



## CHAPTER OVERVIEW

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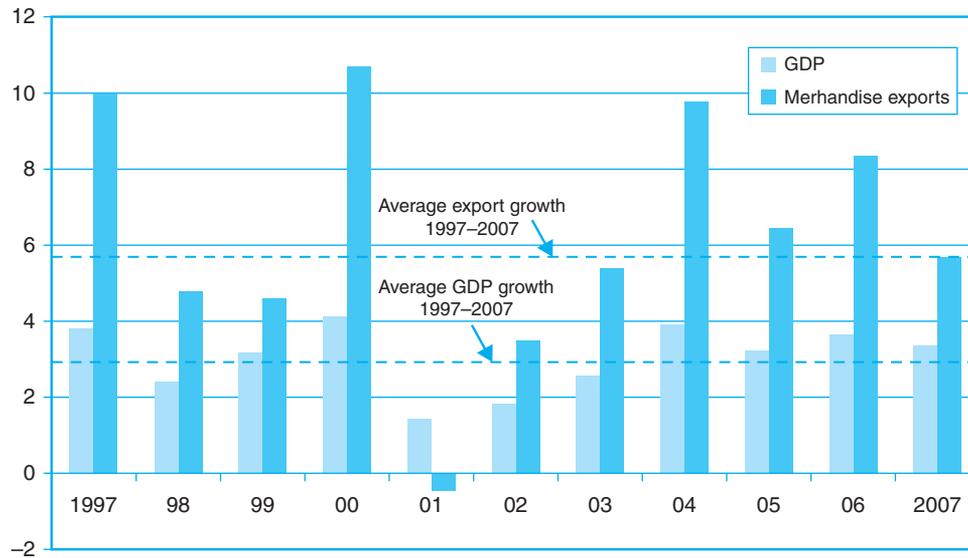
At no other time in economic history have countries been more economically interdependent than they are today. Although the second half of the twentieth century saw the highest ever sustained growth rates in **Gross Domestic Product (GDP)** in history, the growth in international flows in goods and services (called international trade) has consistently surpassed the growth rate of the world economy. Simultaneously, the growth in international financial flows—which includes foreign direct investment, portfolio investment, and trading in currencies—has achieved a life of its own. Thanks to trade liberalization heralded by the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), the GATT's successor, the barriers to international trade and financial flows keep getting lower. From 1997 to 2007, global GDP grew more than 30 percent, while total global merchandise exports increased by more than 60 percent (see **Exhibit 2-1**).<sup>1</sup>

However, the beginning of the 21st century was beset with a recessionary world economy. For example, growth in the value of the United States' trade decelerated throughout 2001. Western Europe's merchandise exports and imports values increased by about 2 percent during the same period. Overall, the year 2001 witnessed the first decline in the volume of world merchandise trade since 1982 and the first decrease in world merchandise output since 1991. On the other hand, the transition economies

<sup>1</sup>World Trade Report 2008, <http://www.wto.org/>, Geneva, World Trade Organization, 2008.

**EXHIBIT 2-1**

GROWTH (IN PERCENT) IN THE VOLUME OF WORLD MERCHANDISE TRADE AND GDP, 1997–2007



Source: *World Trade Report 2008: Trade in a Globalizing World*, www.wto.org, World Trade Organization, 2008.

recorded an outstanding trade growth performance in an adverse global environment. A further strengthening of trade and investment links between the European Union and Central and Eastern Europe contributed largely to this outcome. Africa and the Middle East also expanded their imports despite a fall in prices of oil and other commodities in 2001. Overall, global GDP growth edged up only by about 1 percent due chiefly to a more resilient services sector.<sup>2</sup> Since then, however, the world economy had continued to recover. In 2007, the world GDP maintained a strong increase of 3 percent, and the volume of world merchandise trade grew by 5.5 percent.<sup>3</sup> As stated in Chapter 1, however, U.S. subprime home loan-led financial turmoil has led to an unprecedented global economic slowdown since late 2008. At the time of this writing in early 2009, World Bank predicts that global GDP growth will slip from 2.5 percent in 2008 to 0.9 percent in 2009. Developing country growth is expected to decline from a resilient 7.9 percent in 2007 to 4.5 percent in 2009. Growth in developed countries will likely be negative in 2009.<sup>4</sup>

Expanding world markets will likely remain a key driving force for the 21st century economy. Although the severe slump in Asia in the late 1990s, the renewed financial crisis in South America and the slump in the U.S. and European economies in 2001, and now the worst global recession since the 1930s point up the vulnerabilities to the global marketplace, the long-term trends of fast-rising trade and rising world incomes still remain uncertain.

Since the second half of the 1990s, there have been some strong anti-globalization movements for various reasons including economics, environmental concern, and American cultural hegemony, among others. Let us focus just on economics here. Some in developed countries argue that globalization would result in increased competition from low-income countries, thus threatening to hold down wages, say, in the United States. However, real wages in the United States increased at a 1.3

<sup>2</sup>WTO News: 2002 Press Release, “Disappointing Trade Figures Underscore Importance of Accelerating Trade Talks,” October 7, 2002, <http://www.wto.org/>, accessed November 12, 2002.

<sup>3</sup>*World Trade Report 2008*.

<sup>4</sup>“World Trade to Shrink in 2009: World Bank,” [newsroomamerica.com](http://newsroomamerica.com), December 9, 2008.



**EXHIBIT 2-2****TOP 10 EXPORTERS AND IMPORTERS IN WORLD MERCHANDISE TRADE, 2008**

Rank	EXPORTERS	Value (\$billion)	Export Dependence* (%)	Value per capita (\$)	Rank	IMPORTERS	Value (\$billion)	Import Dependence** (%)	Value per capita (\$)
1	Germany	1,530	40.1	18,574	1	United States	2,190	15.3	7,208
2	China	1,465	34.7	1,101	2	Germany	1,202	31.5	14,592
3	United States	1,377	9.6	4,532	3	China	1,156	27.4	869
4	Japan	777	16.0	6,104	4	France	718	24.1	11,209
5	France	630	21.1	9,835	5	Japan	696	14.4	5,468
6	Italy	566	23.6	8,453	6	United Kingdom	646	23.2	10,167
7	Netherlands	538	59.2	32,321	7	Italy	567	23.6	8,677
8	United Kingdom	469	16.8	7,184	8	Netherlands	485	53.3	29,137
9	Canada	462	29.5	13,910	9	Canada	437	27.9	13,158
10	Belgium	373	70.3	35,852	10	Belgium	375	70.7	36,044

\* Exports/GDP × 100

\*\* Imports/GDP × 100

Source: Computed from trade statistics in Central Intelligence Agency, *World Factbook 2009*, <https://www.cia.gov/library/publications/the-world-factbook/>.

340 percent of its GDP!<sup>10</sup> These trade statistics are relative to the country's GDP. In absolute dollar terms, however, a small relative trade percentage of a large economy still translates into large volumes of trade (See **Exhibit 2-2**). As shown in the last column for exports and imports in Exhibit 2-2, the per-capita amount of exports and imports is another important statistic for marketing purposes as it represents, on average, how much involved or dependent each individual is on international trade.

For instance, individuals (consumers and companies) in the United States and Japan—the world's two largest economies—tend to be able to find domestic sources for their needs since their economies are diversified and extremely large. The U.S. per capita value of exports and imports is \$4,532 and \$2,190 in 2008. For Japan, its per capita value of exports and imports is \$6,104 and \$5,468, respectively. On the other hand, individuals in smaller and rich economies tend to rely more heavily on international trade, as illustrated by the Netherlands with the per capita exports and imports of \$32,321 and \$29,137, respectively. Although China's overall exports and imports amounted to \$1.47 trillion and \$1.16 trillion, respectively, the per capita exports and imports amounted to only \$1,101 and \$869, respectively, in 2008. One implication of these figures is that the higher the per-capita trade, the more closely intertwined is that country's economy with the rest of the world. Intertwining of economies by the process of specialization due to international trade leads to job creation in both the exporting country and the importing country.

However, beyond the simple figure of trade as a rising percentage of a nation's GDP lies the more interesting question of what rising trade does to the economy of a nation. A nation that is a successful trader—i.e., it makes goods and services that other nations buy and it buys goods and services from other nations—displays a natural inclination to be competitive in the world market. The threat of a possible foreign competitor is a powerful incentive for firms and nations to invest in technology and markets in order to remain competitive. Also, apart from trade flows, foreign direct investment, portfolio investment, and daily financial flows in the international money

<sup>10</sup> Computed from trade statistics in U.S. Central Intelligence Agency, *The World Factbook 2009*, <https://www.cia.gov/library/publications/the-world-factbook/>.



"The repairs will take awhile. We need a part from Mexico, a part from Brazil and one from Taiwan."

Even a simple "domestic" job involves inputs from various countries in an intertwined world.

Chon Day/The Cartoon Bank, Inc.

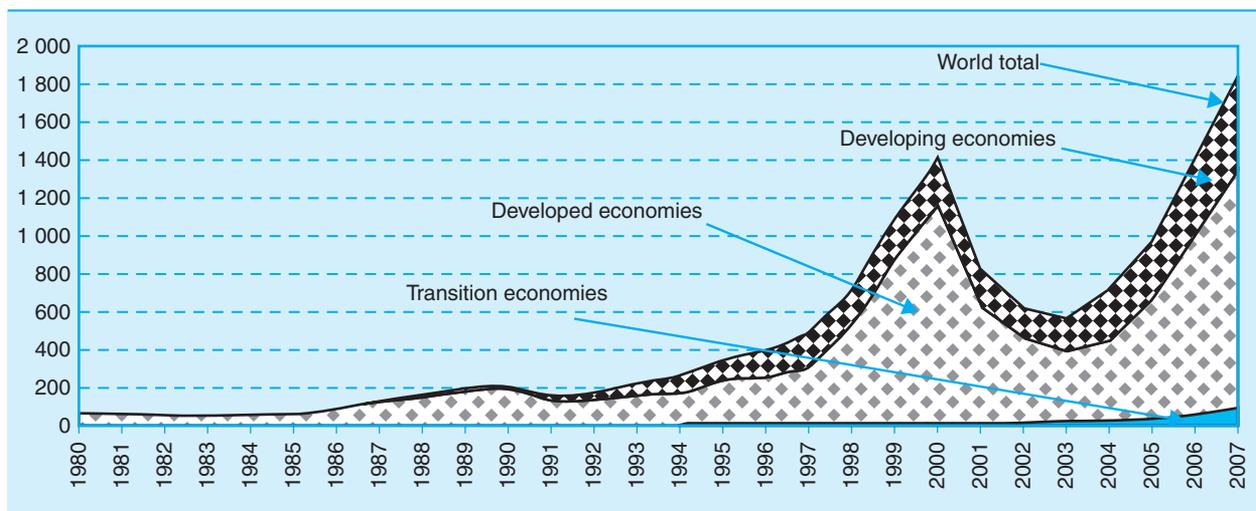
markets profoundly influence the economies of countries that may be seemingly completely separate.

### Foreign Direct Investment

**Foreign direct investment**—which means investment in manufacturing and service facilities in a foreign country with an intention to engage actively in managing them—is another facet of the increasing integration of national economies. As shown in **Exhibit 2-3**, the overall world inflow of foreign direct investment (FDI) increased

#### EXHIBIT 2-3

FOREIGN DIRECT INVESTMENT INFLOWS (IN US\$ BILLION), 1980–2007



Source: UNCTAD, *World Investment Report 2008*, <http://www.unctad.org/>, accessed September 18, 2008.

Note: CIS = Commonwealth of Independent States (Russia, Central Asia, and Caucasus states)

twenty-five fold from 1980 to 2000 when it peaked at \$1,411 billion. Then the global recession that ensued after the September 11, 2001 terrorist attacks on the U.S. soil dampened FDI flows significantly for a few years. Since 2004, global FDI inflows have continued growing, reaching the highest level ever recorded of \$1,833 billion in 2007. Although the continued rise in FDI flows across regions largely reflects strong economic growth and performance in many parts of the world, global FDI flows also largely resulted from a weakening U.S. dollar in 2007. Although not yet available in the latest official statistics, the ongoing worldwide financial and economic crisis (and the sudden appreciation of the U.S. dollar) has changed the FDI situation drastically. In 2008, FDI flows declined by more than 20 percent, and a further decrease in FDI flows is expected in 2009 (at the time of this writing).<sup>11</sup>

Two things should be noted. In the past, foreign direct investment was considered as an alternative to exports in order to avoid tariff barriers. However, these days, foreign direct investment and international trade have become complementary.<sup>12</sup> For example, Dell Computer uses a factory in Ireland to supply personal computers in Europe instead of exporting from Austin, Texas. Similarly, Honda, a Japanese automaker with a major factory in Marysville, Ohio, is the largest exporter of automobiles from the United States. As firms invest in manufacturing and distribution facilities outside their home countries to expand into new markets around the world, they have added to the stock of foreign direct investment. Second, although not shown in the exhibit, the composition of FDI has shifted from manufacturing to services in all regions. FDI in services increased from being one-quarter of the world inflow FDI stock in 1970s to 49 percent in 1990, and to 62 percent with an estimated value of \$6 trillion in 2005. Most notably, although FDI outflows in services are still dominated by developed countries, they are no longer controlled by firms from the United States, but much more evenly distributed among developed countries than before. By 2002, Japan and the European Union had emerged as significant sources of outward FDI in service sectors. Developing countries' outward FDI in services has also grown gradually since the 1990s.<sup>13</sup>

The increase in foreign direct investment is also promoted by efforts by many national governments to woo multinationals and by the leverage that the governments of large potential markets such as China and India have in granting access to multinationals. For example, in 2006, China's FDI inflow still reached \$69 billion, even though this was the first time it declined in seven years due mainly to reduced flows to financial services. Meanwhile, China gradually became a source of FDI. China's outflows increased by 32 percent to \$16 billion in 2006, and its outward FDI stock reached \$73 billion, the sixth largest in the developing world.<sup>14</sup> Sometimes trade friction can also promote foreign direct investment. Investment in the United States by Japanese companies is, to an extent, a function of the trade imbalances between the two nations and by the consequent pressure applied by the U.S. government on Japan to do something to reduce the bilateral trade deficit. Since most of the U.S. trade deficit with Japan is attributed to Japanese cars exported from Japan, Japanese automakers, such as Honda, Toyota, Nissan, and Mitsubishi, have expanded their local production by setting up production facilities in the United States. In 1986, Japanese automakers exported 3.43 million cars from Japan and assembled only 0.62 million cars in the United States. By 1992, the number of exported cars equaled the number of U.S.-built Japanese cars at 1.7 million cars each. Since then, Japanese automakers have manufactured more cars in the United States than exporting from Japan. In 1997, they produced 2.31 million cars in the United

<sup>11</sup>“Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows,” UNCTAD News, <http://www.unctad.org/Templates/Page.asp?intItemID=3665&lang=1>, February 4, 2009.

