CHAPTER 10

International Cooperation Among Nations

Danita Delimont/Alamy

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

1. Explain the importance of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) to international businesses.
2. Contrast the different forms of economic integration among cooperating countries.
3. Analyze the opportunities for international businesses created by completion of the European Union's internal market.
4. Describe the other major trading blocs in today's world economy.

TRADE AND PROSPERITY: THE CASE OF MEXICO

Is trade or aid the best means of promoting economic development? For Mexico, the answer is clear: trade. From 1917 to 1982, Mexico relied on inward-looking economic policies: high tariffs to discourage imports; restrictions on foreign direct investment (FDI) to reduce foreign presence in its economy; government ownership of key industries; and powerful, conservative bureaucracies that strangled entrepreneurship and innovation. Although the Mexican economy grew during this time span, its performance did not match that of export-driven economies such as those of Hong Kong, Taiwan, or South Korea. The last six presidents of Mexico have reversed these policies, in the process lowering tariffs, encouraging FDI, privatizing state-owned enterprises, and joining the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). Under their leadership, Mexico signed a series of free trade agreements with 44 countries, including the United States and Canada, the European Union (EU), Israel, Japan, Chile, and five of its Central American neighbors.

The North American Free Trade Agreement (NAFTA) is the big story. Its implementation in 1994 opened up the U.S. and Canadian markets to factories located in Mexico, allowing them to take advantage of Mexico's lower labor costs. Although most newspaper headlines focused on NAFTA's impact on big industries such as autos or textiles, Mexican entrepreneurs were quick to spot new opportunities. For example, a $100-million-a-year dental supply business sprang up in Mexico as a result of NAFTA, producing labor-intensive products such as buccal tubes (the straps that bind braces to teeth), endodontic files (stainless steel corkscrews used in root canals), and dental wax (a gummy paste used as a mold for crowns). The Mexican service sector also benefitted, as companies located call centers, data-processing facilities, and other customer support services there. For example, Seagate Technology's Reynosa facility provides after-sales support for its North American customers. In 2012, Mexico's exports of such business services to the United States exceeded $3.3 billion.

Unfortunately, China's joining the WTO, coupled with a slowdown in the U.S. economy in 2001, put a damper on Mexico's export surge. Many manufacturers of low-margin, low-valued-added products, such as toys and apparel, and those requiring labor-intensive assembly migrated to China to take advantage of its low labor costs.

The economic advantage of producing such goods in China has atrophied in the past several years, however, as we noted in Chapter 8's closing case, "What's Next for Chinese Manufacturing?". Wages in China have been rising annually at double digit rates for a decade. The average hourly manufacturing wage is estimated to be $3.00 in China and $3.50 in Mexico, but labor productivity is higher in Mexico. As a result, some companies are relocating their manufacturing activities back to Mexico to take advantage of its proximity to the U.S. market and its integration into the supply chains of North American corporations. For instance, manufacturers of flat panel high-definition TVs, such as Samsung, Sony, and Vizio, find Mexico a convenient location to assemble their products for delivery to North American consumers. Contract manufacturer Hon Hai Precision Industries (see Chapter 5's opening case) now assembles custom-order computers for Dell in Ciudad Juárez, while continuing to churn out standardized models in its Chinese factories. Querétaro, a colonial-era city in the country's central highlands, is becoming a hub for aerospace firms. General Electric employs 1,300 engineers at its Querétaro research and development (R&D) center designing engines for Airbus and Boeing wide-body jets, while Bombardier's 1,600 workers are constructing the fuselage, electrical systems, and horizontal and vertical stabilizers for the company's newest line of corporate jets. The Mexican auto industry is also booming. It is now the world's fourth-largest exporter of automobiles—2.1 million vehicles in 2012. And the industry's success has induced auto-parts suppliers to invest heavily in the country. Pirelli sank $400 million in a tire plant in Silao to service Mexican auto-assembly plants. Similarly, Germany's Bosch, Japan's Akebono Brake Industry and Nippon Steel, and the United States' Delphi have made major investments to feed the country's production lines.

Mexico still faces many challenges, of course. The escalation of violence among rival drug gangs has scared off some foreign investors. For instance, Electrolux AB, the giant Swedish appliance manufacturer, chose to locate its newest factory in Memphis, Tennessee, rather than Mexico, in part because of security concerns. Mexican exporters are vulnerable to downturns in the U.S. economy—some 80 percent of Mexico's exports are destined for its northern neighbor. Moreover, Mexican officials recognize that they have to raise the productivity of their workforce and improve the country's infrastructure if Mexico is to continue to compete successfully in the global economy.[1] ■

In Chapter 9 we explored the ways in which national governments intervene in international trade and investment. When a country adopts restrictions on international commerce, it can benefit at least some of its producers and workers. But other countries may retaliate with similar restrictions, thinking that they too will gain. As restrictions proliferate, international trading opportunities decline, and all countries end up losing. They often then realize that each is better off if they cooperate and agree to forswear trade restrictions. Such policy changes underlie the transformation of the Mexican economy, as we just noted.

International cooperative agreements form a major part of the economic environment in which international businesses operate. To be successful, international businesspeople must be knowledgeable about these agreements and use them to create business opportunities for their firms and counteract competitors' actions. Of particular importance is the growth of regional trading blocs, such as the Mercosur Accord and the North American Free Trade Agreement (NAFTA), which are designed to reduce trade barriers among their members. By far the boldest of these regional economic integration efforts is that of the European Union (EU), most of whose members have replaced or are planning to replace their national currencies with a single currency, the euro.

The General Agreements on Tariffs and Trade and the World Trade Organization

The collapse of the international economy during the Great Depression between World Wars I and II has been blamed partly on countries' imposing prohibitive tariffs, quotas, and other protectionist measures on imported goods. Trading and investment opportunities for international businesses dried up as country after country adopted such "beggar-thy-neighbor" policies. By raising tariff and quota barriers, each nation believed that it could help its own industries and citizens, even though in doing so it might harm the citizens and industries of other countries. For example, in 1930 the United States sought to protect domestic industries from import competition by raising tariffs under the Smoot-Hawley Tariff Act to an average of 53 percent. However, as other countries, such as the United Kingdom, Italy, and France, constructed similarly high tariff walls, none gained a competitive advantage over another, and as international trade declined, all suffered from the contraction of export markets.

To ensure that the post–World War II international peace would not be threatened by such trade wars, representatives of the leading trading nations met in Havana, Cuba, in 1947 to create the International Trade Organization (ITO). The ITO's mission was to promote international trade; however, the organization never came into being because of a controversy over how extensive its powers should be. Instead the ITO's planned mission was taken over by the **General Agreement on Tariffs and Trade (GATT)**, which had been developed as part of the preparations for the Havana conference. From 1947 to 1994, the signatories to the GATT (the GATT was technically an agreement, not an organization) fought to reduce barriers to international trade. The GATT provided a forum for trade ministers to discuss policies and problems of common concern. In January 1995, it was replaced by the World Trade Organization, which adopted the GATT's mission.

The Role of the General Agreement on Tariffs and Trade

The GATT's goal was to promote a free and competitive international trading environment benefiting efficient producers, an objective supported by many multinational corporations (MNCs). The GATT accomplished this by sponsoring multilateral negotiations to reduce tariffs, quotas, and other nontariff barriers (NTBs). Because high tariffs were initially the most serious impediment to world trade, the GATT first focused on reducing the general level of tariff protection. It sponsored a series of eight negotiating "rounds," generally named after the location where each round of negotiations began (see Table 10.1), during its lifetime. The cumulative effect of the GATT's eight rounds was a substantial reduction in tariffs. Tariffs imposed by the developed countries fell from an average of more than 40 percent in 1948 to approximately 3 percent in 2005. As Figure 6.1 demonstrated (see page 178), the GATT negotiations have led to dramatic growth in world trade since the end of World War II. (See "People, Planet, and Profits" for a counterexample: an international agreement to reduce trade.)

To help international businesses compete in world markets regardless of their nationality, the GATT sought to ensure that international trade was conducted on a nondiscriminatory basis. This was accomplished through use of the **most favored nation (MFN) principle**, which requires that any preferential treatment granted to one country must be extended to all countries. (See "Bringing the World into Focus" for further discussion of MFN.) Under GATT rules, all members were required to use the MFN principle in dealing with other members. For example, if the United States cut the tariff on imports of British trucks to 20 percent, it also had to reduce its tariffs on imported trucks from all other members to 20 percent. Because of the MFN principle, multilateral, rather than bilateral, trade negotiations were encouraged, thereby strengthening the GATT's role.

