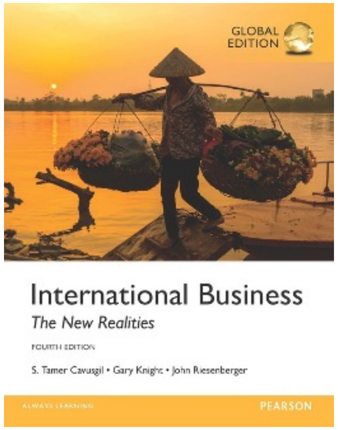
Chapter 7



Government Intervention and Regional Economic Integration

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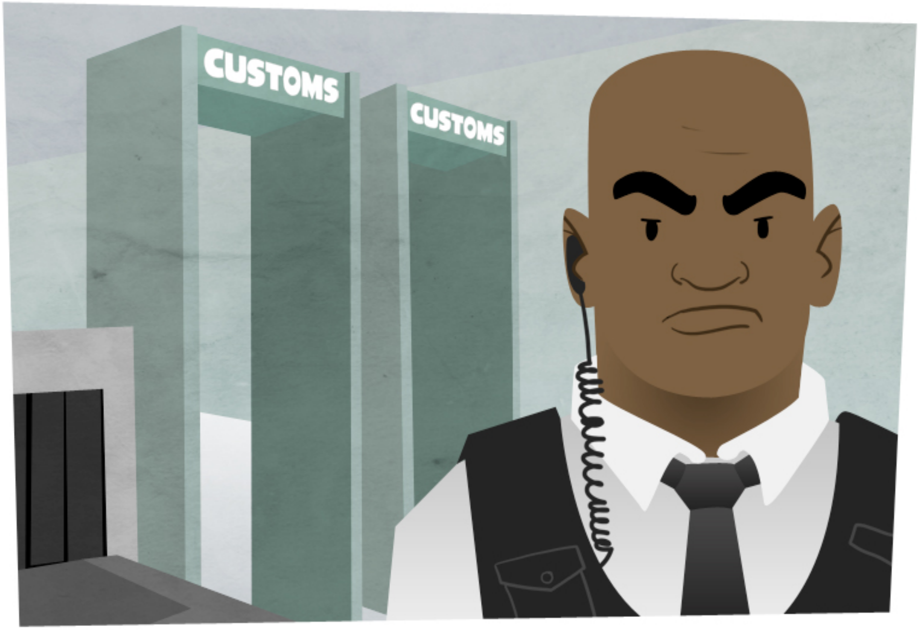
Government Intervention

- **Protectionism** – National economic policies that restrict free trade. Usually intended to raise revenue or protect domestic industries from foreign competition.

- **Customs** – The checkpoint at national ports of entry where officials inspect imported goods and levy tariffs.



Government Intervention: Key Instruments

- **Tariff** – A tax on imports (e.g., Citrus, textiles).

- **Nontariff trade barrier** – Government policy, regulation, or procedure that impedes trade.

- **Quota** – Quantitative restriction on imports of a specific product (e.g., Imports of Japanese cars).

- **Investment barriers** – Rules or laws that hinder foreign direct investment (e.g., Mexico’s restrictions in its oil industry).

Source: Keith Dannemiller/Alamy

Example of Protectionism: U.S. Steel Industry

- The U.S. government imposed tariffs on imports of foreign steel to protect U.S. steel manufacturers from foreign competition, aiming to give the U.S. steel industry time to restructure and revive itself.
- However it resulted in:
  - Higher steel costs.
  - Increased production costs for firms that use steel, such as Ford, Whirlpool, and General Electric.
  - Reduced prospects for selling products in world markets, making U.S. steel firms less competitive.
- The steel tariffs were removed within two years.

Example of Protectionism: Auto Industry

- In the 1970s, the U.S. government imposed “voluntary” export restraints (quotas) on imports of cars from Japan, to insulate the U.S. auto industry from foreign competition.
  - Result 1: Detroit automakers had less of an incentive to improve quality, design, and overall product appeal.
  - Result 2: Detroit’s ability to compete in the global auto industry weakened.

Consequences of Protectionism

- Reduced supply of goods to buyers.
- Price inflation.
- Reduced variety, fewer choices available to buyers.
- Reduced industrial competitiveness.
- Various adverse unintended consequences (e.g., While the home country dithers, other countries can race ahead).

Defensive Rationale for Government Intervention

- **Protection of the national economy** – Weak or young economies sometimes need protection from foreign competitors. e.g., India imposed barriers to shield its huge agricultural sector, which employs millions.

- **Protection of an infant industry** – A young industry may need protection, to give it a chance to grow and succeed. e.g., Japan long protected its car industry.

- **National security** – The United States prohibits exports of plutonium and similar products to North Korea.

- **National culture and identity** – Canada restricts foreign investment in its movie and TV industries.