<sup>12</sup>“Trade by Any Other Name,” *Economist*, October 3, 1998, pp. 10–14.

<sup>13</sup>UNCTAD, *World Investment Report 2008*.

<sup>14</sup>UNCTAD, *World Investment Report 2007*.

States and imported 1.27 million cars from Japan. During the 1986–1999 period, Japanese automakers also increased their purchases of U.S.-made components almost thirteen fold from \$2.5 billion in 1986 to 31.9 billion in 1999.<sup>15</sup> As of April 2008, Toyota conducts its business worldwide with 53 overseas manufacturing companies. It has design centers in California and in France on the Côte d’Azur, and with its engineering centers located in the Detroit area and in Belgium and Thailand.<sup>16</sup> This localization strategy reduced Japanese automakers’ vulnerability to political retaliation by the United States under the Super 301 laws of the **Omnibus Trade and Competitiveness Act of 1988**.

An additional facet to the rising integration of economies has to do with **portfolio investment** (or **indirect investment**) in foreign countries and with money flows in the international financial markets. Portfolio investment refers to investments in foreign countries that are withdrawable at short notice, such as investment in foreign stocks and bonds. In the international financial markets, the borders between nations have, for all practical purposes, disappeared.<sup>17</sup> The trading of enormous quantities of money on a daily basis has assumed a life of its own. When trading in foreign currencies began, it was as an adjunct transaction to an international trade transaction in goods and services—banks and firms bought and sold currencies to complete the export or import transaction or to hedge the exposure to fluctuations in the exchange rates in the currencies of interest in the trade transaction. However, in today’s international financial markets, traders trade currencies most of the time without an underlying trade transaction. They trade on the accounts of the banks and financial institutions they work for, mostly on the basis of daily news on inflation rates, interest rates, political events, stock and bond market movements, commodity supplies and demand, and so on. As mentioned earlier, the weekly volume of international trade in currencies exceeds the annual value of the trade in goods and services.

The effect of this proverbial tail wagging the dog is that all nations with even partially convertible currencies are exposed to the fluctuations in the currency markets. A rise in the value of the local currency due to these daily flows vis-à-vis other currencies makes exports more expensive (at least in the short run) and can add to the trade deficit or reduce the trade surplus. A rising currency value will also deter foreign investment in the country and will encourage outflow of investment.<sup>18</sup> It may also encourage a decrease in the interest rates in the country if the central bank of that country wants to maintain the currency exchange rate and a decrease in the interest rate would spur local investment. An interesting example is the Mexican meltdown in early 1995 and the massive devaluation of the peso, which was exacerbated by the withdrawal of money by foreign investors. And more recently, the massive depreciation of many Asian currencies in the 1997–1999 period, known as the Asian financial crisis, is also an instance of the influence of these short-term movements of money.<sup>19</sup> Unfortunately, the influences of these short-term money flows are nowadays far more powerful determinants of exchange rates than an investment by a Japanese or German automaker.

Another example is provided by Brazil, which was a largely protected market until 1995. Liberalization is on the way as a result of the formation in 1994 of the Southern Common Market (Mercado Común del Sur, or MERCOSUR) (to be explained later in

<sup>15</sup>“JAMA Members Set New Records in Their Purchase of U.S.-Made Auto Part,” Japan Auto Trends, *Today’s JAMA*, March 2000, [http://jamaserv.jama.or.jp/e\\_press/index.html](http://jamaserv.jama.or.jp/e_press/index.html), accessed October 30, 2002.

<sup>16</sup>“The Car Company in Front,” *Economist*, January 27, 2005, pp. 65–67.

<sup>17</sup>Kenichi Ohmae, *The Borderless World* (New York: Harper Collins Books, 1990).

<sup>18</sup>“Beware of Hot Money,” *Business Week*, April 4, 2005, pp. 52–53.

<sup>19</sup>Masaaki Kotabe, “The Four Faces of the Asian Financial Crisis: How to Cope with the Southeast Asia Problem, the Japan Problem, the Korea Problem, and the China Problem,” *Journal of International Management*, 4 (1), 1998, 1S–6S.

the chapter). Since the debt crisis of 1982, Brazil had suffered a chronic hyperinflation that ruined its economy and competitiveness. Brazil's new currency, *real*, was launched in 1994 both as the instrument and as the symbol of a huge effort for Brazil to catch up with the developed world. Financial markets first attacked the Brazilian *real* in March 1995, in the wake of Mexico's peso devaluation. Brazil responded by adopting a pegged exchange rate, under which the *real* devalued by 7.5 percent a year against the U.S. dollar. Then, the Asian financial crisis and the crash of many Asian currencies (with as much as 75 percent in the case of Indonesian currency, *rupiah*, in a matter of a few months) in 1998 reverberated again in Brazil and Mexico as well, because portfolio investors started viewing all emerging markets with a jaundiced eye. Worse yet, in 2002, Argentina caused another financial crisis in Latin America, triggered by one of the largest government debt default ever. The Brazilian *real* was under pressure, falling from R1/US\$ in July 1994 to R3.63/US\$ in October 2002—a whopping 72 percent depreciation since its introduction. The central bank had to sell dollars and buy *real* to shore up the value of the *real*. This led to a credit crunch, causing a slowdown in export growth, only to be temporarily stabilized by the International Monetary Fund's \$30 billion rescue loan to Brazil in 2002.<sup>20</sup> There were also adverse effects on the Indian stock markets as well. The point is that, at least in the short run, these daily international flows of money have dealt a blow to the notion of economic independence and nationalism.

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## COUNTRY COMPETITIVENESS



**Country competitiveness** refers to the productiveness of a country, which is represented by its firms' domestic and international productive capacity. Human, natural, and capital resources of a country primarily shape the nature of corporate productive capacity in the world, and thus the nature of international business. As explained in the Appendix to Chapter 1, a country's relative endowment in those resources shapes its competitiveness.

Country competitiveness is not a fixed thing. The dominant feature of the global economy is the rapid change in the relative status of various countries' economic output. In 1830, China and India alone accounted for about 60 percent of the manufactured output of the world. Since then, the share of the world manufacturing output produced by the twenty or so countries that are today known as the rich industrial economies moved from about 30 percent in 1830 to almost 80 percent by 1913.<sup>21</sup> In the 1980s, the U.S. economy was characterized as “floundering” or even “declining,” and many pundits predicted that Asia, led by Japan, would become the leading regional economy in the 21st century. Then the 1997–1999 Asian financial crisis changed the economic milieu of the world (to be explained in detail in Chapter 3). Since the September 11, 2001 terrorist attacks, the U.S. economy has grown faster than any other developed countries at an annual rate of 3–4 percent. However, even the U.S. economic growth rate pales in comparison to China and India, two leading emerging economic powers in the last decade or so. China and India have grown at an annual rate of 7–10 percent and 4–7 percent, respectively, since the dawn of the

### Changing Country Competitiveness

<sup>20</sup>“A Matter of Faith—Will a big bail-out led by the IMF allow Brazil to avoid defaulting?” *Economist*, August 15, 2002; Brazilian economy has since stabilized and started growing again, which is reflected in the *real*'s appreciation to R2.28/US\$ as of late 2005.

<sup>21</sup>Paul Bairoch, “International Industrialization Levels from 1750 to 1980,” *Journal of European Economic History*, 11 (1982), pp. 36–54.

<sup>22</sup>United Nations Conference on Trade and Development, *Trade and Development Report 2005*, Geneva: United Nations.

**EXHIBIT 2-4**  
GLOBAL COMPETITIVENESS RANKING<sup>23</sup>

Country	Score In 2008/9	Rank in 2005	Rank In 2008/9	Country	Score In 2008/9	Rank In 2005	Rank In 2008/9	Country	Score In 2008/9	Rank In 2005	Rank In 2008/9
<b>United States</b>	5.74	2	1	<b>Hong Kong</b>	5.33	28	11	<b>Iceland</b>	5.04	7	21
<b>Switzerland</b>	5.61	8	2	<b>United Kingdom</b>	5.30	13	12	<b>Ireland</b>	4.99	26	22
<b>Denmark</b>	5.58	4	3	<b>South Korea</b>	5.28	17	13	<b>Israel</b>	4.97	26	23
<b>Sweden</b>	5.53	3	4	<b>Austria</b>	5.23	21	14	<b>New Zealand</b>	4.93	16	24
<b>Singapore</b>	5.53	6	5	<b>Norway</b>	5.22	9	15	<b>Luxembourg</b>	4.85	25	25
<b>Finland</b>	5.50	1	6	<b>France</b>	5.22	30	16	<b>Qatar</b>	4.83	*	26
<b>Germany</b>	5.46	15	7	<b>Taiwan</b>	5.22	5	17	<b>Saudi Arabia</b>	4.72	*	27
<b>Netherlands</b>	5.41	11	8	<b>Australia</b>	5.20	10	18	<b>Chile</b>	4.72	23	28
<b>Japan</b>	5.38	12	9	<b>Belgium</b>	5.14	31	19	<b>Spain</b>	4.72	29	29
<b>Canada</b>	5.37	14	10	<b>Israel</b>	5.05	26	20	<b>China</b>	4.70	*	30

Source: World Economic Forum, *Global Competitiveness Report 2005–2006* and *Competitiveness Report 2008–2009*, <http://www.weforum.org/>.

21st century.<sup>22</sup> Obviously, a decade is a long time in the ever-changing world economy, and indeed, no single country has sustained its economic performance continuously.

### Human Resources and Technology

Although wholesale generalizations should not be made, the role of human resources has become increasingly important as a primary determinant of industry and country competitiveness as the level of technology has advanced. As shown in **Exhibit 2-4**, according to World Economic Forum's *Global Competitiveness Report*, Singapore, one of the four Asian Tigers, consistently ranked among the world's top ten economies. Another one of the four Asian Tigers, Taiwan, also ranked within top 10 (No. 5) in 2005 and within top 20 (No. 17) in 2008/9. These two Asian countries have virtually no natural resources to rely on for building their competitiveness. Clearly, human resources are crucial for the long-term economic vitality of natural resource-poor countries. All the top-10 ranked countries, with the exception of the United States and Canada, are scarce in natural resources.

Similarly, three of the top 10 countries in 2008/9 are Nordic countries, led by Denmark, followed by Sweden and Finland. Although the rankings change to some extent, Norway and Iceland also kept within the top 20 and top 30, respectively. Nordic countries share a number of characteristics that make them extremely competitive, such as very healthy macroeconomic environments and highly transparent and efficient public institutions, with general agreement within society on the spending priorities to be met in the government budget. While the business communities in the Nordic countries point to high tax rates as a potential problem area, there is no evidence that these are adversely affecting the ability of these countries to compete effectively in world markets, or to provide to their respective populations some of the highest standards of living in the world. Indeed, the high levels of government tax revenue have delivered world-class educational establishments, an extensive safety net, and a highly motivated and skilled labor force.<sup>24</sup>

Although the United States kept its top positions of No. 2 and No. 1 in the reports of 2005–2006 and 2008–2009, respectively, the prognosis for the future U.S. competi-

<sup>23</sup>The World Economic Forum has been producing *The Global Competitiveness Report* for over a quarter of a century, and its unique mix of hard and soft data has made it possible to accurately capture the broad range of factors seen to be essential to a better understanding of the determinants of growth.

<sup>24</sup>World Economic Forum, *Global Competitiveness Report 2005-2006* and *Global Competitiveness Report 2008-2009*, <http://www.weforum.org/>.

**EXHIBIT 2-5****CHANGE IN COUNTRY INNOVATIVENESS: A KEY TO A COUNTRY'S LONG-TERM COMPETITIVENESS**

Rank Year	1980	1986	1993	1995	1999	2005 (expected)
1	Switzerland	Switzerland	Switzerland	U.S.A.	Japan	Japan
2	U.S.A.	U.S.A.	Japan	Switzerland	Switzerland	Finland
3	Germany	Japan	U.S.A.	Japan	U.S.A.	Switzerland
4	Japan	Germany	Germany	Sweden	Sweden	Denmark
5	Sweden	Sweden	Sweden	Germany	Germany	Sweden
6	Canada	Canada	Denmark	Finland	Finland	U.S.A.
7	France	Finland	France	Denmark	Denmark	Germany
8	Netherlands	Netherlands	Canada	France	France	France
9	Finland	Norway	Finland	Canada	Norway	Norway
10	U.K.	France	Australia	Norway	Canada	Canada
11	Norway	Denmark	Netherlands	Netherlands	Australia	Australia
12	Denmark	U.K.	Norway	Australia	Netherlands	Austria
13	Austria	Australia	U.K.	Austria	Austria	Netherlands
14	Australia	Austria	Austria	U.K.	U.K.	U.K.
15	Italy	Italy	New Zealand	New Zealand	New Zealand	New Zealand

Source: Adapted from Michael E. Porter and Scott Stern, *The New Challenge to America's Prosperity: Findings from the Innovation Index*, Washington, D.C.: Council on Competitiveness, 1999, pp. 34–35.

tiveness might not be as good as it currently appears. Seemingly contradictory to the current U.S. situation, U.S. Council on Competitiveness<sup>25</sup> reported in 1999 that the U. S. technological competitiveness had peaked in 1985 and that the United States might be living off its historical assets that were not being renewed (See **Exhibit 2-5** showing the change in the innovative capability of leading countries over the years). Although a more recent country innovativeness report is not available, this report clearly pointed to the rise of Finland as a technological powerhouse. Other conclusions include that although the United States and Switzerland had been the most innovative in the last three decades, other OECD nations have been increasingly catching up to the U.S. and Swiss levels. In particular, Denmark and Sweden have registered major gains in innovative capacity since the mid-1980s. Another interesting observation is that despite its economic slowdown in the 1990s, Japan has maintained its innovative capacity over the years without little sign of weakening. The recent strong recovery of the Japanese economy seemed to underscore its technological strengths, among other things.<sup>26</sup> Finally, although not shown in Exhibit 2-5, Singapore, Taiwan, South Korea, India, Israel, and Ireland have upgraded their innovative capacity over the past decade, becoming new centers of innovative activity.<sup>27</sup>

One major lesson here is that we should not be misled by mass media coverage of the current economic situations of various countries. While mass media coverage is factual and near-term focused, it may inadvertently cloud our strategic thinking. In other words, the current performance of the U.S. economy should not erroneously lull us into believing that U.S. companies are invincible in the global economy.<sup>28</sup> Information technology (IT) characterizes one of the most dynamic and turbulent industries today. As presented in **Global Perspective 2-1**, no one can be sure of the U.S. dominance even for the next decade.

