legislative body of the EU. It consists of the ministerial representatives of member states. No proposed legislation becomes EU law unless the Council votes it into law.

- The **European Commission** is the executive body of the EU. It comprises commissioners appointed by each member country—larger countries get two commissioners, smaller countries get one. It has the right to draft legislation, is responsible for managing and implementing policy, and monitoring members’ implementation of and compliance with EU law.

- The **Court of Justice** is the court of appeals of the EU and is composed of one justice from each member country. One type of case that the Court of Justice hears is one in which a member nation is accused of not meeting its treaty obligations. Like the commissioners, justices are required to act in the interest of the EU as a whole, not in the interest of their own countries.

- The **Court of Auditors** comprises 27 members (one from each member nation) appointed for 6-year terms. The Court is assigned the duty of auditing the EU accounts and implementing its budget. It also aims to improve financial management in the EU and report to member nations’ citizens on the use of public funds.

3. **Q:** What is European monetary union? Explain its importance to business in Europe.

   **A:** European monetary union is Europe’s plan that created its own central bank and issued a single currency. A single currency eliminates exchange-rate risk among the countries that previously had their own currencies, reduces transaction costs, and makes prices more transparent.

4. **Q:** Briefly describe the European Free Trade Association.

   **A:** The European Free Trade Association (EFTA) is a trading bloc consisting of Iceland, Liechtenstein, Norway, and Switzerland. It was formed in 1960 by seven nations (only two of which—Norway and Switzerland—are current members) with a focus on trade in industrial, not consumer, goods. However,
member nations remain committed to free trade principles and raising standards of living. The group has a combined population of about 12.5 million people and a combined GDP of about $707 billion.

Quick Study 3 (p. 224)

1. Q: What was the impetus for the formation of the North American Free Trade Agreement?

A: The three nations belonging to the North American Free Trade Agreement (NAFTA) are Canada, Mexico, and the United States. Trade had been significant, especially between Canada and the United States. The main impetus for integration was the accelerating progress made in Europe in the late 1980s and early 1990s.

2. Q: What effect has NAFTA had on trade among its member nations?

A: Trade among Canada, Mexico, and the United States has grown from $297 billion in 1993 to about $1 trillion. Mexico’s exports to the United States rose to $211 billion. Meanwhile, U.S. exports to Mexico grew to more than $136 billion. Canada’s exports to the United States more than doubled to around $300 billion, while U.S. exports to Canada grew to $176 billion. Canada’s exports to Mexico grew more than threefold to nearly $2.7 billion.

The agreement’s effect on employment and wages is not as easy to determine. The U.S. Trade Representative Office claims that exports to Mexico and Canada support 2.9 million U.S. jobs which pay 13 to 18 percent more than national averages for production workers. But the AFL-CIO says that since its formation, NAFTA has cost the United States more than 1 million jobs and job opportunities.

3. Q: List the main benefits the United States obtains from the Central American Free Trade Agreement.

A: The agreement benefits the United States in several ways. CAFTA-DR aims to reduce tariff and nontariff barriers against U.S. exports to the region. It also ensures that U.S. companies are not disadvantaged by Central American nations’ trade agreements with Mexico, Canada, and other countries. The agreement also requires the Central American nations and the Dominican Republic to reform their legal and business environments to encourage competition and investment, protect intellectual property rights, and promote transparency and the rule of law. CAFTA-DR is also designed to support U.S.
national security interests by advancing regional integration, peace, and stability.

Quick Study 4 (p. 225)

1. Q: What is the Andean Community? Identify why its progress is behind schedule.

A: The Andean Community was formed in 1969 and today includes Bolivia, Colombia, Ecuador, and Peru. It is a market of about 97 million consumers with a combined GDP of about $220 billion. The main hindrance to formation of the common market is that each member is given many exceptions in the common tariff structure for trade with nonmember nations.

2. Q: Identify the members of the Southern Common Market (MERCOSUR). How has it performed?

A: The Southern Common Market (MERCOSUR) includes Argentina, Brazil, Paraguay, Uruguay, and Venezuela (Bolivia, Chile, Colombia, Ecuador, and Peru are associate members). MERCOSUR acts as a customs union and continues to make progress on trade and investment liberalization—emerging as the most powerful trading bloc throughout Latin America. Recent economic difficulties in Argentina have produced problems for MERCOSUR.