TABLE 10.1 GATT Negotiating Rounds

Round	Dates	Number of Participants	Average Tariff Cut (%)
Geneva	1947	23	35
Annecy	1949	13	NA
Torquay	1950–1951	38	25
Geneva	1956	26	NA
Dillon	1960–1962	45	NA
Kennedy	1964–1967	62	35
Tokyo	1973–1979	99	33
Uruguay	1986–1994	117	36

PEOPLE, PLANET, AND PROFITS

PROTECTING ENDANGERED SPECIES

Although most trade agreements are designed to promote trade, some trade agreements are designed to eliminate or suppress trade, such as the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES). CITES, as its name suggests, is a 1973 agreement among 178 countries to control international trade in endangered species. The CITES registry now includes 33,000 species (28,000 flora, 5,000 fauna) for which trade is banned or limited. The most publicized problems involve elephants, rhinoceros, and tigers. Elephants are poached for their ivory, while rhino horns and tiger bones are prized for their medicinal values in many Asian cultures, most notably China's. Unfortunately, CITES has had little impact on reducing the killing of these animals. An estimated 25,000 elephants are poached each year in Africa, about 5 percent of their total population on that continent. The population of wild tigers has been halved in the past two decades, despite a trade ban imposed in 1975. In 2012 alone, some 668 rhinos were killed by poachers, although trade in rhino horns has been illegal since 1976.

Ironically, the ban on trade in these animals may be contributing to the problem. High prices create great rewards for law-breakers. Ivory can sell for $800 a pound, while a tiger skin or pound of rhino horn can command 20 times as much. Kenyan officials report that international crime gangs, motivated by the high prices of ivory, are using helicopters and sophisticated weapons to hunt down their prey. They are urging an intensified international effort to stamp out trade in these animals.

Yet other experts believe that improved monitoring and creation of limited legal trade is the better approach. In their view, by creating a controlled market, they will incentivize people to protect endangered

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An estimated 25,000 elephants a year are killed by poachers. The members of CITES are trying to decide if the herds will be better protected by legal but controlled trade in ivory or by a total ban on trade in ivory.

(*Continued*)

species. For instance, an estimated 5,000 tigers are being farmed in China to provide tiger bones for the treatment of rheumatism, reducing the incentive to poach wild tigers. Ivory taken from elephants that died of natural causes can be auctioned off, with the revenues ploughed back into conservation and protection efforts. Such monies are critical in underdeveloped countries facing severe budgetary constraints and many competing uses for available government resources.

Yet wildlife conservation nongovernmental organizations (NGOs) point out that this approach has not worked in the past. CITES members agreed in 1997 and then again in 2007 to allow limited legal sales of ivory. The NGOs believe the legal sales stimulated poaching, allowing the poachers to dispose of their illegal ivory by claiming it as legally obtained. They note that less than half of the 35 African nations signing the CITES agreement imposed workable controls on the ivory trade.

Sources: "Horn of Scarcity," *The Economist*, April 20, 2013, p. 47; "On the way out," *The Economist*, March 16, 2013; "Governments Pledge to Protect More Sharks," *Wall Street Journal*, March 14, 2013; "A Trumpet in the Wild," *Wall Street Journal*, March 14, 2013; "Trade protection," *The Economist*, March 5, 2013; "China Backs Tortoise in Race to Protect Endangered Species," *Wall Street Journal*, March 4, 2013; "Thailand Plans to Put a Stop to Trading in Ivory," *Wall Street Journal*, March 3, 2013; "Debate Over Trading Ivory Heats Up," *Wall Street Journal*, February 28, 2013; "China, Thailand Criticized Over Ivory," *Wall Street Journal*, February 21, 2013.

There are two important exceptions to the MFN principle:

1. To assist poorer countries in their economic development efforts, the GATT permitted members to lower tariffs to developing countries without lowering them for more developed countries. Such reduced rates offered to developing countries are known as the **generalized system of preferences (GSP)**. Each country is free to choose those developing countries to which it will apply GSP treatment. For instance, during the Cold War the United States granted access to the lower GSP tariff rates to countries that were diplomatically allied with it against the Soviet Union. Obviously, by reducing these tariffs, the GSP increases the pressures on domestic firms that are vulnerable to import competition from the developing countries. In contrast, MNCs can reduce their input and production costs by locating factories and assembly facilities in countries benefiting from the GSP.
2. The second exemption is for comprehensive trade agreements that promote economic integration, such as the EU and NAFTA.

Although the GATT's underlying principles were noble, its framers recognized that domestic political pressures often forced countries to retreat from pure free trade policies. The GATT permitted countries to protect their domestic industries on a nondiscriminatory basis, although under GATT rules, countries were supposedly restricted to the use of tariffs only. Quotas and other NTBs can often be applied discriminatorily, and they are less "transparent"—that is, it is often harder to judge their impact on competition. However, there were loopholes in these rules, so many countries adopted quotas and other NTBs yet remained in compliance with the GATT. For example, U.S. quotas restricting imports of peanuts, sugar, and other agricultural products that were granted a "temporary" waiver from GATT rules in 1955 remained in effect for decades. Countries were allowed exemptions to preserve national security or to remedy balance of payments problems. The GATT also permitted countries in certain circumstances to protect themselves against "too much" foreign competition.

The eighth, and final, round of GATT negotiations began in Uruguay in September 1986. Ratified by GATT members in Morocco in March 1994, the **Uruguay Round** agreement took effect in 1995. Like its seven predecessors, the Uruguay Round cut tariffs on imported goods—in this case, from an average of 4.7 percent to 3 percent. As average tariff rates declined, however,

BRINGING THE WORLD INTO FOCUS

MOST NATIONS ARE FAVORED

As part of the rules of membership in the GATT and the WTO, each member must grant every other member MFN status. However, members are also free to grant nonmembers MFN status as well. The United States, for example, grants MFN status to nearly all countries. The few countries excluded are those considered diplomatically hostile to it, such as Cuba and North Korea.

The Clinton administration decided to adopt the term *normal trade relations* (NTR) to replace MFN. It had two reasons for doing so. The public reason was that NTR was a more accurate description; if almost all countries receive such treatment, then the practice is "normal" rather than "most favored." There was also a political reason. The administration was in a battle to secure permanent MFN status for China as part of the administration's agreement to allow China to join the WTO. President Clinton judged that it would be easier to sway public opinion and win the vote in Congress if the United States were perceived to be treating China normally, rather than providing it favorable treatment. Hence, MFN became NTR in U.S. trade documents.

most countries recognized that NTBs had become a more important impediment to the growth of world trade, so the Uruguay Round addressed them as well. For example, the participants made substantial progress in abolishing quotas by encouraging countries to convert existing quotas to tariff rate quotas (see Chapter 9). More importantly, Uruguay Round participants agreed to create the WTO. They established its initial agenda and granted it more power to attack trade barriers than the GATT had possessed.

The World Trade Organization

The **World Trade Organization (WTO)** came into being on January 1, 1995. Headquartered in Geneva, Switzerland, the WTO includes 159 member and 24 observer countries. Members are required to open their markets to international trade and to follow the WTO's rules. The WTO has three primary goals:

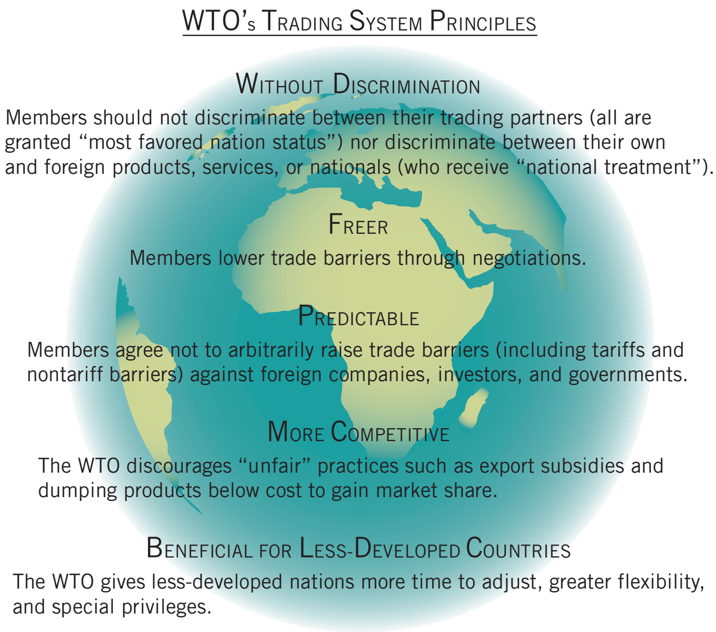
1. Promote trade flows by encouraging nations to adopt nondiscriminatory, predictable trade policies. (Figure 10.1 details the WTO's principles for the world trading system.)
2. Reduce remaining trade barriers through multilateral negotiations. During the first several years of its existence, the WTO emphasized negotiations focused on specific sectors of the world economy. For example, the WTO sponsored the 1996 Information Technology Agreement to eliminate tariffs on such products as computers, software, fax machines, and pagers. Similar agreements covering financial services and telecommunications were signed in 1997. In 2001, the WTO initiated the **Doha Round** of trade negotiations. The Doha negotiations were supposed to be completed by January 2005. The talks deadlocked over several troublesome issues. Although reducing tariffs on manufactured goods exported to developing countries and loosening restrictions on trade in services proved to be stumbling blocks, the most contentious issue facing the Doha negotiators was freeing trade in agricultural goods, a problem that also stymied the GATT. Trade in many agricultural products has been distorted by export subsidies, import restrictions, and other trade barriers. The **Cairns Group**, a group of major agricultural exporters led by Argentina, Australia, Brazil, Canada, and Thailand, has pressured other WTO members to ensure that the Doha Round significantly reduces barriers to agricultural trade but has been unable as yet to structure terms that satisfy China, India, Japan, and many other countries. Although the Doha negotiations have not yet been terminated, few trade experts expect any significant breakthroughs in the near term.[2]
3. Establish impartial procedures for resolving trade disputes among members.

