

# **International Business Economics**

# **Chapter 1**

# **Globalization**



## Today's Globalized Toy

Topper the Trick Terrier is a robotic dog that can talk and stand on its head. But the real trick is where its parts come from. This year 75,000 copies of the dog were made by Qualiman Industrial Co. in Nanhai, China for a Li & Fung American customer, the Original San Francisco Toymakers. It sells for \$29.99 in the U.S.

**PLASTIC EYES:**  
Shenzhen, China

**PLASTIC BODY:**  
Malaysia  
**MICROFIBER FABRIC  
FOR COAT:**  
Korea

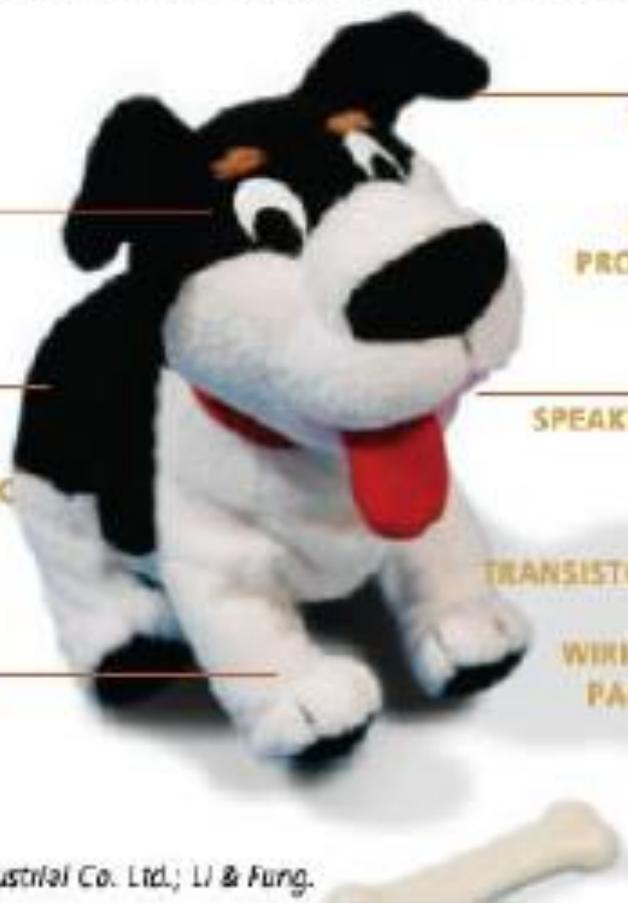
**MOTOR FOR LEGS:**  
Shaoguan, China  
**PLASTIC LEGS:**  
Taiwan

**VOICE-RECOGNITION  
REQUIREMENTS:**  
San Francisco  
**VOICE-RECOGNITION  
PROGRAMMING:** Taiwan

**SPEAKER FOR TOY'S VOICE:**  
Dongguan, China

**TRANSISTORS:** Shenzhen, China  
**IC CHIPS:** Taiwan  
**WIRING:** Dongguan, China  
**PACKAGING:** Hong Kong

Sources: Qualiman Industrial Co. Ltd.; Li & Fung.



*Design: California, USA*

*Moulds, paint  
pigments: USA*

*Assembly: Indonesia  
and Malaysia*

*Marketing: USA*



*Nylon hair: Japan*

*Body material:  
Taiwan*

*Clothing: China*

*Quality testing:  
USA*

Global Process for Producing a Barbie doll

# What Is Globalization?

- The world is moving away from self-contained (**autarkic**) national economies toward an interdependent, integrated global economic system
- Globalization** refers to the shift toward a more integrated and interdependent world economy

Globalization has two facets:

- 1) the globalization of markets
- 2) the globalization of production

# The Globalization Of Markets

- The **globalization of markets** refers to the **merging** of historically distinct and separate national markets into one huge **global marketplace**
- In many industries, it is no longer meaningful to talk about the “German market” or the “American market”
- Instead, there is only the **global market**, e.g., **made in the EU**

# The Globalization Of Markets

- **Falling trade barriers** make it easier to sell internationally
- **Consumers'** tastes and preferences converge on some global norm
- **Firms** help create the global market by offering the same basic products worldwide

# The Globalization Of Production

- The **globalization of production** refers to the sourcing of goods and services from locations around the globe **to take advantage of national differences in production costs, quality of factors of production** like land, labor, and capital, **availability** of productive resources

..... as we'll see .....

- Firms compete more effectively by **lowering** their overall **cost structure** or **improving the quality or functionality** of their product offering by ***internationalizing/globalizing their production process/activity***

# The Emergence Of Global Institutions

**HOWEVER, ....** To keep track and order of this economic internationalization/globalization .....

**...International (Global) Supervising Institutions are needed to:**

- help manage, regulate, and police the global marketplace
- promote the establishment of multinational treaties to govern the global business system

# The Emergence Of Global Institutions

Institutions created over the past half century include:

- the General Agreement on Tariffs and Trade (GATT)
- the World Trade Organization (WTO)
- the International Monetary Fund (IMF)
- the World Bank
- the United Nations (UN)

# The Emergence Of Global Institutions

- The **World Trade Organization** (like its predecessor **GATT**) is primarily responsible for policing the world trading system and making sure that nation-states adhere to the rules laid down in trade treaties signed by WTO members
- In 2007, the 150 nations that accounted for 97% of world trade were WTO members. Today, (since 2016-) it accounts for 164 country-members.
- The **WTO** promotes lower barriers to trade and investment

# Drivers Of Globalization

Two macro factors underlie the trend toward greater globalization:

- the decline in barriers to the free flow of goods, services, and capital that has occurred since the end of World War II
- technological change

# Declining Trade and Investment Barriers

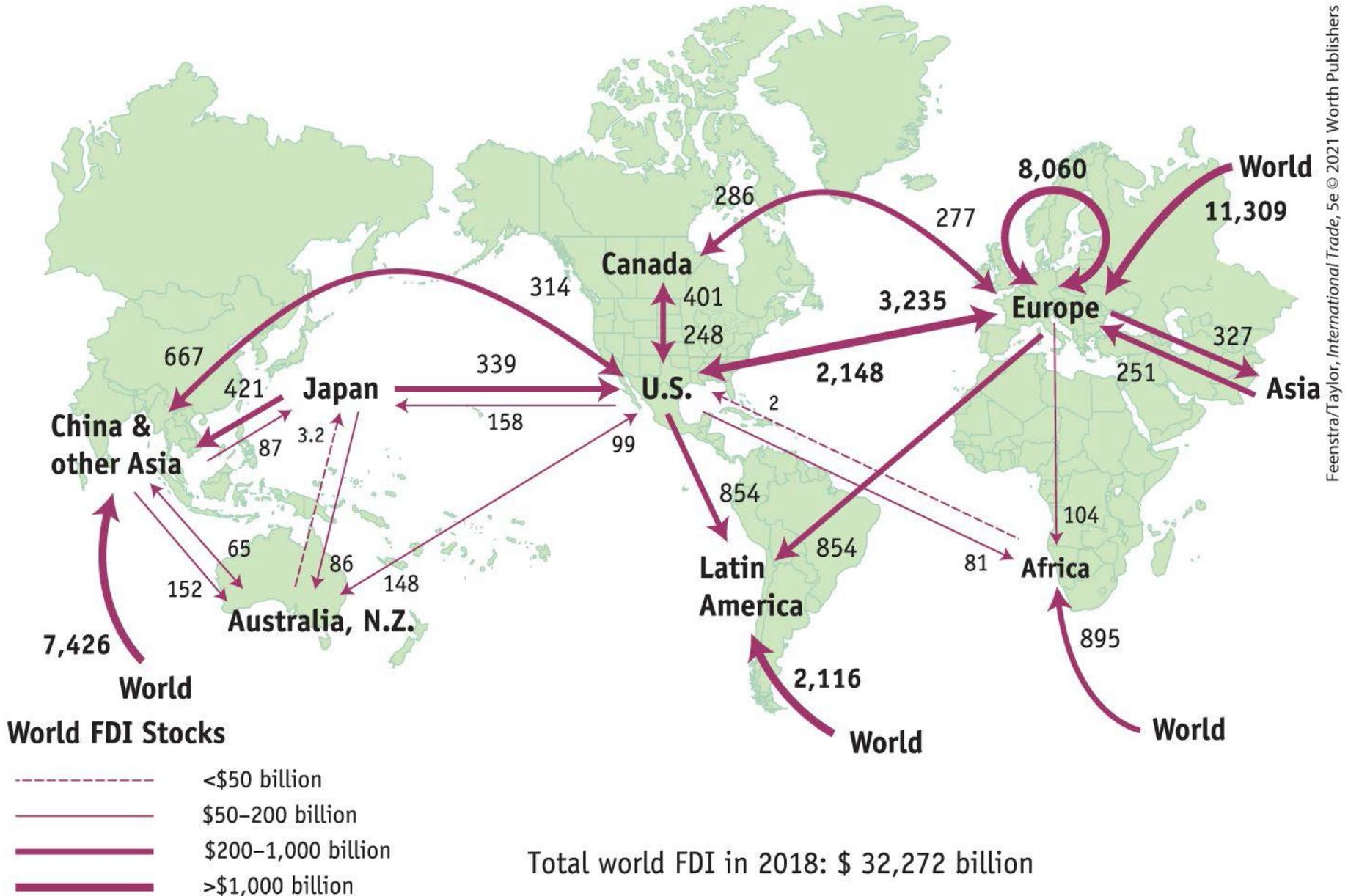
- **International trade** occurs when a firm exports goods or services to consumers in another country
- **Foreign direct investment (FDI)** occurs when a firm invests resources in business activities outside its home country
- Since 1950, **world average tariffs** have fallen significantly:  
2014 (2.87%), 2015 (3.08%), 2016 (2.98%), 2017 (2.59%)
- Countries (National markets) have also been opening markets to FDI