<sup>25</sup>Michael E. Porter and Scott Stern, *The Challenge to America's Prosperity: Findings from the Innovation Index*, Washington, D.C.: Council on Competitiveness, 1999.

<sup>26</sup>"The Viagra Economy," *A Survey of the World Economy Economist*, September 24, 2005, 12–14; and "Japan: The Sun Also Rises," *Economist*, October 6, 2005, pp. 3–6.

<sup>27</sup>Michael E. Porter and Scott Stern, *The Challenge to America's Prosperity: Findings from the Innovation Index*, Washington, D.C.: Council on Competitiveness, 1999, p. 7.

<sup>28</sup>Paul Krugman, "America the Boastful," *Foreign Affairs*, 77 (May/June 1998), pp. 32–45.



## GLOBAL PERSPECTIVE 2-1

### INFORMATION TECHNOLOGY COMPETITIVENESS OF THE UNITED STATES, THE EUROPEAN UNION, JAPAN, AND BEYOND

Is it possible that in the foreseeable future, the industrial competitiveness of the United States, especially in information technology (IT), could be beaten by the European Union (EU) and Japan? Due to the pace at which technology advances, it is often the case that the life cycle of a product gets shorter. So, no one can deny that a new software company with higher and more innovative technology could replace Microsoft Windows, even overnight. Another key consideration is that it is impossible for the U.S. to be ahead of the other two members of the Triad in every sector. Take mobile phone industry. In Japan, people now use their mobile phones not only as a telephone but also as a computer terminal. In this industry, the U.S. lags behind the EU and Japan in terms of both popularity and technology. By introducing even more sophisticated mobile phones, the EU and Japan have found themselves turning into information-based societies more quickly than the U.S.

The EU has launched its ambitious plan, called eEurope, since 2002. It aims to develop modern public services and a dynamic environment for e-business through widespread availability of broadband access at competitive prices and a secure information infrastructure. Its primary goal is the development and delivery of services and applications such

*Sources:* Thomas Bleha, “Down to the Wire,” *Foreign Affairs*, 84, May/June 2005, pp. 111–124; “Widespread and Affordable Broadband Access is Essential to Realize the Potential of the Information Society,” *eEurope*, [http://europa.eu.int/information\\_society/eeurope/2005/all\\_about/broadband/index\\_en.htm](http://europa.eu.int/information_society/eeurope/2005/all_about/broadband/index_en.htm), accessed December 15, 2005.

as eHealth, eBusiness, eGovernment and eLearning, making broadband crucial to European growth and quality of life in the years ahead. A widespread secure broadband infrastructure is essential for these societal goals.

The Japanese government has also launched a similar plan to realize an information-oriented society. For example, by May 2003, a higher percentage of homes in Japan than in the United States had broadband, and Japan had moved well beyond the basic connections still in use in the United States. Today, nearly all Japanese have access to “high-speed” broadband, with an average connection speed 16 times faster than in the United States—for only about \$20 a month. Even faster “ultra-high-speed” broadband, which runs through fiber-optic cable, has become available throughout the country for \$30 to \$40 a month by the end of 2005. And that is to say nothing of Internet access through mobile phones, an area in which Japan is even further ahead of the United States.

It is now clear that Japan and its neighbors will lead the charge in high-speed broadband over the next several years. South Korea already has the world’s greatest percentage of broadband users, and in 2004 the absolute number of broadband users in urban China surpassed that in the United States. These countries’ progress will have serious economic implications. By dislodging the United States from the lead it commanded not so long ago, Japan and its neighbors, as well as Europe, have positioned themselves to be the first states to reap the benefits of the broadband era: economic growth, increased productivity, technological innovation, and an improved quality of life.

## EMERGING ECONOMIES

Large economies and large trading partners have been located mostly in the **Triad Regions** of the world (North America, Western Europe, and Japan, collectively producing over 80 percent of world GDP with 20 percent of the World’s population) in much of the 20th century.<sup>29</sup> However, in the next 10 to 20 years, the greatest commercial opportunities are expected to be found increasingly in ten **Big Emerging Markets** (BEMs)—the Chinese Economic Area (CEA: including China, Hong Kong region, and Taiwan), India, Commonwealth of Independent States (Russia, Central Asia, and Caucasus states), South Korea, Mexico, Brazil, Argentina, South Africa, Central European countries,<sup>30</sup> Turkey, and the Association of Southeast Asian Nations (ASEAN: including Indonesia, Brunei, Malaysia, Singapore, Thailand, the Philippines

<sup>29</sup> Lowell Bryan, *Race for the World: Strategies to Build A Great Global Firm*, Boston, MA: Harvard Business School Press, 1999.

<sup>30</sup> Poland, Czech Republic, Slovakia, Slovenia, Hungary, Estonia, Latvia, Lithuania, Romania, and Bulgaria. See an excellent article, “The Rise of Central Europe,” *Business Week*, December 12, 2005, pp. 50–56.

and Vietnam). For instance, in the past 20 years, China's real annual GDP growth rate has averaged 9.5 percent a year; while India's has been 5.7 percent, compared to the average 3 percent GDP growth in the United States. Companies like Hewlett-Packard (HP) are benefiting a lot from BEMs. For example, growth in such markets as Brazil, Russia, India, and China is helping HP shrug off the effects of a slowdown in the U.S. and prompted the company to raise its sales forecast for 2008. However, we should also realize that, an increasing number of competitors are expected to originate from those emerging economies.

Accordingly, an increasing number of competitors are also expected to originate from those emerging economies. According to trade statistics compiled in *World Factbook 2009*, published by the U.S. Central Intelligence Agency (See **Exhibit 2-2**),<sup>31</sup> the world's ten largest exporting countries accounted for more than half of the world merchandise trade in 2008: Germany (\$1,530 billion), China (\$1,465 billion), the United States (\$1,377 billion), Japan (\$777 billion), France (\$630 billion), Italy (\$566 billion), Netherlands (\$538 billion), United Kingdom (\$469 billion), Canada (\$462 billion), and Belgium (\$373 billion). A look at the trade data in recent years turns out two notable changes attesting to the globalization of the markets. First, since taking over the United States as the largest exporting country for the first time in 2004, Germany has steadily kept its leading position. Second, China then passed the United States and has become the second largest exporting country since 2007. Although not in the top 10 exporting countries group, Korea, Russia, Singapore, and Mexico are immediately behind.

As a result, over the next two decades, the markets that hold the greatest potential for dramatic increases in U.S. exports are not the traditional trading partners in Europe and Japan, which now account for the overwhelming bulk of the international trade of the United States. But they will be those BEMs. Already, there are signs that in the future the biggest trade headache for the United States may not be Japan but China and India.<sup>32</sup> China's trade surplus with the United States ballooned from \$86 billion in 2000 to \$256.2 billion in 2007; it had already surpassed Japan's trade surplus position with the United States by 2000.<sup>33</sup> India has increasingly become a hotbed as sources of information technology (IT), communications, software development, and call centers particularly for many U.S. multinationals. Russia is extremely rich in natural resources, including oil and natural gas, which are dwindling in the rest of the world, and has gradually warmed up to international commerce, and will potentially become a major trading nation. As these three leading emerging economies, among others, are likely to reshape the nature of international business in the next decade, the profiles of these countries will be highlighted here (See **Exhibit 2-6** for summary country profile).

Marketing in emerging markets requires is contextually different from marketing in developed countries. Companies that have succeeded in developed countries may or may not be able to approach those emerging markets the same way. When they enter huge emerging markets in rapidly developing economies, Western companies typically bring with them U.S., Japanese, or Western European quality standards, dismissing local goods as inferior. They know there is a great hunger in those countries for Western goods in the same way as developed-country consumers and businesses might buy in New York, London, or Tokyo. However, they forget that, in spite of the lust for high-quality Western goods, relatively few developing-country customers can afford them. In terms of price and quality, most developing-country customers weight more on the former and choose not-up-to-Western-standards but good enough and inexpensive

<sup>31</sup><https://www.cia.gov/library/publications/the-world-factbook>.

<sup>32</sup>The economic role of smaller emerging economies cannot be ignored. Read, for example, "Good Morning, Vietnam: Intel Deal to Build a Factory is Likely to Spur More Western Investment," *Business Week*, March 13, 2006, pp. 50–51.

<sup>33</sup>*Statistical Abstract of the United States, 2009*, <http://www.census.gov/compendia/statab/2009edition.html>.

**EXHIBIT 2-6**

## LEADING EMERGING ECONOMIES IN 2008



	<i>Brazil</i>	<i>Russia</i>	<i>India</i>	<i>China</i>
Population	196 million	141 million	1,148 million	1,330 million
Population Growth Rate	1.23 percent	-0.47 percent	1.58 percent	0.63 percent
GDP in current US\$	\$1.67 trillion	\$1.76 trillion	\$1.24 trillion	\$4.22 trillion
GDP in current US\$ based on purchasing power parity	\$2.03 trillion	\$2.23 trillion	\$3.32 trillion	\$7.80 trillion
GDP per capita based on purchasing power parity	\$10,300	\$15,800	\$2,900	\$6,100
GDP real growth rate	5.2 percent	6.0 percent	7.3 percent	9.8 percent
Inflation rate	5.8 percent	13.9 percent	7.8 percent	6.0 percent
Current account balance	-\$27.3 billion	\$97.6 billion	-\$38.3 billion	\$368.2 billion

Sources: Compiled from IMF statistics and U.S. Central Intelligence Agency, *The World Factbook 2009*, <https://www.cia.gov/library/publications/>.

local products. The local companies making these “good enough” products costing up to 75 percent less than Western brands are actually serious challengers of their developed-country rivals, especially given that they will finally produce ever-better products as they gain scale, lower costs, and invest in R&D.

Take Nokia for example. The world’s largest supplier of mobile handsets entered the Chinese market early in 1991. As most Western companies usually do, it did market research and identified distributors in the wealthiest cities and sold them product “by the container load.” By 1999, the company outperformed any other domestic or foreign companies and became the No. 1 with a 30 percent share of the handset market. However, Nokia did not realize that, while Nokia was focusing on the biggest cities with Western-grade handsets, local challengers were gradually taking up the populous countryside by selling “good enough” handsets. Soon Nokia and local challengers’ positions were reversed. Nokia’s market share fell from 30 percent in 1999 to the low teens in 2003; and the local challengers’ share jumped from just 2.5 percent in 1999 to

nearly 30 percent. Undoubtedly, Nokia was paying the price for focusing its China strategy on the high-end market. The large loss woke up Nokia to renovate its strategy: it set up its own distribution and sales network across China and introduced cheaper new handsets with fewer bells and whistles, quickly expanding from 10 cities to hundreds of cities. And this reinvention of strategy worked. By 2005, the company created a new peak of sales by selling 51 million — or 35 percent — of the handsets sold in China.<sup>34</sup>

Like Nokia, many developed-country firms fail to fully understand the competitive environment in those emerging markets. They enter these emerging markets ready to sell existing high-end products to increasingly prosperous city dwellers. It might work for a while, but not forever. A valuable lesson from the Nokia example is to have the right products at the right price. There is no doubt about the attractiveness and potential of the emerging markets. To succeed, however, developed-country companies need a new reference. We will further explore issues related to the emerging markets in Chapter 18.

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## EVOLUTION OF COOPERATIVE GLOBAL TRADE AGREEMENTS



In the aftermath of World War II, the then-big powers negotiated the setting up of an **International Trade Organization** (ITO), with the objective of ensuring free trade among nations through negotiated lowering of trade barriers. ITO would have been an international organization operating under the umbrella of the United Nations with statutory powers to enforce agreements. However, when the U.S. government announced, in 1950, that it would not seek congressional approval, ITO was effectively dead. Instead, to keep the momentum of increasing trade through the lowering of trade barriers alive, the signatories to ITO agreed to operate under the informal aegis of the **General Agreements on Tariffs and Trade** (GATT). GATT provided a forum for multilateral discussion among countries to reduce trade barriers. Nations met periodically to review the status of world trade and to negotiate mutually agreeable reductions in trade barriers.

### General Agreements on Tariffs and Trade

The main operating principle of GATT is the concept of **Normal Trade Relations** (NTR) status (formerly known as **Most Favored Nation** or MFN status). The NTR status meant that any country that was a member state to a GATT agreement and that extended a reduction in tariff to another nation would have to automatically extend the same benefit to all members of GATT. However, there was no enforcement mechanism, and over time many countries negotiated bilateral agreements, especially for agricultural products, steel, textiles and automobiles. GATT was successful in lowering trade barriers to a substantial extent (e.g., developed countries' average tariffs on manufactured goods from around 40 percent down to a mere 4 percent) during its existence from 1948 to 1994. However, some major shortcomings limited its potential and effectiveness. The initial rounds of GATT concentrated only on the lowering of tariff barriers. As trade in services expanded faster than the trade in goods and GATT concentrated on merchandise trade, more and more international trade came to be outside the purview of GATT. Second, GATT tended to concentrate mostly on tariffs, and many nations used non-tariff barriers, such as quota and onerous customs procedure, to get around the spirit of GATT when they could not increase tariffs. Finally, as developed nations moved from manufacturing-based economies to services- and knowledge-based economies, they felt the need to bring intellectual property within

<sup>34</sup>Harold Sirkin and Jim Hemerling, "Price Trumps Quality in Emerging Markets," *BusinessWeek.com*, June 4, 2008, <http://www.businessweek.com/>.

the purview of international agreement, because that was where the competitive advantage lay for firms in the developed nations.