The WTO was clearly designed to build on and expand the successes of the GATT; indeed, the GATT agreement was incorporated into the WTO agreement. The WTO differs from the

FIGURE 10.1

The WTO's Principles of the Trading System

Source: Based on "About the WTO." www.wto.org



authorize trade sanctions to be imposed against the countries who subsidized their green energy industries contrary to WTO rules, as discussed in Chapter 9's closing case, once they have exhausted the WTO's appeal process.

Although barriers to international trade and investment remain, no one believed they would come tumbling down like the walls of Jericho as soon as the WTO arrived on the scene. Most trade experts give the WTO good marks for its accomplishments during its first decade of existence, such as the sectoral agreements in telecommunications, information technology, and financial services. However, the failure of the WTO to break the deadlock over the Doha Round negotiations has raised some concerns about future reductions in trade barriers and the future effectiveness of the WTO.[5] Moreover, the growing importance of the WTO has attracted opposition to its actions. Environmentalists and human rights activists, for instance, believe that the WTO needs to incorporate more sensitivity to environmental and human needs in its decision making. Labor unions and workers' groups fear that the WTO's decisions weaken their bargaining power and threaten their members' job security.

In Practice

- The GATT and its successor, the WTO, have promoted freer trade in goods and services post–World War II.
- The WTO's powers are stronger and its agenda is broader than that of the GATT.

For further consideration: What is the appropriate tradeoff between freer trade and protecting human rights and the environment?

Regional Economic Integration

Regional alliances to promote liberalization of international trade are an important feature of the post–World War II international landscape. More than 200 such agreements are in existence, although not all have had much practical impact. They present international businesses with myriad opportunities and challenges. The past decade in particular has seen a rise in the number of trading blocs, as countries seek to integrate their economies more closely to open new markets for their firms and lower prices for their consumers.

Forms of Economic Integration

Regional trading blocs differ significantly in form and function. The characteristic of most importance to international businesses is the extent of economic integration among a bloc's members because it affects exporting and investment opportunities available to firms from member and nonmember countries. There are five different forms of regional economic integration: free trade area, customs union, common market, economic union, and political union. We discuss these next in order of ascending degree of economic integration.

FREE TRADE AREA A **free trade area** encourages trade among its members by eliminating trade barriers (tariffs, quotas, and other NTBs) among them. An example of such an arrangement is NAFTA, which reduces tariffs and NTBs to trade among Canada, Mexico, and the United States.

Although a free trade area reduces trade barriers among its members, each member is free to establish its own trade policies against nonmembers. As a result, members of free trade areas are often vulnerable to the problem of **trade deflection**, in which nonmembers reroute (or deflect) their exports to the member nation with the lowest external trade barriers. Canada, for example, may use high tariffs or quotas to discourage imports of a given product from nonmembers, whereas the United States may impose few restrictions on imports of the same good from nonmembers. Taking advantage of the latter's low barriers, nonmembers may deflect their Canada-destined exports by first shipping the good to the United States and then re-exporting it from the United States to Canada. To prevent trade deflection from destroying their members' trade policies toward nonmembers, most free trade agreements specify **rules of origin**, which detail the conditions under which a good is classified as a member good or a nonmember good.

For example, under NAFTA rules of origin, most goods qualify for preferential treatment as a North American product only if they undergo substantial processing or assembly in Mexico, Canada, or the United States.

CUSTOMS UNION A **customs union** combines the elimination of internal trade barriers among its members with the adoption of common external trade policies toward nonmembers. Because of the uniform treatment of products from nonmember countries, a customs union avoids the trade deflection problem. A firm from a nonmember country pays the same tariff rate on exports to any member of the customs union.

Historically, the most important customs union was the *Zollverein*, created in 1834 by several independent principalities in what is now Germany. The eventual unification of Germany in 1871 was hastened by this customs union, which tightened the economic bonds among the Germanic principalities and facilitated their political union. A more contemporary example of a customs union is the Mercosur Accord, an agreement initially signed by Argentina, Brazil, Paraguay, and Uruguay to promote trade among themselves. In 2010, Russia, Belarus, and Kazakhstan similarly agreed to create a customs union.

COMMON MARKET A **common market** is a third step along the path to total economic integration. As in a customs union, members of a common market eliminate internal trade barriers among themselves and adopt a common external trade policy toward nonmembers. A common market goes a step further, however, by eliminating barriers that inhibit the movement of factors of production—labor, capital, and technology—among its members. Workers may move from their homeland and practice their profession or trade in any of the other member nations. Firms may locate production facilities, invest in other businesses, and use their technologies anywhere within the common market. Productivity within the common market is expected to rise because factors of production are free to locate where the returns to them are highest. An example of a common market is the European Economic Area, which is an agreement by EU members and several other European countries to promote the free movement of labor, capital, and technology among them.

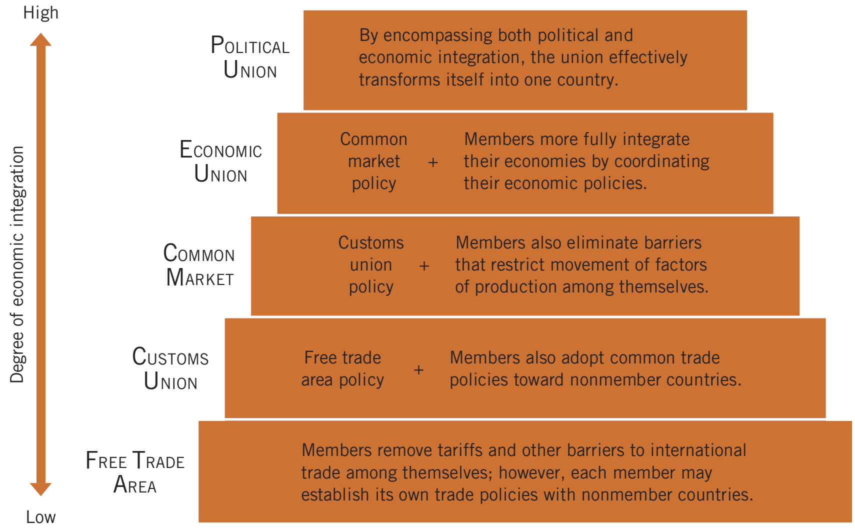
ECONOMIC UNION An **economic union** represents full integration of the economies of two or more countries. In addition to eliminating internal trade barriers, adopting common external trade policies, and abolishing restrictions on the mobility of factors of production among members, an economic union requires its members to coordinate their economic policies (monetary policy, fiscal policy, taxation, and social welfare programs) to blend their economies into a single entity. The members of the EU who have adopted the euro as their domestic currency are in the process of creating an economic union among themselves.

POLITICAL UNION A **political union** is the complete political as well as economic integration of two or more countries, thereby effectively making them one country. An example of a political union is the integration of the 13 separate colonies operating under the Articles of Confederation into a new country, the United States of America. Figure 10.2 summarizes the five forms of economic integration.

The Impact of Economic Integration on Firms

From the viewpoint of an individual firm, regional integration is a two-edged sword. Consider elimination of internal trade barriers, a feature common to all five forms of economic integration. Lowering tariffs within the regional trading bloc opens the markets of member countries to all member country firms. Firms can lower their average production and distribution costs by capturing economies of scale as they expand their customer base within the trading bloc. The lower cost structure will also help the firms compete internationally outside the trading bloc. For instance, many Canadian manufacturers supported their country's free trade agreements with the United States. They believed that improved access to the large U.S. market would allow longer production runs in Canadian factories, thereby lowering their average costs and making Canadian goods more competitive in international markets inside and outside the free trade area. However, elimination of trade barriers also exposes a firm's home market to competition from firms located in other member countries, thus threatening less-efficient firms.

FIGURE 10.2
Forms of Economic Integration



A regional trading bloc may also attract FDI from nonmember countries as firms outside the bloc seek the benefits of insider status by establishing manufacturing facilities within the bloc. Most non-European MNCs, including General Mills, Toyota, and Samsung, have invested heavily in the EU to take advantage of Europe's increased economic integration. These investments bolster the productivity of European workers and increase the choices available to European consumers, but threaten established European firms such as Unilever, Renault, and Siemens.

Typically, each form of economic integration confers benefits on the national economy as a whole but often hurts specific sectors and communities within that economy. As a result, negotiating any form of economic integration is not easy. Special-interest groups that feel they will be harmed by an agreement will lobby against it. For example, U.S. and Canadian autoworkers lobbied against NAFTA, fearing that Ford, GM, and Chrysler would shift production to Mexico to take advantage of its lower-cost labor. As a result of such internal political pressures, few economic integration treaties are "pure"; most contain some exemptions to quiet politically powerful domestic special-interest groups.

In Practice

- There are five forms of regional economic integration: free trade area, customs union, common market, economic union, and political union.
- The complexity of negotiating a regional economic integration agreement increases dramatically as we move from one form to the next.