# Declining Trade and Investment Barriers

## Average Tariff Rates on Manufactured Products as Percent of Value

	<b>1913</b>	<b>1950</b>	<b>1990</b>	<b>2005</b>
France	21%	18%	5.9%	3.9%
Germany	20	26	5.9	3.9
Italy	18	25	5.9	3.9
Japan	30	—	5.3	2.3
Holland	5	11	5.9	3.9
Sweden	20	9	4.4	3.9
Great Britain	—	23	5.9	3.9
United States	44	14	4.8	3.2

# Foreign Direct Investment (FDI), 2018



# Declining Trade and Investment Barriers

Lower barriers to trade and investment mean that firms can:

- View the **world**, rather than a single country, as their market
- Base production in the **optimal location** for that activity

# Globalization: The Role of Technological Change

- Technological change has made the globalization of markets a reality

Important advances have occurred in:

- microprocessors and telecommunications
- the Internet and World Wide Web
- transportation technology

# Globalization: The Role of Technological Change

Technological change for the globalization enables firms to lower:

- **transportation costs** that enable firms to **disperse production** to economical, geographically separate locations
- **information processing and communication costs** that enable firms to **create** and **manage** globally dispersed production systems

# The Changing Demographics of The Global Economy

- There has been a drastic change in the demographics of the world economy in the last 30 years

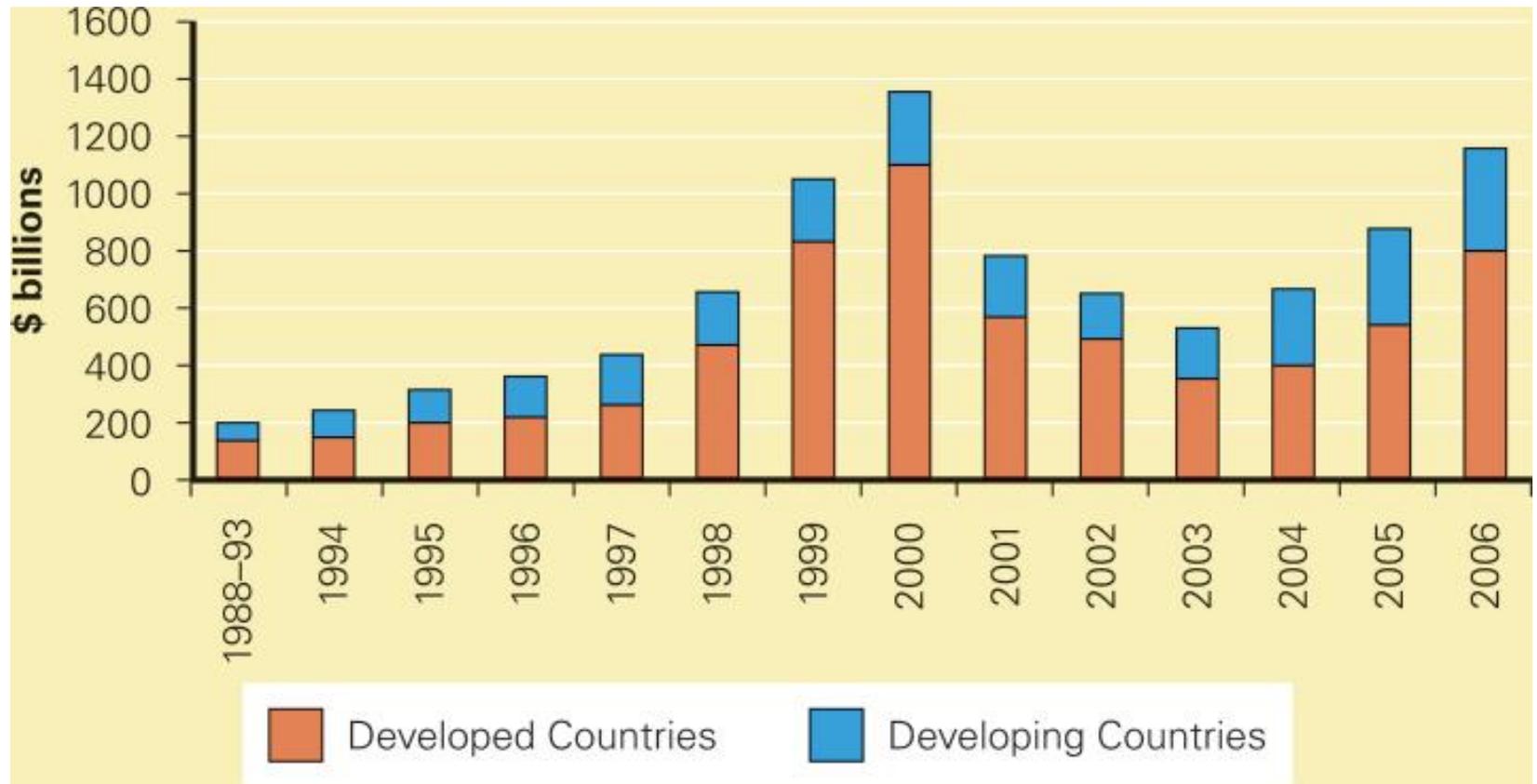
Four trends are important: the changing of

- World Output and World Trade
- Foreign Direct Investment
- Nature of the Multinational Enterprise
- World Order (by and large, non-economic considerations)

# Ratio (Trade / GDP), 2018

Country	Trade/GDP (%)	GDP (\$ billions)
Hong Kong (China)	188%	332
Singapore	163	377
Hungary	84	185
Malaysia	66	438
Thailand	62	507
Switzerland	59	771
Austria	53	511
Denmark	52	419
Sweden	45	669
Germany	44	4,524
Mexico	40	1,505
Greece	36	290
Norway	35	562
Spain	33	2,435
France	32	3,359
United Kingdom	31	3,282
Italy	31	2,456
South Africa	30	493
Russian Federation	26	1,978
India	22	3,269
China	19	1,779
Japan	18	7,109
United States	16	20,494

# The Changing Foreign Direct Investment: FDI Inflows 1988-2006



# The Changing Nature of The Multinational Enterprise

- A multinational enterprise (MNE) is any business that has productive activities in two or more countries
- Since the 1960s, there has been a rise in non-U.S. multinationals, and a growth of mini-multinationals

# The Globalization Debate

- **Supporters** believe that increased trade and cross-border investment mean lower prices for goods and services, greater economic growth, higher consumer income, and more jobs
- **Critics** worry that globalization will cause job losses, environmental degradation, and the cultural imperialism of global media and MNEs

# Globalization, Jobs, And Income

- **Supporters** contend that the benefits of this trend outweigh the costs—that **countries will specialize** in what they do most efficiently and trade for other goods—and all countries will benefit

- **Critics** argue that **falling barriers to trade** are destroying manufacturing jobs in advanced countries

# Globalization, Labor Policies, and the Environment

• **Supporters** claim that tougher **environmental and labor standards** are associated with economic progress, so as countries get richer from free trade, they get tougher environmental and labor regulations

• **Critics** argue that firms avoid costly efforts to adhere to labor and environmental regulations by **moving production to countries** where such regulations do not exist, or are not enforced, e.g., **Pollution Haven Countries**, **(over-) exploitation of depletable natural resources**, e.g., **oil or natural gas reserves**

# Globalization and National Sovereignty

• **Supporters** contend that the power of these organizations is limited to what nation-states agree to grant, and that the power of the organizations lies in their ability to get countries to agree to follow certain actions

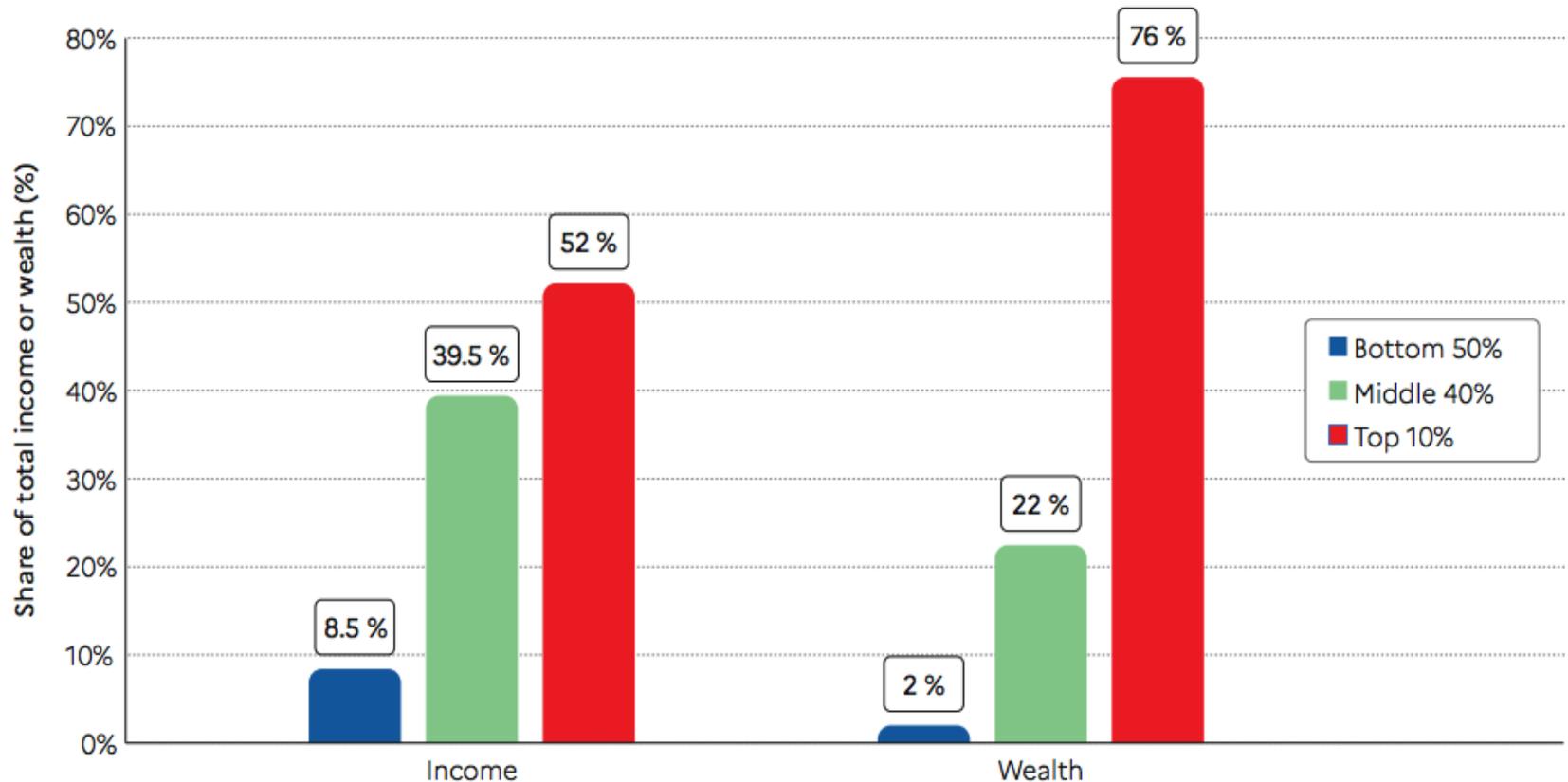
• **Critics** worry that today's interdependent global economy is shifting economic power away from national governments toward supranational organizations like the WTO, the EU, and the UN