Offensive Rationale for Government Intervention

- **National strategic priorities** – Protection helps ensure the development of industries that bolster the nation's economy. Countries create better jobs and higher tax revenues when they support high value-adding industries, such as IT, automotive, pharmaceuticals, or financial services.
- **Increase employment** – Protection helps preserve domestic jobs, at least in the short term. However, protected industries become less competitive over time, especially in global markets, leading to job loss in the long run.

Sampling of Import Tariffs

Country	Average Import Tariff	
	Agricultural Products	Nonagricultural Products
Australia	1.2%	3.0%
Canada	15.9	2.3
China	15.6	9.0
European Union	13.2	4.2
India	33.5	10.2
Japan	19.0	2.6
Mexico	19.7	5.9
United States	5.3	3.1

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

Source: Based on *World Tariff Profiles 2014*, World Trade Organization, www.wto.org.

Subsidies (cont'd)

- **Subsidies** are government grants (monetary or other resources) to firm(s), intended to ensure their survival or success by facilitating production at reduced prices, or encouraging exports.
- Grants include cash, tax breaks, infrastructure construction, or government contracts at inflated prices.

Examples:

● In China, Shanghai Automotive ($12b ann. sales) and numerous other MNEs are partly owned by the Chinese government, and receive huge financial resources.

● Europe and the U.S. provide huge agricultural subsidies to farmers. EU subsidies represent 40% of the EU budget.

Economic Freedom

- ***Economic freedom*** is the absence of government coercion so that people can work, produce, consume, and invest however they want to.
- The *Index of Economic Freedom* assesses the rule of law, trade barriers, regulations, and other criteria.
  - Virtually all advanced economies are “free”.
  - Emerging markets are either “free” or “mostly free”.
  - Most developing economies are “mostly unfree” or “repressed”.
- Economic freedom flourishes with appropriate of intervention; too much regulation harms the economy.

Evolution of Government Intervention

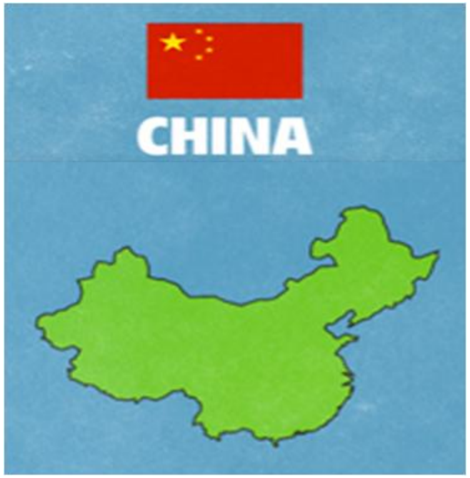
- Protectionist tendencies, the Great Depression, and isolationism shaped early 20th century world trade.

- The Smoot-Hawley Act (1937) raised U.S. tariffs to more than 50% (compared to only 3% today).

- Progressive trade policies reduced tariffs after WWII
- In 1947, 23 nations signed the General Agre on Tariffs and Trade (GATT). The GATT:
  - Reduced tariffs via continuous worldwide trade negotiations;
  - Created an agency to supervise world trade; and
  - Created a forum for resolving trade disputes

Market Liberalization in China

- In 1949, China established communism and centralized economic planning.
- Agriculture and manufacturing were controlled by inefficient state-run industries.
- The country was long closed to international trade.
- In the 1970s, China liberalized its economy.
- In 2001, China joined the WTO.
- China is now a key member of world trading system.



Regional Economic Integration

The growing economic interdependence that results when nations within a geographic region form an alliance aimed at reducing barriers to trade and investment.

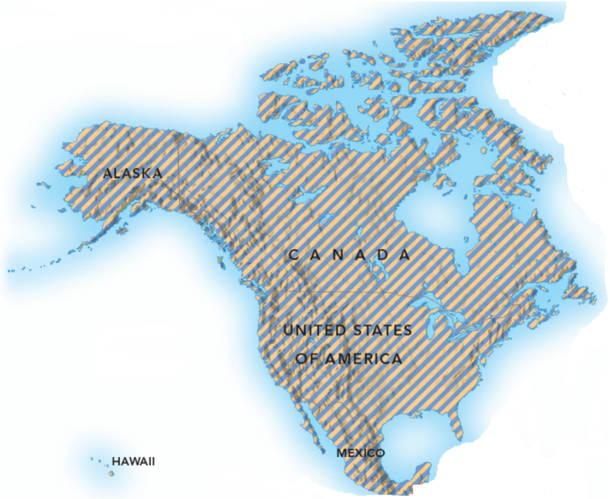
- Over 50 percent of world trade today occurs under some form of preferential trade agreements signed by groups of countries.

- Cooperating nations obtain:
  - increased product choices, productivity, living standards,
  - lower prices, and
  - more efficient resource use.