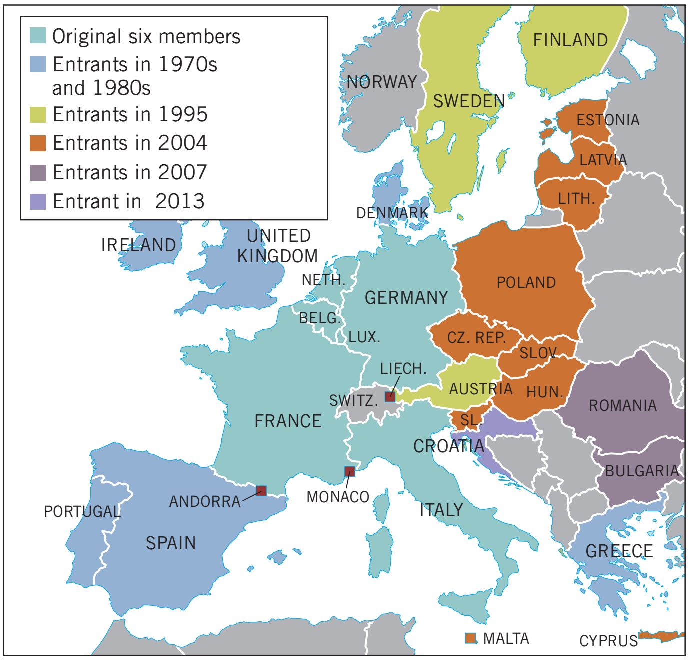
For further consideration: Regional economic integration usually helps consumers. Competitive, efficient firms benefit as well, but uncompetitive, inefficient firms can suffer from an influx of new competition when a regional economic integration agreement is implemented.

The European Union

The most important regional trading bloc in the world today is the EU. The EU's 28 member countries, with a combined population of 508 million, compose one of the world's richest markets, with a total gross domestic product (GDP) of $17.6 trillion, or about 25 percent of the world economy. (See Table 10.2 and Map 10.1.)

Like the International Monetary Fund (IMF), the World Bank, and the GATT, the creation of the EU was motivated by the desires of war-weary Europeans to promote peace and

MAP 10.1
The European Union



Governing the EU

The EU is a unique institution. Its members are sovereign nations that have agreed, sometimes begrudgingly, to cede certain of their powers to the EU. The EU can be characterized both as an "intergovernmental government" (because it is a government of national governments) and as a "supranational government" (because it exercises power above the national level). The EU is governed by five organizations that perform its executive, administrative, legislative, and judicial functions:

- The European Council (meets in Brussels, Belgium)
- The Council of the European Union (headquartered in Brussels, Belgium)
- The European Commission (also based in Brussels)
- The European Parliament (normally meets in Strasbourg, France)
- The European Court of Justice (sitting in Luxembourg)

Because most of the EU's employees are located in Brussels, many Europeans refer to the EU's government as "Brussels," the same way many Canadians refer to their national government as "Ottawa" or many Americans refer to theirs as "Washington."

THE EUROPEAN COUNCIL The **European Council** consists of the heads of government or of state of each of the member states, the President of the European Council, and the President of the European Commission. The EU's High Representative of the Union for Foreign Affairs and Security Policy also participates in its meetings. Normally convening twice every six months, the European Council shapes the EU's political priorities and policy agendas. The European Council's decisions are usually based on consensus, unless the EU treaties require a different voting rule. In reaching these decisions, only the heads of government may vote. Although it has met informally beginning in 1974, the European Council became an official EU institution only in 2009, when the Treaty of Lisbon entered into force.

THE COUNCIL OF THE EUROPEAN UNION The **Council of the European Union** (previously named the Council of Ministers) is composed of 28 representatives, each selected directly by and responsible to his or her home government. Which representative a country sends to a Council meeting depends on the Council's agenda. For example, if the Council is dealing with farm policies, each country typically sends its minister of agriculture. The Council presidency rotates among the members every six months. In most Council decisions, a weighted voting arrangements of the EU reflect the ongoing struggle between the members' desire to retain their national sovereignty and their wish to create a supranational government with an international political and economic stature equal to those of the United States, China, and Japan. As "Venturing Abroad" suggests, many MNCs exploit this power struggle to their benefit. The debate over national sovereignty versus supranational government is manifested in another way: Although the EU may formulate policies, in most circumstances they are implemented by members at a national level, giving the member states additional flexibility to tailor the policies to their unique circumstances.

The Struggle to Create a Common Market

The Treaty of Rome's goal of creating a common market was indeed visionary. Unfortunately, for the first 35 years of the EU's existence, it was nothing more than a cruel mirage. To establish a common market that would permit the free flow of goods, services, labor, capital, and technology, each EU member had to agree to change thousands of its national laws, product standards, and regulations to ensure that they were compatible with those of other EU members. In practice, the member nations moved cautiously because of political pressures from domestic special-interest groups.

As a result, conflicting national regulations, which affected nearly every good and service purchased by Europeans, hindered trade and the completion of the common market. For example, Spain required that keyboards sold within its borders contain a "tilde" key, an accent mark commonly used in the Spanish language. Other EU countries had no such requirement. Italy required pasta to be made of durum wheat, a requirement not decreed by other EU members.

The EU initially relied on a process of **harmonization** to eliminate such conflicts. The EU encouraged member countries to voluntarily adopt common, EU-wide ("harmonized") regulations affecting intra-EU trade in goods and services and movement of resources. The harmonization process moved slowly, however, because domestic political forces within the member states resisted change. For example, to protect the purity of its language, Spain refused to yield on the tilde issue. EU producers spent an estimated $260 billion (in 1988 dollars) annually to comply with different national regulations.[6] These increased costs raised the prices paid by European consumers and reduced the global competitiveness of European manufacturers.

Progress toward eliminating conflicting product standards was so slow that some pessimists believed the EU would disintegrate. In 1979, however, the European Court of Justice heard the now famous *Cassis de Dijon* case. Rewe Zentral AG, a German wholesaler, wished to import Cassis de Dijon, a French liqueur made from black currants, into Germany. Cassis de Dijon failed to meet German regulatory standards, though—its alcohol content was too low. Rewe Zentral sued, arguing that Germany violated its obligations under the Treaty of Rome to promote the free movement of goods. The European Court of Justice found for the German wholesaler. In so doing, the Court created the concept of **mutual recognition**: if one member state determines that a product is appropriate for sale, then all other EU members are also obliged to do so under the provisions of the Treaty of Rome. Because France had determined Cassis de Dijon to be a legitimate liqueur, Germany was obligated to allow its sale as well.

Although the Court's findings contained some loopholes, the implications of the *Cassis de Dijon* case were profound. Adopting the concept of mutual recognition meant that the slow harmonization process could be bypassed, and conflicting product standards would no longer serve as barriers to trade among EU members. The timing of the case was also fortunate: Many European economic and political leaders were becoming increasingly concerned about the competitiveness of European firms in world markets. Their concerns reinvigorated the EU's commitment to completing the common market called for in the Treaty of Rome.

In 1985 the European Commission issued its *White Paper on Completing the Internal Market*. The *White Paper* called for accelerated progress on ending all trade barriers and restrictions on the free movement of goods, services, capital, and labor among members. Accepting the vision of the *White Paper*, in 1986 the members signed the Single European Act, which took effect on July 1, 1987. The act was intended to help complete the formation of the *internal market* (the term developed by the Eurocrats to mean "common market") by December 31, 1992. Under the Single European Act, 279 broad regulatory changes had to be made to complete the internal market. Although not all these changes were fully implemented by the 1992 deadline,

VENTURING ABROAD

LOBBYING THE EUROPEAN UNION

The government of the EU is engaged in many activities that affect international businesses, such as regulating payments to bumped passengers on overbooked airline flights or defining accounting standards. Because of the impact of the EU's decisions on the opening or closing of the enormous European market to international businesses, most countries maintain diplomatic relationships with the EU to ensure that it does not disregard their economic interests. The United States, for example, maintains a United States Mission to the European Union, led by a senior State Department official with ambassadorial status.

Savvy international businesspeople, however, do not rely solely on their home governments to protect them from adverse EU regulations. Indeed, an estimated 15,000 lobbyists work in Brussels, seeking to influence EU policy and decisions. A key to their success is understanding the power relationships within the EU—particularly between the Council of the European Union, which defends national interests, and the European Commission, which promotes the interests of an integrated Europe. Firms threatened by pending EU regulations can adopt two strategies:

1. They may lobby the Commission and its elaborate bureaucracy to adopt regulations more beneficial to their interests. Because the Commission must continually balance the often diverse interests of EU members, firms can often influence the Commission to add their interests to the long list of other factors that it will consider in proposing legislation to the Council. Also, because of the Commission's commitment to completing the EU's internal market, firms have found that arguments promoting increased European integration are particularly well received by Eurocrats. For example, the Commission dropped proposed franchising regulations after U.S. firms convinced its staff that the pending regulations would hinder European integration.
2. Firms may lobby an ally on the Council. For example, remembering that "all politics is local," Japanese automakers that built assembly plants in the United Kingdom were able to enlist the help of the British representative on the Council—who was interested in preserving jobs in his country—when French and Italian automakers were urging the EU to adopt regulations prejudicial to those UK assembly plants.