## World Trade Organization

The World Trade Organization (WTO) was created in the eighth round of GATT talks—called the **Uruguay Round**—that lasted from 1986 to 1994. The WTO took effect on January 1, 1995. The WTO has statutory powers to adjudicate trade disputes among nations to oversee the smooth functioning of the multilateral trade accords agreed upon under the Uruguay Round. *Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.* As of February 28, 2009, the WTO had 153 member countries.<sup>35</sup> This round was successful in bringing many agricultural products and textiles under the purview of GATT. The Uruguay Round created an environment in which a global body of customs and trade law is developing. In particular, the Uruguay Round ensured the ultimate harmonization of the overall customs process and the fundamental determinations that are made for all goods crossing an international border: admissibility, classification, and valuation.<sup>36</sup> It also included provisions for trade in intellectual property for the first time and provided for many services.

Then, the WTO's ninth and latest round—called the **Doha Development Agenda (Doha Round, for short)** was launched in Doha, Qatar in November, 2001. Most notably, the inaugural meeting at the Doha Round also paved the way for China and Taiwan to get full membership in the WTO<sup>37</sup> (See **Global Perspective 2-2** on China's



## GLOBAL PERSPECTIVE 2-2

### CHINA'S ACCESSION TO THE WTO AND ITS IMPLICATIONS

After fifteen years of arduous negotiation, China joined the World Trade Organization (WTO) in December 2001. The United States reached a bilateral agreement with China on WTO accession that secures broad-ranging, comprehensive, one-way trade concession on China's part, in which China made specific commitments to open its market to U.S. exports of industrial goods, service and agriculture to a degree unprecedented in the modern era. For example, China promised to reduce import tariffs from an average of 24.6 percent to 9.4 percent within three to five years. The United States also offered extension of permanent Normal Trade Relations (NTR) to China, as China entered the WTO. The House vote was called one of the most important trade and foreign policy decisions the United States had made in many years. Because of the accession, the markets of WTO members were also opened to China.

Trade officials from the United States, Europe, and Japan have portrayed China's entry into the WTO as an antidote to their growing trade deficits with China. But the reality is that China's agreement to reduce tariffs, phase out import quotas, open new sectors of its economy to foreign investment, and otherwise follow WTO rules will not reverse this imbalance in trade. China's accession to the WTO has begun to boost its economic reforms in the world's most populous nation. There is no doubt that China and its 1.3 billion people benefit tremendously from its WTO accession. It has allowed China to expand trade, attract foreign investment and give private firms a greater role in the economy, but more importantly, it has increasingly integrated China with the rest of the world economy. According to the United Nations Conference on Trade and Development (UNCTAD), although global inflows of foreign direct investment (FDI) declined from 2001 to 2003,

(continued)

<sup>35</sup>New members that joined the WTO in the 21st century are Albania, Armenia, Cambodia, Cape Verde, China, Croatia, Former Yugoslav Republic of Macedonia (FYROM), Georgia, Jordan, Lithuania, Moldova, Nepal, Oman, Saudi Arabia, Chinese Taipei, Tonga, Ukraine, and Viet Nam. At the time of writing this chapter, the application of 31 countries were being considered for accession: Afghanistan, Algeria, Andorra, Azerbaijan, Bahamas, Belarus, Bhutan, Bosnia and Herzegovina, Cape Verde, Comoros, Equatorial Guinea, Ethiopia, Vatican, Iran, Iraq, Kazakhstan, Lao People's Democratic Republic, Lebanese Republic, Republic of Liberia, Libya, Montenegro, Russian Federation, Samoa, Sao Tomé and Principe, Serbia, Seychelles, Sudan, Tajikistan, Uzbekistan, Vanuatu, Yemen.

<sup>36</sup>Paulsen K. Vandevent, "The Uruguay Round and the World Trade Organization: A New Era Dawns in the Private Law of International Customs and Trade," *Case Western Reserve Journal of International Law*, 31 (Winter 1999), pp. 107–38.

<sup>37</sup>Anne McGuirk, "The Doha Development Agenda," *Finance & Development*, 39 (September 2002), 4–7.

(continued)

China experienced an increased trade inflow of 14 percent (\$ 53 billion in 2003) and became the world's largest FDI recipient. China is actively attracting FDI in manufacturing and service sectors from multinational corporations. Multinational corporations have found China's workforce not only cheap and vast but also educated and disciplined. Meanwhile, as an emerging FDI outward investor, firms in China have invested in neighboring countries and in Africa, Latin America, North America, and Europe to access to natural resources, markets, and strategic assets such as technology and brand names. In 2002, China's outward investment flows exceeded \$35 billion, reaching more than 160 countries.

Sources: "Analysis: Chinese Threat to Japan Manufacturers," *Nikkei Net Interactive*, May 29, 2001; Nicholas R. Lardy, "Sweet and Sour Deal," *Foreign Policy*, March/April 2002, 20–21; Bill Powell, "It's All Made in China Now," *Fortune*, March 4, 2002; "Tilting at Dragons," *Economist*, October 25, 2003, pp. 65–66; "The China Price," *Business Week*, December 6, 2004, pp. 102–24.

Entry into the WTO membership followed Beijing winning the right to host the 2008 Olympic games and Shanghai hosting the Asia Pacific Economic Cooperation (APEC) leaders' summit. Driven by government's open policy to foreign investment since 1980s and accession by WTO as an important trade partner to the world, China is emerging as the virtual factory of the world, driving a profound shift in global investment flows.

How will this affect other economies such as the United States, Japan, and Europe? With China's increased trade surplus with the United States, the deflationary crisis in Tokyo, as well as European manufacturers becoming vulnerable to the "Made in China" shock, should China be blamed for the rich countries' economic problems? On the one hand, China has presented business opportunities for firms to offshore manufacturing and services jobs with low-waged, skilled workforce and also lowered its import tariffs since its entry into the WTO; on the other hand, China has cost some firms to lose global market share and job opportunities by conducting cheap-currency strategy.

accession to the WTO). This new round places the needs and interests of developing countries at the heart of its work (**Exhibit 2-7** gives an idea of the "intended" scope of the Doha Round). Agricultural tariffs are five times higher on average than those for industrial products. High tariffs undermine the ability of developing countries to trade their way out of poverty—it is estimated that two-thirds of the world's poorest people are dependent on agriculture. The United States currently spends up to \$19 billion on farm-production subsidies, which heavily distort trade. The EU spends

### EXHIBIT 2-7 AGENDA FOR THE DOHA ROUND

- Implementation-related issues and concerns
- Agriculture
- Services
- Market access for non-agricultural products
- Trade-related aspects of intellectual property rights (TRIPS)
- Relationship between trade and investment
- Interaction between trade and competition policy
- Transparency in government procurement
- Trade facilitation
- WTO rules: anti-dumping
- WTO rules: subsidies
- WTO rules: regional trade agreements
- Dispute Settlement Understanding
- Trade and environment
- Electronic commerce
- Small economies
- Trade, debt and finance
- Trade and transfer of technology
- Technical cooperation and capacity building
- Least-developed countries
- Special and differential treatment

Source: World Trade Organization, [http://www.wto.org/english/thewto\\_e/minist\\_e/](http://www.wto.org/english/thewto_e/minist_e/)

over



Although WTO is a global institutional proponent of free trade, it is not without critics. In December 2005, the sixth ministerial conference of the WTO in Hong Kong was greeted by jeers and riots triggered by labor unions, environmentalists, and other onlookers who were opposed to free trade for various reasons.

\$75 billion.<sup>38</sup> The reluctance of some of the world's richest countries to substantially reduce high farm tariff and non-tariff barriers stymied the opportunity to secure other reforms that would deliver huge benefits to the world trading regime. Broadly speaking, the United States was under pressure to reduce trade-distorting farm subsidies, while Europe and India tried to keep too many farm products from deeper tariff cuts, and some developing countries were under pressure to reduce industrial tariffs further and faster. The agenda also included new trade talks—an action program to resolve developing countries' complaints about the implementation of Uruguay Round agreements, and an accord on **Trade Related Aspects of Intellectual Property Rights** (TRIPS) ensuring that patent protection does not block developing countries' access to affordable medicines. As these countries eventually failed to come to an agreement on farm product issues, the Doha Round of multilateral trade talks did not make much progress in other areas and eventually collapsed on July 29, 2008.<sup>39</sup>

Incidentally, the WTO is not simply an extension of GATT. The GATT was a multilateral agreement with no institutional foundations. The WTO is a permanent institution with its own secretariat. The GATT was applied on a provisional basis in strict legal terms. WTO commitments are full and permanent and legally binding under international law. Although GATT was restricted to trade in merchandise goods, WTO includes trade in services and trade-related aspects of intellectual property. It is to be noted that GATT lives on within WTO. Some of the major issues and agendas in WTO are highlighted below.

**Dispute Settlement Mechanism.** The WTO dispute settlement mechanism is faster, more automatic, and therefore much less susceptible to blockages than the old GATT system. Once a country indicates to WTO that it has a complaint about the trade practices of another country, an automatic schedule kicks in. The two countries have three months for mutual “consultations” to iron out their differences. If the disputants cannot come to a mutually satisfactory settlement, then the dispute is referred to the Dispute Settlement Mechanism of WTO, under which a decision has to be rendered within six months of the setting up of the panel to resolve the dispute. The decision of the panel is supposed to be legally binding. However, trade experts have revealed deep ambivalence about the WTO's experiment with binding

<sup>38</sup>“A Stopped Clock Ticks Again,” *Economist*, October 13, 2005, pp. 76–79.

<sup>39</sup>“So Near and Yet So Far: Trade Ministers Have Come Too Close to a Deal to Let the Doha Round Die,” *Economist*, August 2, 2008, p. 14; and “After Doha,” *Economist*, September 6, 2008, pp. 85–86.



## GLOBAL PERSPECTIVE 2-3

### TRADE BARRIERS AND POLITICS

The United States thinks of itself as a leading exponent of free trade and frequently brings actions against other nations as unfair trading partners. On March 20, 2002, President George W. Bush announced that U.S. would impose tariffs of up to 30 percent on most steel imports, as a means to save the domestic steel industry. But this temporary steel tariff has set a dangerous precedent for the others, opening the floodgates on new tariffs by other World Trade Organization (WTO) members. In response to the U.S. action, the European Union (EU) immediately filed for a complaint to the WTO, and decided to impose six-month protective tariffs of 14.9 percent–26 percent on 15 kinds of steel imports that exceed current quotas. Japan also notified the WTO of its plans to impose 100 percent retaliatory tariffs on U.S. steel imports. China is also preparing to erect new trade barriers in retaliation for the U.S. steep tariffs. In May 2002, Chinese government announced its plan to levy tariff-rate quotas on imports of nine steel products, which would impose tariffs ranging from 7 percent to 26 percent once imports of those products exceed a designated amount. Further, if the WTO panel rules that the U.S. steel tariffs conflict with WTO agreements, China says it will impose

*Sources:* Campion Walsh, “EU’s Lamy Warns US Steel Tariffs A Dangerous Example,” *Dow Jones Newswires*, May 21, 2002; Owen Brown, “EU, China Discuss Campaign Against US Steel Tariffs,” *Dow Jones Newswires*, April 4, 2002; Andrew Batson, “China Prepares Retaliation Against US Steel Tariffs,” *Dow Jones Newswires*, May 21, 2002; “WTO Approves EU Bid for Panel On US Steel Tariff Hikes,” *Dow Jones Newswire*, June 3, 2002; Dan Bilefsky and Edward Alden, “Test for Bush as EU retaliates on Gluten Tariffs,” *Financial Times*, January 21, 2001; “U.S. Puts Tariff on Canadian Lumber amid Allegations of Unfair Subsidies,”

24 percent tariffs on a list of U.S. products including waste paper, bean oil and electric compressors.

The WTO agreed to step into the escalating dispute, agreeing to the EU request for a panel to rule on the legality of the U.S. decision. The panel could take up to a year to rule on the legality of the U.S. tariffs and either side can appeal the ruling, but a decision by the appellate body would then be final. The U.S. argument is the safeguard practice: under WTO rules, countries can impose temporary increases in tariffs to give time for a domestic industry to restructure to improve competitiveness. But according to the EU, Japan, China and South Korea, the U.S. action breaks WTO rules: there was no overall increase in steel imports—a precondition for safeguards action—and that some of the moves target the wrong steel products. Although the U.S. government decided to take back some of its earlier tariffs under pressure from the EU, the U.S. protectionism on its steel industry remains a volatile trade dispute.

The U.S. protectionism on its steel industry is considered a major setback for the world trade system, but it is not something new. In January 2001, the European Commission announced it would retaliate against U.S. restriction on wheat gluten imports in 1998 by imposing a tariff on corn gluten feed exported from the United States, which could cost U.S. exporters up to \$29.1 million a year. WTO panel ruled that the US had failed to establish a causal link between wheat gluten imports and losses being suffered by US companies. Thus the EU is allowed to offset the damage with similar restriction on imports from the United States. In March 2002, U.S. government levied tariffs averaging 29 percent on a popular type of Canadian lumbers, but this was said to be an act of retaliation for Canada’s “unfair trade practices.”

adjudication, and there is little clear sense of where the system should go from here. Litigation draws on different skills, resources, and even cultural attitudes than does diplomacy, with a possibility placing certain nations at a real disadvantage.<sup>40</sup> As **Global Perspective 2-3** shows, the United States frequently violates the WTO principles and resorts to unilateral trade sanctions against foreign trading partners.

Finally, although WTO is a global institutional proponent of free trade, it is not without critics. In December 1999, WTO launched what would have become the beginning of a ninth round of negotiations inaugurated in Seattle, the United States. However, its Seattle meeting was only to be greeted by jeers and riots triggered by labor unions, environmentalists, and other onlookers who were opposed to free trade for various reasons. As a result, the meeting was postponed until 2001 under so much uncertainty, which resulted in the Doha Round mentioned earlier. Indeed, contrary to

<sup>40</sup>Susan Esserman and Robert Howse, “The TWO on Trial,” *Foreign Affairs*, 82 (January/February 2003), pp. 130–40.