# Globalization: Income Inequality and the World's Poor

- **Supporters** claim that the best way for the **poor nations to improve their situation** is to reduce barriers to trade and investment and implement economic policies based on free market economies, and to receive debt forgiveness for debts incurred under totalitarian regimes
- **Critics** argue that **the income gap** between rich nations and poor nations is getting wider

# Global Income and Wealth Inequality (I)

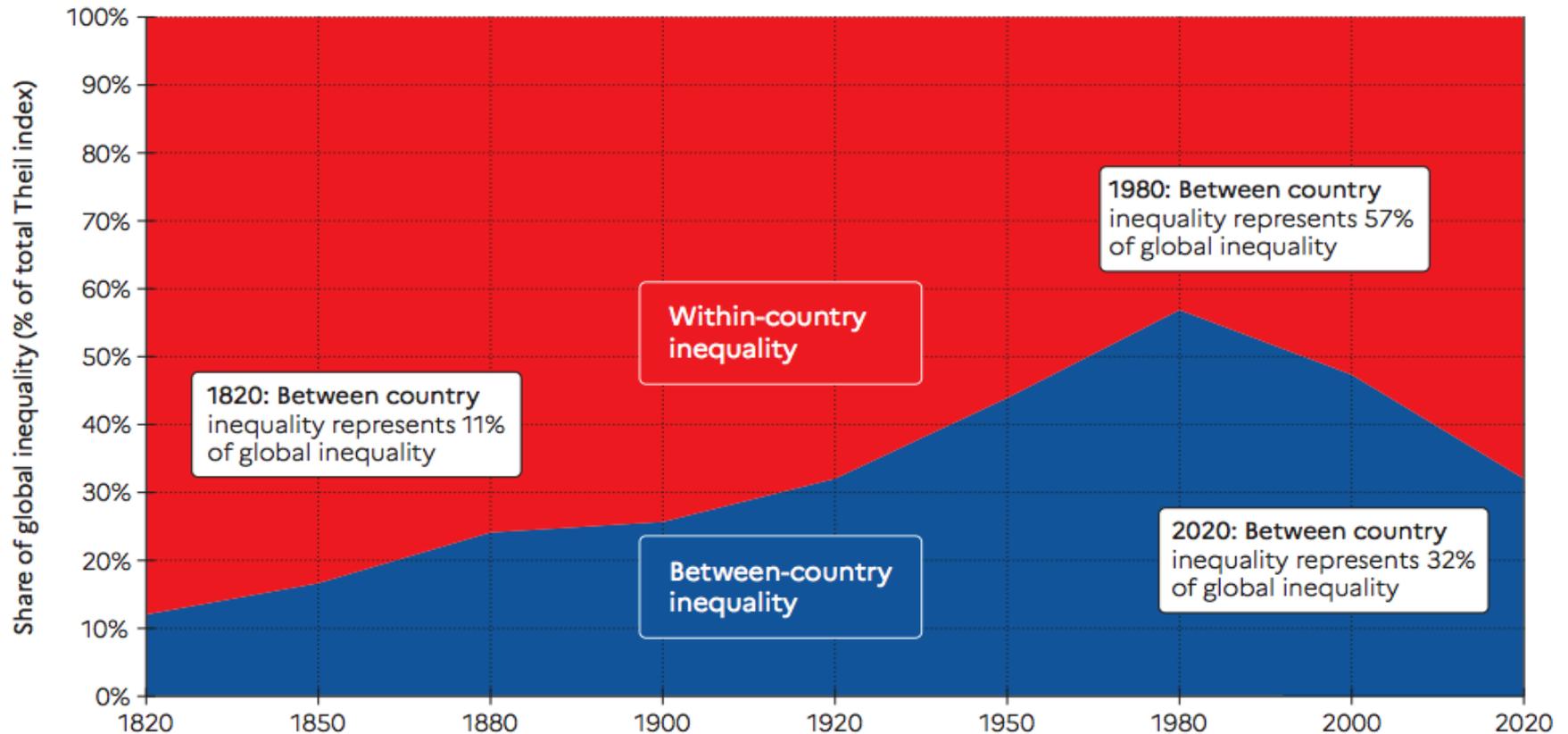
**Figure 1** Global income and wealth inequality, 2021



**Interpretation:** The global 50% captures 8% of total income measured at Purchasing Power Parity (PPP). The global bottom 50% owns 2% of wealth (at Purchasing Power Parity). The global top 10% owns 76% of total Household wealth and captures 52% of total income in 2021. Note that top wealth holders are not necessarily top income holders. Incomes are measured after the operation of pension and unemployment systems and before taxes and transfers. **Sources and series:** [wir2022.wid.world/methodology](http://wir2022.wid.world/methodology).

# Global Income and Wealth Inequality (II)

**Figure 6** Global income inequality: Between vs. within country inequality (Theil index), 1820-2020



**Interpretation:** The importance of between-country inequality in overall global inequality, as measured by the Theil index, rose between 1820 and 1980 and strongly declined since then. In 2020, between-country inequality makes-up about a third of global inequality between individuals. The rest is due to inequality within countries. Income is measured per capita after pension and unemployment insurance transfers and before income and wealth taxes. **Sources and series:** [wir2022.wid.world/methodology](http://wir2022.wid.world/methodology) and Chancel and Piketty (2021).

# Measure of Economic Inequality: The Theil Index

- **Within country income inequality:**

$$T = \frac{1}{N} \sum_{i=1}^N \left( \frac{X_i}{\bar{X}} \ln \frac{X_i}{\bar{X}} \right)$$

$$0 \leq T \leq \infty$$

# **Chapter 2**

## **National Differences in Political Economy**

# Political Systems

- The **political economy of a nation** refers to **how the political, economic, and legal systems** of a country are interdependent; **how they interact and influence** each other, and in doing so **how they affect** the level of economic activity and well-being

# Political Systems

- Political system refers to the system of government in a nation

Political systems can be assessed according to two dimensions

- the degree to which they emphasize collectivism as opposed to individualism
- the degree to which they are democratic or totalitarian

# Collectivism And Individualism

- **Collectivism** refers to a political system that stresses the primacy of collective goals over individual goals

# Collectivism and Individualism

- **Socialists** advocate **state ownership** of the basic means of production, distribution, and exchange
- **Communism** – socialism can only be achieved through violent revolution and totalitarian dictatorship
- **Social democrats** – socialism is achieved through democratic means

# Collectivism And Individualism

- **Individualism** refers to philosophy that an individual should have freedom in her/his own economic and political pursuits
- Under individualism, individual economic and political freedoms are the ground rules on which a society should be based
- **Practically, individualism means democratic political systems and free market economies**

# Democracy And Totalitarianism

- **Democracy** refers to a political system in which government is by the people, exercised either directly or through elected representatives
- **Totalitarianism** is a form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties
- **Democracy** is usually associated with individualism and communism is usually associated with collectivism and totalitarianism

# Economic Systems

- Political ideology and economic systems are connected

In countries where individual goals are emphasized free market economies are likely

- There are three types of economic systems:
  - market economies
  - command economies
  - mixed economies

# Market Economy

- In a **market economy** all productive activities are privately owned and production is determined by the **interaction of supply and demand**
- **The role of government** is to encourage free and fair competition between private producers

# Command Economy

- In a **command economy**, the government plans the goods and services that a country produces, the quantities produced, and the prices at which they are sold
- All **businesses** are **state-owned**, and governments allocate resources for “the good of society”
- However, because there is little incentive to control costs and be efficient, **command economies tend to stagnate**