3. Q: Characterize economic integration efforts throughout Central America and the Caribbean.

A: Attempts at economic integration in Central American countries and throughout the Caribbean basin have been much more modest than efforts elsewhere in the Americas. The Caribbean Community and Common Market (CARICOM) trading bloc was formed in 1973 and comprises 15 nations with a combined GDP of nearly $30 billion and a market of almost 6 million people. In early 2000, CARICOM members signed an agreement calling for the establishment of the CARICOM Single Market, which seeks free movement of factors of production. The main difficulty CARICOM will continue to face is that most members trade more with nonmembers than they do with one another simply because members do not have the imports each other needs.

The Central American Common Market (CACM) was formed in 1961 to create a common market between Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. Together, the members of CACM comprise a market of 33 million consumers and have a combined GDP of $120 billion. Renewed peace is creating more business confidence and optimism, which is
driving double-digit growth in trade among members, but the group has not yet created a customs union. Officials are positive, saying their ultimate goal is European-style integration, closer political ties, and adoption of a single currency—probably the dollar. In fact, El Salvador adopted the U.S. dollar as its official currency in 2000, and Guatemala already uses the dollar alongside its quetzal.

4. **Q:** What is the objective of the Free Trade Area of the Americas? What are its current prospects for success?

**A:** The *Free Trade Area of the Americas (FTAA)* is intended to create a trading bloc stretching from the northern tip of Alaska to the southern tip of Tierra del Fuego in South America. The FTAA would remove tariffs and nontariff barriers among all member countries over an unspecified number of years once agreement is reached. A number of challenges face further integration in the Americas including debates over farm subsidies, disparate income among countries, and corruption in Latin America.

**Quick Study 5 (p. 228)**

1. **Q:** Identify the three main objectives of the Association of Southeast Asian Nations.

   **A:** Main objectives of ASEAN are to: (1) promote economic, cultural, and social development in the region; (2) safeguard the region’s economic and political stability; and (3) serve as a forum in which differences can be resolved fairly and peacefully.

2. **Q:** How do the goals of the Asia Pacific Economic Cooperation forum differ from those of other regional blocs?

   **A:** The organization for *Asia Pacific Economic Cooperation (APEC)* includes 21 nations. Its aim is *not* to build another trading bloc. Its purpose is to strengthen the multilateral trading system and expand the global economy by simplifying and liberalizing trade and investment procedures among member nations.

3. **Q:** What is the Gulf Cooperation Council? Identify its members.

   **A:** The *Gulf Cooperation Council (GCC)* is a trading bloc of six nations in the Middle East. Its membership includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The main achievements of the GCC are
allowing citizens to travel freely among member nations, and allowing citizens to own land, businesses, and other property in other member nations without local partners.

4. **Q: List the aims of both the Economic Community of West African States and the African Union.**

A: One of the most important goals of ECOWAS is the formation of a customs union and eventual common market and monetary union. Progress on market integration is almost nonexistent: the value of trade occurring among ECOWAS nations is just 11 percent of the value of the trade that members undertake with third parties. But ECOWAS has made progress in the free movement of people, construction of international roads, and development of international telecommunication links.

The AU is based on the vision of a united and strong Africa and on the need to build a partnership between governments and all segments of civil society to strengthen cohesion among the peoples of Africa. Its ambitious goals are to promote peace, security, and stability across Africa, and to accelerate economic and political integration while addressing problems compounded by globalization. Specifically, the stated aims of the AU are to: (1) rid the continent of the remaining vestiges of colonization and apartheid; (2) promote unity and solidarity among African States; (3) coordinate and intensify cooperation for development; (4) safeguard the sovereignty and territorial integrity of members; and (5) promote international cooperation within the framework of the United Nations.

TALK IT OVER

1. **Q: Proliferation and growth of regional trading blocs will likely continue into the foreseeable future. At what point do you think the integration process will stop (if ever)? Explain your answer.**

A: In theory, the integration process could continue until all the separate trading blocs merge into one global free trade bloc with a total absence of barriers to trade and investment. In practice, this is highly unlikely because of the relative lack of economic development of certain nations. However, this too could potentially be overcome eventually in a manner similar to that being attempted in the EU whereby the wealthier nations such as France and Germany are funding large economic development in the relatively poorer countries of Central and Eastern Europe. But to believe that all the nations of the world will eventually cast aside nationalism in totality and throw open their doors completely to free trade seems highly utopian.
2. **Q:** Some people believe the rise of regional trading blocs threatens free trade progress made by the World Trade Organization (WTO). Do you agree? Why or why not?

