

International Business, Trade & Protectionism

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1. Introduction: Free Trade

As opposed to domestic trade, international trade advocates multi-lateral trade amongst nations of the world. Multilateral is when nations are completely free to trade with one another, instead of having an *"I will scratch your back and you scratch mine"* approach, which is called Bilateral trade.

The world is increasingly becoming a single global village that is inter-dependent, thus free trade is increasingly advocated. That is why international agreements like GATT (General Agreement on Tariffs and Trade) were signed. The primary aims of GATT are:

- a) to reduce existing barriers to free trade;
- b) to eliminate discrimination in international trade; and
- c) to prevent the growth of protection by getting member states to consult with one another prior to implementing protectionist measures.

GATT is now renamed the WORLD TRADE ORGANISATION (WTO) which has similar aims and objectives.

The Law of Comparative Advantage is that world output will increase if a nation concentrates on producing goods that it has comparative advantage in producing (in terms of specialism, output and cost) and leave other nations to produce goods that *they* have a comparative advantage in producing. The end result is that people will be better off when these goods are freely traded amongst all the nations of the earth. However, in reality, no nation has the political will to produce only goods that they have comparative advantage in, but rather tries to produce everything.

Furthermore, as developed nations prosper economically (“at the expense” of) the vast majority of developing nations are experiencing grinding poverty; in some cases hunger and famine, thus are not achieving the full benefits of international trade. This, some argue, is due to the fact that developed countries have huge advantages as they impose unfair terms of trade on developing countries. Terms of trade are the quantities of domestic goods that a country must give up to obtain a unit of imported goods. Thus, there are now many global movements that are campaigning against this trend (notably the anti-capitalist movement) that culminated into the riots in Seattle, USA during the WTO conference there in 1999.

Some argue, however, that the developing countries are failing because they are not embracing fully the principles of free trade - rather they resort to too much protectionism so do not fully benefit from the positive consequences of free trade.

Another argument is political instability and the absence of democracy in so many developing countries. The environment that is conducive to the full implementation of free trade requires political stability, democracy and accountability.

Nevertheless, some now argue that western countries should cancel the debt owed by developing countries if these countries are to be able to trade with the West and truly benefit from international trade.

2. Arguments for International Business and Trade

Below are some of the arguments for international business and trade:-

a) No nation is self-sufficient

International trade in itself stems from the fact that no nation on earth is self-sufficient. Every country is, to some extent, dependent on other countries for their existence, livelihood and quality of life. A country will therefore trade with other countries by exporting to them what it produces or provides and may import from them what it needs. Thus, every country benefits from trading internationally.

b) Specialisation

International trade based on the law of comparative advantage leads to specialisation. Specialisation in turn leads to economies of scale and reduced cost of production.

c) Large Market Overseas

While there may not yet be huge demand from abroad, companies may still want to transact business internationally because of a large market overseas. This may be based on the belief that sufficient demand could be stimulated in the market because of its size. China is a good example of that. With a population of about 1.5 billion people (which is one quarter of the world’s population), there is a huge potential demand.

d) Demand from Overseas

Demand for goods and services from overseas would attract companies to trade internationally.

e) Increase Sales and Market Share

Increasing sales and market share is another reason for international business. Increase in market share is not exactly the same as increase in profit, for it is possible for cost to

increase in proportion to the increase in sales. Thus, profit may not increase in the short run. However, a steady increase in sales is expected to result in an increase in profit in the long run.

f) Increase in Profit

One very obvious reason for companies transacting international business is to increase profits. Profit maximisation is at the core of private sector business objectives.

g) Creation of Employment

The growth of international business creates employment as new businesses are set up and international business divisions are expanded or formed in existing businesses.

h) Cheaper to produce Overseas

In recent times we have witnessed business producing their goods in a foreign country that are intended for the home market. The car industry is a good example of this practice. This practice is mostly due to the fact that it is cheaper to produce goods in a foreign country - especially developing countries - rather than at home. Cheap labour is the greatest motivation as labour may represent about 60% of the overall cost of production of some companies.

i) Improves the Standard of Living

The creation of jobs coupled with the overall improvement in the economy leads to improvement in the standard of living of the people. The objective of improving living standards at home is particularly true, especially when there is government involvement.

j) Saturation of the Home Market

Another reason for trading internationally is that the home market may be saturated. Extensive competition could create such saturation as profit margins plummet.

k) To earn Foreign Exchange

International business and trade transactions can earn substantial foreign exchange for a country.

l) Improves the Balance of Payment

By trading with other countries, a country could improve its balance of payments if it exports more to other countries than it imports from them. If the exports are more than imports it would have a balance of payment surplus, while the reverse would result in balance of payment deficit.

m) Too Tight Legislative Control at Home Market

An extensively regulated market may be too much to bear, which in turn could drive companies to countries that are deregulated or that have less legislative control. The financial services industry is a good example where the United Kingdom and many western countries are known to have a deregulated financial system.