# Mixed Economy

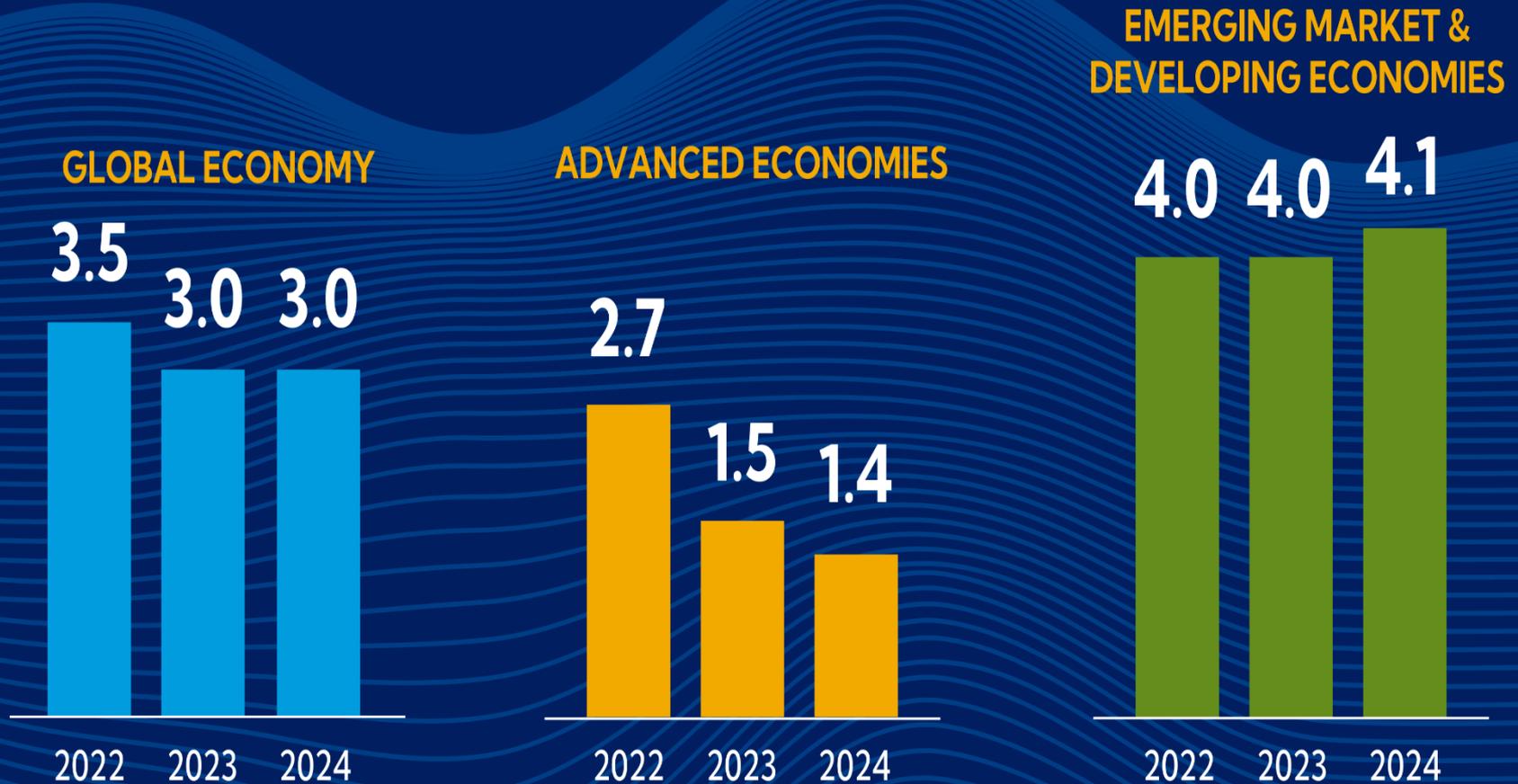
- In a **mixed economy**, certain sectors of the economy are left to private ownership and free market mechanisms while other sectors have significant state ownership and government planning
- **Governments** tend to own firms that are considered important to national security

# The Determinants of Economic Development

- Countries have different levels of economic development. The determinants:
- **Gross national income (GNI)** per person is a common measure of economic development
- **Purchasing power parity (PPP)** involves adjusting GNI by purchasing power

# GROWTH PROJECTIONS

(Real GDP growth, percent)



# World Economic Outlook

## Growth Projections

(Real GDP, annual percent change)	PROJECTIONS		
	2022	2023	2024
<b>World Output</b>	<b>3.5</b>	<b>3.0</b>	<b>3.0</b>
<b>Advanced Economies</b>	<b>2.7</b>	<b>1.5</b>	<b>1.4</b>
United States	2.1	1.8	1.0
Euro Area	3.5	0.9	1.5
Germany	1.8	-0.3	1.3
France	2.5	0.8	1.3
Italy	3.7	1.1	0.9
Spain	5.5	2.5	2.0
Japan	1.0	1.4	1.0
United Kingdom	4.1	0.4	1.0
Canada	3.4	1.7	1.4
Other Advanced Economies	2.7	2.0	2.3
<b>Emerging Market and Developing Economies</b>	<b>4.0</b>	<b>4.0</b>	<b>4.1</b>
Emerging and Developing Asia	4.5	5.3	5.0
China	3.0	5.2	4.5
India	7.2	6.1	6.3
Emerging and Developing Europe	0.8	1.8	2.2
Russia	-2.1	1.5	1.3
Latin America and the Caribbean	3.9	1.9	2.2
Brazil	2.9	2.1	1.2
Mexico	3.0	2.6	1.5
Middle East and Central Asia	5.4	2.5	3.2
Saudi Arabia	8.7	1.9	2.8
Sub-Saharan Africa	3.9	3.5	4.1
Nigeria	3.3	3.2	3.0
South Africa	1.9	0.3	1.7
<b>Memorandum</b>			
Emerging Market and Middle-Income Economies	3.9	3.9	3.9
Low-Income Developing Countries	5.0	4.5	5.2

Source: IMF, *World Economic Outlook Update*, July 2023

Note: For India, data and forecasts are presented on a fiscal year basis, with FY 2022/2023 (starting in April 2022) shown in the 2022 column. India's growth projections are 6.6 percent in 2023 and 5.8 percent in 2024 based on calendar year.

# Differences in Economic Development

<b>Country</b>	<b>GNI per Capita, 2005 (\$)</b>	<b>GNI PPP per Capita, 2005 (\$)</b>	<b>GDP Growth Rate, 1996–2005 (%)</b>	<b>Size of Economy GDP, 2005 (\$ billions)</b>
Brazil	3,460	8,230	2.2	794
China	1,740	6,600	9.1	2,229
Germany	34,580	29,210	1.4	2,782
India	720	3,460	6.3	785
Japan	38,950	31,410	1.3	4,560
Nigeria	560	1,040	4.3	99
Poland	7,110	13,490	4.2	299
Russia	4,460	10,640	4.0	764
Switzerland	54,930	37,080	1.5	366
United Kingdom	37,600	32,690	2.7	2,193
United States	43,740	41,950	3.4	12,455

# Political Economy and Economic Development

What is the relationship between political economy and economic progress? Experts agree that: Innovation and entrepreneurship

- are the engines of long-run economic growth
- Require, by and large, a market economy
- require strong property rights
- Democratic regimes are more conducive to long-term economic growth than a totalitarian one, even of the benevolent kind
- Subsequent economic growth leads to establishment of democratic regimes

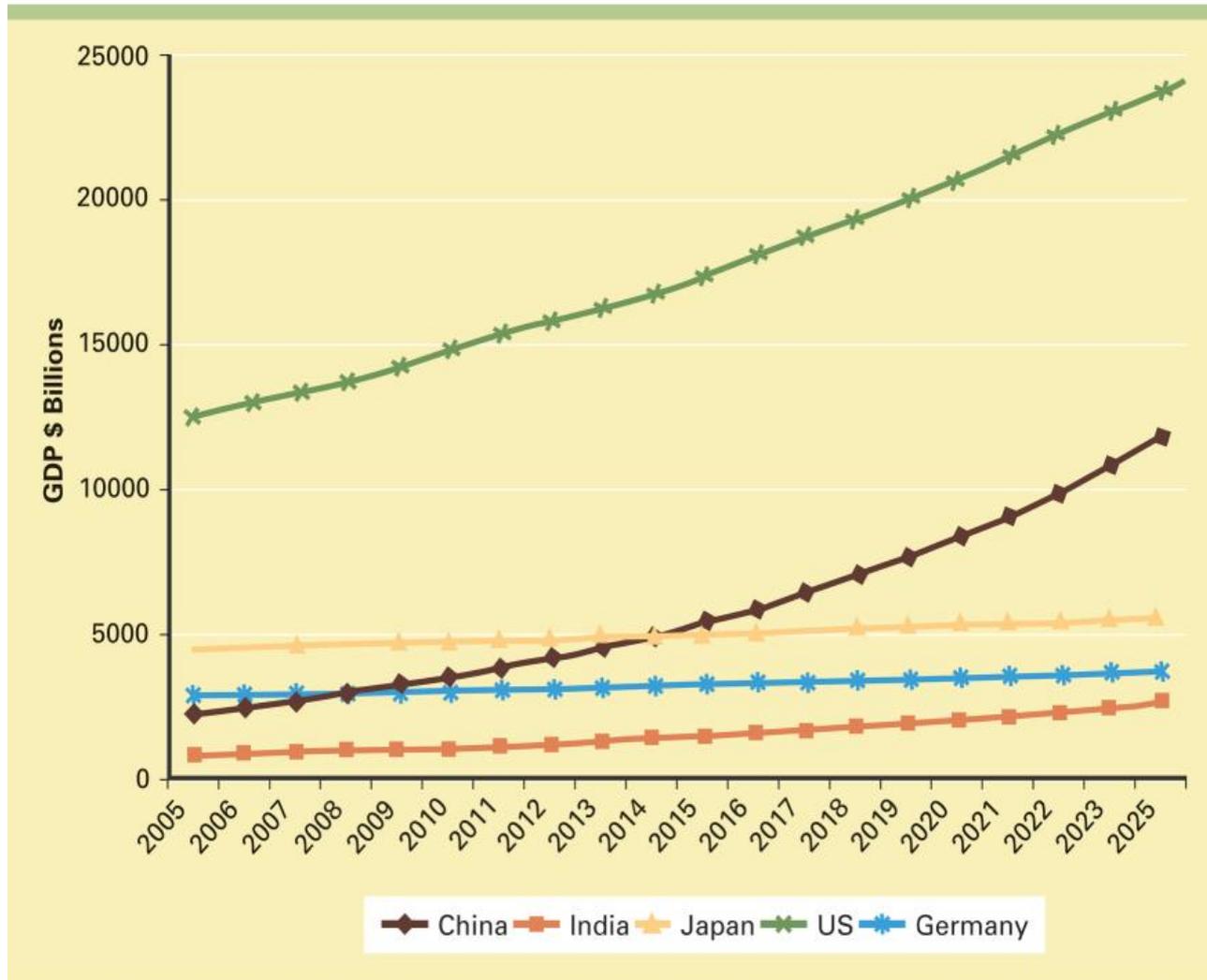
# Geography, Education, and Economic Development

