Chapter 7

Government Intervention and Regional Economic Integration

Learning Objectives *After studying this chapter, you should be able to:*

7.1 Understand the nature of government intervention.

7.2 Know the instruments of government intervention.

7.3 Explain the evolution and consequences of government trade intervention.

7.4 Describe how firms can respond to government trade intervention.

7.5 Understand regional integration and economic blocs.

7.6 Identify the leading economic blocs.

7.7 Understand and explain the advantages and implications of regional integration.

Tripartism: Singapore's Key Competitive Advantage

The Hollywood blockbuster *Crazy Rich Asians*, featuring the lives of ultra-rich Chinese Singaporeans, reflects the island nation's global reputation for its wealth. Yet Singapore is a country with a precarious beginning. When Singapore was expelled from Malaysia on August 9, 1965, Singapore's then prime minister Lee Kuan Yew gave an emotional speech that conveyed a sense of hopelessness. To deepen the gloom, Britain's plans to withdraw its military bases from Singapore by the early 1970s meant a loss of more than 20 percent of Singapore's GDP. How did a small island nation with no natural resources survive under such circumstances?

To facilitate export-oriented economic growth, the Singaporean government had to attract foreign direct investment (FDI) to bring in crucial capital and technology. A more conducive business environment was created through government-linked corporations such as PSA, a port operator founded in April 1964; SIA, which was founded in May 1947 as Malayan Airways and commenced operations in October 1972 as Singapore Airlines; NOL, a shipping line founded in December 1968; DBS Bank, founded in July 1968; and JTC Corporation, a real-estate company and statutory board founded in June 1968. Other statutory boards included the Economic Development Board, formed in August 1961 to coordinate industrialization; the National Productivity Board, established in 1972 to focus on productivity; and the Trade Development Board, established in 1983 to coordinate trade. The government's

Source: Ronnie Chua/Alamy Stock Photo

zero tolerance for corruption increased transparency and ease of doing business in Singapore.

Labor is a major operating cost for business. Harmonious industrial relations improve productivity, lower costs, and increase certainty in doing business. Yet early Singaporean industrial relations from the 1950s to 1960s were frequently acrimonious, marred by frequent labor strikes, political instability, and social unrest. The labor movement was highly politicized until the ruling People's Action Party–aligned National Trade Union Congress (NTUC) became Singapore's sole national trade union in November 1963 (nevertheless, inherent mistrust between employers and labor unions were deep-rooted and persisted).

The NTUC modernization seminar in 1969 and the establishment of the National Wage Council (NWC) in 1972 became major milestones in Singapore's tripartism. In Singapore, tripartism refers to collaboration on labor-related issues between the government, represented by the Ministry of Manpower; business, represented by the Singapore National Employers' Federation; and unions, represented by the NTUC.

The NWC provided a platform for the tripartite partners to formulate wage guidelines for orderly wage rises, marking the beginning of decades of collaborations that forged trust among the tripartite partners, who work on the premise that national interests supersede sectoral interests and that economic progress facilitates jobs creation. This is a competitive advantage made all the more attractive to foreign investment by the country's greater stability in the region. Yet tripartism remains Singapore's key competitive advantage, effectively distinguishing Singapore as an attractive gateway to doing business in Asia.

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Questions

7-1. Describe the nature of government intervention in Singapore. Why has Singapore been effective in attracting FDI?

7-2. Why is tripartism considered Singapore's key competitive advantage?

7-3. Can other countries replicate the Singaporean model?

SOURCES: Lee Kuan Yew, *From Third World to First: The Singapore Story, 1965–2000* (New York: HarperCollins, 2000); Peter Sheldon, Bernard Gan, and David Morgan, "Making Singapore's Tripartism Work (Faster): The Formation of the Singapore National Employers' Federation in 1980," *Business History*, 57(3) (2015), pp. 438–460.

This case was written by Bernard Gan, Griffith University.

Governments intervene in trade and investment to achieve political, social, or economic objectives. They often create trade barriers that benefit specific interest groups, such as domestic firms, industries, and labor unions. A key rationale is to create jobs by protecting industries from foreign competition. Governments also intervene to support homegrown industries or firms.

Government intervention is at odds with *free trade*, the unrestricted flow of products, services, and capital across national borders. Market liberalization and free trade are best for supporting economic growth and national living standards.[1] Many studies have found a strong association between market openness—that is, unimpeded free trade—and economic growth. Emerging markets and developing economies that emphasize openness typically enjoy average annual per-capita GDP growth in excess of 4 percent, whereas relatively closed countries—those that significantly restrict international trade and investment—grow at rates close to zero.[2]

Take the case of Poland. Over time, Poland lowered trade barriers and participated more freely in international trade, adopting the principle of comparative advantage.[3] Poland began to use its resources more efficiently. It generated more overall profits for firms and workers. It acquired more resources with which to import the goods that Polish consumers desire. As it gradually embraced free trade, Poland's average annual income rose from about $1,625 in 1990 to more than $15,000 by 2017. These gains did not occur without some turmoil. Unemployment in Poland increased in

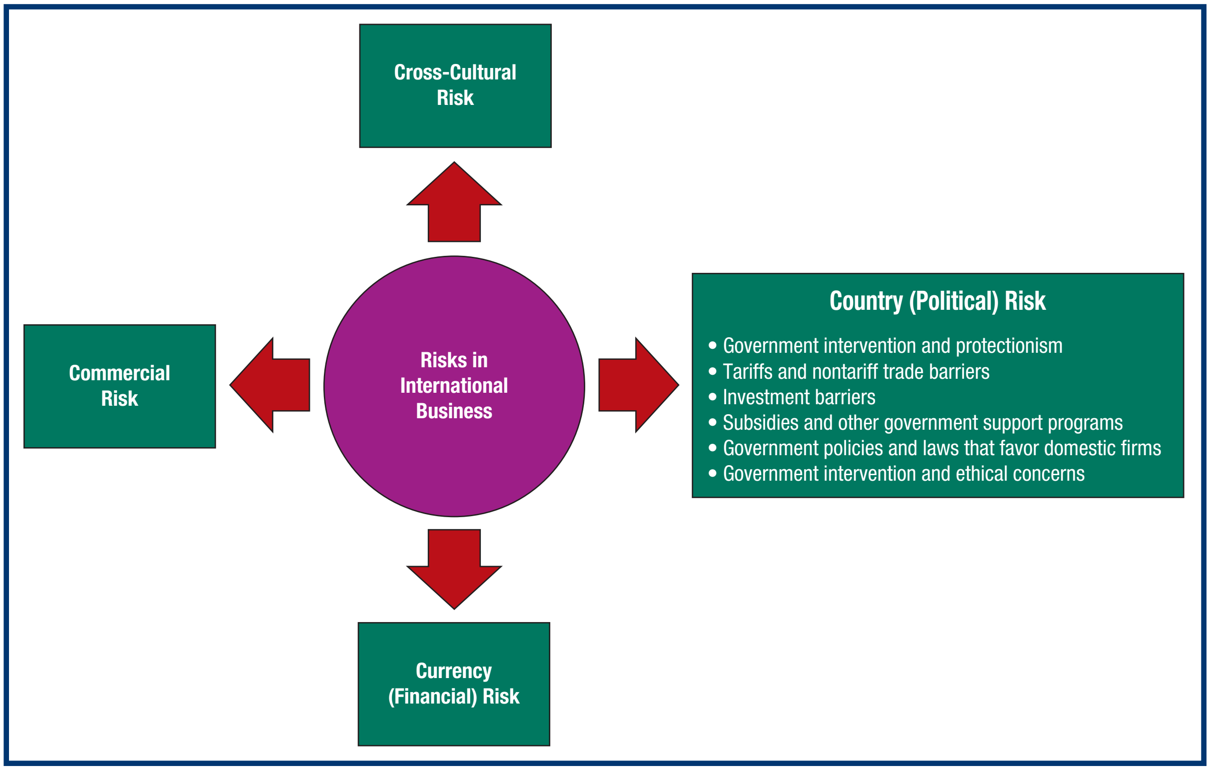


EXHIBIT 7.1

Government Intervention as a Component of Country Risk

some industries as jobs producing certain goods shifted to other countries better suited to make those goods. However, free trade's positive effects substantially outweighed the negative ones.[4] Free trade provides enormous benefits for economic growth and the welfare of nations worldwide.

In reality, however, governments intervene in business and the international marketplace in ways that obstruct the free flow of trade and investment. Intervention alters the competitive position of companies and industries and the status of citizens. As highlighted in Exhibit 7.1, intervention is an important dimension of country risk. In this chapter, we examine the nature, rationale, and consequences of government intervention. We also describe what companies can do to enhance international performance in the face of government intervention worldwide. Finally, we discuss regional economic blocs and their role in international business.

The Nature of Government Intervention

7.1 Understand the nature of government intervention.

Protectionism is perhaps the leading manifestation of government intervention in international business. **Protectionism** refers to national economic policies designed to restrict free trade and protect domestic industries from foreign competition. Protectionism typically arises in the form of tariffs, nontariff barriers such as quotas, and administrative rules designed to discourage imports. A **tariff** (also known as a *duty*) is a tax a government imposes on imported products, effectively increasing the cost of acquisition for the customer. A **nontariff trade barrier** is a government policy, regulation, or procedure that impedes trade through means other than explicit tariffs. Trade barriers are enforced as products pass through **customs**, the checkpoints at the ports of entry in each country where government officials inspect imported products and levy tariffs. An often-used form of nontariff trade barrier is a **quota**, a quantitative restriction placed on imports of a specific product over a specified period. Government intervention may also target foreign direct investment (FDI) flows via investment barriers that restrict the operations of foreign firms.

Protectionism
National economic policies designed to restrict free trade and protect domestic industries from foreign competition.

Tariff
A tax imposed on imported products, effectively increasing the cost of acquisition for the customer.

Nontariff trade barrier
A government policy, regulation, or procedure that impedes trade through means other than explicit tariffs.

Customs
Checkpoints at the ports of entry in each country where government officials inspect imported products and levy tariffs.

Quota
A quantitative restriction placed on imports of a specific product over a specified period.

Government intervention affects economic activity in a nation by hindering or helping the ability of its homegrown firms to compete internationally. Often local companies, labor unions, and other special interest groups convince governments to adopt policies that benefit them. In 2018, for example, the administration of President Donald Trump imposed a 30 percent tariff on imports of solar panel technology into the United States. In 2009, the administration of President Barack Obama imposed 30 percent tariffs on the import of tires into the United States from China. The rationale was to give the U.S. tire industry time to revive itself following years of decline due to competition from foreign tire producers. Following introduction of the tariffs, employment in the U.S. tire industry grew by more than 1,000 jobs. However, manufacturing tires in the United States is relatively expensive, and the added costs were largely borne by American consumers who had to pay more for tires. In addition, the extra money U.S. consumers spent on tires reduced their spending on other retail goods, which may have contributed to the loss of many U.S. retailing jobs. Eventually the tire tariffs were removed but only after causing harm.

As the example suggests, protectionist policies can lead to price inflation because tariffs can restrict the supply of a particular product or necessitate costlier local production. Tariffs may also reduce the choices available to buyers by restricting the variety of products available for sale.

Populism is a political philosophy that aims to support the rights and power of everyday citizens, often in opposition to privileged elites or other special interest groups. Supporters of recent populist movements in Europe and the United States sought to resist perceived threats of globalization, mainly arising from cross-national human migration and growing free trade. The movements increased trade frictions and triggered protectionism. For example, U.S. President Donald Trump sought to renegotiate the North American Free Trade Agreement (NAFTA, launched in 1994 by Canada, Mexico, and the United States) to more strongly favor the United States. Resulting trade tensions dampened trade relations among the NAFTA countries and discouraged inward investment, particularly in Mexico. For example, Toyota scaled back investment in a new factory in Guanajuato, Mexico.[5]

These examples illustrate that government intervention can lead to harmful *unintended consequences*—unfavorable outcomes of policies or laws. In a complex world, legislators and policymakers cannot foresee all possible outcomes. Government intervention should be planned and implemented with great care.

Special interest groups often advocate trade and investment barriers that protect their interests. Consider the recent trade dispute between Mexico and the United States over Mexican cement.

Governments impose tariffs, nontariff trade barriers, and other forms of intervention for four main reasons:

- *To generate revenue.* For example, the Hamilton Tariff, enacted July 4, 1789, was the second statute the newly founded United States passed, providing revenue for the federal government. Today, Jamaica and the Philippines generate more than 30 and 20 percent, respectively, of government revenues from tariffs.
- *To ensure citizen safety, security, and welfare.* For example, governments pass laws to prevent importation of harmful products such as contaminated food.
- *To pursue economic, political, or social objectives.* In most cases, tariffs and similar forms of intervention are intended to promote job growth and economic development.
- *To serve company and industrial interests.* Governments may devise regulations to stimulate development of homegrown industries.

