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Belay Seyoum is Professor of International Business Studies at Nova Southeastern University, USA. Dr. Seyoum has published two books as well as numerous articles in the area of international trade in several prestigious academic journals such as the *International Business Review, European Business Review, The Thunderbird International Business Review, The Asia Pacific Business Review*, and the *Journal of Economic Studies*.

INTERNATIONAL TRADE

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Introduction

A Brief History of International Trade

ANCIENT PERIOD

International trade based on the free exchange of goods started as early as 2500 BC. Archaeological discoveries indicate that the Sumerians of Northern Mesopotamia enjoyed great prosperity based on trade by sea in textiles and metals. The Greeks profited by the exchange of olive oil and wine for grain and metal somewhere before 2000 BC.

By around 340 BC, many devices of modern commerce had made their appearance in Greece and its distant settlements: banking and credit, insurance, trade treaties, and special diplomatic and other privileges.

With the decline of Greece, Rome became powerful and began to expand to the East. In the first century AD the Romans traded with the Chinese along the Silk Road and developed many trade routes and complex trading patterns by sea. However, the absence of peace made traveling unsafe and discouraged the movement of goods, resulting in the loss of distant markets.

By the time of the breakup of the Roman Empire in the fifth century, the papacy (papal supremacy) had emerged as a strong institution in a new and unstable world. The church's support (sponsorship) for the crusades (eleventh century) revived international trade in the West through the latter's discovery and introduction of new ideas, customs, and products from the East. New goods such as carpets, furniture, sugar, and spices brought from Egypt, Syria, India, and China stimulated the markets and the growing commercial life of the West. This helped Italian cities such as Venice and Genoa to prosper and to replace Constantinople as the leading center of international commerce. Letters of credit and bills of exchange and insurance of goods in transit were extensively used to accommodate the growing commercial and financial needs of merchants and travelers.

By the end of the fifteenth century, the center of international commerce had moved from the Mediterranean to Western Europe. Spain, Portugal, and later Holland became the focal points of international commercial activity. The more developed areas of Europe were changing from a subsistence economy to one relying heavily on imports paid by money or letters of credit.

COLONIAL PERIOD (1500–1900)

With the discovery of America in 1492, and sea routes to India in 1498, trade flourished and luxury goods and food products such as sugar, tobacco, and coffee became readily available in the markets of Europe.

The principal motivations behind global expansion (colonization) in the fifteenth century had been to enhance national economic power (mercantilist policy) by exploiting the colonies for the exclusive benefit of the mother country. Colonies were regarded as outposts of the home economy that would reduce trade dependence on rival nations and augment national treasure through exports as well as discoveries of precious metals. This first phase of colonization, which lasted until the advent of the Industrial Revolution in England (1750), was characterized by the following general elements with respect to commerce:

1. All commerce between the colonies and the mother country was a national monopoly, meaning all merchandise exports/imports had to be carried by ships of the mother country and pass through specified ports.
2. Little encouragement was provided toward the development or diversification of indigenous exports. For example, in 1600, precious metals constituted 90 percent of colonial exports to Spain. In the mid-1650s, British imports from its colonies were mainly concentrated in three primary products: sugar, tobacco, and furs. To protect domestic producers, competing colonial exports were restricted or subject to special duties. The patterns of economic relations were fashioned on the basis of dissimilarity, that is, non-competitiveness of colonial and metropolitan production.
3. Certain enumerated products could only be exported to the mother country or another colony. The policy ensured a supply of strategic foodstuffs and raw materials.
4. Private companies in the metropolis received a charter from the government that granted them (i.e., the companies) a monopoly of trade in the colonies. In most cases, the charter also granted complete local administrative authority, ranging from the making of laws and administration of justice to the imposition of taxes. Examples of this include the British East India Company (1600), the Dutch West India Company (1621), and Hudson's Bay Company (1670).