- **Geography** and **education** are also important determinants of economic development
- Countries with **favorable geography** are more likely to engage in trade, and so, be more open to market-based economic systems, and the economic growth they promote
- Countries that invest in **education** have higher growth rates because the workforce is more productive

# Economic Transformation and Economic Development

- **Deregulation** – removing legal restrictions to the free play of markets, the establishment of private enterprises, and the manner in which private enterprises operate
- **Privatization** - transfers the ownership of state property into the hands of private investors
- The creation of a **legal system** to safeguard property rights

# Implications of Changing Political Economy



# Implications For Managers

Two broad implications for managers:

- the political, economic, and legal environment of a country clearly influences the **attractiveness** of that country as a **market and/or investment site**. **“Doing Business Abroad”**

- **Doing Business Abroad:** the political, economic, and legal systems of a country raise important **ethical issues** that have implications for the practice of international business

# Doing Business Abroad: Benefits

- The **long-run benefits of doing business** in a country are a **function of** the **size of the market**, the **present wealth of consumers in that market**, and the **likely future wealth of consumers**
- By identifying and investing early in a potential future economic stars, firms may be able to gain **first mover advantages** (advantages that accrue to early entrants into a market) and establish loyalty and experience in a country

# Doing Business Abroad: Costs

The costs of doing business in a country are influenced by:

- **Political costs:** the cost of paying bribes or lobbying for favorable or fair treatment
- **Economic costs:** relate primarily to the sophistication of the economic system, including the infrastructure and supporting businesses
- It can be more costly to do business in countries with dramatically different product, workplace, and pollution standards, or where there is poor legal protection for property rights

# Doing Business Abroad: Risks

The risks of doing business are:

- **Political risk** is the likelihood that **political forces** will cause drastic changes in a country's business environment that **adversely affects** the profit and other goals of a business enterprise
- **Economic risk** is the likelihood that **economic mismanagement** will cause drastic changes in a country's business environment that adversely affects the profit and other goals of a business enterprise
- **Legal risk** is the likelihood that a trading partner will **opportunistically break a contract or expropriate property rights**

# **Chapter 4**

## **Ethics in International Business**

# Introduction

- Ethics refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization
- **Business ethics** are the accepted principles of right or wrong governing the conduct of business people
- **Ethical strategy** is a strategy, or course of action, that does not violate these accepted principles

# Ethical Issues in International Business

- employment practices
- human rights
- environmental regulations
- corruption
- the moral obligation of multinational companies

# Employment Practices

If work conditions in a host nation are clearly inferior to those in a multinational's home nation, **should companies apply:**

- home country standards?
- host country standards?
- something in between?

# Human Rights

- In developed countries, basic human rights such as freedom of association, freedom of speech, freedom of assembly, and freedom of movement, are taken for granted
- In other countries, these rights may not exist

# Environmental Pollution

- Ethical issues arise when environmental regulations in host nations are far inferior to those in the home nation (**Pollution Havens**)
- Environmental issues are important because some parts of the environment are a public good that no one owns, but anyone can despoil
- The **Tragedy of the Commons** occurs when a resource held in common by all, but owned by no one, is **overused** by individuals, resulting in its degradation

# Corruption

- Economists believe that in a country where political structures distort or limit the workings of the market mechanism, **corruption in the form of black-marketeering, smuggling, and side payments to government bureaucrats to “speed up” approval for business investments may enhance welfare**
- **BUT, on the other hand,** it **reduces the returns on business investment** and leads to low economic growth

# Moral Obligations

- **Social responsibility:** Businesses should take the social consequences of economic actions into account when making business decisions, and that there should be a presumption in favor of decisions that have both good economic and good social consequences
- Advocates argue that businesses need to recognize their **honorable obligation** and give something back to the societies that have made their success possible

# **Chapter 5**

## **International Trade Theory**

# An Overview Of Trade Theory

- Free Trade

A situation where a government does not attempt to influence through import/export quotas or duties (taxes and subsidies) what its citizens can buy/sell from another country or what they can produce and sell to another country

## Why countries trade

Model	Determinant of trade	Key assumptions	Original idea
Ricardian model	Differences in technology	Labor is the only scarce factor of production, all occupations pay the same wage, labor unit requirements are constant.	Henry Martyn, <i>Considerations upon the East India Trade</i> (1701) David Ricardo, <i>The principles of Political Economy and Taxation</i> (1817)
Heckscher-Ohlin model	Relative endowments of productive factors	Two factors of production (capital and labor), same technology, factor mobility between sectors.	Eli Heckscher (1919) and Bertil Ohlin, <i>Interregional and International Trade</i> (1933)
Specific factors model ("Ricardo-Viner")	Factor specificity and endowments	Extension of the Ricardian model with three factors of production (one mobile and two that are specific to a sector).	Ronald Jones (1971) and Paul Samuelson (1971)
Models of trade with imperfect competition / New trade theory	Scale economies, size, location, initial conditions	Increasing returns, differentiated products, imperfect competition (monopoly, duopoly, oligopoly, monopolistic competition)	Chamberlin (1933), Dixit and Stiglitz (1977), Krugman (1979,1980), Brander and Krugman (1980), Helpman (1981)
Models of heterogeneous firms / New new trade theory	Organizational choices of firms, trade costs, relationship between trade and FDI, unbundling, sourcing patterns	Intra-industry heterogeneity of producers, imperfect competition, incomplete contracts, trade in tasks	Bernard, Eaton, Jensen and Kortum (2003), Melitz (2003), Antràs and Helpman (2004), Grossman and Rossi-Hansberg (2006)

# The Benefits Of Trade

- **Smith, Ricardo and Heckscher-Ohlin** show why it is beneficial for a country to engage in international trade even for products it is able to produce for itself

International trade allows a country:

- **to specialize (produce) and export** products that it can produce efficiently
- **import** products that can be produced more efficiently in other countries

# The Patterns Of International Trade

- Some patterns of trade are fairly easy to explain - it is obvious why Saudi Arabia exports oil, Ghana exports cocoa, and Brazil exports coffee
- ... **But**, why does Switzerland export chemicals, pharmaceuticals, watches, and jewelry? Why does Japan export automobiles, consumer electronics, and machine tools?

# Trade Theory and Government Policy: Absolute Advantage

- **Adam Smith** argued that a country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it
- According to Smith, a country should specialize in the production of and export goods for which they have an absolute advantage, then trade these goods for the goods produced by other countries, i.e., import goods at which the country has an absolute disadvantage

# Absolute Advantage: Gains from Trade

**Resources: Ghana 200 units, S. Korea 200 units**

<b>Resources Required to Produce 1 Ton of Cocoa and Rice</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	10	20
South Korea	40	10
<b>Production and Consumption without Trade</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	10.0	5.0
South Korea	2.5	10.0
Total production	12.5	15.0
<b>Production with Specialization</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	20.0	0.0
South Korea	0.0	20.0
Total production	20.0	20.0
<b>Consumption After Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	14.0	6.0
South Korea	6.0	14.0
<b>Increase in Consumption as a Result of Specialization and Trade</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	4.0	1.0
South Korea	3.5	4.0

# Comparative Advantage: Gains from Trade

- **David Ricardo** asked what might happen when one country has an absolute advantage in the production of all goods
- **Comparative advantage:** countries should specialize in the production of goods they produce relatively most efficiently (comparative advantage) and buy goods that they produce relatively less efficiently (**comparative disadvantage**) from other countries, even if this means buying goods from other countries that they could produce more efficiently (**absolute advantage**) at home

# Comparative Advantage: Gains from trade

Resources: Ghana 200 units, S. Korea 200 units

<b>Resources Required to Produce 1 Ton of Cocoa and Rice</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	10	13.33
South Korea	40	20
<b>Production and Consumption without Trade</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	10.0	7.5
South Korea	2.5	5.0
Total production	12.5	12.5
<b>Production with Specialization</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	15.0	3.75
South Korea	0.0	10.0
Total production	15.0	13.75
<b>Consumption After Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	11.0	7.75
South Korea	4.0	6.0
<b>Increase in Consumption as a Result of Specialization and Trade</b>		
	<b>Cocoa</b>	<b>Rice</b>
Ghana	1.0	0.25
South Korea	1.5	1.0

# Qualifications And Assumptions

The simple example of comparative advantage assumes:

- Zero transportation costs
- Free trade
- Resources are mobile between goods within countries, but not across countries
- Fixed stocks of resources
- No effects on income distribution within countries

# Heckscher-Ohlin Theory

- Eli Heckscher and Bertil Ohlin argued that comparative advantage arises from differences in national **factor endowments** – the extent to which a country is endowed with resources like land, labor, and capital
- The Heckscher-Ohlin Theory predicts that countries will export goods that make intensive use of those factors that are **locally abundant**, while importing goods that make intensive use of factors that are **locally scarce**