Sources: "Astroturfing takes root," *Financial Times*, June 27, 2013, p. 7; Europe proposes U.S.-style measures aimed at lobbyists," *Wall Street Journal*, May 4, 2006, p. A10; James N. Gardner, "Lobbying, European-style," *Europe*, November 1991 (Number 311), pp. 29–30; "European bureaucrats are writing the rules Americans will live by," *Wall Street Journal*, May 17, 1989, p. A1; "Lobbying Brussels in anticipation of 1992," *Wall Street Journal*, March 6, 1989, p. A12.

sufficient progress was made that many experts believed the Treaty of Rome's goal of creating a common market was close to being realized—but it took 35 years to do so! Still, if you think of the magnitude of the challenge—getting so many governments to cooperate peacefully on such a broad range of activities—perhaps 35 years is a remarkably short period of time.

The benefits of creating the common market are substantial to European firms, economies, and workers. The common market offers firms the opportunity to sell their goods in a large, rich market free from barriers to trade. However, although firms in EU member countries have gained improved access to a larger market, they also face increased competition in their home markets from other members' firms. This increased competition benefits consumers throughout the EU. Marketing, production, and R&D costs have been reduced because firms generally have to comply with only one, EU-wide set of regulations instead of 28 separate sets of national regulations. Many firms have been able to restructure their European manufacturing operations to capture economies of scale and lower their production costs. And the EU has been a magnet for new investment from other foreign firms eager to enter the lucrative European market and benefit from its common market. U.S. FDI in the EU has risen from $84 billion in 1985, when the *White Paper* was first issued, to $2.2 trillion in 2012. Similarly, more than 500 Japanese companies have established operations in the EU since 1985. More recently, Chinese firms have targeted the EU. From 2008 to 2010, Chinese companies invested $44 billion in the EU, seeking to access the area's rich consumer market and sophisticated technologies.[7]

From Common Market to European Union

The EU members were justifiably proud of the progress made under the Single European Act. As the necessary changes were being finalized, the Cold War ended. The Soviet Union dissolved, the countries of Eastern Europe and Central Europe abandoned communism, and the threat of nuclear war diminished. The United States stood alone as the world's remaining superpower. Some European politicians believed that Europe should reassert itself on the world's stage and free itself from geopolitical domination by the United States. Meanwhile,

VENTURING ABROAD

THE TOBIN TAX

One controversial issue splitting EU members is the imposition of the so-called Tobin tax, named after Yale economics professor and Nobel Laureate James Tobin. In the 1960s Tobin proposed placing a small tax—perhaps 0.1 percent—on financial transactions such as sales of stock and bonds. Tobin viewed the tax as a means of curbing speculation, reducing volatility, and raising revenues. In 2012, citing Tobin's reasoning, the European Commission proposed adopting a Tobin tax of 0.1 percent on stock and bond sales and .01 percent on derivatives trades. It estimated the tax would raise €30–35 billion a year. Left unsaid was that the tax would fall on two groups unpopular with the Eurocrats. The first group was bankers and financiers in general—in the popular view, they were the ones that caused the global recession, and then profited from it when government after government bailed out their banking industries to avoid additional economic calamities. The second group was the British government. Under Conservative Prime Minister David Cameron, the British government has been the primary obstruction to a variety of measures favored by the European Commission, including increasing the EU's budget (the British want it decreased) and imposing EU-wide banking regulations (the British disagree). Moreover, the most important center of the global capital market is the City of London; thus the bulk of the tax would be borne by British-based institutions. The British government argues that a Tobin-tax imposed by the EU would drive financial transactions from London to other centers of international finance, such as New York, Tokyo, Singapore, and Hong Kong, thereby destroying one of the mainstays of the British economy. This is a small price to pay, in the view of some continental European residents.

Source: "Britain challenges EU over Tobin tax," *Financial Times*, April 20/21, 2013, p. 3; British leaders must act fast to save the Square Mile," *Financial Times*, March 7, 2013, p. 9; "The whys and wherefores of an EU "Tobin tax'," *Financial Times*, March 4, 2013, p. 14; "U.S. banks fire warning as EU prepares to unveil 'Tobin tax'," *Financial Times*, February 14, 2013, p. 13.

In Practice

- The 28-member EU is by far the most important and most comprehensive regional economic integration agreement in the world.
- Nonetheless, the EU faces numerous challenges, in part because it is hard for its disparate members to reach consensus on the economic, political, demographic, and governance challenges the EU needs to resolve.

For further consideration: Is the EU a success or a failure? Defend your answer.

Other Regional Trading Blocs

The EU's success in enriching its members through trade promotion has stimulated the development of other regional trading blocs. Every inhabited continent now contains at least one regional trading group. Europe, for example, has many other smaller trading blocs, such as the **European Free Trade Association**. Its members are Iceland, Liechtenstein, Norway, and Switzerland. The first three of these countries have joined with the EU to create a common market known as the **European Economic Area**, which promotes the free movement of goods, services, labor, and capital among its members. Russia, Belarus, and Kazakhstan formed a customs union in 2010, with a goal of creating a common market in 2012.

The North American Free Trade Agreement

Another important example of regional economic integration is NAFTA. Implemented in 1994 to reduce barriers to trade and investment among Canada, Mexico, and the United States, NAFTA builds on the 1988 Canadian–U.S. Free Trade Agreement. Canada and the United States enjoy the world's largest bilateral trading relationship, with two-way trade totaling $715 billion in 2012. The United States is Mexico's largest trading partner, while Mexico is the third-largest trading partner of the United States (after Canada and China). Trade between Canada and Mexico, which totaled $35.4 billion in 2012, has increased more than sixfold since the signing of NAFTA.

NAFTA increased the integration of the North American economies. Over a 15-year time span, tariff walls were lowered, NTBs reduced, and investment opportunities increased for firms located in the three countries. However, some industries received special treatment in the agreement. Negotiators from all three countries recognized the political sensitivity of certain issues and industries and chose to compromise on their treatment within NAFTA to ensure the agreement's ratification. For example, because Canada fears being dominated by U.S. media, NAFTA allows Canada to limit foreign investments in its culture industries (publishing, music, television, radio, cable, and film). Similarly, Mexico may restrain foreign investments in its energy sector, and the United States may bar foreign ownership in its airline and broadcasting industries.

U.S. and Canadian negotiators also were concerned that firms from nonmember countries might locate so-called screwdriver plants in Mexico as a means of evading U.S. and Canadian tariffs. A **screwdriver plant** is a factory in which little transformation of a product is undertaken. Speaking metaphorically, in such factories the only tool workers need is the screwdriver they use to assemble a product. Therefore, the negotiators developed detailed rules of origin that defined whether a good was North American in origin and thus qualified for preferential tariff status. In the automobile industry, for example, U.S. and Canadian labor unions worried that European and Asian automakers would exploit the treaty by producing major components elsewhere and then establishing a North American factory merely to assemble motor vehicles, thereby causing the loss of jobs at Canadian and U.S. parts-producing factories. To diminish this problem, NAFTA specifies that for an automobile to qualify as a North American product, 62.5 percent of its value must be produced in Canada, Mexico, or the United States. Similarly, to protect textile industry jobs, clothing and other textile products must use North American–produced fibers to benefit from NAFTA's preferential tariff treatment.

Most experts believe that NAFTA has benefited all three countries, although the gains have been more modest in Canada and the United States than most NAFTA advocates expected. NAFTA's overall impact on the Mexican economy has been dramatic, as the chapter's opening case indicated.

Other Free Trade Agreements in the Americas

Many other countries are negotiating or implementing free trade agreements on a bilateral or multilateral basis. For example, Mexico has negotiated free trade pacts with five of its Central American neighbors—Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

THE CARIBBEAN BASIN INITIATIVE In 1983 the United States established the **Caribbean Basin Initiative (CBI)** to facilitate the economic development of the countries of Central America and the Caribbean Sea. The CBI overlaps two regional free trade areas: the Central American Common Market and the Caribbean Community and Common Market (their members are listed in Table 10.3 and shown in Map 10.2). The CBI, which acts as a unidirectional free trade agreement, permits duty-free import into the United States of a wide range of goods that originate in Caribbean Basin countries, or that have been assembled there from U.S.–produced parts. However, some politically sensitive goods were excluded from the CBI. Through this pattern of duty-free access to the U.S. market, the United States hopes to stimulate investment by domestic, U.S., and other foreign firms in new industries in the Caribbean Basin countries.

THE CENTRAL AMERICA–DOMINICAN REPUBLIC FREE TRADE AGREEMENT This agreement among the United States, five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), and the Dominican Republic was signed in 2004. The Central America–Dominican Republic Free Trade Agreement (CAFTA-DR) calls for the reduction of tariffs, NTBs, and investment barriers in commerce among its members. Approximately 80 percent of U.S. exports to and imports from these countries were immediately duty-free as a result of CAFTA-DR or other existing trade treaties. The remaining tariffs are to be phased out over a 10-year period.