The U.S. government imposed duties of about $50 per ton on the import of Mexican cement after U.S. cement makers lobbied Congress. The stakes were huge. Mexican imports can reach 10 percent of U.S. domestic cement consumption. Mexico proposed substituting import quotas in place of the tariffs. The two governments have negotiated for years to resolve the dispute.[6]

Trade and investment barriers can be considered either defensive or offensive. Governments impose defensive barriers to safeguard industries, workers, and special interest groups and to promote national security. Governments impose offensive barriers to pursue strategic or public policy objectives such as increasing employment or generating tax revenues. Let's review the specific rationale for government intervention.

Defensive Rationale

Four major defensive motives are particularly relevant: protection of the nation's economy, protection of an infant industry, national security, and national culture and identity.

PROTECTION OF THE NATIONAL ECONOMY Proponents argue that firms in advanced economies cannot compete with those in developing countries that employ low-cost labor. Protectionists demand trade barriers to curtail the import of low-priced products. The action is intended to protect jobs and ensure higher wages for workers in advanced economies.

However, protectionism defies the principle of comparative advantage, which implies that nations should engage in more international trade, not less. Trade barriers interfere with country-specific specialization of labor. When countries specialize in the products they can produce best and then trade for the rest, they perform better. They deliver superior living standards to their citizens. Blocking imports can reduce the availability and increase the cost of products sold in the home market. Protectionism can trigger retaliation. This results in foreign governments imposing their own trade barriers, which reduces sales prospects for exporters.

PROTECTION OF AN INFANT INDUSTRY In an emerging industry, companies are often inexperienced and lack the latest technologies and know-how. They also may lack the large size typical of competitors in established industries abroad. A very young industry may need temporary protection from foreign competitors. A government may impose temporary trade barriers on foreign imports to ensure that young firms gain a large share of the domestic market. Protecting infant industries has allowed some countries to develop a modern industrial sector. For example, government intervention allowed Japan and South Korea to become dominant players in the global automobile and consumer electronics industries. The U.S. government imposed tariffs on the import of inexpensive Chinese-made solar cells to protect the emerging U.S. solar power industry.[7]

Once in place, however, such protection may be hard to remove. Industry owners and workers tend to lobby to preserve government protection. Infant industries in many countries (especially in Latin America, South Asia, and Eastern Europe) have shown a tendency to remain dependent on government protection for many years. Protected companies are often less efficient than unprotected firms that compete in free markets. Faced with few or no competitors, protected companies may produce lower quality products or charge higher prices for them, which can harm domestic consumers.[8]

NATIONAL SECURITY Countries impose trade restrictions on products viewed as critical to national defense and security. These include military technology and computers that help maintain domestic production in security-related products. For example, Russia blocked a bid by German engineering giant Siemens to purchase the Russian turbine manufacturer OAO Power Machines on grounds of national security. The Russian government has strict legislation that limits foreign investment in sectors considered vital to Russia's national interests.[9] Countries may also impose **export controls**, government measures intended to manage or prevent the export of certain products or trade with certain countries. For example, many countries prohibit exports of plutonium to North Korea because it can be used to make nuclear weapons. The United States generally blocks exports of nuclear and military technology to countries it deems state sponsors of terrorism, such as Iran and Syria.

Source: Roman Borodaev/123RF

To safeguard its national culture, the French government prevents foreign companies from owning television and movie companies in France. Shown here is Cannes, the site of France's popular film festival.

NATIONAL CULTURE AND IDENTITY Should foreign entities—say, the Japanese or the Saudis—be allowed to purchase national landmarks such as the Eiffel Tower or Rockefeller Center? In most countries, certain occupations, industries, and public assets are seen as central to national culture and identity. Governments may impose trade barriers to restrict imports of products or services seen to threaten such national assets. In the United States, authorities opposed Japanese investors' purchase of the Seattle Mariners baseball team because it is viewed as part of the national heritage. France does not allow significant foreign ownership of its TV stations because of concerns about foreign influence on French culture.

Export control
A government measure intended to manage or prevent the export of certain products or trade with certain countries.

Offensive Rationale

Offensive rationales for government intervention fall into two categories: national strategic priorities and increasing employment.

NATIONAL STRATEGIC PRIORITIES Government intervention sometimes aims to encourage the development of industries that bolster the nation's economy. It is a *proactive* variation of the infant industry rationale and related to national industrial policy. Countries with many high-tech or high value-adding industries, such as information technology, pharmaceuticals, car manufacturing, or financial services, create better jobs and higher tax revenue. Countries with low-tech or low value-adding industries, such as agriculture, textile manufacturing, or discount retailing create lower value jobs and less tax revenue. Governments in Germany, South Korea, and numerous other countries have devised policies that promote the development of relatively desirable industries. Such governments may provide financing for investment in high-tech or high value–adding industries. They may encourage citizens to save money to ensure a steady supply of loanable funds for industrial investment. These loans enable funding for public education to provide citizens the skills and flexibility they need to perform in key industries.[10]

INCREASING EMPLOYMENT Governments often impose import barriers to protect employment in designated industries. Insulating domestic firms from foreign competition stimulates national output, leading to more jobs in the protected industries. The effect is usually strongest in import-intensive industries that employ much labor. For example, the Chinese government has traditionally required foreign companies to enter its huge markets through joint ventures with local Chinese firms. This policy creates jobs for Chinese workers. A joint venture between Shanghai Automotive Industry Corporation (SAIC) and Volkswagen created jobs in China.

Instruments of Government Intervention

7.2 Know the instruments of government intervention.

The main instruments of trade intervention and the traditional forms of protectionism are tariffs and nontariff trade barriers. Individual countries or groups of countries, such as the European Union (europa.eu), can impose these barriers. However, barriers can be a serious impediment to

Intervention Type	Definition	Practical Effect on Customers, Firms, or Government	Examples
Tariff	Tax imposed on imported products.	Increases cost to the importer, the exporter, and usually the buyer of the product; discourages product imports; generates government revenue.	Switzerland charges a 37% tariff on imported agricultural products. Bolivia charges a 35% tariff on most apparel and textiles.
Quota	Quantitative restriction on imports of a product during a specified period of time.	Gives early importers monopoly power and the ability to charge higher prices; harms late importers; usually results in higher prices to the buyer.	Japan maintains strict quotas on the import of leather shoes and various types of seafood.
Local content requirements	Requirement that firms include a minimum percentage of locally sourced inputs in the production of given products or services.	Discourages imports of raw materials, parts, and supplies, which harms manufacturers' sourcing options; may result in higher costs and lower product quality for buyers.	At least 50% of the value of all cars assembled in Venezuela must be from parts or other inputs produced in Venezuela.
Regulations and technical standards	Safety, health, or technical regulations; labeling requirements.	May hinder the entry of imported products and reduce the quantity of available products, resulting in higher costs to importers and buyers.	Saudi Arabia bans imports of firearms and used clothing. The EU requires extensive testing on thousands of imported chemicals.
Administrative and bureaucratic procedures	Complex procedures or requirements imposed on importers or foreign investors that hinder trade and investment.	Slows the import of products or services; hinders or delays firms' investment activities.	Russia imposes extensive inspections and bureaucratic procedures on the import of alcoholic beverages.
FDI and ownership restrictions	Rules that limit the ability of foreign firms to invest in certain industries or acquire local firms.	Limits how much foreigners can invest in a country, and/or the proportion of ownership that foreigners can hold in firms in the country.	In Switzerland, foreign-owned insurance companies must be managed by a Swiss national, and most board members must be European citizens.
Subsidy	Financing or other resources that a government grants to a firm or group of firms, to ensure their survival or success.	Increases the competitive advantage of the grantee while diminishing the competitive advantages of those that do not receive the subsidy.	Turkey gives export subsidies of up to 20% to local, Turkish producers of wheat and sugar.

EXHIBIT 7.2

Types and Effects of Government Intervention

Source: Adapted from the Office of the United States Trade Representative, retrieved from www.ustr.gov.

cross-border business. The United Nations estimated that trade barriers alone cost developing economies more than $500 billion in lost trading opportunities with advanced economies every year.[11] Exhibit 7.2 highlights the most common forms of government intervention and their effects.

Tariffs

The most common type of tariff is the *import tariff*, a tax levied on imported products. Import tariffs are usually *ad valorem.* They are assessed as a percentage of the value of the imported product. In other cases, a government may impose a *specific tariff,* a flat fee or fixed amount per unit of the imported product. It is based on weight, volume, or surface area, such as barrels of oil or square meters of fabric. A *revenue tariff* is intended to raise money for the government. A tariff on cigarette imports, for example, produces a steady flow of revenue. A *protective tariff* aims to protect domestic industries from foreign competition. A *prohibitive tariff* is one so high that no one can import any of the items.

The amount of a tariff is determined by examining a product's harmonized code. Products are classified under about 8,000 unique codes in the *harmonized tariff* or *harmonized code* schedule. The harmonized code is standardized worldwide. Without it, firms and governments might have differing opinions on product definitions and the tariffs charged.

Import tariffs can generate substantial revenue for national governments. This helps explain why they are common in developing economies. The United States charges tariffs on many consumer, agricultural, and labor-intensive products. The U.S. typically collects high tariffs (often 48 percent) on imports of basic, low-quality shoes, and low tariffs (just 9 percent) on luxury shoes. Low-income shoe buyers end up paying the highest tariffs. The European Union applies tariffs of up to 191 percent on meat, 118 percent on cereals, and 106 percent on sugar and confectionary products.[12]

Exhibit 7.3 provides a sample of import tariffs in selected countries. Under the North American Free Trade Agreement (NAFTA), Canada, Mexico, and the United States have eliminated nearly all tariffs on product imports from each other. However, Mexico maintains significant tariffs with the rest of the world—14.6 percent for agricultural products and 5.7 percent for nonagricultural goods. India's tariffs are relatively high, especially in agriculture, where the average rate is 32.7 percent. China has reduced its tariffs since joining the World Trade Organization (WTO, www.wto.org), but trade barriers remain high in some areas.

Half of all workers in Africa are employed in agriculture. Significant tariffs and other trade barriers in the advanced economies hinder imports of agricultural goods from Africa. This worsens already severe poverty in many African countries.

Because high tariffs inhibit free trade and economic growth, governments have tended to reduce them over time. This was the primary goal of the General Agreement on Tariffs and Trade (GATT; now the WTO). Countries as diverse as Chile, Hungary, Turkey, and South Korea have liberalized their previously protected markets, lowering trade barriers and subjecting themselves to greater competition from abroad. Exhibit 7.4 illustrates trends in average world tariff rates over time. Notice that developing economies have been lowering their tariff rates since the early 1980s. Continued reductions represent a major driver of market globalization.

Nontariff Trade Barriers

Nontariff trade barriers are government policies or measures that restrict trade without imposing a direct tax or duty. They include quotas, import licenses, local content requirements, government regulations, and administrative or bureaucratic procedures. The use of nontariff barriers has grown substantially in recent decades. Governments sometimes prefer them because they are easier to hide from the WTO and other organizations that monitor international trade.

Quotas restrict the physical volume or value of products that firms can import into a country. In a classic type of quota, the U.S. government imposed an upper limit of roughly 2 million pounds on the total amount of sugar that can be imported into the United States each year. Sugar imports that exceed this level face a tariff of several cents per pound. U.S. sugar producers are protected from cheaper imports, giving them a competitive edge over foreign sugar producers. However, U.S. consumers and producers of certain types of products, such as

EXHIBIT 7.3
A Sampling of Import Tariffs, Percentages

	Average Import Tariff	
Country	Agricultural Products	Nonagricultural Products
Australia	1.2%	2.7%
Brazil	10.0	14.1
Canada	15.6	2.2
China	15.5	9.0
European Union	11.1	4.2
India	32.7	10.2
Japan	13.1	2.5
Mexico	14.6	5.7
United States	5.2	3.2

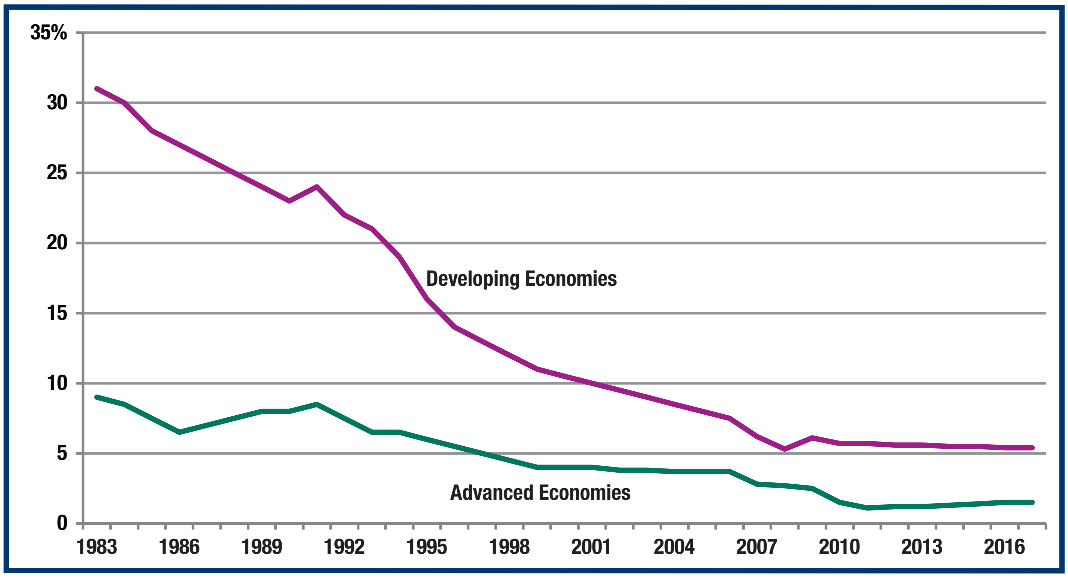
Note: Exhibit shows the average, most favored nation-applied tariff.