The second historical phase of overseas expansion (1765–1900) was dictated more by commercial considerations than by mere territorial gains. Britain emerged as the dominant colonial power and by 1815 had transformed its empire into a worldwide business concern. By the 1860s, the Industrial Revolution had transformed the social and economic structure of England, and mass production dictated an expansion of the market for goods on an international scale. The political economy of mercantilism that had proliferated over the preceding century was gradually replaced by that of free trade. By 1860, Britain had unilaterally repealed the Corn Laws and had abolished the Navigation Act restrictions (foreign ships were permitted to take colonial goods anywhere), as well as the commercial monopolies given to particular companies. Preferential duties on empire goods were gradually abolished. In trade, as in foreign policy, Britain led the free trade ideology based on non-discrimination. At the time, Britain was most likely to benefit from free trade because of its industrial and commercial lead over other nations.

1900 TO THE PRESENT

The major characteristics of economic relations from 1900 until the outbreak of World War I were the further development of trade and the emergence of a world economy. These were also the result of the international migration of people and capital from Europe, particularly Britain, since the 1850s, to other countries such as the United States, Australia, Argentina, Brazil, and Canada. This pattern of world economy provided the industrial economies with new sources of food and raw materials and new markets for exports of manufactures. For example, by 1913, Brazil was the source of two-thirds of German coffee imports, whereas North Africa supplied over half of French imports of wine. However, much of the import trade in Europe was subject to trade restrictions, such as tariffs, to secure home markets for local producers. Even within Britain, there were mounting pressures for the abolition of free trade.

The post-World War I recovery was further delayed by the disruption of trading links, as new nations were created and borders were redrawn. State intervention and restrictive economic policies had been consolidated in Europe and other countries by the end of the war. The U.S. government introduced the Fordney-McCumber Tariff, which imposed high tariffs on agricultural imports in 1922, and later, the Smoot-Hawley Tariff in 1930, which provoked widespread retaliation. Britain imposed high duties on various industrial products, such as precision instruments and synthetic organic chemicals, to encourage domestic production under the Safeguarding of Industries Act 1921. The volume of world trade in manufactures fell by 35 percent between 1929 and 1932, and prices also fell by a similar amount. The volume of trade in primary products fell by 15 percent, but prices fell by about 50 percent. To alleviate the worst effects of the Depression, countries resorted to more protectionism. This wave of protectionism produced a massive contraction of international trade and further aggravated the Depression. Many of the barriers placed on trade included tariffs and quotas, a variety of price maintenance schemes, as well as arbitrary currency manipulation and foreign exchange controls and management.

To avoid a repetition of the economic situation of the previous two decades, Allied countries met even before the outbreak of World War II to discuss the international financial arrangements that should govern trade and capital movements in the postwar world. In 1944, they established the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The IMF was to be concerned with facilitating the growth and expansion of global trade through the system of fixed exchange rates, while IBRD was established to promote long-term investment. This was followed by an agreement (the General Agreement on Tariffs and Trade, or the GATT) in 1948 to permit the free flow of goods among nations.

PART I

Overview of International Trade

CHAPTER 1

Growth and Direction of International Trade

LEARNING OBJECTIVES:

1.1 Describe international trade
1.2 Learn about the growth of world trade in goods and services
1.3 Learn about the importance of trade to the global economy
1.4 Understand the major determinants of trade
1.5 Learn about the volume and direction of world trade
1.6 Describe important developments in trade

International Trade in Practice

Covid-19 and Its Effects on International Trade

The Covid-19 pandemic has had a devastating human toll in many parts of the world where it has killed thousands of people. It has also brought the world economy into a depression with serious adverse effects on trade worse than the global financial crisis. Efforts to contain the pandemic resulted in lockdowns and other restrictions that impacted trade.

- Seaports such as Rotterdam and Shanghai witnessed a significant drop in container throughput volumes.
- Cargo volumes declined as many countries began to change port protocols ranging from port closure and quarantine measures to additional documentation requirements.
- Lockdowns also impacted the availability of labor to unload ships. It also raised costs due to increased protective equipment for workers. Additional costs were incurred by firms due to the introduction of health and safety measures for participants.
- The additional measures implemented to prevent transmission resulted in higher transaction costs for firms engaged in international trade.