**A:** This is a debate that perhaps will never be fully resolved. Some observers say that regional trade agreements do not override the power of the WTO and that they in fact follow the letter and spirit of the WTO. They credit regional trading blocs with advancing the cause of lowering trade and investment barriers because consensus is easier to obtain in a smaller group of nations than in the WTO. Others argue that trading blocs discriminate against companies from nonmember states in many different ways. For example, they can levy a higher tariff on products coming from nonmember nations as opposed to those from member nations. They could also implement local content requirements and force companies to produce within the bloc to have access to the bloc’s markets. In this sense, it might be argued successfully that such measures act against the objectives of the WTO.

3. **Q:** Certain groups of countries, particularly in Africa, are far less economically developed than other regions, such as Europe and North America. What sort of integration arrangement do you think developed countries could create with less-developed nations to improve living standards? Be as specific as you can.

**A:** First of all, developed nations could extend to less-developed countries the same favorable treatment that they receive as members of their particular trading agreements. This would probably cause nationalist sentiment in developed nations to rise as labor groups, populist politicians, and others complain of cheap imports destroying domestic jobs. However, this is likely an inevitable byproduct of such an arrangement. Another option would be to grant each less-developed country the same preferential treatment that members of a trading bloc receive, but in only a single product category that suits their national competitive advantage. Then, according to Porter’s national competitive advantage theory, the nation would benefit from the cluster of supporting industries that would spring up around this core industry. However, this industry has to be involved in some high value-added activity. It probably would not be very effective if based on some commodity such as minerals or agricultural products, or other product with a low value-added.

**TEAMING UP**

1. **Q:** Debate Project. In this project, two groups of four students each will debate the merits of extending NAFTA to more advanced levels of economic (and political) integration. After the first student from each side has spoken, the second student will question the opponent’s arguments, looking for holes
and inconsistencies. The third student will attempt to answer these arguments. A fourth student will present a summary of each side’s arguments. Finally, the class will vote to determine which team offered the more compelling argument.

A: There would be many economic and political obstacles in expanding NAFTA to more advanced levels of integration and to include other countries. First, there is the problem of unequal levels of development of the three existing members’ economies. It will be quite a long time before Canada and the United States will allow Mexican workers to travel freely to their countries to find work. The disparity in wages between those countries and Mexico would literally cause a flood of workers to flee northward. Second, each subsequent country entering NAFTA would need to be given time and exceptions to ensure the smooth transitions of their economies. This would be a very long-term affair taking many years. Third, the problem that political integration faces is the fear among many countries that this would mean surrendering their national sovereignty to the United States—which through its enormous economic and political muscle could dictate what the bloc’s political position should be. One need only look at the difficulties facing political integration in the EU to see how problematic this can be. Not that it is impossible, but that it would take a very long time if it could ever be accomplished. At any rate, students should be prepared to defend their positions with conceptual information and facts from countries and companies affected by regional integration.

2. Q: Market Entry Strategy Project. This exercise corresponds to the MESP online simulation. For the country your team is researching, identify any regional integration efforts in which the nation may be participating. What other nations are members? What economic, political, and social objectives drive integration? So far, what have been the positive and negative results of integration? How are international companies (domestic and nondomestic) coping? Explain why companies’ coping strategies are, or are not, succeeding. Integrate your findings into your completed MESP report.

A: This may be a good time to get students working on their Market Entry Strategy Project. This exercise gets students to learn more about a country, and to generate interest in countries other than their own. The project focuses on important aspects of each country and the process can begin to develop teamwork in the course.

ETHICAL CHALLENGES

1. Q: You are a member of the United States Congress from the state of Florida. Many constituents in your district have complained that NAFTA and CAFTA-DR are unfair to their extended families living on the Caribbean islands. Some
experts argue that the term “free trade agreement” is misleading. They say these agreements are really “preferential trade agreements” that offer free trade only to members and relative protection against nonmembers. You worry that this is the case for Caribbean nations excluded from NAFTA and CAFTA-DR. Some argue that from apparel factories in Jamaica to sugar cane fields in Trinidad, these trade agreements have cost jobs, market share, and income for the vulnerable island nations as jobs moved to Mexico. Given the impact on nonmember nations, do you think such trade agreements are ethical? Why do you think islands in the Caribbean basin were not invited to be part of NAFTA or CAFTA-DR? As a member of the U.S. Congress, what arguments do you make for including the Caribbean in the expansion of NAFTA or CAFTA-DR?

A: One question to be addressed here is the responsibility that the United States has to its neighbors. Certainly, many Caribbean nations have strong economic and cultural ties to the United States. The “free trade” versus “preferential trade” ethical debate is nothing new. There is no practical way of ever creating a regional trading bloc that does not cause displacement of workers in other countries. However, governments must do all they can to minimize this byproduct. For example, they could establish a quota system that limits the amount of textiles allowed to pass from Mexico to Canada and the United States while guaranteeing market access for a certain amount of textiles from the Caribbean.