Source: Based on *World Tariff Profiles 2017,* World Trade Organization, www.wto.org.

EXHIBIT 7.4

Trends in Average Tariff Rates, Percentages

Source: Based on the World Bank, http://data.worldbank.org.



Hershey's and Coca-Cola, pay more for sugar. Companies that manufacture products containing sugar may save money by moving production to countries that do not impose quotas or tariffs on sugar.

Governments can impose voluntary quotas, under which firms agree to limit exports of certain products. These are also known as *voluntary export restraints*. For example, import quotas in the European Union led to an impasse in which millions of Chinese-made garments piled up at ports and borders in Europe. The EU impounded the clothing because China had exceeded the voluntary import quotas it had negotiated with the EU.[13]

Import license
Government authorization granted to a firm for importing a product.

Governments occasionally require importing firms to obtain an **import license**, a formal permission to import, which restricts imports in a way that is similar to quotas. (Do not confuse import licenses with *licensing*, a strategy for entering foreign markets in which one firm allows another the right to use its intellectual property in return for a fee.) Governments sell import licenses to companies on a competitive basis or grant the licenses on a first-come, first-served basis. This tends to discriminate against smaller firms, which typically lack the resources to purchase them. Obtaining a license can be costly and complicated. In some countries, importers must pay hefty fees to government authorities. In other countries, they must deal with bureaucratic red tape. In Russia, a complex web of licensing requirements limits imports of alcoholic beverages.

Local content requirements require manufacturers to include a minimum of local value added—that is, production that takes place locally. Local content requirements are usually imposed in countries that are members of an economic bloc, such as the EU and NAFTA. The so-called *rules of origin requirement* specify that a certain proportion of products and supplies or of intermediate goods used in local manufacturing must be produced within the bloc. For a car manufacturer, the tires or windshields it purchases from another firm are intermediate goods. When the firm does not meet this requirement, the products become subject to trade barriers that member governments normally impose on nonmember countries. Thus, producers within the NAFTA zone of Canada, Mexico, and the United States pay no tariffs on the products and supplies they obtain from each other, unlike countries such as China or the United Kingdom that are not part of NAFTA. Roughly 60 percent of the value of a car manufactured within NAFTA must originate within the NAFTA member countries. If this condition is not met, the product is subject to the tariffs charged to non-NAFTA countries.

Government regulations and technical standards are another type of nontariff trade barrier. Examples include safety regulations for motor vehicles and electrical equipment, health regulations for hygienic food preparation, labeling requirements that indicate a product's country of origin, technical standards for computers, and bureaucratic procedures for customs clearance, including excessive red tape and slow approval processes. The European Union strictly regulates food that has been genetically modified (GM). The policy blocks some food imports into Europe from Africa and the United States. In China, the government requires foreign firms to obtain special permits to import GM foods. Chinese government censorship of material it considers subversive has hindered Google's attempts to enter China's huge Internet market.[14]

Governments may impose *administrative or bureaucratic procedures* that hinder the activities of importers or foreign firms. For example, the opening case revealed how India's business sector is burdened by countless regulations, standards, and administrative hurdles at the state and federal levels. In Mexico, government-imposed bureaucratic procedures led United Parcel Service to suspend its ground delivery service temporarily across the U.S.–Mexican border. Similarly, the United States barred Mexican trucks from entering the United States on the grounds that they were unsafe.[15]

Some countries impose "localization barriers to trade." These are measures designed to protect, favor, or stimulate domestic industries, at the expense of goods and services imports from other countries. Localization barriers may include local content requirements as well as incentives offered to foreign MNEs only if they manufacture goods locally and use local inputs and production factors. For example, the U.S. state of Wisconsin provided a $3 billion incentive package to lure Taiwanese manufacturer Foxconn to build a large manufacturing plant in the state. Half of Wisconsin's incentives were contingent on how many workers Foxconn hired.[16] The incentives sought to localize manufacturing and create jobs in the state, at the expense of imports from China where Foxconn has a big presence manufacturing smartphones and other electronics.

Saudi Arabia is home to various restrictive practices that hinder international trade. Every foreign business traveler to the Arab kingdom must hold an entry visa that can be obtained only by securing the support of a sponsor. A sponsor can be a Saudi citizen or organization who vouches for the visitor's actions. Because few Saudis are willing to assume such responsibility, foreigners who want to do business in Saudi Arabia face difficulty.[17]

Investment Barriers

As we saw in the opening case about India, countries also impose restrictions on FDI and ownership. These restrictions hinder the ability of foreign firms to invest in some industry sectors or acquire local firms. Excessive restrictions in India prevent the approval of many investment proposals that could produce billions of dollars in revenue to the local economy and government. Worldwide, FDI and ownership restrictions are particularly common in industries such as broadcasting, utilities, air transportation, military technology, and financial services. The restrictions are also present in industries in which the government has major holdings, such as oil and key minerals. The Mexican government restricts FDI by foreign investors to protect its oil industry, which is deemed critical to the nation's security. The Canadian government restricts foreign ownership of local movie studios and TV networks to protect its indigenous film and TV industries from excessive foreign influence. FDI and ownership restrictions are particularly burdensome in the services sector because services usually cannot be exported, and providers must establish a physical presence in target markets to conduct business there.

Currency control
Restrictions on the outflow of hard currency from a country or on the inflow of foreign currencies.

Currency controls restrict the outflow of widely used currencies, such as the dollar, euro, and yen, and occasionally the inflow of foreign currencies. Controls can help conserve especially valuable currency or reduce the risk of capital flight. They are particularly common in developing economies. Some countries employ a system of dual official exchange rates, offering exporters a relatively favorable rate to encourage exports, while importers receive a relatively unfavorable rate to discourage imports.

Source: Kanok Sulaiman/Shutterstock
State-owned oil company PEMEX (Petroleos de Mexico) benefits from investment barriers in Mexico that prevent foreign firms from gaining control of Mexican oil companies.

Currency controls both help and harm firms that establish foreign subsidiaries through FDI. They favor companies when they export their products from the host country but harm those that rely heavily on imported parts and components. Controls also restrict the ability of MNEs to *repatriate* their profits—that is, transfer revenues from profitable operations back to the home country.

As an example, Venezuela's currency controls have led to a shortage of dollars and other hard currencies. Multinational firms avoid doing business in Venezuela because strict currency rules limit the amount of profit they can take out of the country or limit their ability to receive payment for imports at reasonable prices. Venezuela imposed the controls to keep imports inexpensive and maintain a base of hard currencies in the country.[18]

Subsidies and Other Government Support Programs

Subsidy
Monetary or other resources that a government grants to a firm or group of firms, usually intended to encourage exports or facilitate the production and marketing of products at reduced prices, to ensure that the favored firms prosper.

Subsidies are monetary or other resources that a government grants to a firm or group of firms, intended either to encourage exports or simply to facilitate the production and marketing of products at reduced prices, to help ensure that the involved companies prosper. Subsidies come in the form of outright cash disbursements, material inputs, services, tax breaks, the construction of infrastructure, and government contracts at inflated prices. For example, the French government has provided large subsidies to Air France, the national airline.

Exhibit 7.5 displays the countries with the most government-owned firms active in international business. These state-owned multinational enterprises (SOMNEs) receive generous subsidies and other resources from their home-country governments. China has the most SOMNEs, approximately 257. China Minmetals, Shanghai Automotive, and other Chinese SOMNEs account for as much as 40 percent of China's economic output. In total, China is home to some 150,000 state-owned enterprises, of which about 50,000 (33 percent) are owned by the central government and the remainder by local governments.[19]

Critics argue that subsidies give unfair advantages to recipients by reducing their cost of doing business. In Qatar and the United Arab Emirates, local governments have provided billions of dollars in subsidies to Qatar Airways, Etihad Airways, and Emirates Airline. The subsidies provide these airlines with competitive advantages, such as the ability to offer flights at lower prices, which deters customers from using rival carriers. Foreign airlines such as Delta and United complain that the subsidies violate free trade agreements. Note, however, that numerous nations subsidize home-country airlines.[20] The WTO prohibits subsidies when it can be proven that they hinder free trade. Subsidies, however, are hard to define. For example, when a government provides land,

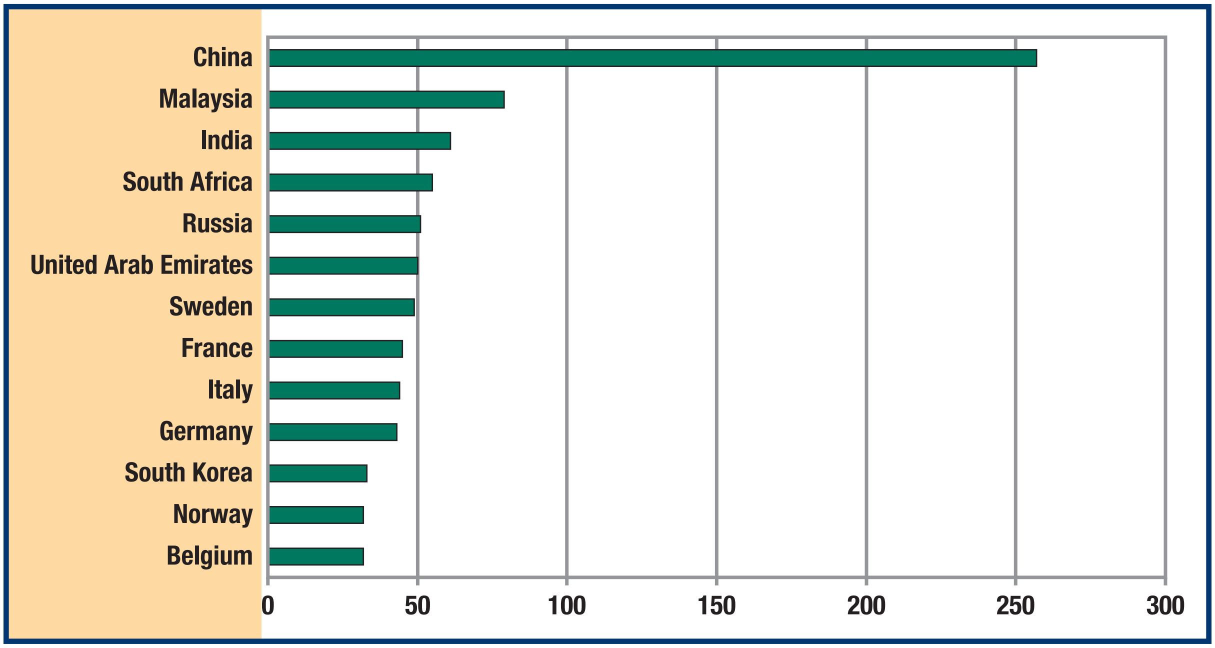


EXHIBIT 7.5

Number of State-Owned Multinational Enterprises, by Country

Source: UNCTAD, *World Investment Report* (New York: United Nations, 2017), www.unctad.org.

infrastructure, telecommunications systems, or utilities to the firms in a corporate park, this is technically a subsidy. Yet many view this type of support as an appropriate public function.

In Europe and the United States, governments frequently provide agricultural subsidies to supplement the income of farmers and help manage the supply of agricultural commodities. The U.S. government grants subsidies for more than two dozen commodities, including corn, soybeans, wheat, cotton, and rice.[21]

Governments sometimes retaliate against subsidies by imposing **countervailing duties**, tariffs on products imported into a country to offset subsidies given to producers or exporters in the exporting country. In this way, the duty serves to cancel out the effect of the subsidy, eliminating the price advantage the exporters would otherwise obtain.

Source: Sean Pavone/Shutterstock

The Ministry of Economy, Trade, and Industry in Japan is typical of national federal agencies that promote international trade and investment.

Subsidies may allow a manufacturer to practice **dumping**—that is, to charge an unusually low price for exported products, typically lower than that for domestic or third-country customers or even lower than the cost to manufacture the good.[22] The European Union has provided billions of euros in subsidies every year to EU sugar producers, which allowed Europe to become one of the world's largest sugar exporters at artificially low prices. Without the subsidies, Europe would be one of the world's biggest sugar importers.

Countervailing duty
Tariff imposed on products imported into a country to offset subsidies given to producers or exporters in the exporting country.