Economic Bloc

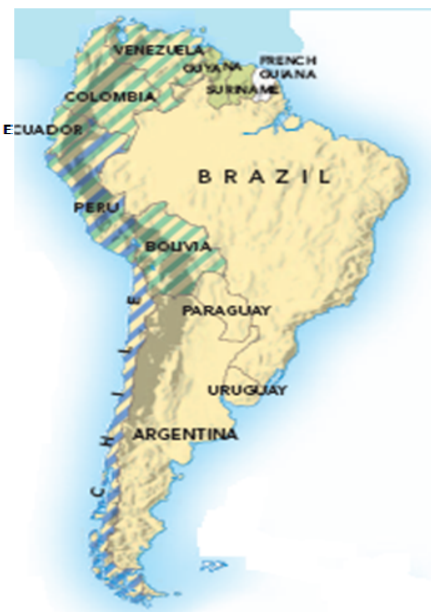
A geographic area consisting of two or more countries that agree to pursue economic integration by reducing tariffs and other barriers to the cross-border flow of products, services, capital, and, in more advanced cases, labor.

- Examples: European Union, NAFTA, MERCOSUR, APEC, ASEAN, GCC, and many others.
- There are five possible levels of economic integration.



Levels of Regional Integration

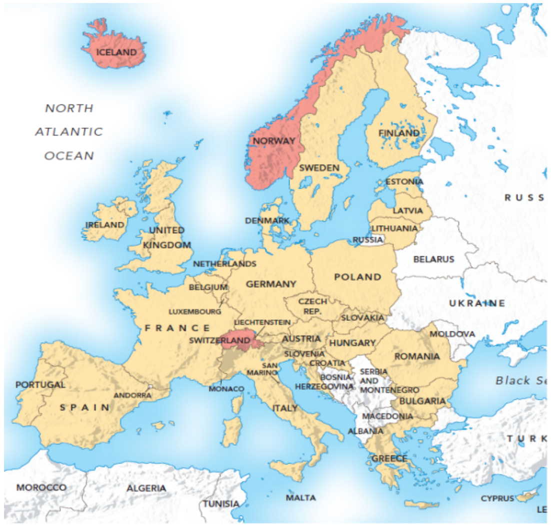
- **Free trade area**: Simplest, most common arrangement. Member countries agree to gradually eliminate formal trade barriers *within* the bloc, while each member maintains an independent international trade policy with countries *outside* the bloc. One example is NAFTA.
- **Customs union**: Similar to a free trade area except the members harmonize their trade policies toward nonmember countries, by enacting *common* tariff and nontariff barriers on imports from nonmember countries. MERCOSUR is an example.



Levels of Regional Integration (cont'd)

- **Common market**: Like a customs union, except products, services, and *factors of production* such as capital, labor, and technology can move freely among the member countries. e.g., The EU countries put in place many common labor and economic policies.

- **Economic union**: Like a common market, but members also aim for common fiscal and monetary policies, and standardized commercial regulations. The EU is moving toward an economic union by forming a monetary union with a single currency, the euro.

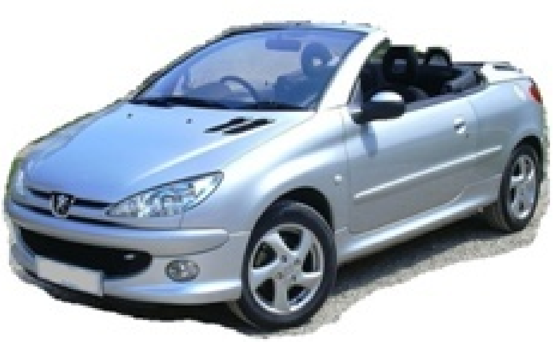


The EU: A Full-Fledged Economic Union

1. ***Market access***. Tariffs and most nontariff barriers have been eliminated.
2. ***Common market***. Barriers to cross-border movement of production factors—labor, capital, and technology.
3. ***Trade rules***. Cross-national customs procedures and regulations have been eliminated, which has streamlined transportation and logistics within Europe.
4. ***Standards harmonization***. Technical standards, regulations, and enforcements have been harmonized.
5. ***Common fiscal, monetary, taxation, and social welfare policies*** is the ultimate goal over time.

The European Union Today

- 27 members. Founders members are Belgium, Italy France, Germany, Luxembourg, and the Netherlands.
- New members such as Poland, Hungary, Czech Republic – are low-cost manufacturing sites.
    - Peugeot, Citroën (France) – factories in Czech Republic
    - Hyundai (South Korea) – Kia plant in S
    - Suzuki (Japan) – factory in Hungary



- Most new EU entrants are in Eastern Europe – one-time satellites of the Soviet Union, most are emerging markets with fast economic growth rates

NAFTA (Canada, Mexico, the United States)

Passage of NAFTA in 1994 was facilitated by the *maquiladora* program, thru which U.S. firms located factories just south of the U.S. border to access low-cost labor without significant tariffs. NAFTA:

- Eliminated tariffs and most nontariff barriers for products and services.
- Established trade and investment rules, uniform customs procedures, and intellectual property rights.
- Provided procedures for settling trade disputes.