The economic contraction in China was smaller than the global average as the country managed to control the outbreak relatively quickly and reopened its economy. The economic effects of the pandemic were particularly severe in the USA, Japan, and the European Union. Latin America and the Caribbean was the most affected developing region. The effects of the virus were transmitted through global supply chains. For example, when China implemented a lockdown on the affected region and its national borders, exports of intermediate goods for autos, electronics, and medical supplies were suspended, forcing importing firms in other countries to shut down for several months. The initial supply shock was compounded by a demand shock which occurred as a result of measures adopted in North America, Europe, and other countries. It also resulted in increased automation, e-commerce, and teleworking.

One of the major casualties of the pandemic was trade in services. Tourism, for example, which generally accounts for a quarter of global exports of services, registered a steep decline. In many countries, arrivals dropped by 60–80 percent.

Viable measures to alleviate adverse effects include:

- Maintenance of open supply chains for essentials
- Avoidance of export restrictions that would exacerbate the problem.
- Rejection of protectionist policies that distort trade.

Opportunities include:

- Pursuance of paperless trade
- Preparation of advance measures to reduce vulnerability to external shocks
- Promotion of regional value chains to take advantage of economies of scale.

International trade is the exchange of goods and services across national boundaries. It is the most traditional form of international business activity and has played a major role in shaping world history. It is also the first type of foreign business operation undertaken by most companies because importing or exporting requires the least commitment of, and risk to, the company's resources. For example, a company could produce for export by using its excess production capacity. This is an inexpensive way of testing a product's acceptance in the market before investing in foreign production facilities. A company could also use intermediaries, who will take on import–export functions for a fee, thus eliminating the need to commit additional resources to hire personnel or maintain a department to carry out foreign sales or purchases (Daniels, Radebaugh, and Sullivan, 2017).

World merchandise trade volume declined by 0.1 percent in 2019 (compared to 2.9 percent growth in 2018), the first contraction since the global financial crisis in 2008–2009. This is well below the average annual growth rate of (by volume) 2.3 percent since the financial crisis. In US dollar value terms, world merchandise exports fell by 3 percent to 19 trillion in 2019. Global service exports also declined to 5.89 trillion (2019) showing a mere growth of 2 percent from the 9 percent recorded in 2018 (WTO, 2020). During the past few years (2014, 2015, 2019), the growth of world trade has lagged behind global GDP. The overall decline in the growth of world trade can be attributed to persistent trade tensions as well as weaker global GDP growth. Furthermore, the Covid-19 pandemic has contributed to a significant contraction in trade and economic growth in 2020. Table 1.1 presents a breakdown of global trade figures alongside GDP growth, while Table 1.2 shows world export values in 2019.

IMPORTANCE OF INTERNATIONAL TRADE TO THE GLOBAL ECONOMY

International trade allows manufacturers and distributors to seek out products and services produced in foreign countries. Companies acquire them because of cost advantages or in order to learn about advanced technical methods used abroad, for example, methods that help reduce the cost of production, lower prices and in turn, induce more consumption, thus producing increased profit. Trade also enables firms to acquire resources that are not available at home. Besides providing consumers with a variety of goods and services, international trade increases incomes and employment. In 2016, the number of U.S. jobs supported by exports ($2.3 trillion) to all foreign markets reached 10.7 million (Rasmussen, 2017). Many studies show the positive role of international trade in raising employment and wages.

- Case studies reviewing the experience of the twelve most rapidly growing countries over the past sixty years shows the important contribution of trade in raising employment and incomes (OECD, 2012).
- Trade represents about 30 percent of the US economy. In 2017, nearly 20 percent of US jobs were linked to international trade (Trade Partnership Worldwide, 2019).

Even though imports are associated with loss of jobs due to plant closings or production cut-backs of domestic industries, the export job-generation effect is about 7.5 percent larger than the import job-loss effect (Belous and Wyckoff, 1987). Most occupations show a net job gain from an equal amount of exports and imports except for blue-collar occupations, which are shrinking in most developed countries due to increasing pressure from low-wage imports.