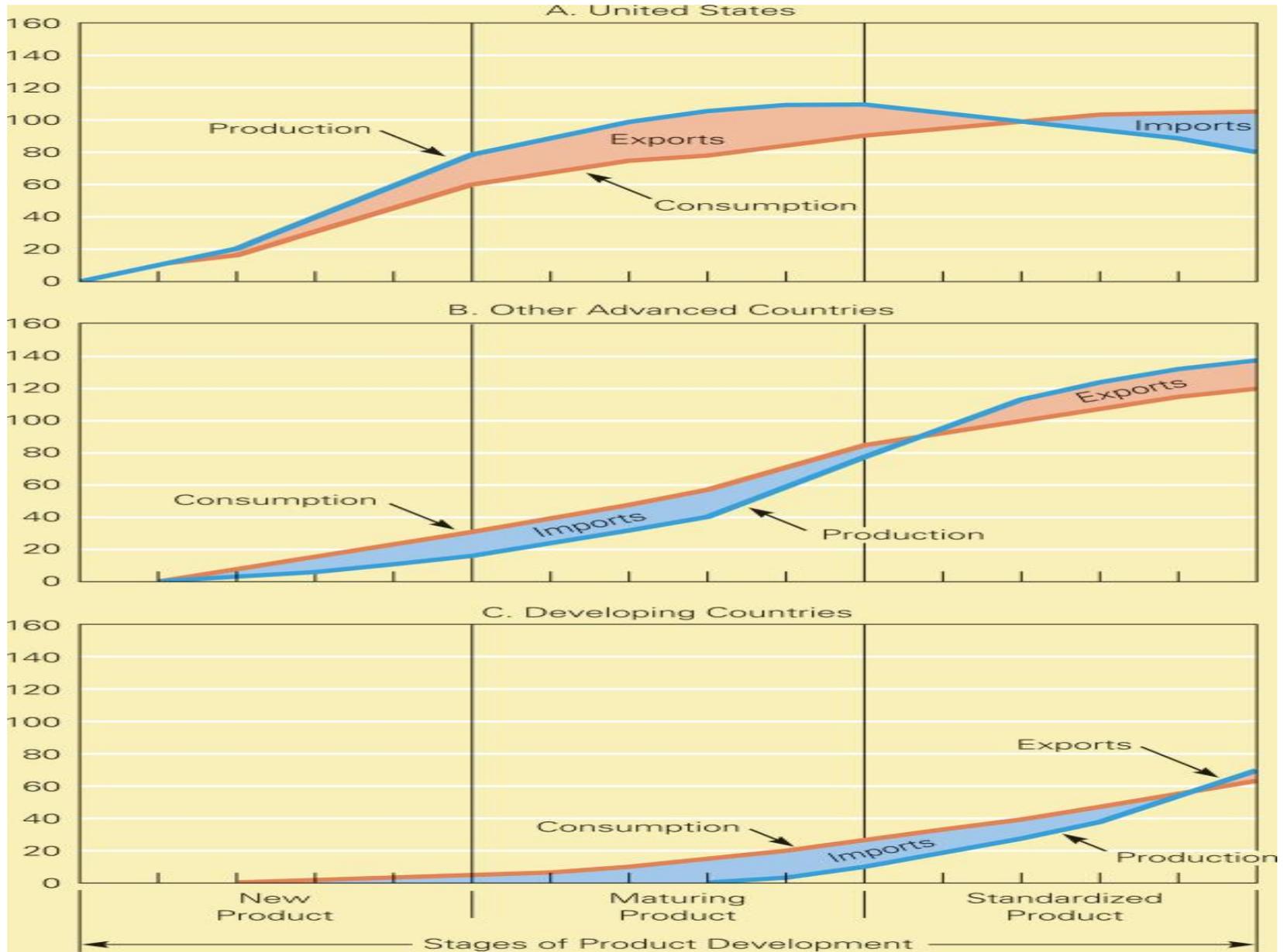
# The Product Life Cycle Theory: Dynamic Comparative Advantage

- The **Product Life-cycle Theory**, proposed by **Raymond Vernon**, suggested that **as products mature both the location of sales, and the optimal production location will change affecting the flow and direction of trade**
- **Raymond Vernon (1979):** the size and wealth of a country's market give a country's firms a strong incentive to develop new products
- **Initially**, the product is produced and sold **locally**.
- **Later**, as demand grows in other developed countries, firms begin to **export**
- **Over time**, **demand** for the new product **grows** in other advanced countries making it worthwhile for **foreign producers to begin producing for their home markets**

# The Product Life Cycle Theory: Dynamic Comparative Advantage

- Firms might also set up production facilities in those advanced countries where demand was growing limiting the exports from the “home” country
- As local and foreign markets mature, the product becomes more standardized
- Producers based in other advanced countries where labor costs are lower may now be able to export back to the “exporting” country
- If cost pressures become intense, developing countries begin to acquire a production advantage over advanced countries
- The “developed countries” switch from being exporters of the product to importers of the product as production becomes more concentrated in lower-cost foreign locations

# The Product Life Cycle Theory: US Growth and Production of PCs



# New Trade Theories: Imperfect Competition

- New trade theories suggest that
  - The ability of firms to gain **economies of scale** (unit cost reductions associated with a large scale of output) can have **important implications for international trade**
  - Through **economies of scale**, trade can increase the **varieties of the same goods** available to consumers and **decrease the average cost of production** (unit cost) of those goods
  - In those industries when output required to attain economies of scale represents a significant proportion of total world demand, **the global market may only be able to support a small number of (large) enterprises**

# Economies of Scale, First Mover Advantages, and the Pattern of Trade

- The **pattern of trade** we observe in the world economy may be the result of **first mover advantages** (the economic and strategic advantages that accrue to early entrants into an industry) **and economies of scale**
- **New trade theories** suggest that for those products where **economies of scale** are significant and represent a substantial proportion of world demand, **first movers** can gain a **scale-based cost advantage** that **later entrants** find difficult to match

# Implications For Managers

Three main implications for international businesses:

- Location implications
- First-mover implications
- Policy implications

# Location

- Different countries have advantages in different productive activities
- It makes sense for a firm to disperse its various productive activities to those countries where they can be performed most efficiently
- International trade theory suggests that firms which fail to do this, may be at a competitive disadvantage

# First-Mover Advantages

- Being a first mover can have important competitive implications, especially if there are economies of scale and the global industry will only support a few competitors
- Firms that establish a first-mover advantage may dominate global trade in that product ....
- ... but .... First-mover's "disadvantages"? ....

# Policy Implications

- Government policies with respect to free trade or protecting domestic industries can significantly impact global competitiveness
  
- Businesses should work to encourage governmental policies that support free trade

# **Chapter 6**

## **The Political Economy of International Trade**

# Introduction

- **Free trade** occurs when governments do not attempt to restrict what its citizens can buy from another country or what they can sell to another country
- Many nations tend to intervene in international trade to protect the interests of politically important groups

# Instruments of Trade Policy

The main instruments of trade policy are:

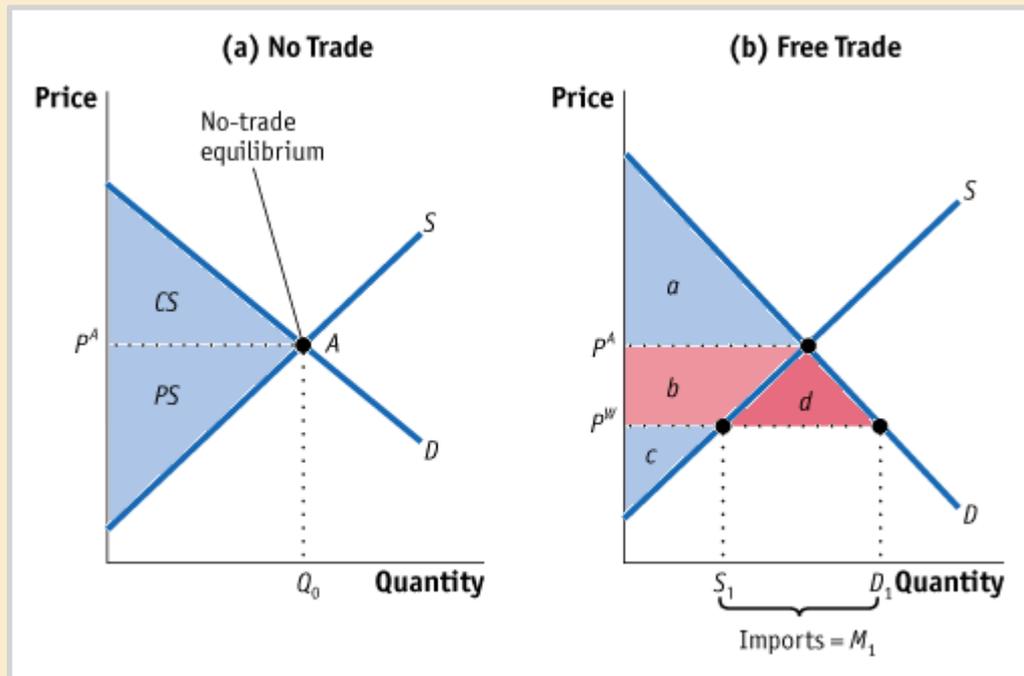
- Tariffs (Imports)
- Subsidies (Exports)
- Import / Export Quotas
- Voluntary Export Restraints
- Local Content Requirements
- Administrative Policies
- Antidumping Policies

# Tariffs

- **Tariffs** are taxes levied on imports that effectively raise the cost of imported products relative to domestic products
- **Specific tariffs** are levied as a fixed charge for each unit of a good imported
- **Ad valorem tariffs** are levied as a proportion of the value of the imported good
- **Tariffs create government revenues**, provide protection to domestic producers, and force consumers to pay more for certain imports
- **Tariffs are unambiguously pro-producer and anti-consumer, and tariffs reduce the overall productive efficiency of BOTH the local and the world economy**

# GAINS FROM FREE TRADE

## No Trade, Free Trade for a Small Country, Gains from Trade



The Gains from Free Trade at Home With Home demand of  $D$  and supply of  $S$ , the no-trade equilibrium is at point  $A$ , at the price  $P^A$  producing  $Q_0$ .