Dumping
Pricing exported products at less than their normal value, generally less than their price in the domestic or third-country markets, or at less than production cost.

Investment incentive
Transfer payment or tax concession made directly to foreign firms to entice them to invest in the country.

Dumping violates WTO rules because it amounts to unfair competition, but dumping is hard to prove because firms usually do not reveal data on their cost structures. A large MNE that charges very low prices could conceivably drive competitors out of a foreign market, achieve a monopoly, and then raise prices later.[23]

Related to subsidies are governmental **investment incentives**, transfer payments or tax concessions made directly to individual foreign firms to entice them to invest in the country. Hong Kong's government put up most of the cash to build Hong Kong Disneyland (www.hongkongdisneyland.com). Although the park and facilities cost about $1.81 billion, the government provided Disney an investment of $1.74 billion to develop the site.

Recently, Austin, Texas, and Albany, New York, competed for the chance to have the Korean manufacturer Samsung Electronics (www.samsung.com) build a semiconductor plant in their regions. Austin offered $225 million worth of tax relief and other concessions in its successful bid to attract Samsung's $300 million plant, estimated to create nearly 1,000 new jobs locally. To entice MNEs to establish local production facilities, the country of Macedonia offers such incentives as low corporate taxes, immediate access to utilities and transportation, and financial support for training workers (see www.investinmacedonia.com).

Governments also support domestic industries by adopting *procurement policies* that restrict purchases to home–country suppliers. Several governments require air travel purchased with government funds to be booked with home–country carriers. Such policies are especially common in countries with large public sectors, such as China and Russia. In the United States, government agencies favor domestic suppliers unless their prices are high compared to foreign suppliers. In Japan, government agencies often do not even consider foreign bids, regardless of pricing. Public procurement agencies often impose requirements that effectively exclude foreign suppliers.

Evolution and Consequences of Government Intervention

7.3 Explain the evolution and consequences of government trade intervention.

A century ago, trade barriers worldwide were relatively high. The trading environment worsened through two world wars and the Great Depression. The United States passed the Smoot-Hawley Tariff Act in 1930. It raised U.S. tariffs to near-record highs of more than 50 percent, compared to only about 4 percent today. Tariffs that other countries imposed to retaliate against Smoot-Hawley

Source: reddees/Shutterstock

India is a major clothing exporter that faces high tariffs, especially in markets of the advanced economies. Here, Indian clothing merchants show their samples in Hyderabad.

choked off foreign markets for U.S. agricultural products. This resulted in falling farm prices and many bank failures. In an effort to revive trade, many governments began to reduce tariffs in the late 1940s.

However, governments in Latin America and other developing nations gradually adopted protectionist policies aimed at supporting domestic industrialization. The approach did not succeed. Domestic firms that enjoyed government subsidies and the protection of high tariffs never became competitive in world markets. Living standards remained relatively low.

By contrast, from the 1970s onward, Singapore, Hong Kong, Taiwan, and South Korea achieved rapid economic growth by encouraging the development of export-intensive industries. Their model, known as *export-led development*, proved highly successful. These countries, along with Thailand, Indonesia, and others in East Asia, substantially increased international trade and raised living standards. A rising middle class helped transform these countries into competitive economies.

Japan launched an ambitious program of industrialization and export-led development. The country's rise from poverty in the 1940s to become one of the world's wealthiest countries by the 1980s has been called the *Japanese miracle*. The feat was achieved with the help of national strategic policies. The policies included tariffs that fostered and protected Japan's infant industries such as automobiles, shipbuilding, and consumer electronics.

China and India long sheltered themselves through protectionism and government intervention. Both countries relied on centralized economic planning in which agriculture and manufacturing were controlled by state-run industries. Around 1990, China and India began to liberalize their economies. In 2001, China joined the WTO and committed to reducing trade barriers. Trade became an enormous factor stimulating the Chinese economy. By 2015, its GDP was more than ten times the 1998 level. The value of China's exports reached $2.2 trillion. In India, trade liberalization and privatization of state enterprises helped fuel economic progress. Between 2000 and 2015, India's average annual income rose from about $470 in real terms to more than $1,800 in 2015, an impressive achievement.

General Agreement on Tariffs and Trade (GATT)

A trade agreement among 23 nations in 1947 that reduced tariffs and other barriers to trade through a process of continuous negotiations among member countries.

In 1947, 23 nations signed the **General Agreement on Tariffs and Trade (GATT)**, the first major effort to reduce trade barriers systematically worldwide. The GATT created a process to reduce tariffs through continuous negotiations among member nations, an agency to serve as watchdog over world trade, and a forum for resolving trade disputes.

The GATT introduced the concept of *normal trade relations* in which each nation agreed to extend the tariff reductions covered in a trade agreement with a trading partner to all other countries. A concession to one country became a concession to all. In 1995, the WTO succeeded the GATT and grew to include more than 150 member nations. The organization proved extremely effective and resulted in the greatest global decline in trade barriers in history.

The global recession and financial crisis that began in 2008 have raised new questions about government's role in national economies. The crisis arose from inadequate regulation in the banking and finance sectors. In response, governments worldwide increased regulation.[24]

Some governments increased protectionism in an effort to safeguard jobs and wage levels. Argentina and Brazil, for example, increased import tariffs on numerous products. Russia raised tariffs on dozens of goods, including cars and combine harvesters.[25] The United Kingdom provided substantial subsidies to UK banks and financial institutions. China pumped hundreds of billions of dollars into its own economy.[26] The new round of protectionism has had an impact on international commerce, extending beyond the banking and financial areas.[27]

In general, however, as illustrated in Exhibit 7.4, average tariffs have declined over time. Simultaneously, as shown in Exhibit 7.6, world trade and GDP have flourished. Decreasing trade barriers are a major factor in the growth of global commerce and consequently in rising incomes around the world. Firms that participate actively in international trade and investment not only improve their performance but also contribute to reducing global poverty.[28]

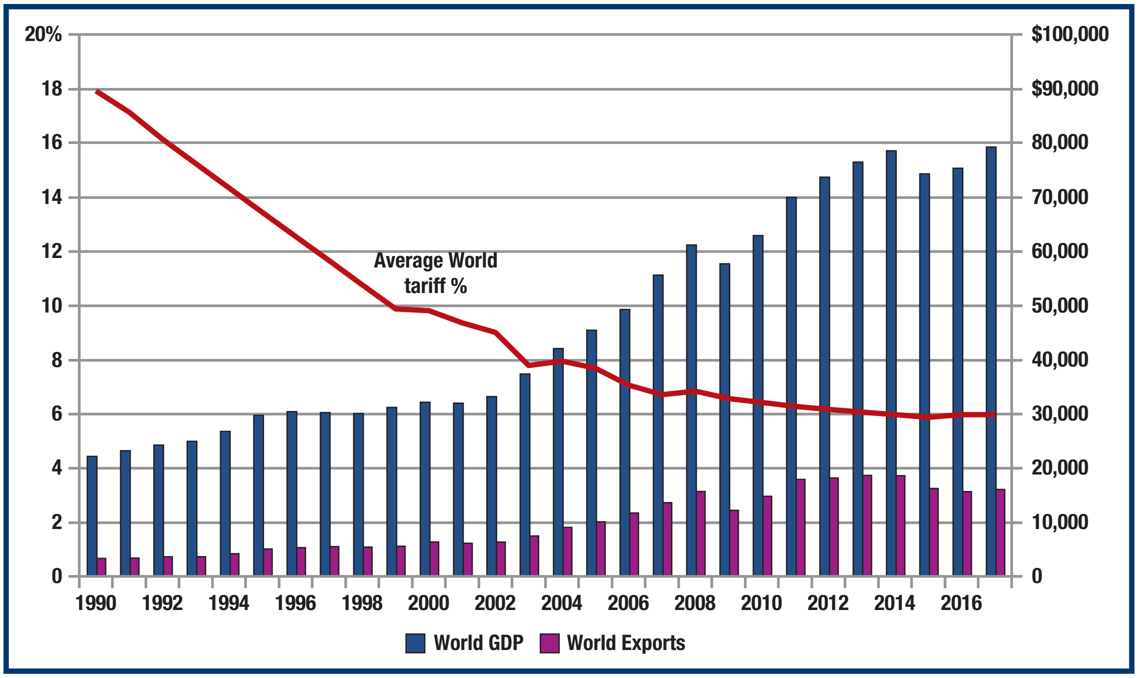


EXHIBIT 7.6

Relationship Among Tariffs, World GDP, and the Volume of World Trade

Note: Tariffs given as average percent (red line), World GDP given in billions of U.S. $ (blue column), and Volume of World Exports given in billions of U.S. $ (purple column). Left axis measures tariffs. Right axis measures world GDP and volume of world exports.

Sources: Based on International Monetary Fund World Economic Outlook Database, at www.imf.org; UNCTAD, http://unctadstat.unctad.org; World Bank, http://data.worldbank.org.

Ease of Doing Business is an index the World Bank develops annually. It ranks 189 countries and is useful for evaluating the effects of government intervention. A high ease of doing business ranking means a country's regulatory environment is conducive to starting and operating a company there. The index obtains a total ranking by rating each country in terms of ten variables: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.[29]

Exhibit 7.7 shows the ease of doing business for each country. Most of the easiest countries are advanced economies that enjoy high living standards. The easiest group also includes numerous emerging markets that have simplified their regulatory environment in an effort to encourage entrepreneurship and investment. The exhibit's moderately hard and hardest countries are relatively difficult places to do business and are characterized by severe poverty and other hardships.

Government intervention and trade barriers raise ethical concerns for developing economies. For example, United States import tariffs on clothing and shoes often exceed 20 percent. The tariffs hurt poor countries such as Bangladesh, Pakistan, India, and several nations in Africa, where clothing and shoe exporters are concentrated. United States tariffs on imports from Cambodia are far higher than on imports from the United Kingdom. The tariffs that confront less-developed economies are often several times those faced by the richest countries.[30]

Government intervention can also offset harmful effects. For example, trade barriers can create or protect jobs. Subsidies can help counterbalance harmful consequences that disproportionately affect the poor. In Europe, for example, globalization has affected thousands of workers whose jobs have been shifted to other countries with lower labor costs. Increasingly, jobs available to younger workers in Europe are based on temporary contracts, which provide limited benefits. Meanwhile, European governments provide subsidies for the unemployed to fund retraining aimed at upgrading job skills or finding work in other fields.[31]

EXHIBIT 7.7

Countries Ranked by Ease of Doing Business, 2018

Sources: Based on *Doing Business: Economy Rankings* and *Doing Business 2018* (Washington, DC: World Bank Group, 2018) www.doingbusiness.org/rankings.

International trade is good for international relations. Cross-national trade encourages the development of economic ties and friendly relations. This helps explain why the World Bank, WTO, United Nations, and other international bodies consistently have sought to encourage international trade. A key goal of such organizations is to reduce international tensions and promote world peace by fostering global commerce. But just as relations among

Source: jakobradlgruber/123RF

Many firms lobby national governments, such as Germany's central government in Berlin, for lower barriers to trade and investment.

friends can ebb and flow, so too do relations among nations. In 2017, the World Bank estimated that about 2 billion people worldwide live in areas significantly affected by fragility, conflict, and violence. The share of such people has increased significantly since 2010 and is projected to rise further through the 2020s. Continued tensions within and among many of the world's nations result from the negative consequences of globalization, rising world population, competition for resources, social and economic inequality, stagnant economies, geopolitical fragmentation, rising nationalism, mass migration, rapid urbanization, and other such phenomena. These trends harm international trade, which in turn worsens economic conditions, inequality, and other concerns. However, historical experience suggests that international relations will improve again, and when they do, cross-border trade is likely to rise.[32]

7.4 Describe how firms can respond to government trade intervention.

How Firms Can Respond to Government Intervention

Firms generally must cope with protectionism and other forms of intervention. In extractive industries such as aluminum and petroleum, for example, companies may have little choice but to operate in nations that impose formidable barriers. The food-processing, biotechnology, and pharmaceutical industries also encounter countless laws and regulations abroad.

Strategies for Managers

China, India, and numerous other countries in Africa, Asia, and Latin America feature extensive trade barriers and government involvement. Yet many firms target emerging markets and developing economies because of the huge long-term potential they offer.[33] Firms devise various strategies to manage harmful government intervention.

RESEARCH TO GATHER KNOWLEDGE AND INTELLIGENCE Experienced managers continually scan the business environment to identify the nature of government intervention and to plan market-entry strategies and host-country operations. They review their return-on-investment criteria to account for the increased cost and risk of trade and investment barriers. For example, the EU is devising new guidelines that affect company operations in areas ranging from product liability laws to standards for investment in European industries.

CHOOSE THE MOST APPROPRIATE ENTRY STRATEGIES Tariffs and most nontariff trade barriers apply to exporting, whereas investment barriers apply to FDI. If high tariffs are present, managers may consider FDI, licensing, and joint ventures that allow the firm to operate directly in the target market and avoid import barriers. For example, Taiwan's Foxconn, a contract manufacturer for Apple and other electronics firms, built a factory in Brazil partly to avoid the country's high tariffs on imported goods.