Exports create high wage employment. Exporters in the United States, for example, on average pay wages that are some 6 percent higher than non-exporters (Bernard et al., 2007). A study by the International Trade Commission (Riker, 2015) shows that export-intensive industries pay more on average and that the export earnings premium is larger for blue-collar workers in production and support occupations than white-collar workers in management and professional occupations. The general export earnings premium in 2014 was estimated at 16.3 percent (manufactures) and 15.5 percent (service industries). Imports are also found to have a strong positive effect on wages through their positive effects on productivity. An OECD-led study on a broad sample of countries (1970–2000) shows that workers in the manufacturing sector in open economies benefitted from pay rates that were between 3 and 9 times greater than those in closed economies (depending on the region) (Flanagan and Khor, 2012). Another study on wages and trade also finds a strong positive correlation between export intensity and wages. This could be partly explained by the fact that export-intensive sectors tend to show higher levels of productivity than other

TABLE 1.1 GDP and Trade (Goods and Services) by Value, 2016–2019 (Annual % change)

	GDP growth				Export (import) growth*			
	2016	**2017**	**2018**	**2019**	**2016**	**2017**	**2018**	**2019**
World	2.59	3.26	3.04	2.48	2.68 (2.28)	5.09 (6.02)	4.27 (4.19)	1.46 (1.61)
North America	1.51	2.31	2.84	2.27	0.28 (1.67)	3.05 (4.63)	3.03 (4.08)	2.92 (1.70)
USA	1.57	2.22	2.93	2.33	-0.01 (1.99)	3.48 (4.71)	3.02 (4.37)	-1.1 (-1.7)
Canada	1.00	3.17	2.01	1.66	1.41 (0.05)	1.41 (4.24)	3.08 (2.60)	1.28 (0.56)
Latin America & Caribbean	-0.34	1.77	1.57	0.83	2.43 (-1.17)	3.79 (6.31)	4.09 (5.04)	0.67 (-0.82)
European Union	2.05	2.73	2.15	1.52	3.39 (4.38)	5.72 (5.43)	3.68 (3.56)	2.65 (3.78)
Central Europe & Baltics	3.05	4.79	4.42	3.69	7.00 (6.32)	7.60 (8.17)	5.42 (6.86)	3.93 (3.92)
Middle East & N. Africa	4.96	1.72	2.38	1.81	5.41 (-3.08)	2.45 (6.83)	6.29 (6.10)	7.2 (5.5)
East Asia & Pacific	4.09	4.76	4.17	3.76	2.04 (1.47)	6.41 (6.72)	4.69 (5.04)	-2.5 (3.5)
South Asia	7.78	6.83	6.10	4.83	4.35 (4.38)	4.12 (16.54)	11.81 (9.96)	-0.51 (-4.40)
Africa	1.24	2.55	2.41	2.28	2.42 (-2.76)	6.51 (1.92)	2.16 (6.19)	2.01 (1.03)

*Based on constant 2010 US dollars

Source: WTO, 2019

TABLE 1.2 World Exports of Merchandise and Commercial Services, 2019 (US$ trillions)

Trade	Value	Trade	Value
Merchandise trade	**19.05**	**Services trade**	**5.89**
Agriculture	1.8	Transportation	1.12
Fuels/minerals	3.0	Travel	1.42
Manufactures	13.0	Other commercial services	3.17

Source: WTO, 2019

firms. It is also consistent with economic theory which states that industries in which a nation enjoys comparative advantage are likely to be those where workers are more productive and therefore receive higher wages. It also shows that greater import penetration is associated with greater demand elasticity, which reduces workers' bargaining power (Harless, 2006).