THE MERCOSUR ACCORD In 1991, the governments of Argentina, Brazil, Paraguay, and Uruguay signed the Mercosur Accord, an agreement to create a customs union among themselves. They agreed to establish common external tariffs and to cut, over four years, their internal tariffs on goods that account for 85 percent of intra-Mercosur trade. Full implementation of the customs union began in 1995. Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela later joined Mercosur as associate members, allowing them to participate in the accord's free trade area component. Venezuela became a full member in 2012. Firms from the 10 countries have preferential access to a combined market of 394 million people and a total GDP of $4.2 trillion.

The Mercosur Accord is a direct response to the growth of other regional trading blocs. It is also a key element of the free-market-oriented economic reforms adopted by the Argentine

MAP 10.2

Free Trade Agreements in Central and South America and the Caribbean

ANDEAN COMMUNITY The Andean Community resulted from a 1969 agreement to promote free trade among five small South American countries—Bolivia, Chile, Colombia, Ecuador, and Peru—to make them more competitive with the continent's larger countries. Venezuela joined the pact in 1973, but Chile dropped out in 1976. During its first 20 years, the agreement was not successful; trade among members totaled only 5 percent of their total trade. Geography played a role in this failure: The Andes mountain range, from which the agreement got its name, makes land transportation of goods between some members costly. More importantly, most members adopted protectionist, import substitution policies that hindered trade.

In response to the threat posed by the Mercosur Accord, in 1991 the Andean Community members agreed to reinvigorate their agreement. A year later the members established a customs union that provided for phased elimination of tariffs among themselves on most goods, a common external tariff, and harmonized regulations on capital movements, immigration, and agriculture. The new approach has had modest success: In 2011, about 7 percent of members' $134 billion in merchandise exports were purchased by other Andean Community members. Yet the liberalization has not gone smoothly. Creation of a common external tariff was stalled by political squabbling over the appropriate tariff level and structure. Peru suspended its membership in the group after judging that the customs union agreement permitted too many loopholes that allowed members to subsidize local firms and erect barriers to imported goods. In 2005, the Andean Community negotiated a cooperative agreement with Mercosur. As part of this agreement, Argentina, Brazil, Paraguay, and Uruguay joined the Andean Community as associate members, and the nations of the Andean Community became associate members of Mercosur. However, in 2006, Venezuela withdrew from the Andean Community in protest of Colombia's and Peru's signing trade promotion agreements with the United States.

Trade Arrangements in the Asia-Pacific Region

Trade groups are also growing in importance in the Asia-Pacific region. One of the longest standing is governed by the Closer Economic Relations Trade Agreement between Australia and New Zealand. More recently, the Association of Southeast Asian Nations has initiated a free creation of an ASEAN Free Investment Area. ASEAN increased its importance in the world market in 2003 by signing a free trade pact with China, with the first set of tariff cuts commencing in 2004.[12] As with other new trading blocs, firms have reacted quickly to take advantage of opportunities created by AFTA. Shortly after the agreement was negotiated, for instance, Philippine brewer San Miguel, which controls 90 percent of its home market, purchased Jakarta-based Delta brewery, which controls 40 percent of the Indonesian beer market. By moving rapidly, San Miguel hoped to dominate the entire ASEAN market before the fall of tariff rates triggered by AFTA.

THE ASIA-PACIFIC ECONOMIC COOPERATION INITIATIVE **Asia-Pacific Economic Cooperation (APEC)** includes 21 countries from both sides of the Pacific Ocean (see Map 10.4). It was founded in 1989 in response to the growing interdependence of the Asia-Pacific economies. A 1994 APEC meeting in Indonesia led to a declaration committing members to achieve free trade in goods, services, and investment among members by 2010 for developed economies and by 2020 for developing economies. This objective was furthered at APEC's 1996 meeting in Manila, where many countries made explicit pledges to reduce barriers to Asia-Pacific trade. In 2011, merchandise exports from APEC members were valued at more than $8.7 trillion and represented about 47 percent of total world merchandise exports.[13]

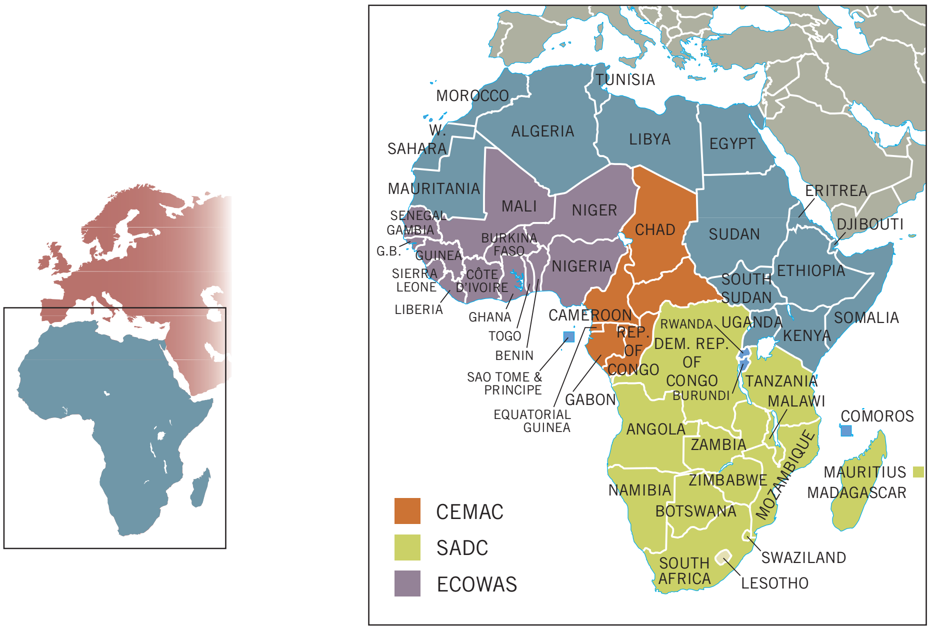
African Initiatives

Many African countries have also established regional trading blocs. As shown in Table 10.3 and Map 10.5, the most important of these groups are the **Southern African Development Community (SADC)**, the **Economic and Monetary Community of Central Africa (CEMAC)**, and the **Economic Community of West African States (ECOWAS)**. Although these groups were established during the 1970s and early 1980s, they have not had a major impact on regional trade. This is due to inadequate intraregional transportation facilities[14] and the failure of most domestic governments to create economic and political systems that encourage significant regional trade. Intra-Africa trade to date accounts for less than 11 percent of the continent's total exports.

MAP 10.4

Asia-Pacific Economic Cooperation Initiative (APEC)

MAP 10.5
Free Trade Agreements in Africa



In Practice

- Every inhabited continent is home to at least one regional economic integration agreement.
- The ASEAN and APEC agreements hold the promise of becoming the largest and most important regional economic integration agreements because of the rapid growth and vast size of the Asian market, but gaining agreement of their diverse memberships to implement bold actions has not been easy.

For further consideration: Do you think the growth of regional economic integration agreements is good or bad?

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CHAPTER REVIEW

Summary

Countries have come together to create numerous international agreements and organizations to promote their joint interests in international commerce. One of the most important was the GATT. The goal of this 1947 agreement was to promote global prosperity by reducing international trade barriers. Through a series of negotiating rounds over 47 years, the GATT significantly reduced the average level of tariffs facing exporters. The most recent series of GATT negotiations, the Uruguay Round, continued the trend of reducing tariffs and NTBs. In 1995, the GATT's mission was taken over by the WTO.

Countries may also band together in various ways to integrate their economies regionally. Free trade areas promote economic integration by abolishing trade barriers among their members. Members of a customs union carry regional economic integration a step farther by adopting common external trade barriers as well as abolishing internal barriers to trade. A common market combines the characteristics of a customs union with the elimination of controls on the free movement of labor, capital, and technology among its members. An economic union adds the coordination of economic policies to the features of a common market. A political union involves complete political as well as economic integration of two or more countries.

The most important example of a regional trading bloc is the EU, a market of 508 million consumers and a combined GDP of $17.6 trillion. Spurred by the passage of the Single European Act of 1987, EU members dismantled most of the physical, technical, and fiscal trade barriers among themselves. Under the Maastricht Treaty, many EU members have adopted a common currency and are attempting to create a true economic union, an effort that goes beyond the common market originally envisioned by the 1957 Treaty of Rome.

A second but much newer regional integration effort occurred in North America. The United States, Mexico, and Canada instituted NAFTA, which went into effect in January 1994. NAFTA's implementation signaled a commitment to tightening the economic bonds among the North American countries.

The development of regional trading blocs in Europe and North America stimulated efforts to promote regional economic integration on other continents. South America is home to the Mercosur Accord and the Andean Community. The chances of their future success have been increased by the economic reforms many South American countries have adopted, reforms that have increased the competitiveness of the countries' products in international markets. Australia and New Zealand and the ASEAN countries have similarly created free trade areas to promote regional economic integration. Several regional economic integration agreements negotiated by various African countries have yet to show much promise.

Review Questions

10-1. What does *most favored nation* (*MFN*) mean?

10-2. Under what conditions can WTO members not use MFN when dealing with one another?