Tariffs usually vary with the *form* of an imported product. To minimize the impact of tariffs, many firms ship manufactured products "knocked-down" (as parts and components) and then assemble them in the target market. For example, BMW ships automobiles knocked-down to Brazil, India, Russia, Thailand, and other emerging markets to avoid paying higher tariffs. In Brazil, the average tariff on imported cars is about 35 percent, compared to 15 to 20 percent for unassembled parts and components. Upon arriving in Brazil, the knocked-down cars are assembled in local factories and sold to consumers. BMW could ship finished vehicles to such countries, but the tariff on parts and components is lower. By doing final assembly in Brazil and other emerging markets, BMW avoids paying higher tariffs.[34]

TAKE ADVANTAGE OF FOREIGN TRADE ZONES In an effort to create jobs and stimulate local economic development, governments establish foreign trade zones (also known as *free trade zones* or *free ports*). A **foreign trade zone (FTZ)** is an area within a country that receives imported goods for assembly or other processing and subsequent re-export.[35] Products brought into an FTZ are not subject to duties, taxes, or quotas until they, or the products made from them, enter the non-FTZ commercial territory of the country where the FTZ is. Firms use FTZs to assemble foreign dutiable materials and components into finished products, which are then re-exported. Firms may use FTZs to manage inventory of parts, components, or finished products that eventually will be needed at some other location. In the United States, for example, Japanese carmakers store vehicles at the port of Jacksonville, Florida, without having to pay duties until the cars are shipped to U.S. dealerships.

Foreign trade zone (FTZ)
An area within a country that receives imported goods for assembly or other processing and re-export. For customs purposes, the FTZ is treated as if it is outside the country's borders.

FTZs exist in more than 75 countries, usually near seaports or airports. In Panama, the Colon Free Zone (www.colonfreezone.com) is an enormous FTZ where products are imported, stored, modified, repacked, and re-exported without being subject to tariffs or customs regulations. The many private firms and wholesalers that set up shop inside the huge zone transship their merchandise from Panama to other parts of the Western Hemisphere and Europe. Some firms obtain FTZ status within their own physical facilities.

The Chinese government in 2017 launched 11 FTZs at locations throughout China to encourage more inward foreign investment. The new FTZs feature lower import tariffs and corporate tax rates of about 16 percent, half the usual tax rate in mainland China. The government relaxed FDI laws in the FTZs and now allow foreign firms that produce satellites, rail transport equipment, and numerous other products to establish operations in China without having to establish joint ventures with local Chinese firms. The FTZs are part of China's "One Belt, One Road" initiative, which aims to increase trade with about 60 nations in industries considered vital to China's economy.[36]

Maquiladoras are one example of FTZs. Maquiladoras are export-assembly plants in northern Mexico along the U.S. border. They produce components and finished products typically destined for the United States. Since the 1960s, maquiladoras have imported materials and equipment on a tariff-free basis for assembly or manufacturing and then re-exported the assembled products. Today under NAFTA, maquiladoras employ millions of Mexicans who assemble clothing, furniture, car parts, electronics, and other goods. The arrangement enables firms from the United States, Asia, and Europe to tap low-cost labor, favorable duties, and government incentives while serving the U.S. market. Maquiladoras account for about half of Mexico's exports.

Maquiladoras
Export-assembly plants in northern Mexico along the U.S. border that produce components and typically finished products destined for the United States on a tariff-free basis.

SEEK FAVORABLE CUSTOMS CLASSIFICATIONS FOR EXPORTED PRODUCTS One approach for reducing exposure to trade barriers is to have exported products classified in the appropriate harmonized product code. Many products can be classified within two or more categories, each of which may imply a different tariff. For example, some telecommunications equipment can be classified as electric machinery, electronics, or measuring devices. The manufacturer should analyze the trade barriers on differing categories to ensure that exported products are classified under the lowest tariff code. Alternatively, the manufacturer may be able to modify the exported product in a way that helps minimize trade barriers. South Korea faced a quota on the export of nonrubber footwear to the United States. By shifting manufacturing to rubber-soled shoes, Korean firms increased footwear exports.

TAKE ADVANTAGE OF INVESTMENT INCENTIVES AND OTHER GOVERNMENT SUPPORT PROGRAMS Obtaining economic development incentives from host- or home–country governments is another strategy to reduce the cost of trade and investment barriers. When Mercedes built a factory in Alabama, it benefited from reduced taxes and direct subsidies the Alabama state government provided. When Siemens built a semiconductor plant in Portugal, it received subsidies from the Portuguese government and the EU. Incentives cover nearly 40 percent of Siemens's investment and training costs. In Europe, Japan, and the United States, governments increasingly

MyLab Management Watch It! 1
If your professor has assigned this, go to the Assignments section of **www.pearson.com/mylab/management** to complete the video exercise titled Government Intervention a Spotlight on China and Germany.

You Can Do It RECENT GRAD IN IB

ASHLEY LUMB

Ashley's majors in college: Finance and international business
Objectives: Career growth and international perspective
Internships during college: Merrill Lynch
Jobs held after college:

- Junior analyst, KPMG, London, England
- Marketing representative, Vins Sans Frontieres, Nice, France
- Account representative, The Ultimate Living Group, Monte Carlo, Monaco
- Marketing associate, Made in Museum, Rome, Italy
- Advertising/marketing coordinator, Vogue Italia, New York, United States
- Fine art curator, Melbourne, Australia

Source: Ashley Lumb

In Ashley Lumb's senior year in college, a six-week study abroad program to Europe sparked a desire for an international career. Following graduation, Ashley interned as a junior analyst at KPMG in London, where she gained technical training and analytical skills. She took a six-month contract job at Vins Sans Frontieres (VSF), where she enrolled in its wine courses at the company headquarters in the south of France. VSF imports wine from around the world and sells it exclusively to private yachts along the French Riviera. Ashley gained experience in various marketing methods. For example, VSF attends yacht trade fairs and hosts wine tastings. Its marketing reps such as Ashley scour the ports from San Remo, Italy, to St. Tropez, France, daily, speaking with yacht chefs, stewards, or captains about wine and distributing wine catalogs.

Ashley then took a position as a marketing associate at Made in Museum (MIM) in Rome, Italy. MIM specializes in the design, production, and delivery of authorized museum reproductions and markets jewelry, sculptures, mosaics, and Etruscan pottery. Ashley organized the products into groups and restructured the inventory and website.

While in Italy, Ashley developed a passion for the fashion industry, so she decided to move to New York. Before leaving Italy, Ashley took coursework in fashion industry marketing. In New York, she worked at the headquarters of fashion houses Hermès and J. Crew. Subsequently, she used the services of a bilingual recruiting agency, Euromonde Inc., to land a job at Vogue Italia magazine in Times Square to work as the U.S. advertising/marketing coordinator. Ashley also worked at Vogue India in Mumbai and Vogue Turkey in Istanbul. Most recently, Ashley has been working as a fine art curator in Melbourne, Australia.

Ashley's Advice for an International Career

"Working abroad helped me sort through my career goals, as Europe offered a view into other industries that the U.S. lacked. I was able to experience different cultures and work environments and, although they might seem far apart, I saw a shared passion for exceptional products and dynamism. Back in the U.S., my international experience was an impressive asset to prospective employers; it is valued as proof of one's ability to handle challenging assignments and work with people from diverse cultures and backgrounds."

Success Factors

"The two most important factors in working abroad were hard work and networking. I cast a wide net and met many people, sent a lot of résumés, asked many questions, and researched the market. To keep myself afloat between assignments, I took some unglamorous jobs. Some days I wanted to give up and go home, but instead I just kept going.... Hard work and persistence are crucial."

Challenges

"The decision to work abroad carries some risks. After all, you're leaving much of what you know behind and stepping outside a clearly defined career path. The language barrier is always present. The work was usually in English, though I did pick up Italian and a bit of French through classes and immersing myself in the culture."

Source: Courtesy of Ashley Lumb.

provide incentives to entice firms to set up shop within their borders. In addition to cash outlays, incentives also include reduced utility rates, employee training programs, tax holidays, and construction of new roads and other infrastructure.

LOBBY FOR FREER TRADE AND INVESTMENT More nations are liberalizing markets to create jobs and increase tax revenues. The trend results partly from the efforts of firms to lobby domestic and foreign governments to lower their trade and investment barriers. The Japanese have achieved much success in reducing trade barriers by lobbying U.S. and European governments. In China, domestic and foreign firms often lobby the government to relax protectionist policies and regulations that make China a difficult place to do business. Foreign firms often hire former

Chinese government officials to help lobby their former colleagues.[37] The private sector lobbies federal authorities to undertake government-to-government trade negotiations aimed at lowering barriers.

In this chapter's *You Can Do It: Recent Grad in IB*, we feature Ashley Lumb, who has had several fascinating jobs in international business.

Regional Integration and Economic Blocs

7.5 Understand regional integration and economic blocs.

Related to government intervention is the worldwide trend toward **regional economic integration**. Also known as *regional integration*, regional economic integration refers to the growing economic interdependence that results when two or more countries within a geographic region form an alliance aimed at reducing barriers to trade and investment. As happened following formation of the European Union (EU), regional integration increases economic activity and makes doing business easier among nations within the alliance. At a minimum, the countries in an economic bloc become parties to a **free trade agreement**, a formal arrangement between two or more countries to reduce or eliminate tariffs, quotas, and other barriers to trade in products and services. The member nations also undertake cross-border investments within the bloc.

Regional economic integration
The growing economic interdependence that results when two or more countries within a geographic region form an alliance aimed at reducing barriers to trade and investment.

Free trade agreement
A formal arrangement between two or more countries to reduce or eliminate tariffs, quotas, and barriers to trade in products and services.

In the past half century, most countries have sought to cooperate with others, aiming for some degree of regional integration. Today, more than 50 percent of world trade occurs as part of a preferential trade agreement signed by groups of countries. The trend is based on the premise that, by cooperating, nations within a common geographic region connected by historical, cultural, linguistic, economic, or political factors can gain mutual advantages.[38]

Regional integration results from the formation of a *regional economic integration bloc* or, simply, an *economic bloc*. This refers to a geographic area that consists of two or more countries that agree to pursue economic integration by reducing tariffs and other restrictions to the cross-border flow of products, services, capital, and, in more advanced stages, labor. (In this text, following convention, we use the French term *bloc* instead of *block*.) Two of the best-known examples are the European Union (EU) and the North American Free Trade Agreement (NAFTA). NAFTA consists of Canada, Mexico, and the United States.

More advanced economic blocs, such as the EU, permit the free flow of capital, labor, and technology among their member countries. The EU is also harmonizing monetary policy (to manage the money supply and currency values) and fiscal policy (to manage government finances, especially tax revenues) and gradually integrating the economies of its member nations. However, recent crises in Greece, Italy, Spain, and Portugal and general discord among EU members are challenging the progress of regional integration in Europe.

Why would a nation opt to be a member of an economic bloc instead of working toward a system of worldwide free trade? The main reason is that it is much easier to reach agreement on free trade with a handful of countries than with all the nations in the world. This helps explain why there are hundreds of regional trade integration blocs around the world today. They present both opportunities and challenges to internationalizing firms.[39]

Levels of Regional Integration

Exhibit 7.8 identifies five possible levels of regional integration. We can think of these levels as a continuum, with economic interconnectedness progressing from a low level of integration—the free trade area—through higher levels to the most advanced form of integration—the *political union*. The political union represents the ultimate degree of integration among countries, which no countries have yet achieved.

The **free trade area** is the simplest and most common arrangement, in which member countries agree to eliminate formal barriers gradually to trade in products and services within the bloc. Each member country maintains an independent international trade policy with countries outside the bloc. NAFTA is an example. The free trade area emphasizes the pursuit of comparative advantage for a group of countries rather than for individual states. Governments may impose *local content requirements*. They specify that locally produced products must contain a minimum proportion of locally manufactured parts and components. If the content requirement is not met, the product becomes subject to the tariffs that member governments normally impose on nonmember countries.

Free trade area
A stage of regional integration in which member countries agree to eliminate tariffs and other barriers to trade in products and services within the bloc.