## GLOBAL PERSPECTIVE 2-4

### ANTI-GLOBALIZATION MOVEMENT

Oppositions to corporate and economic globalization have been growing for many years, but have received media attention only since the late 1990s. Anti-globalization movement, launched by a French farmer, quickly spread the network to other parts of the world. The growing trend toward anti-globalization activism is directed, first, against multinational corporate power and, second, against global agreements on economic growth made by international trade institutions, such as the World Trade Organization (WTO), the World Bank, and International Monetary Fund (IMF).

The movement is often described as “multi-generational, multi-class, and multi-issue.” Participants protest against

capitalism, free trade, international investment (especially from the West to the Third World), cultural and economic globalization, wars, and Western politics. During the last few years, massive anti-globalization protests have accompanied international meetings in cities such as Seattle, Quebec City, Genoa, and Washington, D.C. The anti-globalization movement became front-page stories when its protesters gathered during the WTO meeting in Seattle in late 1999, when the activists almost disrupted the meeting. Later protests focused on the World Bank and IMF. Their main slogan is “Here, another world is possible.”

There are two kinds of people in the movement: Reformists and Radicals. Reformists are often engaged in a serious exchange of ideas and proposals on socioeconomic and environmental changes, which ask for a broader international participation in decision-making. Protests organized by radicals often go violent and disruptive. Campaigners cyber-attacked international businesses’ websites, burned their properties, and destroyed international meetings. Multinational companies are often accused of social injustice, unfair labor practices—including slave labor wages, living and working conditions—as well as a lack of concern for the environment, mismanagement of natural resources, and ecological damage.

*Sources:* Konstantin Lezhandr, “The Future of Europe’s Anti-globalization Activists,” *Itogi*, April 24, 2002, p. 26; “Anti-Globalization: A Spreading Phenomenon,” *Perspectives* (Canadian Security Intelligence Report #2000/08), [http://www.csis-scrs.gc.ca/eng/miscdocs/200008\\_e.html](http://www.csis-scrs.gc.ca/eng/miscdocs/200008_e.html); Sean Higgins, “Anti-Globalization Protesters Discover New Enemy: Israel,” *Investor’s Business Daily*, April 23, 2002, p. A16; James Petras, “Porto Alegre 2002: A Tale of Two Forums—Correspondence; Anti-Globalization Social Forum,” *Monthly Review* 53, April 1, 2002, p. 56; Julian Nundy, “Fire Destroy McDonald’s Site in France; Police Suspect Arson,” *Bloomberg News*, May 7, 2002.

the globalization forces at work, anti-globalization sentiment has been building over the years (See **Global Perspective 2-4**).

**Trade Related Aspects of Intellectual Property Rights (TRIPS).** Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement, concluded as part of the GATT Uruguay Round, mandates that each member country accord to the nationals of other member countries the same treatment as its nationals with regard to intellectual property protection (see Chapter 5 for details). However, it is not an international attempt to create a universal patent system. In March 2002, the WTO’s TRIPS Council has started work on a list of issues at the November 2001 Ministerial Conference in Doha. These include specific aspects of TRIPS and public health, geographical indications, protecting plant and animal inventions, biodiversity, traditional knowledge, the general review of the TRIPS Agreement, and technology transfer. One hot issue is to find a solution to the problems countries may face in making use of compulsory licensing if they have too little or no pharmaceutical manufacturing capacity. During a special session, WTO members have also embarked on two-phase program for completing negotiations on a multilateral registration system for geographical indications for wines and spirits.<sup>41</sup>

**Global E-Commerce.** Due to an explosive use of the Internet, a global effort to regulate international e-commerce has become increasingly necessary (See Chapter 19

<sup>41</sup>Compiled from TRIPS Material on the WTO Website, [http://www.wto.org/english/tratop\\_e/trips\\_e/trips\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/trips_e.htm); “Patently Problematic,” *Economist*, September 14, 2002, pp.75-76; and Donald Richards, “Trade-Related Intellectual Property Rights,” *Review of International Political Economy*, 12, August 2005, pp. 535-51.

for the impact of the Internet on various marketing activities). According to the Internet World Statistics, the number of Internet users reached 1.46 billion by July 2008, a four-time increase from 2000 to 2008.<sup>42</sup> To address this issue, the WTO's Work Program on Electronic Commerce has been working on how to define the trade-related aspects of electronic commerce that would fall under the parameters of WTO mandates. The Work Program submitted a report to the organization's General Council on March 31, 1999 in which it sought to define such services as intellectual barriers to trade in the context of electronic commerce. Probably the best thing the WTO can do to assist the development of electronic commerce in global trade is to meet its stated goal of assisting in the creation of an environment in which electronic commerce can flourish. According to WTO documents, such an environment requires liberalized market policies and predictable trade regimes that encourage the massive investments in technology that is required for electronic commerce to work.<sup>43</sup>

The U.S. is taking the lead in bringing e-commerce-related issues to the table. A U.S. document that was presented to the Work Program's general meeting on March 22, 1999, clearly outlined both the issues raised by the introduction of e-commerce in international trade and the importance of e-commerce to the global economy. The United States also proposed that the WTO examine services that may emerge as more viable in terms of international trade through e-commerce. For example, with widespread use of the Internet, has the notion of retailing across borders—previously inhibited by different time zones and the high cost of international communications—now become commercially viable? Now that networked appliances increasingly are used, will remote monitoring, testing and diagnostics of such devices become increasingly important? Much has yet to be clarified and resolved.

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## INFORMATION TECHNOLOGY AND THE CHANGING NATURE OF COMPETITION



As the nature of value-adding activities in developed nations shifts more and more to information creation, manipulation, and analysis, the developed nations have started taking an increased interest in international intellectual property protection measures. Imagine a farmer in the nineteenth century headed into the twentieth century. The intrinsic value of food will not go away in the new century, but as food becomes cheaper and cheaper to produce, the share of the economy devoted to agriculture will shrink (in the United States agriculture contributes less than 3 percent to the GDP) and so will the margins for the farmer. It would be advisable to move into manufacturing, or at least into food processing, to maintain margins.

An analogous situation faces a content maker for **information-related products** such as software, sheet music, movies, newspapers, magazines, and education in the late-twentieth century headed into the twenty-first century. Until now, content has always been manifested physically—first in people who knew how to do things; then in books, sheet music, records, newspapers, loose-leaf binders, and catalogs; and most recently in tapes, discs, and other electronic media. At first, information could not be “copied”: it could only be re-implemented or transferred. People could build new machines or devices that were copies of or improvements on the original; people could tell each other things and share wisdom or techniques to act upon. (Reimplementation was cumbersome and re-use did not take away from the original, but the process of building a new implementation—a new machine or a trained apprentice—took considerable time and physical resources.)

Later, with symbols, paper, and printing presses, people could copy knowledge, and it could be distributed in “fixed” media; performances could be transcribed and

<sup>42</sup>Internet World Stats, <http://www.internetworldstats.com/stats.htm>, accessed September 1, 2008.

<sup>43</sup>David Biederman, “E-Commerce and World Trade,” *Traffic World*, 258 (April 26, 1999), p. 22.

recreated from musical scores or scripts. Machines could be mass-produced. With such mechanical and electronic media, intellectual value could easily be reproduced, and the need (or demand from creators) to protect intellectual property arose. New laws enabled owners and creators to control the production and distribution of copies of their works. Although reproduction was easy, it was still mostly a manufacturing process, not something an individual could do easily. It took time and money. Physical implementation contributed a substantial portion of the cost.

### Value of Intellectual Property in Information Age

However, with the advent of the Information Age, firms face a new situation; not only is it easy for individuals to make duplicates of many works or to re-use their content in new works, but the physical manifestation of content is almost irrelevant. Over the Internet, any piece of **electronically represented intellectual property** can be almost instantly copied anywhere in the world. Since more and more of value creation in the developed nations is coming from the development and sale of such information-based intellectual property, it is no surprise that developed nations are highly interested in putting strong international intellectual property laws in place. For instance, a recent survey of more than 200 largest firms in United Kingdom disclosed that 83 percent of those firms had experienced different types of cyber crime in 2003. Further, according to an international specialist in computer forensics, roughly 70 percent of UK business professionals have stolen corporate intellectual property through personal e-mails when leaving the employer. Obviously, it is costly for corporations to protect their intellectual property, and to adjust for losses in productivity and perceived damage to corporate brand and share price.<sup>44</sup> The U.S. insistence on the inclusion of provisions relating to intellectual property in WTO's TRIPS agreement is a direct consequence, and is understandable as cyber crime affects all parties with intellectual property. Technology-based protection of electronic information through hardware, software, or a combination thereof in the form of encryption and digital signatures has been suggested as the means of circumventing the problem of unauthorized copying.<sup>45</sup>

Controlling copies (once created by the author or by a third party), however, becomes a complex challenge. A firm can either control something very tightly, limiting distribution to a small, trusted group, or it can rest assured that eventually its product will find its way to a large non-paying audience—if anyone cares to have it in the first place. But creators of content on the Internet still face the eternal problem: the value of their work generally will not receive recognition without wide distribution. Only by attracting broad attention can an artist or creator hope to attract high payment for copies. Thus, on the Internet, the creators give first performances or books (or whatever) away widely in hopes of recouping with subsequent works. But that breadth of distribution lessens the creator's control of who gets copies and what they do with them. In principle, it should be possible to control and charge for such widely disseminated works, but it will become more and more difficult. People want to pay only for what is perceived as scarce—a personal performance or a custom application, or some tangible manifestation that cannot easily be reproduced (by nature or by fiat; that is why the art world has numbered lithographs, for example).

The trick may be to control not the copies of the firm's information product but instead a relationship with the customers—subscriptions or membership. And that is often what the customers want, because they see it as an assurance of a continuing supply of reliable, timely content. Thus, the role of marketing may be expected to assume increasing importance. A firm can, of course, charge a small amount for mass copies. Metering schemes will allow vendors to charge—in fractions of a penny, if desired—according to usage or users rather than copies. However, it will not much change the overall approaching-zero trend of content pricing. At best, it will make it much easier to charge those low prices.

<sup>44</sup> DeeDee Doke, "Sniffing Out the Evidence," *Personnel Today*, May 11, 2004, pp. 20–22.

<sup>45</sup> Ravi Kalakota and Andrew B. Whinston, *Frontiers of Electronic Commerce* (Reading, Mass.: Addison Wesley, 1996). See Chapter 15.

There are other hurdles for content creators with the emergence of electronic commerce (e-commerce). One is the rise of a truly efficient market for information. Content used to be **unfungible**: it was difficult to replace one item with another. But most information is not unique, though its creators like to believe so. There are now specs for content such as stock prices, search criteria, movie ratings, and classifications. In the world of software, for instance, it is becoming easier to define and create products equivalent to a standard. Unknown vendors who can guarantee functionality will squeeze the prices of the market leaders. Of course the leaders (such as Microsoft) can use almost-free content to sell ancillary products or upgrades, because they are the leaders and because they have reinvested in loyal distribution channels. The content is advertising for the dealers who resell, as well as for the vendors who create. This transformation in the form of value creation and ease of dissemination implies a jump in economic integration, as nations become part of an international electronic commerce network. Not only money but also products and services will flow faster.

The other consequence of fungible content, information products, and electronic networks is an additional assault on the power of national governments to regulate international commerce. Ford uses a product design process whereby designers at Dearborn, Michigan, pass on their day's work in an electronic form to an office in Japan, which then passes the baton along to designers in Britain, who pass it back to Dearborn the next day. When the information represented in the design crosses borders, how do the governments of the United States, Japan, and Britain treat this information? How will such exchanges be regulated? Less-open societies like China and Malaysia, recognizing the power of electronic networks, are already attempting to regulate the infrastructure of and access to the electronic network.

The similar problem applies to electronic commerce. The rapid proliferation of e-commerce led by Internet and e-commerce providers, such as AOL, Yahoo, Amazon.com as well as by traditional marketers that have gone into e-commerce, such as Dell Computer, Victoria's Secret, and Nokia, has spawned a type of international commerce and transactions that countries' regulations have not kept pace with. In terms of e-commerce, how do countries control online purchases and sales? If one looks at Europe, each country has different tax laws and Internet regulations, as well as consumer protection laws. In addition, import and export formalities still apply to goods bought electronically. How to monitor electronic commerce transactions remains a problem for most national governments.<sup>46</sup>

One such example is illustrated by the launch of Viagra by Pfizer in 1998. The company celebrated the most successful drug launch in history with the introduction of Viagra, the first pill that allows effective oral treatment for men who suffer from erectile dysfunction (impotence). Since that time the name Pfizer has become a synonym for Viagra and vice versa, due to a media hype that arose after this launch of the first of so-called "lifestyle drugs" to treat undesired symptoms that suppress quality of life. The Internet attracted the portion of patients from all over the world who are not willing to talk about their problem even to their doctors. The Internet quickly filled up with "virtual" pharmacies that promised to supply Viagra via a mouse click. Internet pharmacies sometimes try to conceal their location, set up in offshore places and sell their items in a gray area of doing business. Customers who are not willing to disclose their erectile dysfunction can easily order Viagra without consultation of their physician, but run the risk to become victims of fraud. Internet pharmacies that are selling genuine Viagra pills have found a way to get around prescription by their customers' physicians in the following way: An online-consultation form can be filled out within a few minutes (at a consultation fee of \$65–\$75). The pharmacy's

## Proliferation of E-Commerce and Regulations

<sup>46</sup>Kim Viborg Andersen, Roman Beck, Rolf T. Wigand, Niels Bjørn-Andersen, and Eric Brousseau, "European e-Commerce Policies in the Pioneering Days, the Gold Rush and the Post-Hype Era," *Information Polity*, 9 (3/4), 2004, pp. 217–32.

physician then will issue the prescription based on the information (“honestly”) given by the candidate.<sup>47</sup> This procedure allows the customer to retain a high degree of anonymity, while the pharmacy fulfills the obligation to distribute Viagra only after a physician’s consultation.