n) It improves Communication Between Countries

International business involves great deal of negotiation, letter writing, telephoning, visits, etc., which in turn improves communication between countries. Such improvement in

communication would create better appreciation of one another's cultures, beliefs and practices.

o) Improves Relationships Between Countries

The improvement in communication as discussed above would lead to improved and better relationships between countries. Furthermore, fewer international conflicts would exist as countries seek to resolve their differences in other peaceful means.

p) Historical Ties

International trade may in some cases be influenced by historical relationships between the trading nations. Countries in the British Commonwealth are good examples of such relationships as they were all British Colonies at some time.

q) Religious Relationships

Similar to historical ties is international trade ties influenced by religious relationships. Some Islamic nations have such relationships.

r) As an Aid

Some international trading relationships would represent more as a foreign aid to the developing countries than a profitable trade agreement. The United Kingdom's trade with some developing countries may involve providing technical advice, training of personnel and in some cases help such countries develop their legal and financial systems and improve human rights.

3. Problems Associated With International Business and Trade

Despite the very many positive reasons discussed above, international trade is not without problems. Some of these are as follows:-

a) Destruction of local industry

One of the biggest argument against free trade is it is that it could destroy local industries, especially in developing countries.

As they are still in their infancy, such local industries cannot possibly compete with foreign businesses if they are allowed freely into the country. Thus, governments would resort to protectionism measures, some of which are to impose limits on how much of particular goods that will be allowed entry into the country. They may do this by the use of import licenses, quotas, import taxes or, in extreme cases impose a complete ban.

However, the problem with a complete ban is that the foreign countries would almost certainly retaliate, thus precipitating a trade war.

b) Dumping

Another argument against free trade is that it could lead to companies (especially multinationals) dumping goods in developing countries.

Dumping occurs where, in order to enter the developing country, multinationals sell their goods at extremely low - sometimes unprofitable - prices to local people.

In some cases, they may be goods that are no longer acceptable or are banned in the home countries of the multinationals. A good example is selling asbestos to developing countries when it is no longer possible to do this in developed countries because of its inherent health hazards.

c) Cost of Transportation

While domestic trade also involves transport costs, the cost of transportation in international trade can be a lot higher because of the greater distances involved.

d) Greater Trading Risks

The trading risks associated with international trade are much greater. The risk of loss and damage to goods are examples of such trading risks.

e) Legislation

Trading with some countries can be very cumbersome as a result of legislation in that country. This could be expensive, time consuming and frustrating.

f) Language and Cultural Problems

In the majority of cases, there will normally be no language and cultural problems when transacting business at the home market. However, these can be very obvious problems in international trade and business.

While interpreters could be used, language barriers may cause transaction delay and disruptions. It may also create misunderstanding and disagreement as to the terms of the contract.

Cultural considerations are also important in international business. In some cultures, certain colours are regarded as a sign of bad luck or taboo. Proper market research should however avoid these pitfalls.

g) Currency and Exchange Rate Problems

Trading with other countries means that foreign currency may have to be bought on a regular basis for the transactions and payment. Not only would this be inconvenient but it may also involve a considerable amount of cost in terms of charges and commissions.

Furthermore, a major problem that may be encountered in international business is exchange rate fluctuations, which can create uncertainty and loss or possible business failure. To have a better appreciation of the problem take for instance a UK company ABC Ltd which exported goods worth £1 million to US based company PJF Ltd with an agreement to pay in US dollars. If the exchange rate is £1 to \$2, then ABC Ltd is expected to be paid \$2 million. Suppose however, there is such a wild fluctuation in the US Dollar that the exchange rate is at present £1 to \$4. If PJF Ltd pays back the \$2 million it owes, ABC Ltd would lose out as it would receive only £500,000 based on the present exchange rate instead of the £1 million it should have received.

h) Problems with Taxes and Duties

Exports to some countries can attract severe taxes and duties as a result of protectionist measures. This may make it less attractive for a company to trade internationally.

i) Problems with Non-Payment

It certainly would be a lot more difficult to deal with a debt from a company which has failed to pay for supplies. Unlike the home market, tracing the debt may not be at all easy.

j) Problems with Litigation and Debt Recovery

A derivative of non-payment is the problems with litigation. Where to sue the debtor and which country's law is applicable could all pose a great deal of problems unless the contract expressly includes all of these details.

k) State of the Financial System

The state of the banking and financial system in the overseas country will play an important role in the success of international business. A rigid and underdeveloped financial system could delay or impede business transactions. There is also the additional problem of difficulties in remitting funds in and out of the country.

l) Infrastructure in the Overseas Country

International business could be impeded, delayed or frustrated if there is no proper infrastructure in the overseas market. Examples of such problems are sub-standard transportation and modern communications systems like telephones, mail and Internet facilities.

m) Political Instability and Conflicts

Political instability and conflicts are common features in many developing countries. This could be in the form of military coups, unrests, riots, civil wars and frequent changes of government. Instability creates uncertainty and lack of confidence by investors. It could also mean financial ruin for those who have invested or transacted business with that country.

n) 'Sweat Shop' Conditions

This is a situation where western businesses overseas employ very cheap labour in the overseas country with terrible and unacceptable working conditions.