2. Q: You are a world-renowned economist hired by Ecuador’s government to advise it on its current involvement with the Andean Community. The Andean Community is a customs union that consists of four nations in South America: Bolivia, Colombia, Ecuador, and Peru. Member nations are permitted free access to one another’s markets, with nonmember nations required to negotiate tariffs with community members. Because Ecuador recently adopted the U.S. dollar as its currency, some believe the other Andean members are perhaps holding Ecuador back from more rapid development. As the consultant, what pros and cons do you present to the Ecuadorian government for breaking free from the Andean Community?

A: Ecuador is in a precarious position now that it has dollarized. On the positive side of the ledger, potential foreign investors will have less fear of currency devaluation with the U.S. dollar in place. The country’s relationship with the United States, a major trade partner, should also improve. Further, local real wages are bound to increase, which helps the work force. Negatives include the higher labor costs for employers, less autonomy in financial planning at the top government level, and an economy that is tied to U.S. economic decision making. Cultural issues, such as the historical significance of replacing a currency with that of a different nation, can also be explored.
3. Q: You are the economic advisor to the President of Mexico. Labor unions and environmentalists in the United States aren’t the only ones speaking out against NAFTA. There continues to be opposition in Mexico by those complaining of a loss of national sovereignty and who feel that the income gap between the two countries will never be narrowed. Average hourly wages on the U.S. side of the border can be six times that on the Mexican side. Mexican critics fear that their entire country will be subsumed by companies from the United States that do not contribute to Mexico’s higher standard of living, but who instead use Mexico as a low-cost assembly site while keeping high-paying, high-skilled jobs at home. Do you think there is a way for trade agreements to help close the economic gap between poor and wealthy partners? Or will the interests of poorer nations always be subordinate to wealthier countries within regional trading blocs? As economic advisor, how do you suggest the president protect Mexico’s workforce?

A: NAFTA has had many implications, some positive and some negative, for Mexico. Trade agreements can help poorer nations close the economic development gap (witness what the EU is doing—having wealthier EU nations provide poorer EU ones with funding for economic development projects). Only if poorer nations place themselves firmly on the path of economic development for the long term, will they be able to have power in promoting their interests. However, any nation that is subordinate to another will have difficulty getting its way on important matters unless it can hold the dominant nation hostage to something it badly desires that the subordinate possesses. Mexico must stay the course and continue with investment in potential high-growth sectors. Also, Mexico must now reconsider its position as a low-wage nation with the competition from China and other parts of Asia.

PRACTICING INTERNATIONAL MANAGEMENT CASE

Global Trade Deficit in Food Safety

1. Q: How do you think countries with a high volume of exports to the United States, such as Mexico, would respond to stricter food-safety rules? Do you think such measures are a good way to stem the tide of food-related illnesses? Why or why not?

A: They will clearly be opposed to it. How would the U.S. government react if Mexico wanted to send its federal investigators around the United States to inspect its farming methods and safety systems? It would rightly say that the Mexican government is meddling in its domestic affairs. Education of farmers in the safe handling and shipping of agricultural products and closer inspections at U.S. borders would seem to be a better approach that would not smack of heavy-handedness and arrogance.
2. Q: Sue Doneth of Marshall, Michigan, is a mother of one of the schoolchildren who was exposed to the Hepatitis A virus after eating tainted frozen strawberry desserts. Speaking before Congress she said, “We are forcing consumers to trade the health and safety of their families for free trade. That is not fair trade. NAFTA is not a trade issue: it is a safety issue.” Do you think food-safety regulations should be built into an extension of NAFTA? Why or why not? What are the benefits and drawbacks of putting food-safety regulations into international trade pacts?

A: It is probably not necessary to place food-safety regulations within the free trade agreement itself. Free trade means that goods can enter other member nations tariff-free, not inspection free. All that governments need to do is enforce the food-safety regulations on the books, or pass more stringent ones if current ones are unacceptable. It would be a far better approach than exploiting food contamination for political purposes.

3. Q: The lack of harmonized food-safety practices and standards is just one of the challenges faced by the food industry as it becomes more global. What other challenges face the food industry in an era of economic integration and opening markets?

A: Perhaps the most important issue is whether relatively less efficient farmers will be able to compete with the large farming operations existing in developed nations. Throwing the doors to trade wide open without protection for small family-operated farms can spell disaster for the rural farming communities of relatively less developed countries.