With free trade, the world price is  $P^W$ , so quantity demanded increases to  $D_1$  and quantity supplied falls to  $S_1$ .

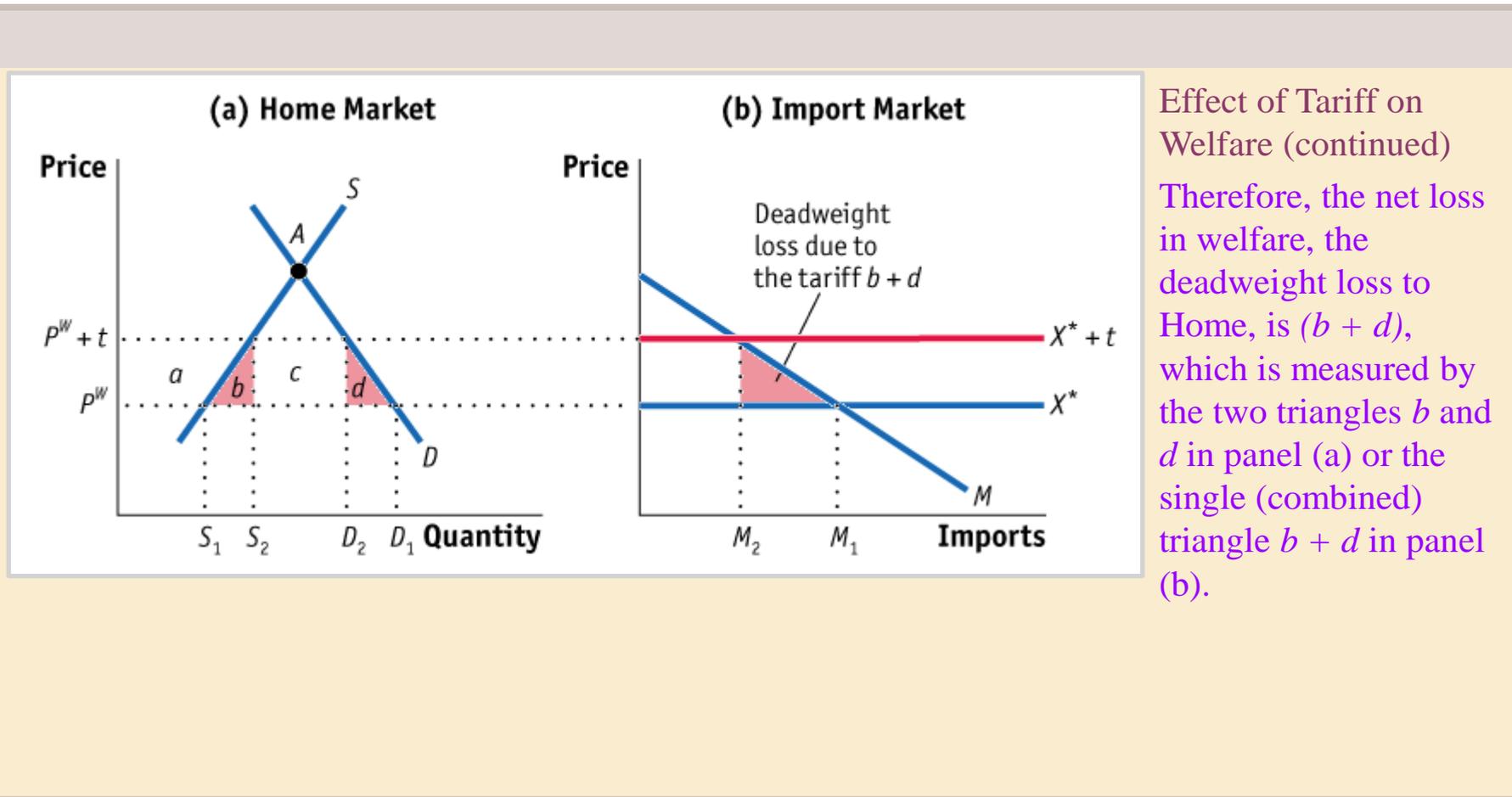
Since quantity demanded exceeds quantity supplied, Home imports  $D_1 - S_1$ .

Consumer surplus increases by the area  $(b + d)$ , and producer surplus falls by area  $b$ .

The gains from trade are measured by area  $d$ .

# Import Tariffs

Effect of Tariff on Consumer Surplus, Producer Surplus, Government Revenue, Overall Effect of the Tariff on Welfare, Production Loss and Consumption Loss



# Production / Export Subsidies

- Subsidies are government payments to domestic producers/exporters
- Consumers are those who actually absorb the costs of export subsidies. Consumers NOT affected by production subsidies

Subsidies help domestic producers in two ways:

- To compete against low-cost foreign imports
- To gain export markets

# Import Quotas and Voluntary Export Restraints (VERs)

- **Import quotas** directly restrict the quantity of some good that may be imported into a country
- **Voluntary export restraints (VERs)** are quotas on trade imposed by the exporting country, typically at the request of the importing country's government
- A **quota rent** is the extra profit that producers make when supply is artificially limited by an import quota
- **Import quotas and voluntary export restraints benefit domestic producers of import competing goods by limiting import competition, BUT, harm producers of other goods, and consumers by raising the prices of imported goods**

# Local Content Requirements

- A **local content requirement** demands that some specific fraction of a good be produced domestically
- Local content requirements benefit domestic producers of import competing goods, but consumers face higher prices

# Administrative Policies

- **Administrative trade polices** are bureaucratic rules that are designed to make it difficult for imports to enter a country
- **These polices hurt consumers by denying access to possibly superior foreign products**

# Dumping and Antidumping Policies

- **Dumping**: the selling goods in a foreign market below their **average cost** of production, or selling goods in a foreign market below their **“fair” market value**
- Dumping enables firms to unload excess production in foreign markets
- Some dumping may be **predatory behavior**, with producers using substantial profits from their home markets to subsidize prices in a foreign market with a view to driving indigenous competitors out of that market, and later raising prices and earning substantial profits
- **Antidumping polices (or countervailing duties)** are designed to **“punish”** foreign firms that engage in dumping and protect domestic producers from **“unfair”** foreign competition

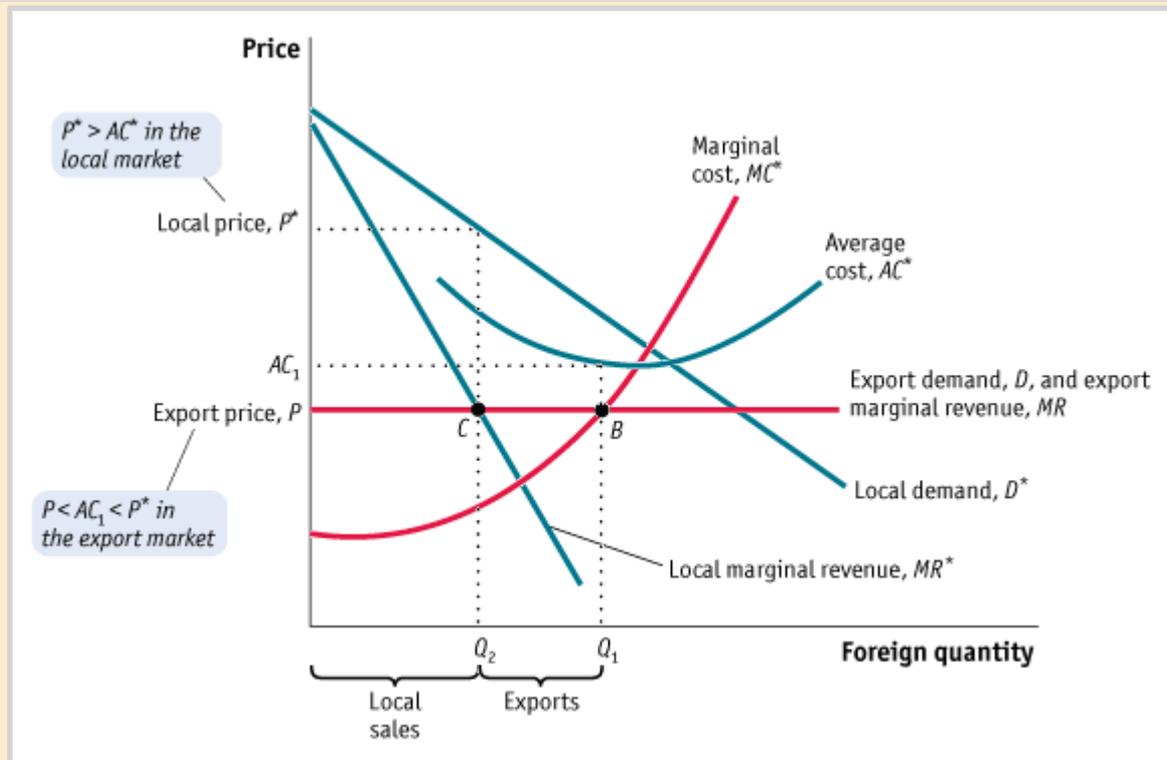
# DUMPING

## Foreign Discriminating Monopoly

The quantity sold in the local market,  $Q_2$  (at point C), is determined where local marginal revenue equals export marginal revenue,  $MR^* = MR$ .

The Foreign monopolist sells  $Q_2$  to its local market at  $P^*$ , and  $Q_1 - Q_2$  to its export market at  $P$ .

Because  $P < P^*$  (or alternatively  $P < AC_1$ ), the firm is dumping.