Many people in the UK and indeed all over the developed world are now very opposed to such exploitation by western multinational companies.

4. Protectionism

Protectionism is a term used to describe measures taken by governments to:-

- (a) protect local and infant industries;
- (b) protect structural decline;
- (c) avoid dumping;
- (d) avoid 'sweat shop' conditions; and
- (e) prevent 'flight' of hard currency from the country.

Thus, despite the many benefits of free trade that are discussed above, almost every country resort to protectionist measures at some point in time.

Some of the most commonly used protectionist measures are discussed below:-

(a) Tariffs

These are taxes and customs duties that are imposed on imports. The idea is that by taxing these imports; they become more expensive to consumers as the importers need to sell at higher prices to make profit. However, as a result of these higher prices, the goods become less attractive to buy. Thus, tariffs are intended to achieve the following:

- (i) to make consumers buy fewer imported goods,
- (ii) to make domestic producers increase their supplies,
- (iii) to make foreign producers reduce their quantity; and
- (iv) to generate revenue for the government.

(b) Quotas

Quotas are physical limits imposed by the government on the quantity of imported goods within a particular period. These limits may be mandatory or by agreement between the government, local importers and exporters in the foreign country.

The government may affect quotas in the following ways:

- (i) by granting the right to import goods to a selected few importers; or
- (ii) by auctioning limited import licences, which is a source of revenue for the government.

(c) Embargoes

This is a complete ban imposed on certain types of goods usually for the protection of the health and welfare of consumers or purely for political purposes.

The problem with a politically motivated embargo is that, it will almost certainly attract retaliation from the foreign country so that in the end no country wins. As a result it must be handled with care, if possible, avoided.

(d) Subsidies

Government's intention here is that by subsidising the cost of production, producers can sell their goods at lower prices to be more competitive.

There are several ways that the government may apply subsidies, some of which are:

(i) Direct Subsidies

This is where the government gives money directly to local producers to meet some of their costs. Reduced cost of production means that they can sell at lower prices thereby making imported goods attractive in terms of prices.

There is however, an unusual type of this type of subsidy in the UK agriculture industry where some farmland owners are paid money not to produce food. The idea is that too much food will bring down food prices too low that in the end, farming would not be an attractive profession which in turn would be bad for society in general.

(ii) Export Subsidies

In some cases, this may also be in the form of direct subsidy but the whole objective is to subsidise the export costs incurred by exporters. This will increase the export of the country and make local producers much more competitive. It is worth noting that subsidies are a cost, not revenue to the government, but can be effective protectionist measures.

(e) Legislation and Standards

This method of protectionism is that imported goods are made to comply with some-times harsh local legislations and standards. The car industry is a good example where imported foreign cars are made to meet certain quality and emission requirements.

Making foreign manufacturers subject to strict requirements increases the cost of production for those manufacturers. As a result of this increased cost, they are less likely to be able to sell the cars as cheaply as they would wish to, thus making these foreign manufacturers less competitive in the local market.

(f) Exchange Rates

Exchange rate policy can be used as a protectionist measure. By devaluing a country's currency, it is able to export more as it becomes cheaper for foreigners to buy products from the country. Conversely, this will lead to fewer imports as they will now be much more expensive for local people as a result of the devaluation.

Exchange rate policy should be handled with extreme care as devaluation, though increasing exports, can lead to terrible inflation especially if the country is hugely dependent on foreign goods and hardware.

(g) Administrative Delays

This is a very subtle protectionist measure that is prevalent in some countries, notably Japan. This is a situation where exporters (in foreign countries) or local importers are subjected to complicated, tedious and lengthy administrative process to the extent that they become so frustrated and give up.

It is a deliberate attempt to frustrate the process of importing goods to the country.

Conclusion

All the countries of the world should be able to benefit from international trade, to the extent that it will increase their wealth. There are still barriers to trade, but broadly speaking, free trade is still viewed as very desirable.

However, almost everyone now agree that developing countries are not benefiting from free trade as much as they should be. This is due partly to the unfair terms of trade imposed on them by developed countries. As a result, while developed countries become more prosperous, the vast majority of developing countries are getting poorer.

Nevertheless, it is worth pointing out that there is a great deal of corruption, lack of democracy and accountability that is prevalent in many developing countries. This is one of the major causes of poverty in developing countries.

Self-Assessment Questions

- 1. What does GATT stand for?*
- 2. What is the difference between GATT and WTO?*
- 3. Some believe that not all countries benefits from international trade? Do you agree?*
- 4. Explain the Law of Comparative Advantage.*
- 5. List the main reasons that international trade exists.*
- 6. Of all the different problems that are associated with international trade, which do you think are the 5 worst? Give reasons for your answer.*
- 7. Why do some countries resort to protectionism?*
- 8. What protectionist measures may some countries apply?*

These pages have been left blank for you to write the answers to your self-assessment questions.