Pfizer and counterfeiting experts have warned the public not to buy from Internet pharmacies.<sup>48</sup> In reputable pharmacies cases of fraud usually do not occur, but there are tens of other fraud websites that will exploit the patient’s unwillingness to talk about impotence. The Federal Trade Commission (FTC) is in charge of cases where entities are trying to mislead potential customers and commit fraud. The FTC sent out some warnings about products that claim to be related to Viagra, and no prescription is necessary. The warnings advise people to check credentials of suppliers. Fraud on the Internet can be found in reports where businesses set up to sell counterfeit pills managed to have about 150,000 customers in about a year. The owner of these “enterprises” advertised pills under names similar to Viagra, like Viagrae. Pfizer sued and the FTC was able to find that this name was only one small part in a larger fraud to distribute large amounts of phony pills.<sup>49</sup>

Regulating international e-commerce obviously requires cross-border cooperation. The rising problems resulted in numerous international treaties. For example, in May 2001, the Council of Europe, working with Canada, Japan, South Africa and the United States, approved the 27th draft of the Convention on cyber crime—the first international treaty on crime in cyberspace. The treaty requires participating countries to create laws regarding various issues including digital copyrights and computer-related fraud. It offers international businesses the best hope for legal recourse if they become the victim of cyber crime in e-commerce. The United Nations Commission on International Trade Law (UNCITRAL), the core legal body within the United Nations system in the field of international trade law, has also formed a Working Group on Electronic Commerce to re-examine these treaties.<sup>50</sup>

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## ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ REGIONAL ECONOMIC ARRANGEMENTS

An evolving trend in international economic activity is the formation of multinational trading blocs. These blocs take the form of a group of countries (usually contiguous) that decide to have common trading policies for the rest of the world in terms of tariffs and market access but have preferential treatment for one another. Organizational form varies among market regions, but the universal reason for the formation of such groups is to ensure the economic growth and benefit of the participating countries. Regional cooperative agreements have proliferated after the end of World War II. There are already more than 120 regional free trade areas worldwide. Among the more well-known ones existing today are the European Union and the North American Free Trade Agreement. Some of the lesser-known ones include the MERCOSUR (Southern Cone Free Trade Area) and the Andean Group in South America, the Gulf Cooperation Council in the Arabian Gulf region (GCC), the South Asian Agreement for Regional Cooperation in South Asia (SAARC) and the Association of South East Asian Nations (ASEAN). The existence and growing influence of these multinational groupings implies that nations need to become part of such groups to remain globally competitive. To an extent, the regional groupings reflect the countervailing force to the increasing integration of the global economy—it is an effort by governments to control the pace of the integration.

<sup>47</sup>See e.g., [www.qualitymed.com](http://www.qualitymed.com), [www.medservices.com](http://www.medservices.com), or [www.MDHealthline.com](http://www.MDHealthline.com).

<sup>48</sup>“Black Market Filled Phony Viagra Tablets,” article at [www.cafecrowd.com](http://www.cafecrowd.com), accessed August 10, 1999.

<sup>49</sup>See “FTC: Watch for Viagra Knock-Offs,” at [www.msnbc.com/news/2090](http://www.msnbc.com/news/2090), accessed August 10, 1999.

<sup>50</sup>Bill Wall, “An Imperfect Cybercrime Treaty,” *CIO*, February 15, 2002; and Jason R. Boyarski, “United Nations Working Group Focuses on E-Commerce,” *Intellectual Property & Technology Law Journal*, 13 (October 2001).

Market groups take many forms, depending on the degree of cooperation and inter-relationships, which lead to different levels of integration among the participating countries. There are five levels of formal cooperation among member countries of these regional groupings, ranging from free trade area to the ultimate level of integration—which is political union.

Before the formation of a regional group of nations for freer trade, some governments agree to participate jointly in projects that create economic infrastructure (such as dams, pipelines, roads) and that decrease the levels of barriers from a level of little or no trade to substantial trade. Each country may make a commitment to financing part of the project, such as India and Nepal did for a hydroelectric dam on the Gandak River. Alternatively, they may share expertise on rural development and poverty alleviation programs, may lower trade barriers in selected goods such as in SAARC, which comprises India, Pakistan, Sri Lanka, Bangladesh, Nepal, Maldives, and Bhutan. This type of loose cooperation is considered a precursor to a more formal trade agreement.

A **Free Trade Area** has a higher level of integration than a loosely formed regional cooperation and is a formal agreement among two or more countries to reduce or eliminate customs duties and non-tariff trade barriers among partner countries. However, member countries are free to maintain individual tariff schedules for countries that do not belong to the free trade group. One fundamental problem with this arrangement is that a free trade area can be circumvented by nonmember countries that can export to the nation having the lowest external tariff in a free trade area, and then transport the goods to the destination country in the free trade area without paying the higher tariff applicable if it had gone directly to the destination country. In order to stem foreign companies from benefiting from this tariff-avoiding method of exporting, *local content laws* are usually introduced. Local content laws require that in order for a product to be considered “domestic,” thus not subject to import duties, a certain percentage or more of the value of the product should be sourced locally within the free trade area. Thus, local content laws are designed to encourage foreign exporters to set up their manufacturing locations in the free trade area.

## Free Trade Area

The North American Free Trade Agreement (NAFTA) is the free trade agreement among Canada, the United States, and Mexico. It provides for elimination of all tariffs on industrial products traded between Canada, Mexico, and the United States within a period of ten years from the date of implementation of the NAFTA agreement—January 1, 1994. NAFTA was preceded by the free trade agreement between Canada and the United States, which went into effect in 1989. The United States has a free trade area agreement with Israel as well. Canada signed a trade deal with the Andean Group in 1999 as a forerunner to a possible free trade agreement.<sup>51</sup> Mexico also established a formal trans-Atlantic free trade area agreement with the European Union without U.S. involvement in 2000,<sup>52</sup> and with Japan in 2005.<sup>53</sup> On the other hand, the United States also reached a free trade agreement with Chile on December 11, 2002,<sup>54</sup> formed the Central American-Dominican Republic Free Trade Agreement (CAFTA-DR) with Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua, effective on January 1, 2006,<sup>55</sup> and most recently concluded another free trade agreement with Colombia on February 27, 2006.<sup>56</sup>

<sup>51</sup>“Canadian Companies Get Andean Boost,” *World Trade*, 12 (September 1999), p. 14.

<sup>52</sup>“Mexico Turns To Europe,” *Europe*, July/August 2001, pp. 18–19.

<sup>53</sup>Joseph P. Whitlock, “US Has Stake in Japan-Mexico FTA,” *Journal of Commerce*, 6 (23), June 6, 2005, pp. 34–34.

<sup>54</sup>“U.S. and Chile Reach Free Trade Accord,” *New York Times*, <http://www.nytimes.com>, December 11, 2002.

<sup>55</sup>“CAFTA-DR to Build Options over Time,” *Marketing News*, February 1, 2006, pp. 13–14.

<sup>56</sup>“United States and Colombia Conclude Free Trade Agreement,” U.S. Department of State, <http://www.state.gov/w/wha/rls/62197.htm>, accessed August 20, 2008.

Another free trade group is the European Free Trade Association (EFTA) comprising Iceland, Liechtenstein, Norway, and Switzerland. Although Austria, Finland, and Sweden used to be EFTA member countries, they have joined the European Union (EU) and Switzerland has been negotiating with EU to become a member.<sup>57</sup> It appears that some, if not all of, the remaining EFTA members may gradually merge into the European Union (which we discuss later). In the meantime, Singapore and EFTA have also agreed to form a free trade area effective on January 1, 2003.<sup>58</sup> MERCOSUR is a free trade area consisting of Brazil, Argentina, Uruguay, and Paraguay with Chile, Bolivia, Peru, and Venezuela as associate members,<sup>59</sup> with the intention to lower internal trade barriers and the ultimate goal of the creation of a customs union.<sup>60</sup>

One probably the most ambitious free trade area plan is also in the works. The Free Trade Area of the Americas (FTAA) was proposed in December, 1994, by thirty-four countries in the region as an effort to unite the economies of the Western Hemisphere into a single free-trade agreement, which was originally planned for completion by January 2005. For various political oppositions and reluctance from some major countries, such as Brazil and Venezuela, the negotiations for the agreement were stalled even at the most recent Summit of the Americas in November 4–5, 2005.<sup>61</sup> If completed, however, the FTAA agreement would encompass an area from the Yukon to Tierra del Fuego with 800 million people and about \$13 trillion in production of goods and services, making it the most significant regional trade initiative presently being pursued by the United States. Regional cooperative agreements in the 1990s such as NAFTA and MERCOSUR have made trading within the continent much easier, but the South America markets are still less open than those of East Asia. Despite the fact that many doubted the U.S. government's power to stand up to domestic industries crying for protection, many are seeing FTAA as more than a remote hypothesis and are already preparing for it. Brazil, member of the MERCOSUR and South America's largest economy, is not so sure about the agreement, but cannot afford the loss if the rest of the Americas rush to sign the deal without it.<sup>62</sup>

Japan had not been keen on regional free trade area agreements, as it preferred a broader multilateral free trade regime as espoused by WTO. However, under pressure from an increasing number of successful regional trade agreements, Japan has also decided to join this fray, aiming to offset the economic challenges posed by the EU and the NAFTA zones, by having formed a free trade agreement with Singapore, recently another with Mexico,<sup>63</sup> and having resumed free trade area talks with the ASEAN<sup>64</sup> (see **Global Perspective 2-5** on Japan's further push for free trade areas in Asia). Immediately after the collapse of the Doha Round of multilateral trade negotiations in late July 2008, India also reached a free trade agreement with the ASEAN. The ASEAN also announced another regional free trade deal with Australia and New Zealand.<sup>65</sup> Such regional free trade agreements are clearly on the rise.

<sup>57</sup>Sieglinde Gstöhl, "Scandinavia and Switzerland: Small, Successful and Stubborn towards the EU," *Journal of European Public Policy*, 9 (August 2002), pp. 529–49.

<sup>58</sup>"Singapore-EFTA Agreement Sets New Standards," *Managing Intellectual Property*, (July/August 2002), pp. 11–12.

<sup>59</sup>At the time of this writing, Venezuela is expected to become a permanent member of MERCOSUR in December 2005. See "Venezuela to Fully Join Mercosur," BBC News, <http://news.bbc.co.uk/>, October 17, 2005.

<sup>60</sup>Maria Cecilia Coutinho de Arruda and Masaaki Kotabe, "MERCOSUR: An Emergent Market in South America," in Masaaki Kotabe, *MERCOSUR and Beyond: The Imminent Emergence of the South American Markets* (Austin, TX: The University of Texas at Austin, 1997).

<sup>61</sup>"Hemisphere Meeting Ends without Trade Consensus," *New York Times*, November 6, 2005.

<sup>62</sup>"A Really Big Free-Trade Zone," *Business Week*, December 23, 2002, p. 40; and Alan M. Field, "Grand Illusion?" *Journal of Commerce*, April 7, 2008, pp. 18–22.

<sup>63</sup>Joseph P. Whitlock, "US Has Stake in Japan-Mexico FTA," *Journal of Commerce*, 6 (23), June 6, 2005, pp. 34–34.

<sup>64</sup>"Japan To Propose E Asia Development Concept In Singapore," *NikkeiNet Interactive*, <http://www.nni.nikkei.co.jp>, August 24, 2008.

<sup>65</sup>"Regional Trade Agreements: A Second-Best Choice," *Economist*, September 6, 2008, p. 16.



## GLOBAL PERSPECTIVE 2-5

### FREE TRADE AREAS IN ASIA

The global trend of forming strategic trade blocs is accelerating, given the success of the EU and the NAFTA. The United States, already has a NAFTA under its belt, is now creating a pan-American trade area. Since the United States and European countries now have entered the final stages of creating huge economic zones, Japan figured that it is time to catch up.

In January 2002, the Japanese government, having criticized and opposed free trade areas (FTAs) for years, had its first-ever free trade agreement with Singapore. Now it is proposing an East Asia Free-trade Area no later than 2012. The grouping, dubbed by Japanese officials as “ASEAN plus five,” would represent a third of the world’s population and would cover the ten-member Association of Southeast Asian Nations (ASEAN), as well as Japan, mainland China, South Korea, Hong Kong and Taiwan. Indeed, Japan’s exports to China outstripped those to the United States for the first time

*Sources:* Yoshikuni Sugiyama, “Economic Forum—Japan Does About-Face on Asia FTAs,” *Yomiuri Shimbun*, September 11, 2001; “Japan to Reopen Trade Pact Talks with ASEAN in April,” *NikkeiNet Interactive*, <http://www.nni.nikkei.co.jp>, March 11, 2006; “Japan-China-Bound Exports Outstrips Shipments to U.S. for 1st time after WWII,” *NikkeiNet Interactive*, August 21, 2008; and “Japan To Propose E Asia Development Concept In Singapore,” *NikkeiNet Interactive*, August 24, 2008.

in the postwar, making the fast-growing Asian economy the country’s largest trading partner, in August 2008. With progress in ASEAN-India economic ties also being under way, the establishment of a Pan-Asian economic zone covering a wide area from East Asia to South Asia may be possible. As a result, the creation of a Pan-Asian economic zone that would include “ASEAN plus five” and India is also being advocated.

Japan proposed a new initiative calling for region-wide cooperation in promoting deregulation, improvement of distribution networks and other measures in East Asia at a meeting of economic ministers from Asian countries held in Singapore in 2008. The initiative for creating a “large industrial artery in East Asia” covers Japan, China and South Korea, the Association of Southeast Asian Nations (ASEAN), India and other economies. The initiative also examines the possibility of streamlining rules on customs procedures and tax systems, which vary widely among East Asian countries, and consider ways to use capital in the private sector more effectively. The proposal is aimed at facilitating economic integration in East Asia, which has a population of 3.1 billion, to build the foundations for the region’s role as a global growth hub. Japan seeks to use the broad development proposal to set the stage for concluding an economic partnership agreement among 16 nations in the region, including India, Australia and New Zealand.

The inherent weakness of the free trade area concept may lead to its gradual disappearance in the future—though it may continue to be an attractive stepping-stone to a higher level of integration. When members of a free trade area add common external tariffs to the provisions of the free trade agreement then the free trade area becomes a **customs union**.