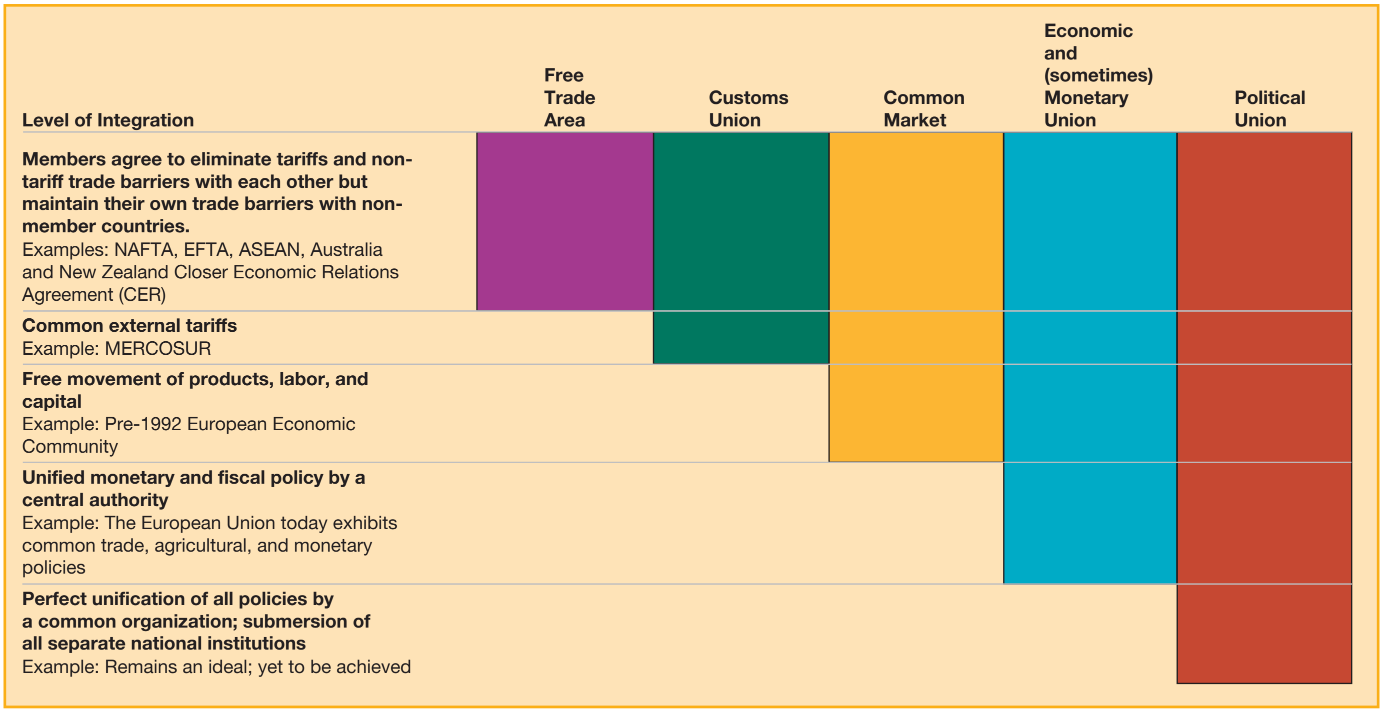


EXHIBIT 7.8

Five Potential Levels of Regional Integration Among Nations

Source: Based on Bela Balassa, *The Theory of Economic Integration* (Milton Park, Oxford, UK: Routledge Revivals, 2012).

Note: the five levels above build upon each other. For example, a customs union has the features of a free trade area plus common external tariffs.

Customs union
A stage of regional integration in which the member countries agree to adopt common tariff and nontariff barriers on imports from nonmember countries.

Common market
A stage of regional integration in which trade barriers are reduced or removed; common external barriers are established; and products, services, and factors of production are allowed to move freely among the member countries.

Economic union
A stage of regional integration in which member countries enjoy all the advantages of early stages but also strive to have common fiscal and monetary policies.

The second level of regional integration is the **customs union**. It is similar to a free trade area except that member states harmonize their external trade policies and adopt *common* tariff and nontariff barriers on imports from nonmember countries. MERCOSUR, an economic bloc in Latin America, is an example of this type of arrangement. The adoption of a common tariff system means that an exporter outside MERCOSUR faces the *same* tariffs and nontariff barriers when trading with *any* MERCOSUR member country. Determining the most appropriate common external tariff is challenging because member countries must agree on the percentage level of the tariff and on how to distribute proceeds from the tariff among the member countries.

In the third stage of regional integration, member countries establish a **common market** (also known as a single market), in which trade barriers are reduced or removed, common external barriers are established, and products, services, and *factors of production* such as capital, labor, and technology are allowed to move freely among the member countries. Like a customs union, a common market also establishes a common trade policy with nonmember countries. The EU is a common market. It has gradually reduced or eliminated restrictions on immigration and the cross-border flow of capital. A worker from an EU country has the right to work in other EU countries, and EU firms can freely transfer funds among their subsidiaries within the bloc. In the EU, Germany has seen an influx of workers from Poland and the Czech Republic because these workers can earn much higher wages in Germany than they can in their home countries.

An **economic union** is the fourth stage of regional integration, in which member countries enjoy all the advantages of early stages but also strive to have common fiscal and monetary policies. At the extreme, each member country adopts identical tax rates. The bloc aims for standardized monetary policy, which requires establishing fixed exchange rates and free convertibility of currencies among the member states, in addition to allowing the free movement of capital. This standardization helps eliminate discriminatory practices that might favor one member state over another. Through greater mobility of products, services, and production factors, an economic union enables firms within the bloc to locate productive activities in member states with the most favorable economic policies.

The EU has made great strides toward achieving an economic union. For example, 19 EU countries have established a *monetary union* in which a single currency, the euro, is now in circulation. Monetary union and the euro have greatly increased the ease with which European financial institutions establish branches across the EU and offer banking services, insurance, and savings products. The single currency also makes trading and investment easier for European firms doing business within the union.

The United States provides a good analogy for an economic union. Imagine each state is like an individual country, but all are joined in a union. The members have a common currency and a single central bank with a uniform monetary policy. Trade among the members takes place unobstructed, and both labor and capital move freely among them. The federal government applies a uniform tax and fiscal policy. Just as would occur in an economic union, the individual U.S. states also govern themselves in such areas as education, police protection, and local taxes. This analogy only goes so far, of course. The United States is a country, and unlike members of a real economic union, the states cannot withdraw.

Leading Economic Blocs

7.6 Identify the leading economic blocs.

The leading economic blocs are illustrated in Exhibit 7.9. Europe has the longest experience with regional integration and is home to several economic blocs. The most important of these are the EU and the European Free Trade Association.

The European Union

In 1957, six countries—Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany—formed an alliance called the European Economic Community (EEC). Its successor is today's European Union (EU), established in 1992. The EU features 28 countries from both Eastern and Western Europe. It is the world's most advanced and largest regional economic bloc. Home to a half billion people, the EU's total annual GDP is about $18 trillion.

The EU has taken the following specific steps to become an economic union.

- *Market access.* Tariffs and most nontariff barriers have been eliminated for trade in products and services. Rules of origin favor manufacturing using inputs produced in the EU.
- *Common market.* Barriers to the cross-national movement of production factors—labor, capital, and technology—have been removed. For example, an Italian worker now has the right to take a job in Ireland, and a French company can invest freely in Spain.
- *Trade rules.* Customs procedures and regulations have been eliminated, streamlining transportation and logistics within Europe.
- *Standards harmonization.* Technical standards, regulations, and enforcement procedures related to products, services, and commercial activities are being harmonized. For example, where British firms once used imperial measures (pounds, ounces, and inches), they have converted to the metric system that all EU countries use.

In the long run, the EU is seeking to adopt common fiscal, monetary, taxation, and social welfare policies. Introduction of the euro—the EU's common currency and now one of the world's leading currencies—simplified cross-border trade and enhanced Europe's international competitiveness. The *European Central Bank* is based in Luxembourg and oversees EU monetary functions.

Other EU institutions include the *Council of the European Union,* a representative body that makes decisions on economic policy, budgets, foreign policy, and admission of new member countries. The *European Commission* proposes legislation and policies and is responsible for implementing the decisions of the European Parliament and the Council of the EU. The *European Parliament* consists of elected representatives and develops EU legislation, supervises EU institutions, and makes decisions about the EU budget. The *European Court of Justice* interprets and enforces EU laws and settles legal disputes between member states.[40]

The newest EU members are mainly in Eastern Europe. They are important, low-cost manufacturing sites for EU firms.[41] Most of the newest EU entrants are one-time satellites of the former Soviet Union and have grown rapidly. Most are poised to achieve per-capita income levels similar to those of the EU's wealthier countries. However, less-developed economies such as Romania, Bulgaria, and Lithuania will require years of developmental aid to catch up. In recent years, economic crises afflicted long-standing EU members such as Greece and Spain.

EXHIBIT 7.9

The Most Active Economic Blocs

The EU's Common Agricultural Policy (CAP) is a system of agricultural subsidies and programs that guarantees a minimum price to EU farmers and ranchers. The CAP consumes almost half the EU's annual budget and complicates negotiations with the WTO for reducing global trade barriers. High import tariffs on agricultural goods harm exporters from developing economies such as Africa. The EU is working to reform the CAP, but progress has been slow.

In 2016, the United Kingdom (UK) voted to withdraw from the European Union. By a slim margin, UK voters passed the European Union Membership Referendum, commonly known as "Brexit." The majority vote surprised the government of Prime Minister David Cameron, leading to his resignation. Many voters believed the EU central government in Belgium had too much influence over British affairs and that membership in the EU threatened UK autonomy. Some voters resented the millions of migrant workers in the UK. Brexit likely will reduce some of the advantages of free trade from which the UK had benefited under regional integration with the EU. It also will affect the status of countless migrant workers. For example, prior to Brexit the number of workers in the UK from Poland alone numbered 850,000.

In the wake of Brexit, the UK faced various options. One option was to exit from the EU altogether. Another option was to adopt an approach similar to Norway, which maintains free movement of goods, capital, and workers with the EU but is not an EU member and follows only those EU regulations accepted by the Norwegian Parliament. The Brexit vote reflects rising nationalism and a rejection of globalization. Brexit set a precedent and other European countries may seek to exit the EU.[42]

MyLab Management Watch It! 2

If your professor has assigned this, go to the Assignments section of **www.pearson.com/mylab/management** to complete the video exercise titled Regional Economic Integration Outlook for the European Union.

North American Free Trade Agreement (NAFTA)

Launched in 1994, NAFTA consists of Canada, Mexico, and the United States. It is the most significant economic bloc in the Americas and comparable to the EU in size (see www.nafta-sec-alena.org). NAFTA's passage was smoothed by the existence, since the 1960s, of the *maquiladora* program under which U.S. firms located factories in northern Mexico to access low-cost labor and avoid tariffs.

What has NAFTA accomplished for its members? Initially, the accord increased market access between Canada, Mexico, and the United States. It eliminated tariffs and most nontariff barriers for products and services traded in the bloc and made it possible for member–country firms to bid for government contracts in all three countries. NAFTA also established trade rules and uniform customs procedures and regulations. The members agreed to rules for investment and intellectual property rights. NAFTA also provides for dispute settlement in such areas as investment, unfair pricing, labor issues, and the environment.

Since the bloc's inception, Canada and Mexico have become the most important export markets of the United States, accounting for about one-third of U.S. exports. In the three-year period through 2012, the largest increase in U.S. export growth stemmed from exports to Canada and Mexico. In the 1980s, Mexico's tariffs averaged 100 percent and gradually decreased over time, eventually disappearing under NAFTA. Annual NAFTA foreign investment in Mexico rose dramatically as U.S. and Canadian firms invested in their southern neighbor. Following NAFTA's passage, Mexico's per-capita income has risen substantially. Mexico is now Latin America's wealthiest country in per-capita income terms.[43]

Source: Rafal Cichawa/123RF

These women are hauling crops to market in Ethiopia. External tariffs of the EU and NAFTA hinder African agricultural exports to Europe and North America.

Other economic blocs are found worldwide. They include:

- The *European Free Trade Association,* which includes Iceland, Liechtenstein, Norway, and Switzerland. It is linked to the European Union. It has free trade agreements with many countries worldwide.
- *MERCOSUR*, or the *El Mercado Comun del Sur* (the Southern Common Market), the strongest bloc in South America, established in 1991 (see www.mercosur.int).
- The *Association of Southeast Asian Nations* (*ASEAN*), created in 1967 with the goal of maintaining political stability and promoting regional economic and social development among its members (see www.aseansec.org).
- *Asia Pacific Economic Cooperation* (*APEC*), which aims for greater free trade and economic integration of the Pacific Rim countries. It incorporates 21 nations on both sides of the Pacific, including Australia, Canada, Chile, China, Japan, Mexico, Russia, and the United States (see www.apec.org).
- The *Australia and New Zealand Closer Economic Relations Agreement* (*CER*), founded in 1983, which promotes free trade between the two nations.
- The *Gulf Cooperation Council* (*GCC*; see www.gcc-sg.org/eng), which aims to coordinate economic, social, and cultural affairs among its members: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Sources: Sara Muñoz, "Latin Countries Forge Trade Accord with Eyes on Asia," *Wall Street Journal*, February 11, 2014, p. A10; H. Vinayak, Fraser Thompson, and Oliver Tonby, "Understanding ASEAN," *McKinsey & Company*, May 2014, www.mckinsey.com/insights.

Advantages and Implications of Regional Integration

7.7 Understand and explain the advantages and implications of regional integration.

Regional integration is the most popular form of reciprocal trade liberalization. In pursuing regional integration, nations seek at least four advantages:[44]

Expand Market Size

Regional integration greatly increases the scale of the marketplace for firms inside the economic bloc. For example, although Belgium has a population of just 10 million, membership in the EU gives Belgian firms free access to a total market of nearly 500 million EU buyers.