10-3. How does the WTO differ from the GATT?

10-4. What are the differences between Free Trade Agreement and Common Markets?

10-5. Why do free trade areas develop rules of origin?

10-6. What was the goal of the Treaty of Rome?

10-7. Why is the EU a unique example of regional association?

10-8. What kind of economic integration is ASEAN?

10-9. What is the Caribbean Basin Initiative? What is its goal?

10-10. What efforts have South American countries made to regionally integrate their economies?

Questions for Discussion

10-11. Consider the opening case in this chapter. How has Mexico's success affected the Canadian and U.S. economies?

10-12. Suppose you are deciding whether to locate a factory in China or in Mexico to serve the U.S. market. What factors would influence your location decision? Suppose the price of oil suddenly rises. What impact would this have on your decision?

10-13. How does the WTO affect the operations of large MNCs? Did MNCs benefit from the successful completion of the Uruguay Round?

10-14. Discuss Free Trade Agreements in terms of trade creation and trade diversion.

10-15. What strategies can North American and Asian firms adopt to ensure access to the enormous EU market?

10-16. Is the abandonment of import substitution policies by South American governments a necessary condition for the success of the Andean Community and the Mercosur Accord?

10-17. Of what importance are rules of origin to international businesses?

10-18. Why does the MFN principle promote multilateral, rather than bilateral, negotiations among WTO members?

Building Global Skills

The United States and the EU have agreed to negotiate a new Transatlantic Free Trade Agreement (TAFTA). Advocates have lauded the initiative as creating major new market opportunities for U.S. and European businesses; opponents have criticized it as harmful to workers and farmers by subjecting them to increased competition. This exercise will help you learn more about the effects of TAFTA on various firms.

Your instructor will divide the class into groups of four to five students each. Working with your group members, identify four products made by firms in each of the two regions (United States and the EU) that would be part of TAFTA. The four products should include two that would seem to benefit from TAFTA and two that would seem to face increased threats from competitors in the other region as a result of TAFTA.

For example, identify two U.S.-made products that have considerable market potential in the EU and two U.S.-made products that would seem to face new competition from European firms. Each group should identify a total of 8 different products.

Next, work with your group members to determine and assess the appeal of each product in the TAFTA market. Investigate for each the current market share, domestic competitors, foreign competitors, and so forth. Discuss how TAFTA may potentially affect each product.

10-19. Why will TAFTA significantly affect world trade when it is finally signed?

10-20. Explain with examples the ways in which the rules of origins will be applied in TAFTA.

10-21. Do you think the effects of TAFTA on each product you selected will be consistent with what advocates or critics of TAFTA might have predicted?

CLOSING CASE The European Union's Challenges

As we noted in this chapter, the members of the EU have made remarkable progress in creating a common market and in promoting peace and prosperity throughout the 28-nation community. The EU, unfortunately, has hit a rough patch subsequent to the Global Recession of 2008–2009, facing some of the most vexing and contentious issues that have arisen in its six decades of existence. Some of its problems are structural in nature, others are political.

The EU faces a demographic challenge. As we noted in Chapter 1's closing case, the population of many EU countries is shrinking and aging, elevating their old-age dependency ratios (the ratio of people of retirement age to people of working age). Because many members also have extensive social safety networks, these demographic changes suggest that taxes need to be raised on younger workers to support retired workers, retired workers need to suffer a contraction of their standards of living, or countries need to encourage immigration. All three of these options are normally politically unpopular, and any officeholder campaigning in support of them has a high probability of becoming an ex-officeholder. As famously stated by Luxembourg's Prime Minister, Jean Claude Juncker, "We all know what to do, we just don't know how to get re-elected after we have done it." A fourth alternative, of course, is to encourage higher birth rates through tax breaks and public subsidies. However, such incentives are usually small relative to the costs of raising a child and have not proven to be successful. Sweden is a notable exception. In Sweden's case, parents of a new child receive generous parental leaves, but the program is structured to encourage both the father and the mother to use the leave. As a result, Sweden's fertility rate is 1.94 children born per woman, in comparison to Germany's 1.41 and Italy's 1.40.

The second set of challenges is ideological in nature. The member states have fundamental disagreements on the role of government in the economy. The United Kingdom, particularly when controlled by Conservative governments, argues for free markets for goods and services and labor markets using employment-at-will principles. Denmark, Ireland, and the Netherlands similarly emphasize the importance of perfecting the EU's internal market, facilitating the free flow of products, capital, and technology throughout the EU. Other countries, such as France, believe governments should actively intervene to promote economic and social justice, and that workers should be given strong job rights and protections. For instance, France's President François Hollande threatened to nationalize automaker PSA Peugeot Citroën if the company proceeded with its plans to lay off 8,000 employees and shutter an assembly plant near Paris. Germany and Austria promote a social market system, which blends market capitalism with extensive social insurance and strong protection of union bargaining rights. Accordingly, the EU is riven by philosophical conflicts over economic policy. Should governments be able to bail out financially threatened firms to protect workers jobs… or is that a betrayal of the Treaty of Rome's common market ideals? Should the EU adopt common policies toward maternal and paternal leave and the rights of part-time workers, or is this decision best left to the national governments? Often such issues favor one group of countries but harm the economic interests of other countries. (See, for example, the discussion of the Tobin Tax on page 310; consider the implications for London's or Luxembourg's competitiveness in the global financial market if the tax were adopted.) To complicate matters further, big rifts exist on the appropriate size of the EU's budget, with wealthy countries, such as the United Kingdom, Germany, Sweden, and the Netherlands, trying to curb Brussels' spending, whereas poorer southern, eastern, and central European countries lobby for the EU's regional development expenditures and other subsidy programs to expand.

A third challenge is institutional in nature. The EU lacks EU-wide institutions to deal with economic crises. Consider the Global Recession of 2008–2009. The Bush and Obama administrations created programs such as the Troubled Asset Relief Program and the American Recovery and Reinvestment Act to address the crisis. The Federal Reserve Bank responded with its quantitative easing programs to assure liquidity and stimulate bank lending. Conversely, the EU had no such institutions in place. Financial assistance to governments in distress resulted from a series of contentious ad hoc negotiations among the affected governments and other EU members. The European Central Bank and the Bank of England separately developed policies for restoring liquidity and faith in European banking institutions.

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10-27. What are the five forms of regional economic integration? How do they differ from one another?

10-28. Discuss the history of the EU. What are the major challenges the EU has had to overcome to reach its current preeminence?

10-29. Mymanagementlab Only—comprehensive writing assignment for this chapter.

Endnotes

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PART 2 CLOSING CASES

Twenty-First Century Pirates

Most economists would agree that intellectual property rights (IPR) are critical components of a well-functioning market system. They encourage inventors to develop new technologies to benefit consumers or lower production costs and motivate firms to develop products and brand names that consumers can trust. For many firms, ownership of IPR forms the basis on which they compete in world markets. Yet one of the unexpected consequences of globalization is increased levels of product piracy, which threaten the profitability and sometimes the existence of firms that have invested heavily in intellectual property. A pharmaceutical company that spends 20 percent of its revenues on R&D, for example, is at a cost disadvantage to a rival who steals its innovations and invests nothing itself in R&D.

The Business Software Alliance believes that $63 billion of software is illegally sold by pirates each year. Piracy of recorded music and illegally duplicated DVDs is estimated to cost recording studios and movie studios $18 billion a year. Counterfeit drugs yearly cost legitimate pharmaceutical manufacturers $37 billion in sales. The fake Rolex watches, Louis Vuitton luggage, Prada handbags, and other faux luxury goods peddled on the streets of Asia, Europe, and the Americas amount to additional untold billions of losses for the companies whose intellectual property has been stolen.

China appears to be the home of many of the worst offenders. A recent study by the United Nations indicated that China is the source of two-thirds of the counterfeit goods sold around the world. According to the Business Software Alliance, 77 percent of the software sold in China has been pirated, as is an estimated 85–90 percent of recorded music. Movie studios lose an estimated $280 million annually to Chinese counterfeiters. Entertainment firms have adopted a variety of approaches to try to cut their losses. Warner Brothers slashed the prices it charges in China for DVDs featuring its newest movies to $2 to $4, in hopes of reducing the street trade for illegal copies, which normally sell for $1. The company also altered the release schedules of its movies, opening them simultaneously in China and in the United States, to reduce the ability of the pirates to illegally tape movies in U.S. theaters for duplication and distribution in China. Electronic Arts, the California-based developer and marketer of video games, decided to shift its distribution strategy in China to combat pirates. Instead of distributing its games on easily copied CDs or DVDs, the California company decided to focus on online, live multiplayer games, which is already a $540 million business in China.

The problem is not limited to entertainment products. Some Chinese firms manufacture counterfeit drugs, which threaten public safety and the reputation of companies should they contain contaminants or improper dosages of their active ingredients. For instance, in 2012, Angolan officials seized 1.4 million doses of fake Coartem, an antimalarial drug developed by Novartis, that were traced to an exporter based in Guangzhou. The counterfeit product contained none of the active ingredient necessary to combat malaria, a disease that kills nearly a million people a year.