# Numerical Example of Dumping

Suppose the Foreign firm has the following cost and demand data:

Fixed costs	=	\$100
Marginal costs	=	\$10 per unit
Local price	=	\$25
Local quantity	=	10
Export price	=	\$15
Export quantity	=	10

The profits earned from selling in its local market are

$$\underbrace{(\$25 \cdot 10)}_{\text{Revenue}} - \underbrace{\$10 \cdot 10}_{\text{Variable cost}} - \underbrace{\$100}_{\text{Fixed cost}} = \underbrace{\$50}_{\text{Profits}}$$

Notice that the average costs for the firms are

$$\text{Average costs} = \frac{\$200}{10} = \$20$$

Now suppose that this firm sells an additional 10 units abroad, at the price of \$15, which is less than its average cost of production. It is still worthwhile to sell these extra units because profits become

$$\underbrace{(\$25 \cdot 10 + \$15 \cdot 10)}_{\text{Revenue}} - \underbrace{\$10 \cdot 20}_{\text{Variable cost}} - \underbrace{\$100}_{\text{Fixed cost}} = \underbrace{\$100}_{\text{Profits}}$$

# Government Intervention

Arguments for government intervention:

- **Political arguments** are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)
- **Economic arguments** are typically concerned with boosting the overall wealth of a nation (to the benefit of all, both producers and consumers), generating government revenues, protecting domestic sectors/industries, e.g., Infant or traditional sectors and industries

# Political Arguments For Free Trade

- protecting jobs
- protecting industries deemed important for national security
- retaliating to unfair foreign competition
- protecting consumers from “dangerous” products
- protecting the human rights of individuals in exporting countries

# Protecting Jobs And Industries

- Protecting jobs and industries is the most common political reason for trade restrictions
- Usually this results from political pressures by unions or industries that are "**threatened**" by **more efficient foreign producers**, and have more political clout than the consumers that will eventually pay the costs

# National Security

- Industries such as aerospace or electronics are often protected because they are deemed important for national security

# Retaliation

- When governments take, or threaten to take, specific actions, other countries may remove trade barriers
- If threatened governments don't back down, tensions can escalate and new trade barriers may be enacted

# Protecting Consumers

- Governments may intervene in markets to protect consumers

# Protecting Human Rights

- Trade policy can be used to improve the human rights policies of trading partners
- However, unless a large number of countries choose to take such action, it is unlikely to be successful
- Some critics have argued that the best way to change the internal human rights of a country is to engage it in international trade
- The decision to grant China MFN status in 1999 was based on this principle

# Economic Arguments for Intervention

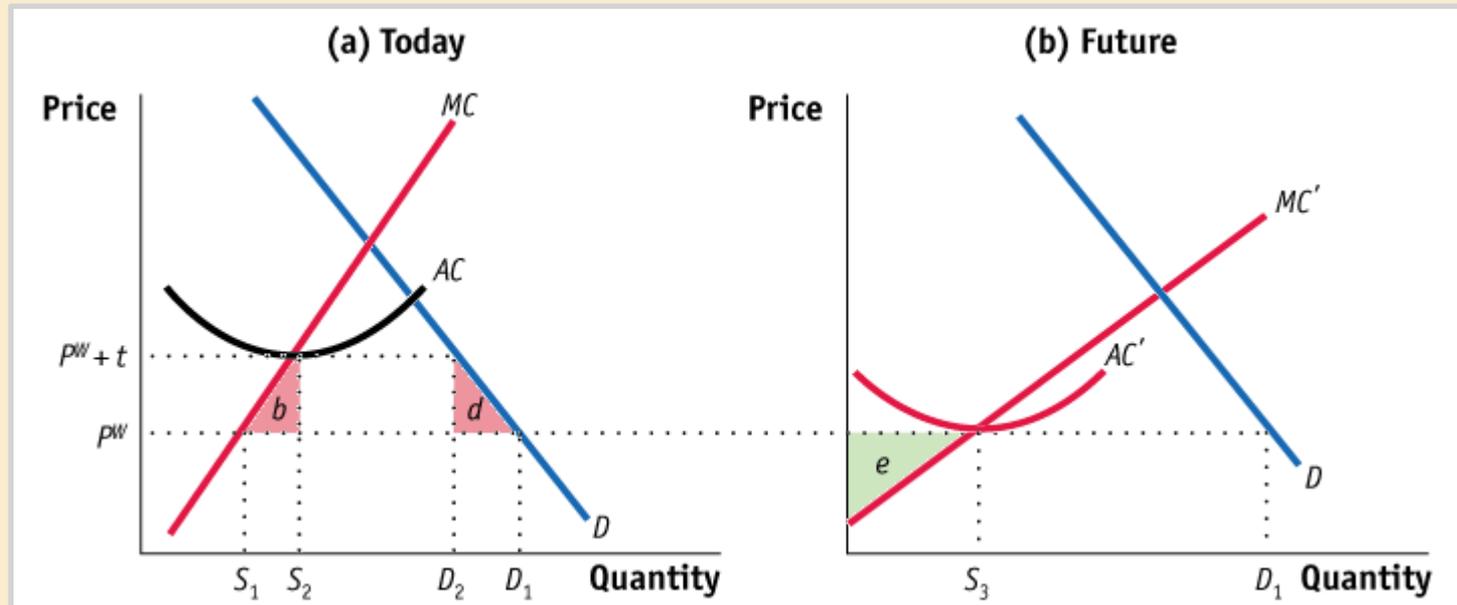
- the Infant Industry Argument
- Strategic Trade Policy (Import Tariffs, Export Subsidies)

# The Infant Industry Argument

- The infant industry argument suggests that an industry should be protected until it can develop and be viable and competitive internationally
- The infant industry argument has been accepted as a justification for temporary trade restrictions under the WTO
- However, it can be difficult to gauge when an industry has “grown up”
- Critics argue that if a country has the potential to develop a viable competitive position its firms should be capable of raising necessary funds without additional support from the government

# INFANT INDUSTRY-Free-Trade Equilibrium and Tariff Equilibrium

## Equilibrium Today, Equilibrium in the Future, Effect of the Tariff on Welfare



### Infant Industry Protection

Panel (a):  $P^W < AC$  -> Losses to the firm. A tariff ( $t$ ); new price  $P^W + t = AC$

Panel (b): producing today allows the average cost curve to fall through learning to  $AC'$ .

In the future, the firm can produce the quantity  $S_3$  at the price  $P^W$  without tariff protection and earn producer surplus of  $e$ .

# Strategic Trade Policy

- Strategic trade policy suggests that:
  - in cases where there may be important **first mover advantages**, governments can help firms from their countries attain these advantages
  - governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage

# Payoff Matrix: Boeing and Airbus: Decision to (not) Produce

**Payoff Matrix:** The lower-left number in each quadrant shows the profits of Boeing, and the upper-right number shows the profits of Airbus. Each firm must decide whether to produce a new type of aircraft.

		Airbus	
		Produce	Not produce
Boeing	Produce	-\$5 million / -\$5 million	\$0 / \$100 million
	Not produce	\$0 / \$100 million	\$0 / \$0

For this pattern of payoffs, there are two possible outcomes, in the upper-right and lower-left quadrants, where one firm produces, and the other does not.

**Each firm makes its own best decision, taking as given each possible action of the rival firm.**

**When each firm is acting that way, the outcome of the game is “a non-cooperative equilibrium”.** The action of each player is the best possible response to the action of the other player.

## Payoff Matrix: Boeing and Airbus: Decision to (not) Produce

Best Strategy for Boeing If Airbus produces, then Boeing is better off not producing (upper-right quadrant). *Having both firms produce is not possible.* Boeing would never stay in production, since it prefers to drop out of the market whenever Airbus produces

Best Strategy for Airbus Lower-left quadrant, with Airbus producing and Boeing not producing,

		Airbus	
		Produce	Not produce
Boeing	Produce	-\$5 million / -\$5 million	\$0 / \$100 million
	Not produce	\$100 million / \$0	\$0 / \$0

## Payoff Matrix with Subsidy: Boeing and Airbus: Decision to (not) Produce

		Airbus	
		Produce	Not produce
Boeing	Produce	-\$5 million \$20 million	\$100 million \$0
	Not produce	\$0 \$125 million	\$0 \$0

Payoff Matrix with Airbus Subsidy The European governments provide a subsidy of \$25 million to Airbus, its profits increase by that much when it produces a new aircraft.

Now there is only one market equilibrium: the lower-left quadrant. Airbus produces but Boeing does not. Airbus profits have increased from 0 to \$125 million. The subsidy cost only \$25 million, so there is a net gain of \$100 million in European welfare

**Best Strategy for Airbus** With the subsidy, Airbus now earns \$20 million by producing instead of losing \$5 million

**Best Strategy for Boeing** Boeing will want to drop out of the market. Once Boeing makes the decision not to produce, Airbus's decision doesn't change

# Revised Case For Free Trade

**Paul Krugman:** Restrictions on trade may not be inappropriate in the cases of:

- Retaliation and Trade War
- Domestic Politics

# Retaliation And Trade War

- **Paul Krugman** argues that strategic trade policies aimed at establishing domestic firms in a dominant position in a global industry are **beggar-thy-neighbor policies** that boost national income at the expense of other countries
- **Countries that attempt to use such policies will probably provoke retaliation**

# Domestic Policies

- When special interest groups can influence governments, strategic trade policy is almost certain to be captured by such groups who will distort it to their own ends

# Implications For Managers

- Managers need to consider how trade barriers affect the strategy of the firm and the implications of government policy on the firm

# Trade Barriers And Firm Strategy

- **Trade barriers** raise the cost of exporting products to a country
- **Voluntary export restraints** (VERs) may limit a firm's ability to serve a country from locations outside that country
- To conform to **local content requirements**, a firm may have to locate more production activities in a given market than it would otherwise
- All of the above more often than not raise the firm's costs above the level that could be achieved in a world without trade barriers

# Policy Implications

- International firms have an **incentive to lobby for free trade**, and keep protectionist pressures from causing them to have to change strategies
- While there may be **short run benefits** to having governmental protection in some situations, in the **long run** these can **backfire** and other governments can **retaliate**