Achieve Scale Economies and Enhanced Productivity

Expansion of market size within an economic bloc gives member-country firms the opportunity to increase the scale of operations in both production and marketing, gaining greater concentration and increased efficiency. Although a German firm may be only moderately efficient when producing 10,000 units of product for Germany, it greatly increases its efficiency by producing 50,000 units for the much larger EU market. Internationalization inside the bloc helps firms learn to compete outside the bloc as well. More efficient resource usage can lead to greater productivity and lower prices for consumers.

Attract Direct Investment from Outside the Bloc

Foreign firms prefer to invest in countries that are part of an economic bloc because factories they build there receive preferential treatment for exports to all member countries within the bloc. Many non-European firms—for example, General Mills, Samsung, and Tata—invested heavily in the EU to take advantage of Europe's economic integration. By establishing operations in a single EU country, these firms gain free trade access to the entire EU market.

Source: Noppasin Wongchum/123RF

Brussels, Belgium, picture here, is the capital of the European Union.

Acquire Stronger Defensive and Political Posture

Regional integration helps strengthen member-countries relative to other nations and world regions. This was one of the motives for creating the European Community (the precursor to the EU), whose members sought to fortify their mutual defense against the former Soviet Union. Today, the EU is one way Europe counterbalances the power and international influence of the United States. Broadly speaking, countries are more powerful when they cooperate than when they operate alone.

In 1990, there were approximately 50 regional economic integration agreements worldwide. Today, some 400 are in various stages of development. Many nations belong to more than one. Regional economic integration is not slowing the progress of global free trade. Rather, global free trade will tend to emerge as economic blocs link with each other over time. The evidence suggests regional economic integration is gradually giving way to a system of free trade worldwide.

Managerial implications of regional integration include:

- *Internationalization inside the bloc.* The elimination of trade and investment barriers presents new opportunities. Regional integration pressures or encourages member-companies to internationalize into neighboring countries within the bloc.
- *Restructuring operations.* In the early stages of regional integration, firms begin to view the bloc as a unified whole. Managers develop strategies suited to the region as a whole rather than to individual countries. For example, a firm might combine multiple plants into a single factory.
- *Regional products and marketing.* As firms increasingly view the bloc as one large market, they tend to standardize their products and marketing. They start selling much the same products, using similar marketing approaches, to all countries inside the bloc.
- *Internationalization from outside the bloc.* Emergence of an economic bloc makes a region more attractive to companies based outside the bloc. Many will use FDI to establish a physical presence inside the bloc to access better all the benefits the bloc can offer.

CLOSING CASE South Korean Industry Policy and Economic Modernization

Introduction South

Korea's elite, both political and business, were autocratic for much of the post-1945 period, ruling the nation with an iron fist up until the democratization process began to take shape in the late 1980s to mid-1990s. While democratization has delivered a far more open and progressive political-social structure, it has not heralded a significant break from past state industry policy, which has delivered to the nation global brand names such as Hyundai, Samsung, and LG. The South Korean elite (public and private) continue to adapt and develop an existing array of state-policy instruments and to promote South Korea as a global economic brand—one capable of hosting events such as the joint Japan–Korea Football World Cup in 2002, membership of the Formula 1 Grand Prix club, and acting as host to the G20 Summit (November 2010) to herald membership of this most powerful of economic clubs. To understand South Korea's transformation fully is to appreciate that at the end of the Korean War (1950–1953) the newly formed nation, split from the antagonistic North Korean communist regime that rules to this day, was a political and economic "basket case" incapable of feeding its own people and reliant on the United States for all manner of strategic and economic support. One also needs to understand that South Korea's rise to G20 status today is not a story of purely entrepreneurial market-driven laissez-faire enterprise but of a form of state policy and state entrepreneurship. State policies centered on developing further human capital, financial capital, and infrastructure that were initially acquired under brutish Japanese colonial rule over Korea (1910–1945) and later refined under the autocratic rule of President Park Chung Hee (1961–1979). To understand prosperous, democratic South Korea today is to understand that its political stability and economic prosperity were forged through non-democratic, highly autocratic political rule, one that gave primacy to national security and economic development based on state industry policy.

The three key periods of South Korean modernization

1. Japan's Colonization of Korea (1910–1945)

Modern South Korea cannot be understood without an understanding of the nation's colonial past under Japanese rule. Japan's colonial acquisition of Korea from 1910 to 1945 can be defined in the context of the commitment by Japan's ruling elite, the Meiji oligarchy, to Kokutai ideology. This ideology placed agricultural development, industry, sanitation, education, communication, and law and order as essential requirements for any modern society. This Meiji model of a modern society was to be brutally enforced not only in Japan itself but also within all its colonies, including Korea. While Japan's colonization of Korea was based purely on self-interest (primarily as a source of agricultural and mineral resources for Japan), there can be no doubt about the quality of the administrators appointed to oversee Meiji rule over Korea. Ito Hirobumi, himself a founding father of modern Japan, became the first resident general, essentially the undisputed ruler of Korea. These Japanese colonial administrators abolished feudalism, established codified law, outlawed discrimination against commoners, instituted and controlled financial institutions, and placed technical skills before Confucian scholarship. These reforms were to provide the post-1945 South Korean elite with modern Meiji-founded state institutions with which to enforce their own rule over a population that itself had been molded by its experience under authoritarian and efficient Japanese colonial rule. The reforms also provided for new agricultural and industrial methods previously absent from the Korean peninsula, which would provide the launching pad into post-1953 industrial modernization. Above all else, however, the principal legacy of the Japanese colonial experience came in the form of developing (through education) an administrative elite (*yangban*, or traditional elite) and successful policymaking and institutional structures. Also to emerge at this time was a small group of merchants with close links to the national leadership, with three out of the top four post-1945 chaebol leaders emerging from this group. ("Chaebol" is the name given to South Korea's largest and most influential corporations.)

2. Park Chung Hee Regime (1961–1979)

The regime of Park Chung Hee, which ruled over South Korea's industrialization from 1961 until Park's assassination in 1979, can be clearly identified as an interventionist state exercising industrial policy. General Park's early training at a Japanese military college was to have a profound and continuing influence upon him and on the building of South Korea: As an officer in the Japanese colonial army during its occupation of Korea and northern China, Park had seen with his own eyes the industrial and infrastructure development wrought by the Japanese during their brief tenure. And like the economic daimyo and samurai of the Meiji period, which reformed Japan's traditional economy and brought it into the modern, industrial age, Park believed in a strong and interventionist state. Political and economic revolution would be carried out from above. Park even borrowed a Japanese name for the reform program he introduced in 1972. He called his measures *Yushin*, from the Japanese ishin, or "renovation." It is important to understand that the Japanese military college Park attended, like the U.S. West Point, educated students extensively in engineering, the sciences, world affairs, and languages. Graduates would emerge as highly qualified engineers fluent in several languages. They were the national elite. In his books, *Our Nation's Path* (1962) and *The Country, the Revolution, and I* (1964), Park identified as the central ideological tenets of his regime those within the same vein as his educators and Korea's former colonial rulers, the Meiji leadership of Japan. Park Chung Hee's peasant origins and Japanese-officer's training at the Japanese Military Academy in the 1930s led him to adapt the Meiji lexicon of "strengthening the nation" (*Bu Kuk Gang Byung*) to reunify the divided Korean nation and develop its economic power. Not surprisingly, Park supported private enterprise only on the basis that it was responsive to state nation-building efforts. In turn, the private sector elite were rewarded with policy loans to build up strategic industries for national development. This was in fact a pragmatic decision, as the private sector had no history of driving Korean development, the Korean War's legacy left much of the industrial capacity in the hands of North Korea, and the economic plight of the South Korean populace was pitiful. When Park came to power in 1961, South Korea's per capita income was less than $100 per annum, with the overwhelming majority of the populace living in poverty. Furthermore, South Korea's geo-strategic position was far from secure, as North Korea possessed the bulk of the mineral and industrial base of the former unified nation. The one institution that did have a history and capacity of national development was the South Korean military and its elite officers. Simply no other institution, public or private, capable of harnessing the collective national resources for national development existed within South Korea at this time. Nothing less than astute state intervention could ensure the infant South Korean nation's geostrategic security and ability to build sustainable markets. Between 1963 and 1979, South Korean state enterprises accounted for 38 percent of GDP, and they accounted for 30 percent of the infrastructure's share of the gross domestic investment (GDI) in the 1960s and 33 percent during the following decade (1970s). State enterprises and the state-sponsored chaebols embraced areas covering the national economy—from textiles and steel to oil and finance—and where initial capital requirements were large, investment-return periods long, and investment risks high. The economic and strategic successes of the Park regime cannot be denied. By the time Park's reign ended (1979), per capita income had multiplied tenfold and his state's geostrategic position was effectively secured.

3. The Process of Democratization in South Korea (1987–)

The introduction of democracy in South Korea began with the introduction of a new constitution on October 12, 1987 that provided for free and fair elections, a free press, increased power for the legislature, and open unionization. The National Assembly approved the new constitution, which was subsequently approved by 94 percent of the population. During this time (mid-1980s), economic technocrats within the South Korean bureaucracy also recognized that the time of the central tenet of Park's economic strategy—overt support for the private chaebol corporations—had passed. The chaebols were now massive conglomerates, and the top economic officials rightfully recognized that they could, and should, be forced to stand on their own merits within the international marketplace. Unfortunately, their policy concerns were overridden by the successive political regimes, including those of Chun Doo Hwan (1979–1987), Roh Tae Woo (1987–1992), and Kim Young Sam (1992–1997), who failed to maintain the strict policy of autonomy from chaebol interests established by Park Chung Hee. Progress was made in the arena of political and legal accountability; the Kim Young Sam administration (1992–1997), under the weight of domestic and international pressure, successfully prosecuted two former Korean presidents, Chun Doo Hwan and Roh Tae Woo, who along with 13 other retired generals were convicted on August 26, 1996 of corruption, collusion, and murder. While some feared that this could lead to retribution politics after every president left office, it was largely viewed as a positive indication of Korea's growing democratic ideals. By the beginning of 1997 South Koreans had every expectation that their nation was a modern political democracy with one of the world's leading export-oriented economies. By the end of 1997 the country's national democrat credentials had been reinforced, but the economy was left temporarily shattered. In June–July of that year, beginning in Thailand, Asia was quickly gripped by a financial crisis that, through contagion, quickly saw the economies of Thailand, South Korea, and Indonesia on their knees and other economies such as Malaysia, Singapore, Hong Kong, and Japan weakened. South Korea's high level of private sector chaebol debt was brutally exposed by the 1997–1998 Asian financial crisis. The resulting economic bailout by the International Monetary Fund required austerity measures that saw mass worker layoffs and national protests as South Koreans came to realize that the excesses protectionism offered to the chaebols did not enhance national prosperity but in fact were an illusion built on short-term debt. As a result, the 1997 election became a watershed moment in South Korean political and economic history with the election of Democratic Party leader Kim Dae Jung to the Korean presidency. Kim's political legitimacy in the eyes of the South Korean people rested firmly on his prominent, consistent, and long-term advocacy of South Korean democracy. Kim's 1997 election victory, despite his numerous political setbacks, was also possible because in South Korea powerful political bases were formed around the individual, with the party acting as a support mechanism rather than an initiator of leadership or ideas. South Korean politics under Kim remained dominated by executive leadership in the form of the president who, as both the chief executive of the Korean government and the supreme commander of the armed forces, is the highest decision maker in both domestic and foreign policy areas. Furthermore, along with the presidency, a small, informal group, which includes the president and his top aides, but not the national parliament, usually makes the all-important decisions. The power of the presidency was displayed openly by Kim, who rammed through political and economic reforms against considerable business and union opposition in the wake of the 1997–1998 financial crisis, and in doing so quickly restored Korea's economic fortunes. Kim Dae Jung forced the chaebols to focus on core operations with international competitiveness and, in doing so, rapidly returned them to positions of long-term viability. Kim's successors, Roh Moon Hyun (2003–2008), Lee Myung Bak (2008–2013), Park Geun-hye (2013–2017), and Moon Jae-in (2017–present) have continued national support of the chaebols as they drive South Korea's export sector, upon which the nation's prosperity hinges, but they have incorporated the lessons and preconditions instituted by Kim Dae Jung. Today, the chaebols stand or fall entirely upon their ability to manage their own international growth and competitiveness. In conclusion, nothing symbolizes the political and economic success of South Korea today as much as its hosting of the G20 Summit in Seoul in November 2010, when it was embraced by the world's other powerful national economies not only as a rightful member of the organization, but also as a worthy host.

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Case Questions

7-4. One cannot understand contemporary South Korean society without understanding Japanese colonial history. Is there another country this may apply to as well?

7-5. What lessons does South Korea offer students examining the link between democracy and economic development?

7-6. Do some research to identify the reasons why South Korea is becoming more internationally active, such as taking on the role of hosting a G20 summit.