Therefore, members of a customs union not only have reduced or eliminated tariffs among themselves, but also they have a common external tariff of countries that are not members of the customs union. This prevents nonmember countries from exporting to member countries that have low external tariffs with the goal of sending the exports to a country that has a higher external tariff through the first country that has a low external tariff. The ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam) is a good example of a currently functional customs union with the goal of a common market. The Treaty of Rome of 1958, which formed the European Economic Community, created a customs union between West Germany, France, Italy, Belgium, Netherlands, and Luxembourg.

As cooperation increases among the countries of a customs union, they can form a **common market**. A common market eliminates all tariffs and other barriers to trade among members of the common market, adopts a common set of external tariffs on nonmembers, and removes all restrictions on the flow of capital and labor among member nations. The 1958 Treaty of Rome that created the European Economic Community had the ultimate goal of the creation of a common market—a goal that was substantially achieved by the early 1990s in Western Europe.

### Customs Union

### Common Market

The **Maastricht Treaty**, which succeeded the Treaty of Rome, entered into force on November 1, 1993, calling for the creation of a union (and hence the change in name to European Union). At a historic summit on December 13, 2002, EU agreed to add ten new member countries, creating the 25-member **European Union** effective on May 1, 2004, with a total economy larger than that of the United States.<sup>66</sup> In 2007, two countries, Bulgaria and Romania, became new additional members of EU, expanding the total number of EU member to 27.<sup>67</sup> Those new members are mostly Eastern and Central European countries once part of the Soviet empire. Now German banks can freely open branches in Poland, and Portuguese workers can live and work in Luxembourg.

### Monetary Union

The Maastricht Treaty also laid down rules for, and accomplished, the creation of a **monetary union** with the introduction of the euro—a new European currency in January 1999, which began its circulation since January 2002. As per the Maastricht Treaty, the EU's sixteen member countries<sup>68</sup> have adopted the euro so far. The United Kingdom, Denmark and Sweden have not accepted the third stage and the three EU members still use their own currency today. A monetary union represents the fourth level of integration with a single common currency among politically independent countries. In strict technical terms, a monetary union does not require the existence of a common market or a customs union, a free trade area or a regional cooperation for development. However, it is the logical next step to a common market, because it requires the next higher level of cooperation among member nations.

### Political Union

The culmination of the process of integration is the creation of a **political union**, which can be another name for a nation when such a union truly achieves the levels of integration described here on a voluntary basis. The ultimate stated goal of the Maastricht Treaty is a political union with the adoption of a constitution for an enlarged European Union. However, the member countries have varying levels of concern about ceding any part of their sovereignty to any envisaged political union. In May 2005, France shocked the whole Europe by voting against the EU constitution with a decisive margin. Meanwhile, in June, Dutch voted more strongly against the constitution. According to the analyst, the rejection from Dutch and French are a terrible blow to the morale of true believers in political union in EU. In order for the constitution to come into force, all twenty-five members of EU must ratify it. Since France has always been politically central to the EU, as one of the six founders and one of the twelve members that have joined the European currency, it is extremely difficult for the EU to handle the current crisis. Previously some political leaders urged voters to approve the constitution to make Europe more efficient, dynamic, and democratic. However, French consider the constitution as a means for the EU members to impose “Anglo-Saxon” free market policies on them. They voted against the constitution to protect their jobs, employment rights, and social benefits from low-cost, low-tax, deregulated countries.<sup>69</sup>

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## MULTINATIONAL CORPORATIONS

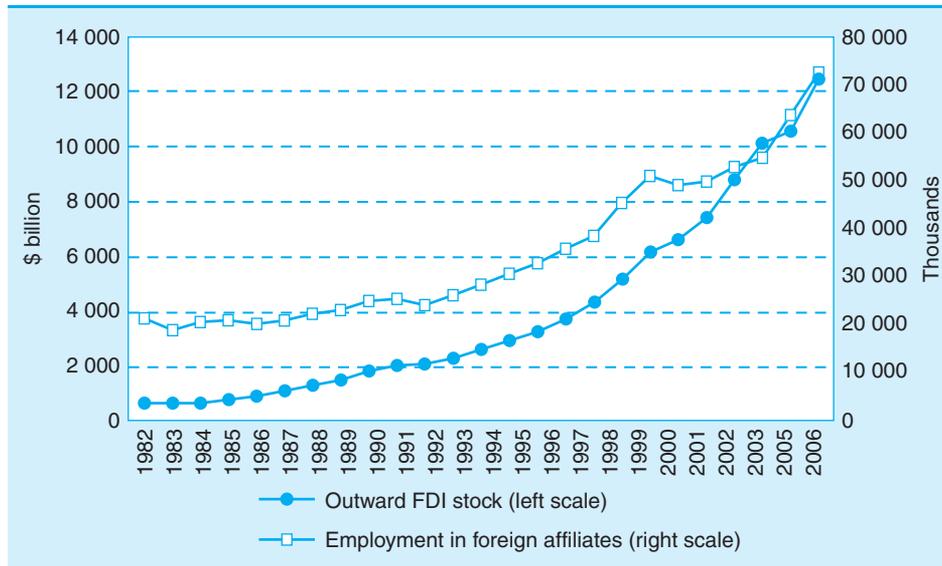
Although no steadfast definition of **multinational corporations** (MNCs) exists, the U.S. government defines the multinational company for statistical purposes as a company that owns or controls 10 percent or more of the voting securities, or the equivalent, of at

<sup>66</sup>As of the beginning of 2006, the European Union consists of 25 countries including: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, the Netherlands, United Kingdom.

<sup>67</sup>[http://europa.eu/index\\_en.htm](http://europa.eu/index_en.htm), Accessed on March 1, 2009.

<sup>68</sup>The euro member countries, as of March 1, 2009, are Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

<sup>69</sup>“Dead, But Not Yet Buried,” *Economist*, June 4, 2005, pp. 47–48.

**EXHIBIT 2-8****OUTWARD FOREIGN DIRECT INVESTMENT (FDI) STOCK AND EMPLOYMENT IN FOREIGN AFFILIATES, 1982–2006**

Source: *World Investment Report 2007*, <http://www.unctad.org/>, accessed August 20, 2008.

least one foreign business enterprise. Many large multinationals have many subsidiaries and affiliates in many parts of the world. In the early 1970s, Howard Perlmutter, a professor at the Wharton School in Philadelphia, predicted that by 1985 around 80 percent of the noncommunist world's productive assets would be controlled by just 200–300 companies. As shown in **Exhibit 2-8**, now some 78,000 multinational companies have 78,000 affiliates in foreign countries. In 2006, foreign affiliates employed about 73 million people around the world, compared to 24 million in 1990. The stock of outward foreign direct investment (FDI) increased from \$627 billion in 1982, to \$1.8 trillion in 1990, and to \$12.5 trillion in 2006. Foreign affiliates' sales account for 52.1 percent of world GDP as of 2006. By far the highest share of FDI in the primary industries has been in mining (grouped along with quarrying) and petroleum. While FDI stock and flow estimates are not available for mining and petroleum separately, data on cross-border mergers and acquisitions (M&As) suggest that both these industries have attracted increasing volumes of investment in recent years. During 2005 and 2006, the value of cross-border M&As in petroleum (representing an annual average of \$63 billion) was nearly twice that in mining. Although FDI stock in manufacturing has experienced a consecutive decline over fifteen years since 1990, world inflow FDI stock in services climbed from 49 percent of the region's total inward stock in 1990 to 62 percent in 2005, with an estimated value of \$6 trillion. During the same period, world inflow FDI stock in manufacturing fell from 41 percent to 30 percent. Outward FDI in services continues to be dominated by developed countries, although FDI is more evenly distributed among them than before. By 2002, Japan and the European Union had emerged as significant sources of outward FDI in service sectors. Developing countries' outward FDI in services has also grown gradually since the 1990s.<sup>70</sup>

The forces of economies of scale, lowering trade and investment barriers, need to be close to markets, internalization of operations within the boundaries of one firm, and

<sup>70</sup>World Investment Report 2008, <http://www.unctad.org/>, accessed March 1, 2009.

the diffusion of technology will continue to increase multinationals' influence in international trade and investment. The sovereignty of nations will perhaps continue to weaken due to multinationals and the increasing integration of economies. Some developing countries harbor negative feelings about the sense of domination by large multinationals, but the threat to sovereignty may not assume the proportions alluded to by some researchers.<sup>71</sup> Although established multinationals' sheer size may appear hegemonic and have some monopolistic power in smaller economies, they have yet to solve the problem associated with their large size. Current trends indicate that beyond a certain size firms tend to become complacent and slow and they falter against competition. They are no longer able to remain focused on their businesses and lack the drive, motivation, and a can-do attitude that permeates smaller firms. Those firms that do focus on their core businesses shed unrelated businesses, as the latter tend to be less profitable or even incur losses.<sup>72</sup> For example, Novartis, the Swiss pharmaceutical group, recently sold off its Swedish Wasa biscuits and crackers subsidiary to the Italian food company, Barilla, in order to concentrate on its health science products.<sup>73</sup> Thus, the nation-state, while considerably weaker than its nineteenth century counterpart, is likely to remain alive and well.

Currency movements, capital surpluses, faster growth rates, and falling trade and investment barriers have all helped multinationals from many countries join the cross-border fray. In today's world it is not unusual for a startup firm to become global at its inception. Those firms are known as "born global."<sup>74</sup> It is now easier than ever for small firms to be in international business through exports and imports and through electronic commerce (e-commerce). A major survey of companies with fewer than 500 employees by Arthur Andersen & Co. and National Small Business United, a trade group, found that exporters averaged \$3.1 million in revenue, compared with \$2.1 million for all companies in the survey in 1996, and also reported that exporters' profits increased 4.4 percent while the overall average was 2.6 percent. Exporters are also more technology-savvy: 92 percent have computers (versus 79 percent overall) and 70 percent use the Internet (versus 44 percent overall).<sup>75</sup>

<sup>71</sup>Raymond Vernon, *Sovereignty At Bay*, New York: Basic Books, 1971.

<sup>72</sup>John A. Doukas and L. H. P. Lang, "Foreign Direct Investment, Diversification and Firm Performance," *Journal of International Business Studies*, 34 (March 2003), pp. 153–72.

<sup>73</sup>Paul Betts, "Barilla Pays SFr475m for Wasa Biscuits," *Financial Times*, (April 27, 1999), p. 33.

<sup>74</sup>Alex Rialp, Josep Rialp, Gary A. Knight, "The Phenomenon of Early Internationalizing Firms: What do We Know after a Decade (1993-2003) of Scientific Inquiry?" *International Business Review*, 14 (April 2005), pp. 147–66.

<sup>75</sup>"Export Energy," *Business Week*, November 17, 1997.

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## SUMMARY

The severe global recession since late 2008 has slowed down the world economy. Nevertheless, the world economy is increasingly intertwined, and virtually no country is immune from the economic events in the rest of the world. It is almost as if participation in the international economy is a *sine qua non* of economic growth and prosperity—a country has to participate in the world economy in order to grow and prosper—but participation is not without its risks. Events outside one country can have detrimental effect on the economic health of that country. The Asian financial crisis that started in 1997 with a precipitous depreciation of Thailand's *baht*, Indonesia's *rupiah*, Malaysia's *ringgit*, and Korea's *won*, among others, is an example of a situation where withdrawal of funds by portfolio investors caused a severe economic crisis. In effect, participating in the international economy imposes

its own discipline on a nation, independent of the policies of the government of that nation. This is not to suggest that countries should stay outside the international economic system because of the risks. Those countries that have elected to stay outside the international economic system—autarkies like Burma and North Korea—continue to fall farther behind the rest of the world in terms of living standards and prosperity.

Various forces are responsible for the increased integration. Major emerging economies have begun to reshape the nature of international trade and investment. Growth in international trade continuously outpaces the rise in national outputs. Transportation and communications are becoming faster, cheaper, and more widely accessible. The nature of value-adding activities is changing in the advanced countries

from manufacturing to services and information manipulation. Such changes are a result of and are a force behind the rapid advancement in telecommunications and computers. Even developing nations, regardless of their political colors, have realized the importance of telecommunications and electronic commerce and are attempting to improve their infrastructure. The capital markets of the world are already integrated for all practical purposes, and this integration affects exchange rates, interest rates, investments, employment, and growth across

the world. Multinational corporations have truly become the global operations in name and spirit that they were envisaged to be. Even smaller companies are leapfrogging the gradual expansion pattern of traditional multinational companies by adopting e-commerce that has no national boundaries. In short, to repeat an old maxim, the world is becoming a global village. When Karl Marx said in 1848 that the world was becoming a smaller place, he could not have imagined how small it truly has become.

## KEY TERMS

Common market	General Agreements on Tariffs and Trade (GATT)	Normal Trade Relations (NTR) status [formerly, Most Favored Nation (MFN) status]	Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement
Country competitiveness	Gross domestic product (GDP)	Political union	World Trade Organization (WTO)
Customs union	Maastricht Treaty	Portfolio (indirect) investment	
Big Emerging Markets (BEMs)	Monetary union		
Foreign direct investment	Multinational corporation (MNC)		
Free trade area			

## REVIEW QUESTIONS

1. What are some of the visible signs that reflect the current increased economic interdependence among countries? What are some reasons for this growth in interdependence and for the rise in global integration?
2. What is GATT, and what is its role in international transactions?
3. How is the WTO different from GATT? What functions is WTO expected to perform?
4. In what ways have the U.S. foreign direct investment and trade patterns changed over the past decade?
5. Cooperative inter-relationships between countries (regional groupings) can be classified into five broad categories. What are these categories, and how do they differ from each other?
6. Do current measures of balance of payments accurately reflect a country's transactions with the rest of the world? What are the concerns?
7. What challenges do the content creators and information providers face due to the advent and popularity of the electronic media? Are there current mechanisms to protect their rights? What are the macroeconomic implications for industrialized countries?
8. What are some of the forces influencing the increase in size of multinational corporations? Are there any forces that are influencing them to downsize?