One Indiana company, Abro Industries, which sells adhesive products such as epoxies, glues, and sticky tape, did not have just its products pirated; the company seemingly was pirated as well. A Chinese company with no connection to Abro, Hunan Magic Power Industrial Company, marketed and distributed more than 40 different products bearing the Abro brand; the chief executive officer of Hunan even used business cards with Abro's logo. Abro has spent more than $600,000 suing Hunan Magic Power and other pirates, but has been frustrated by the Chinese legal system. To date, the total penalty imposed by Chinese authorities on Hunan for its actions is a fine of $600. IKEA, Apple, Dairy Queen, and Subway have faced a different problem: local entrepreneurs have constructed their own versions of these companies' stores, providing customer service comparable to the real stores.

This is not to say that Chinese authorities never enforce IPR. For example, the Intermediate Court of Nantong (a city near Shanghai) sentenced two men to jail terms of three and four years and fined them a total of $105,000 for shipping counterfeit versions of luxury perfumes made by LVMH Moët Hennessy Louis Vuitton. However, such sentences are rare. A report issued in 2006 by the Office of the U.S. Trade Representative noted, "In the IPR area, while China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR enforcement remains a major challenge" (p. 93). The same report went on to say, "Counterfeiting and piracy in China remain at epidemic levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy" (p. 121). Most local firms who are prosecuted face minor fines in administrative courts, which they write off as a cost of doing business. The risk of serious punishment for IPR violations is small: In 2004, less than 200 trademark or copyright infringement cases investigated by Chinese officials—out of a total of more than 60,000—were forwarded to criminal courts. Many of the major violators, particularly counterfeiters of CDs and DVDs, are allegedly owned by companies linked to the state, government officials, or the military. Not surprisingly, local officials are oftentimes unwilling to aggressively prosecute firms that are so well connected politically.

The problem of counterfeit goods is not limited to China, of course. North Korea, for instance, is a primary source of counterfeit cigarettes—an estimated 2 billion packs a year. Major tobacco companies believe that the North Korean government is earning $80 to $160 million annually in payoffs from the crime gangs that control this trade. But China has attracted the most attention for IPR violations because of its growing presence in the world economy. Some experts fear that China will not truly protect intellectual property until the issue becomes important for local firms. To this end, Microsoft, one of the largest victims of Chinese intellectual property theft, decided to help build a Chinese software industry, in hopes that local entrepreneurs would encourage the government to more aggressively attack intellectual property thieves. For example, it created a Shanghai-based joint venture, Wicresoft, which provides customer support for other Chinese software firms.

In 2006, Chinese officials once again agreed to reinvigorate their pursuit of intellectual property thieves. They pledged to increase fines for IPR violations, lower the hurdles for prosecuting IPR violations in criminal rather than civil courts, and establish new offices in 50 cities to handle IPR complaints. Another important step involves computer operating systems. Bowing to government pressure, China's three largest manufacturers of PCs—Lenovo, Founder, and Tsinghua Tongfang—have agreed to ship their products with preinstalled operating systems. Previously, most PCs sold in China came without an operating system; consumers simply loaded a pirated copy of Windows 7 or similar product onto their computers, which they could buy from a street vendor for a dollar or two. This policy ensures that software companies such as Microsoft will be compensated for the use of their intellectual property.

Case Questions

P2-1. How important is intellectual property to the world economy?

P2-2. Should the average consumer concern himself or herself with theft of intellectual property? What about the average citizen? The average worker?

P2-3. Does intellectual property theft undermine the workings of the free-market system?

P2-4. What is the impact of China's lack of aggressive enforcement of IPR on its economic development in the short run? If the long run?

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Jumbo Battle over Jumbo Jets

Since its initial commercial flight in 1969, the Boeing 747 benefited from its status as the world's largest commercial aircraft. Its costs per seat mile were lower than that of any other aircraft available, largely because the 747 can seat as many as 495 people. Although its low costs were attractive on transatlantic and transcontinental routes, they were of particular importance in charter, transpacific, and freighter operations. Boeing's monopoly in the jumbo jet market gave it an advantage over Airbus in selling smaller aircraft as well. Spare parts can often be used for different models of aircraft produced by the same manufacturer, which sometimes is enough of an advantage to sway an airline to purchase a Boeing product over the comparable one manufactured by Airbus.

Airbus targeted the 747 for years. In 2000, its engineers finalized the plans for a 650-seat aircraft, the A380, which dwarfs the 747. The A380 then underwent extensive design, testing, and certification procedures. In October 2007, Singapore Airlines offered the first commercial flight of an A380, from Singapore to Sydney.

Airbus executives believe this aircraft will destroy the lucrative monopoly that the Boeing 747 held in the jumbo jet market. Airbus calculates the A380's costs per seat mile are 17 percent less than those of the 747. However, R&D costs for the A380 are estimated to have run between $12 billion and $16 billion. To help finance these up-front costs, Airbus obtained $3.5 billion in low-cost loans—called "launch aid"—from the German, French, and British governments. (Airbus' original investors were from France, Germany, Spain, and the United Kingdom.) Boeing officials asserted these loans to Airbus were nothing more than government subsidies and should be barred under international trade law. Moreover, Boeing believed that Airbus officials vastly overestimated the size of the market. Airbus judged the market for superjumbo jets will reach 1,500 in the next 20 years, and thus the A380 has a bright future. Boeing argued that the true market is only one-quarter to one-third of that estimate, and thus the A380 will be a financial disaster. Should Boeing be correct, it fears that the government loans to its rival will be forgiven. Worse, the A380 would then continue in production, dragging down the profitability of Boeing's 747 operations.

The EU and the United States have fought over this issue before. The U.S. government has argued that previous European loans to Airbus have been written off as worthless, thereby providing the airframe manufacturer with illegal subsidies. For example, in early 1999 the German Finance Ministry relieved DaimlerChrysler Aerospace AG of an obligation to repay $750 million in loans to design Airbus' A330 and A340 jets. EU officials respond that Boeing's commercial aircraft division has benefited from hidden subsidies from the U.S. government. EU officials believe that Boeing has been able to develop new aircraft technologies by winning U.S. Defense Department contracts that are limited to U.S. firms. Having acquired that technology from its defense contracts, Boeing then can transfer the technology to its commercial aircraft operations.

A 1992 agreement between the EU and the United States led to a truce in this verbal war. That accord limited the amount of indirect subsidies the United States could grant Boeing through military contracts, while European governments were allowed to provide limited loans to Airbus for development of new aircraft. However, this agreement predates the WTO and the new obligations imposed on members of that organization (see Chapter 10's discussion of the WTO). In 2004, U.S. officials withdrew from the 1992 accord and filed a complaint with the WTO, arguing that the A380 has indeed benefited from illegal subsidies. The EU quickly filed a counter complaint against Boeing. In 2010 the WTO ruled that the EU's launch aid for the A380, as well as for the A300, A310, A320, A330, and A340 series of Airbus aircraft violated its rules. In total, the WTO deemed a total of some $20 billion in government loans an improper export subsidy because they offered terms to Airbus unavailable in normal commercial lending markets. In 2011, the WTO ruled that Boeing received $5.3 billion in subsidies through contracts awarded by the U.S. Department of Defense and the National Aeronautics and Space Administration. Both parties have appealed the WTO's decisions, but most expert observers believe the United States and the EU will ultimately have to negotiate a settlement because the monies involved are so large.

Case Questions

P2-5. Why does the EU offer aid to Airbus? Why does the United States offer aid to Boeing?

P2-6. Who benefits from this aid? Who loses?

P2-7. If the U.S. government's aid to Boeing and the EU's aid to Airbus just cancelled each other out, would there be any winners or losers from these aid programs?

P2-8. In 2013, Delta Airlines filed a lawsuit against the Export-Import Bank of the United States, alleging that the bank's offering low interest rates loans to foreign companies who buy Boeing aircraft hurts Delta's competitiveness. The Air Line Pilots Association (ALPA), a union representing 47,000 pilots at 28 U.S. airlines, supported Delta's lawsuit. What is the logic behind Delta's lawsuit? Do you agree with Delta and ALPA?

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Will Whirlpool Clean Up in Europe?

For years, international businesses looked forward to the EU's emergence as a single, integrated market. Among these firms are ones that produce so-called white goods, or appliances such as refrigerators, dishwashers, ovens, washers, and dryers. (In the past kitchen and laundry room appliances mostly came in white, hence, the industry's name. Consumer electronics such as radios, televisions, and stereos came in brown, so these consumer durables are called "brown goods." Today's widespread use of color in appliances makes these labels somewhat anachronistic.)

The emergence of a single market in Europe has changed the way white-goods manufacturers do business. Previously, they had to customize their products to meet the often conflicting requirements of the EU's 28 national governments. Fortunately, the Single European Act promoted harmonized product standards, thus allowing the manufacturers to cut product development and production costs. Reduced barriers to intra-EU trade allow them to concentrate production in one factory that can serve markets throughout the EU. Reduced impediments to cross-border advertising make it easier to develop pan-European brands, which in turn reduce marketing and distribution costs. Elimination of physical barriers at border crossing points and of restrictions on trucking competition by national governments leads to productivity gains in logistics and physical distribution management.