Sources: M.S. Dobbs-Higginson, *Asia Pacific: Its Role in the New World Disorder* (London: Mandarin, 1994), p. 272; Park Chung Lee, *Our Nation's Path: Ideology of Social Reconstruction* (Seoul: Dong-a Publishing, 1962), pp. 120–121.

This case was written by Ian Austin, Edith Cowan University.

MyLab Management **Watch It! 3**

If your professor has assigned this, go to the Assignments section of **www.pearson.com/mylab/management** to complete the video exercise titled Airbus vs. Boeing.

END-OF-CHAPTER REVIEW

MyLab Management

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Key Terms

common market 230
countervailing duty 221
currency control 219
customs 213
customs union 230
dumping 221
economic union 230
export control 215
foreign trade zone (FTZ) 227
free trade agreement 229
free trade area 229
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import license 218
investment incentive 221
maquiladoras 227
nontariff trade barrier 213
protectionism 213
quota 213
regional economic integration 229
subsidy 220
tariff 213

Summary

In this chapter, you learned about:

- **The nature of government intervention**

  Despite the value of free trade, governments often intervene in international business. Protectionism refers to national economic policies designed to restrict free trade and protect domestic industries from foreign competition. Government intervention arises typically in the form of tariffs, nontariff trade barriers, and investment barriers. Tariffs are taxes on imported products, imposed mainly to collect government revenue and protect domestic industries from foreign competition. Nontariff trade barriers consist of policies that restrict trade without directly imposing a tax. Governments impose trade and investment barriers to achieve political, social, or economic objectives. Such barriers are either defensive or offensive. A key rationale is the protection of the nation's economy, its industries, and its workers. Governments also impose barriers to protect infant industries.

- **Instruments of government intervention**

  Governments also impose regulations and technical standards as well as administrative and bureaucratic procedures. Countries may also impose currency controls to minimize international withdrawal of national currency. FDI and ownership restrictions ensure that the nation maintains partial or full ownership of firms within its national borders. Governments also provide subsidies, a form of payment or other material support. With dumping, a firm charges abnormally low prices abroad. Governments support homegrown firms by providing investment incentives and biased government procurement policies.

- **Evolution and consequences of government intervention**

  From the 1930s onward, countries reduced trade barriers worldwide. The nature and outcomes of government intervention have varied across Latin America, Japan, India, and China. The most important development for reducing trade barriers was the General Agreement on Tariffs and Trade (GATT), replaced by the World Trade Organization (WTO). Government intervention and trade barriers can raise ethical concerns that affect developing economies and low-income consumers. However, government intervention also can be used to offset such harmful effects.

- **How firms can respond to government intervention**

  Firms should conduct research to understand the extent and nature of trade and investment barriers abroad. When trade barriers are substantial, FDI or joint ventures are often the most appropriate entry strategies. When importing is essential, the firm can take advantage of foreign trade zones, areas where imports receive preferential tariff treatment. Government assistance in the form of subsidies and incentives helps reduce the impact of protectionism. Firms sometimes lobby the home and foreign governments for freer trade and investment.

- **Regional integration and economic blocs**

  Under regional economic integration, groups of countries form alliances to promote free trade, cross-national investment, and other mutual goals. This integration results from regional economic integration blocs (or economic blocs), in which member countries agree to eliminate tariffs and other restrictions on cross-national commerce. At minimum, the countries in an economic bloc become parties to a free trade agreement, which eliminates tariffs, quotas, and other trade barriers. The stages of regional integration include the free trade area, the customs union, the common market, and the economic union.

- **The leading economic blocs**

  There are hundreds of economic integration agreements in the world. The European Union (EU) is the most advanced. It has increased market access, improved trade rules, and harmonized standards among its members. The North American Free Trade Agreement (NAFTA) consists of Canada, Mexico, and the United States. Other blocs are prominent worldwide and have achieved varying degrees of success.

- **Advantages and implications of regional integration**

  Regional integration contributes to corporate and industrial growth and hence to economic growth, better living standards, and higher tax revenues for the member countries. It increases market size by integrating the economies within a region. It increases economies of scale and factor productivity among firms in the member countries and attracts foreign investors to the bloc. Regional integration leads to increased internationalization by firms inside their economic bloc. Firms restructure their operations. Managers revise marketing strategies by standardizing products.

Test Your Comprehension

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7-7. How are tariff payments physically assessed and collected by a country?

7-8. In what ways do government subsidies amount to protectionism?

7-9. What is the rationale for intervention? Why do governments engage in protectionism?

7-10. Describe various company strategies to manage government intervention.

7-11. Distinguish between a free trade agreement and a free trade area.

7-12. The European Union has taken specific steps to become an economic union. Explain the nature and purpose of these steps.

7-13. Why do we say that the United States and Russia belong to an economic bloc? How do they benefit from membership?

7-14. What are the stages of regional integration? Why are countries likely to go beyond a free trade agreement?

7-15. Why might a corporation based outside a bloc choose FDI as their method of entry into the bloc?

7-16. What strategies should companies use to maximize the benefits of regional integration?

Apply Your Understanding

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7-17. John and Rose Wilson have developed quite a reputation in the al-fresco food business in Australia and New Zealand. They have established distributor deals for their marinades and rubs in 18 countries stretching as far as Japan. They focus on the stereotypical Australian-style barbeque experience and are now looking at launching their brand in the UAE and using that launch as a springboard into the broader Middle East market. The Wilsons have a developed export department in-house but need guidance and assurance about dealing with the UAE before they invest upwards of $1.2 million on the launch. In the role of an export and trade professional, provide the Wilsons with a broad outline of the factors they should take into account, such as tariffs and duty rates as well as product certification, labeling, and packaging.

7-18. You are Vice President for International Sales at a pharmaceutical company based in your own country. Sales of some of your key products have slumped in recent years largely due to the fact that many of them no longer have enforceable patents and generic copies are being manufactured. In order to sustain the business in the short to medium term, the CEO has told you to find new markets in the region to dump excess production to keep the manufacturing plants busy until new drugs are ready for the market. Each year, the World Bank releases their "Doing Business" report, which examines and compares business regulation for domestic firms in 190 economies. As you tend to operate via a local distributor or a number of distributors, this could provide a valuable insight into which markets are easier to target. Examine at least ten potential markets in your part of the world and rank them according to ease of doing business. What are the commonalities and differences in your top five target markets?

7-19. Levi Strauss & Co. (LS; www.levistrauss.com) makes and sells blue jeans, Dockers, and Slates brand name apparel in more than 100 countries. With the onset of regional integration in Europe and Latin America, LS management decided to revise the firm's production and marketing strategies to make them more appropriate for regional, as opposed to national, operations. Based on the regional integration changes underway in these areas, and on your understanding of the business implications of regional integration, what should LS do? In answering, think in terms of LS's major value chain activities, especially production and marketing. What are the pros and cons to LS of producing and marketing its apparel on a regional basis as opposed to a national or global basis? Justify your answer.

7-20. *Ethical Dilemma*: Suppose you are a member of a government task force evaluating the future of NAFTA between Canada, Mexico, and the United States. Proponents want to transform NAFTA into a common market by removing barriers to the movement of labor. The goal is to reduce poverty in Mexico by allowing Mexican citizens to work freely and legally in Canada and the United States. Critics oppose the common market because of the big income difference between the countries. They argue that an open border would encourage millions of Mexicans to migrate northward, seeking work, and threaten jobs in the United States and Canada. Proponents argue that, as economic integration progressed under a common market, average wages in the three countries would equalize and eliminate pressures on northern job markets. Analyze this situation using the ethical framework in Chapter 4. Should the task force recommend the common market? What could U.S. and Canadian firms do to maintain their competitiveness relative to Mexican firms, given Mexico's low-wage advantage?

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INTERNET EXERCISES

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7-21. Your firm is considering exporting to two countries: Kenya and Vietnam. However, management's knowledge about the trade policies of these countries is limited. Conduct a search at globalEDGE™ to identify the current import policies, tariffs, and restrictions in these countries. Prepare a brief report on your findings. In addition to globalEDGE™, other useful sites include the World Trade Organization (www.wto.org; enter country name in the search engine) and the U.S. Commercial Service (www.buyusa.gov).

7-22. The United States Trade Representative (USTR) develops international trade and investment policies for the U.S. government. Visit the USTR website from globalEDGE™ or directly (www.ustr.gov). Search for "National Trade Estimate Report" for the latest year. This document summarizes trade barriers around the world. See the reports for the country of your choice. What are the country's import policies and practices? What are its nontariff trade barriers? What about barriers in the services sector? Are there any sectors that seem to be particularly protected (for example, energy, telecommunications)? What is the nature of government restrictions on e-commerce? If you worked at a firm that exported its products to the country, how would you use the USTR report to develop international business strategies?

7-23. There has been opposition to the World Trade Organization (WTO). For a sampling of arguments against the WTO, visit www.globalexchange.org, www.citizenstrade.org, and www.twn.my. Also visit the site of the WTO at www.wto.org, or obtain information on the organization from globalEDGE™. Based on your reading of this chapter, evaluate the arguments against the WTO. Do you agree with arguments the critics make? Why or why not? Does the WTO favor advanced economies over developing economies? How does the organization support international trade? Justify your answers.

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Performing a Preliminary Country Risk Analysis

Before venturing into most countries, managers investigate the likelihood and nature of country risk and its probable effect on company operations and performance. Country risk refers to potentially adverse effects on company operations and performance caused by changes in a country's political and legal environments. Finding out about country risks is a task performed in MNEs and other firms with substantial international operations. Smaller companies with limited resources, and thus less able to withstand failure, also perform country risk analysis when expanding abroad.

In this exercise, you will gain an understanding of the factors that determine country risk, acquire an understanding of the variables to consider when locating company operations abroad, develop market research skills for acquiring knowledge concerning country risk for planning company operations abroad, and obtain exposure to the types of country risk that firms encounter.

Assume you are an employee with a company that plans to build a factory abroad. Management is considering each of three countries as possible locations: China, Mexico, and Poland. You must decide which location is best for building the factory. Management prefers the country with the lowest risk. Your task is to conduct market research to investigate the degree of country risk in China, Mexico, and Poland. Then prepare a brief report that includes an estimate of the level of country risk in each of these countries by examining corruption, political rights, freedom status, and economic freedom.

Background

Country risk arises primarily from government intervention. Governments may impose laws and regulations that increase business costs, delays, or lost opportunities. Governments may restrict access to important markets, impose complex bureaucratic procedures, or limit the amount of returns that can be realized from foreign operations.

Political or legislative actions can harm business interests. Every country needs a sufficient legal and regulatory framework to support economic activity. Many governments impose too much regulation, poorly conceived regulation, or regulation that results in harmful, unintended consequences. Countries should aim for the right balance of appropriate regulation, not too much and not too little. However, finding the right balance is always challenging and evolves with time and circumstances.

Country risk affects management decision making regarding strategies for entering foreign markets. By entering a market by exporting, the firm's level of market commitment and risk are relatively low, and if substantial risk arises, the firm can rapidly withdraw or reduce its operations there. By contrast, the level of risk is relatively high for firms that internationalize by FDI, which results in establishing a physical facility in the target country, usually to perform production or marketing activities. Country risk is especially common in emerging markets and other less economically developed countries.

To complete this exercise in your MyLab, go to the **Career Toolbox**.

Endnotes

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Chapter 8

Understanding Emerging Markets

Learning Objectives *After studying this chapter, you should be able to:*

8.1 Understand advanced economies, developing economies, and emerging markets.

8.2 Know what makes emerging markets attractive for international business.

8.3 Learn how to assess the true potential of emerging markets.

8.4 Evaluate the risks and challenges of emerging markets.

8.5 Learn the success strategies for emerging markets.

8.6 Understand corporate social responsibility, sustainability, and the crisis of global poverty.

New Global Challengers: Top Firms from Emerging Markets

Consider a company that describes itself in the following way: "We are the world's largest baking company on the basis of brand positioning, production volume, and sales... We are the indisputable leader in our field in Mexico, Latin America, and the United States. We are present in 22 countries in America, Asia, and Europe; we offer more than 10,000 products and over 100 brands."

You probably did not guess that this is Grupo Bimbo ("Bimbo"), a leading company based in Mexico (www.grupobimbo.com). Bimbo owns such brands as Sara Lee, Brownberry, Arnold, and Plus Vita, among others. Founded in humble circumstances in 1945, this privately held company is now a global player in the bread, bakery, and snack markets.

Bimbo is one of thousands of companies from emerging markets that compete on a global scale. Emerging markets are lower-income countries that, in contrast to advanced economies, are currently experiencing rapid industrialization, modernization, and economic growth. Examples include Brazil, China, India, Russia, and Mexico. Emerging markets represent attractive markets and low-cost manufacturing bases. However, they also have high-risk business environments with evolving commercial infrastructure and legal systems. Despite their drawbacks, emerging markets have begun to produce *new global challengers*, top firms that are fast becoming key contenders in world markets. Bimbo is an example of a global challenger.