## DISCUSSION QUESTIONS

1. Recently in response to a dispute with both the U.S. and the EU's possible action toward imposing tariffs on cheap textile products from China, China took countermeasure actions to exclude those products from the existing export tariffs to ward off damages to its economy. To resolve the issue, in June 2005, EU signed an agreement with China imposing new quotas on ten categories of textile goods, limiting growth in those categories to between 8 percent and 12.5 percent a year. The agreement was in hope of providing EU's domestic manufacturers time to adjust to a world of unfettered competition. But for most retailers in Europe, which had already placed orders for mountains of new goods from China, it turned out to be a disaster since tens of millions of garments piled up in warehouses and customs checkpoints, when Chinese textile manufacturers exceeded their quotas right after the restriction. As a matter of fact, less than a month after the agreement, men's trousers hit their import quota, followed rapidly by blouses, then bras, T-shirts and flax yarn. It is estimated that France lost about a third of its jobs in the sector between 1993 and 2003. Italy has also seen its firms suffer since the euro transition. Nevertheless, it is not clear as to how the quota restriction on Chinese goods would help domestic producers, especially when there are so many low-cost firms in low-wage countries like Bangladesh and Costa Rica waiting to take up any Chinese slack. According to an EU official, the action against China was designed to help workers in those very countries in that "The EU also considered the effect the Chinese market share was having on other developing countries that have historically been dependent on our market. Who will protect jobs in Tunisia and Morocco?" While large

retailers will probably be able to find new sources for their autumn and winter lines under the quota restriction, it seems that smaller stores may be driven into bankruptcy as the clothes they have bought would be buried in warehouses around Europe. Do you think the EU textile war with China will eventually save their domestic businesses? Should U.S. follow the EU to impose textile quota on Chinese imports to protect domestic businesses? Why or why not?

2. A justification of developing countries against product patents for pharmaceutical products has been that if they were enforced, life-saving drugs would be out of reach for all but the very rich. A similar argument is being used in a populist move in the U.S senate for reducing the patent lives of innovative drugs, in a bid to reduce health care costs. Some senators and the pharmaceutical industry leaders claim that this move would discourage medical innovation and slow down the development of drugs for the cure of such diseases as AIDS and cancer, and thereby increase the costs of taking care of current and future patients. How would you react to the arguments and counterarguments for reducing patent lives, and what would be your stance on this issue? In your opinion, what would be the international repercussions if this bill were to pass? How do you think other developed and developing countries would react?

3. Today, some 150 million EU citizens shop online from websites such as Amazon.com and eBay, spending on average \$1248 (800 euros) per capita. However, only one-fifth of them buy goods and services from another EU state. The EU's consumer chief is currently planning new rules to make it easier and safer for the bloc's 490 million consumers to shop online in any corner of the 27-nation EU. As the latest step from Brussels to make itself more friendly and relevant to people's everyday lives, particularly after the rejection of the EU's Lisbon Treaty in Ireland, this move is expected to tear down barriers to cross-border web shopping barriers to boost competition, offer businesses a bigger market and cut prices for consumers. What advantages and difficulties do you think EU has in setting such rules? What can EU members benefit individually or as a whole from such a move? Are there any implications from the move, if successfully set, for the rest of the world? Why or why not?

4. Information technology is having significant effects on the globalization activities of corporations. Texas Instruments is now developing sophisticated chips in India. Motorola has set up programming and equipment design centers in China, India, Singapore, Hong Kong, Taiwan, and Australia. Similarly, a large number of U.S. and European corporations are looking at ways to transfer activities such as preparing tax returns, account statements, insurance claims, and other information processing work to Asia. Although until now it was only blue-collar employees in the industrialized countries who faced the threat of competition from low-wage countries (which could be countered to some extent through direct and indirect trade barriers), this new trend in movement of white-collar tasks may be a cause for concern to industrialized countries, as the sophistication of these tasks increases. This movement of white-collar jobs could be a cause for social concern in the near future. Do you foresee social pressures in developed countries having the potential of reversing the trend of movement of white-collar tasks to developing countries? Given the intangibility of information, are there any effective ways of controlling the movement of information across borders?

5. The effects of the formation of regional trade blocs on international trade could be interpreted in two ways. One way is to view regional blocs as one step forward in the process of ensuring completely free trade between countries on a global basis. On the other hand, the formation of regional blocs could be seen as a step backward toward an era of greater protectionism and greater trade tensions between the regions. Which view would you agree with, and why?

6. Electronic commerce (e-commerce) blurs the distinction between a good and a service. Under WTO, goods tend to be subject to tariffs; services are not, but trade in services is limited by restrictions on "national treatment" or quantitative controls on access to foreign markets. For example, a compact disc sent from one country to another is clearly a good, and will be subject to an import tariff as it crosses the national border. But if the music on the disc is sent electronically from a computer in one country to another on the Internet, will it be a good or a service? Customized data and software, which can be put on CD, are usually treated as services. What kind of confusion would you expect with WTO overseeing increased transaction on the Internet?

## SHORT CASES



### ASE 2-1



#### RUSSIA: A HUGE EMERGING CAR MARKET ISOLATED FROM OIL CRISIS

High oil prices are causing pain for carmakers in America as people there are sacrificing their fancy for pick-up trucks and sport-utility vehicles for more frugal small vehicles. In May 2008, General Motors announced a 30 percent fall in car sales, compared with a year earlier; Ford posted a 19 percent drop, and sales of its F-150 pick-up fell behind Toyota's Camry and Corolla for the first time. But far in Russia, the high oil price is powering the expansion of the market rather than painful restructuring. Thanks to abundant natural resources, Russia has been witnessing a rising economy since decade ago. With nearly doubled and steadily rising real disposable income, cars are no longer unaffordable for many Russians.

Currently, car ownership in Russia is still low at about 200 per 1,000 people, compared with the over 500 in most of Western Europe and the around 800 in American (even in other former communist countries in Central Europe, the number is between 300 and 350). But the car market there is expanding: in 2007 Russia's sales of new cars grew 36 percent by volume and 57 percent by value; sales of passenger vehicles exceeded 2.7 million. According to analysts, Russia could outstrip Germany as Europe's biggest market by 2008, with sales reaching around 3.3 million; by 2012 Russians will be buying more than 5 million new cars a year, of which nearly 90 percent will be foreign brands.

However, all of the growth has been met by foreigners. Sales of Russian brands have stayed flat for the past few years—hovering between 750,000 and 800,000. Early in 2002, a few years before foreign carmakers' rushing into Russia, the Russian government slapped a 25 percent duty on imported used cars when domestic carmakers were struggling with challenges from imported second-hand cars. Unfortunately, later new imports took their place as the sale of used imports fell. The new rivals took 48 percent of the market by value in 2005. This time, instead of raising import duties again, Russian government passed a measure intended to encourage foreign makers to set up local assembly plants so as to revive the Russian car industries. According to the terms, to qualify for relief from import duty, foreign carmakers have to build a factory with a capacity of more than 25,000 vehicles a year—a minimum investment of at least \$100m. Within five years of production starting, the local content in each car had to reach 30 percent.

This triggered a scramble by the world's biggest car firms to build factories in Russia. On the crowded list are American firms Ford and GM's Chevrolet, Japan's Toyota, Suzuki, Nissan, Isuzu, and Mitsubishi, South Korea's Kia, Hyundai and Daewoo, and European makers Renault, Volkswagen, Fiat and BMW. Chinese carmakers like Chery, Great Wall, and SsangYong are also trying to head into Russia.

Doubtlessly, the foreign carmakers' rush into Russia is promoting this country's car industry as the government

expected. Currently, assembly of foreign models alone has attracted significant investment over \$2 billion in the first stage. And investment plans already announced suggest that new capacity could reach 1.6m units by 2012. However, foreign carmakers' expansion on the Russian market is at the expense of Russian ones.

In 1990 Russian carmakers built 1.2 million passenger vehicles, but in 2007 they sold just 756,000. AvtoVAZ, which makes more than 90 percent of the Russian-brand passenger cars, is still selling its Ladas in provincial Russia because of its low price, the large number of dealers, and few alternatives there. Currently, the main threat to Lada comes from very cheap Chinese cars and the possible change in the used-car business policy. Although so far the likes of Chery and Great Wall from China haven't received permissions from the Russian authorities to set up in Russia, such situation may not last long. And if as expected the 18 percent VAT on used cars sold by dealers is abolished, Lada's price advantage will vanish. Now AvtoVAZ's main hope lies in the 25 percent stake recently acquired by Renault for \$1 billion. Based on Renault platforms, the largest Russian carmaker is expecting to bring new Ladas to market by 2010.

Another local producer, Severstal-Auto, has decided to focus on small vans and trucks rather than taking on foreign car brands due to the potentially large demand from the fast-growing retail sectors. Severstal already has a joint venture with Fiat to produce its Albea and Linea saloons. In May 2008, the first Fiat Ducato van was successfully driven off the firm's new production line in Elabuga, a "free economic zone" in Tatarstan. Severstal also makes small and medium-sized Isuzu trucks. Another possible section of this company probably will be high-margin services—actually Severstal is as well thinking about building a dealer network so as to sell services such as adapting vehicles for school and hospitals, providing full-service leasing arrangements and offering credit terms with local banks.

#### DISCUSSION QUESTIONS

1. Do you think it is a good idea for the Russian government to take the measure of encouraging foreign carmakers to build factories in Russia instead of setting trade barriers as it did in 2002 to help relieve its carmakers from the challenges from the imported used cars? Why or why not?
2. What obstacles might foreign carmakers encounter when they expand to Russia's market?
3. Russia's domestic carmakers are facing fierce competitions from foreign counterparts as many local firms in other countries might do upon the arrivals of foreign firms. Do you think the strategies of Russia's domestic carmakers will work? Why

or why not? Are there any other strategic options? What implications can you draw from the case regarding competitions between domestic firms and foreign firms as a common worldwide issue?

Sources: “Crisis? What Oil Crisis?” *Economist*, June 7, 2008, pp. 73–74; “VW Opens Huge Factory Near Moscow,” *BusinessWeek.com*, November 29, 2007; and “Russian Car Boom Catches Eye of Japan, Germany,” *JapanTimesOnline*, May 28, 2007.



## BOEING VERSUS AIRBUS? OR THE U.S. VERSUS THE EU? LET THE WTO DECIDE!

So, who gets to decide which party wins when two of the world’s largest aircraft manufacturers engage in a trade war? Well, apparently, the World Trade Organization (WTO), which received its biggest international trade petition in 2005 since its establishment in 1995: The case to settle the dispute between U.S.-based Boeing and European Airbus. Airbus is jointly owned by European aerospace companies EADS and BAE Systems.

The dispute is not new. It dates back to the 1980s when the two behemoths went head on against each other in the market for civil aircraft. In 1992, the two rivals attempted to reach a settlement. Airbus had been largely reliant on ‘launch aid’ from European governments such as those of France, Germany and the United Kingdom (UK) while Boeing also received subsidies from American government agencies, mainly the Department of Defense and NASA (National Aeronautics and Space Administration). Airbus’ launch aid consisted of loans for product development that were written off if the products failed in the market. However, if the product were a success, the governments would continue to get royalties even after the loans were paid off. Under the bilateral settlement in 1992, the companies and the countries involved agreed that Boeing’s aid from external parties would not exceed 4 percent of its revenues and Airbus’s loans would be maintained at 33 percent of its development costs for an aircraft.

But the newfound peace in 1992 did not last too long. Both parties remained suspicious that the other was breaking the terms of the bilateral contract. What exacerbated the situation was when Airbus launched five new products since the 1992 agreement, its final blow to Boeing being its most recent A380 model. Boeing meanwhile managed to introduce only one new product in the same time period. Furthermore, Airbus became a profitable company and was on par with Boeing’s market position and therefore, according to Boeing, Airbus no longer needed help from the European governments. In May 2004, U.S. Trade Representative Robert E. Zoellick met with European Commissioner for Trade, Pascal Lamy to suggest that both parties agree to rule out the use of new subsidies for aircraft. But, the Europeans refused to make any promises. In fact, Airbus continued to seek launch aid from the government. And so the discussions went on.

In October 2004, the U.S. filed a complaint with the WTO against Airbus and the EU retaliated by immediately filing a

countersuit with the WTO against Boeing. Their reasons remained the same—EU government aid versus American subsidies. But, in order to avoid an expensive legal encounter, once again, the two parties decided to engage in bilateral negotiations with the expectation that they would reach a settlement by April 11, 2005. But it was not meant to be. Boeing and its supporters maintained their stance against Airbus, which instead insisted that Boeing’s Japanese suppliers had obtained soft loans from their government and therefore Boeing benefited from these indirect subsidies as well. Finally, in June 2005, both parties re-approached the WTO.

The WTO’s trade agreement on Subsidies and Countervailing Measures disallows government subsidies or subsidies from public bodies to a particular company or industry. The U. S. side of the appeal to the WTO includes its claim that Airbus breached these WTO’s rules when it accepted around \$15 billion in loans from the EU governments. On the other hand, the EU claims that Boeing broke the WTO rules when it received around \$23 billion in subsidies. It will be interesting to see who wins the case, Boeing or Airbus and since their respective governments are solidly intertwined with the companies, the U.S. or the European Union.

The last time the WTO adjudicated a similar case was back in the 1990s, the case being Brazil’s Embraer versus Canada’s Bombardier, both medium-sized jets manufacturers. However, in that case, even though the WTO granted a ‘guilty’ verdict to both parties, there was no special action taken by either party. Their governments continued to grant subsidies to the companies. According to experts, it is likely that the WTO would find both parties guilty in the Boeing-Airbus case as well, which may once again lead the firms to pursue another bilateral agreement.

While the outcome of the WTO’s decision might chart out the course of future competition between Boeing and Airbus, the importance of the case sheds light on the role of the WTO in world trade negotiations and policy. Even though a lot of countries still have bilateral trade agreements, more countries are turning to the WTO to arbitrate their disputes. With a growing membership that rests at 148 at present, the WTO’s authority on trade matters is being recognized and its world trade rules supersede bilateral and other similar trade pacts. In the meantime, Boeing and Airbus wait for a verdict.

**DISCUSSION QUESTIONS**

1. On one hand, the WTO's role in international trade is becoming more significant. On the other hand, its verdict on the Brazil's Embraer versus Canada's Bombardier case did not seem to solve the problem. Discuss.
2. Why does the Boeing-Airbus case, a dispute between two firms, extend to their governments?
3. What issues should the WTO take into consideration before making a decision? How should the WTO make a decision?

Sources: "In the Race," *Aviation Week & Space Technology*, October 10, 2005, pp. 22–23, and various other sources.

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