DETERMINANTS OF TRADE

Why do some countries trade more than others? Several studies have been conducted to establish major factors that influence exports. The trade and exchange rate regime (import tariffs, quotas, and exchange rates), the presence of an entrepreneurial class, efficiency-enhancing government policy, as well as secure access to transport (and transport costs) and marketing services are considered to be important influential factors of export behavior (Kaynak and Kothavi, 1984; Fugazza, 2004). A study on the nature, composition, and determinants of Singapore's technology exports suggests that the country's open trade and investment regime, and development-oriented economic policy have been the key factors in enhancing the country's exports. Singapore's economy has shown continued and remarkable growth in exports for over thirty years with only three brief and mild recessions in the mid-1970s, mid-1980s and July 2020 during the pandemic. Its total trade as a proportion of GDP remains one of the highest in the world, approximately 319 percent in 2019 (World Bank, 2020). A recent study on the determinants of export performance underlines the importance of foreign direct investment (FDI) and the general quality of the institutional framework. Foreign direct investment contributes to capital formation and helps promote the development and export of knowledge-based industries (Fugazza, 2004).

Much of the research literature on imports underlines the importance of high per capita incomes, price of imports, and the exchange rate in determining import levels (Lutz, 1994). For developing countries, however, determinants of import demand also include factors such as government restrictions on imports and availability of foreign exchange. A study examining the factors influencing import demand in South Korea (Kim et al., 2017) shows that i) the growth of exports is associated with imports of intermediate goods and raw materials used as production inputs for exports, ii) imports of intermediate goods and raw materials are positively associated with inward foreign investment.

VOLUME AND DIRECTION OF TRADE

In 1990, the world reached a milestone when the value of international trade in goods and services measured in current dollars surpassed $4 trillion. By 2019, the value of exports of goods and services was over six times the 1990 levels, approaching $25 trillion. The dollar value of total world trade in 2020 was greater than the gross national product of every nation in the world including the United States (US GDP estimated at $22 trillion in 2020). Another measure of the significance of world trade is that one fourth of everything grown or made in the world is now exported.

The rapid increase in the growth of world trade after World War II can be traced to increased consumption of goods and services as more people joined the middle class in many countries of the world. Trade liberalization, both at the regional and international level, has also created a global environment that is conducive to the growth and expansion of world trade. New technologies such as computers, telecommunications, and other media also assisted in the physical integration of world markets.

Small countries tend to be more dependent on international trade than larger ones because they are less able to produce all that they need. Larger countries (in terms of population) import fewer manufactured goods on a per capita basis because such countries tend to have a diversified economy that enables them to produce most of their own needs. The above statement can be exemplified by the case of the United States, Japan, India, and China, which have low import propensities compared to countries such as Belgium or the Netherlands.

Merchandise trade currently accounts for about four-fifths of world trade. The top ten exporters accounted for just over one-half of world merchandise exports (China, United States, Germany, Japan, Netherlands, France, South Korea, Italy, United Kingdom, and Mexico) (Table 1.3). Merchandise trade includes three major sectors: agriculture, mining and manufactures. Trade in manufactured goods has been the most dynamic component of world merchandise trade. In 2019, the value

TABLE 1.3 Leading exporters and importers of merchandise and commercial services, 2019 ($ billions)

Merchandise exporters		Merchandise importers		Service exporters		Service importers	
Country	**Value**	**Country**	**Value**	**Country**	**Value**	**Country**	**Value**
China	2499	USA	2568	USA	824	USA	571
USA	1646	China	2077	UK	412	China	497
Netherlands	709	Germany	1234	Germany	331	Germany	360
Japan	706	Japan	721	China	282	Ireland	320
France	570	UK	692	France	280	UK	278
South Korea	542	France	651	Netherlands	262	France	256
Hong Kong	535	Netherlands	636	Ireland	238	Netherlands	246
Italy	533	Hong Kong	578	India	214	Japan	202
UK	469	South Korea	503	Singapore	205	Singapore	199
Mexico	461	India	484	Japan	201	India	178

Source: WTO, 2020

of world merchandise exports was estimated at US$19 trillion compared to that of US$5.89 trillion for services (WTO, 2020).

Industrial market economies account for the largest part of world trade. Trade among these countries is estimated to be approximately 47 percent of global merchandise trade. Over the last few decades, one observes shifting patterns of trade as evidenced by a steady growth in the role of developing countries especially that of emerging economies and increasing levels of trade among developing nations.

IMPORTANT DEVELOPMENTS IN TRADE

Multilateral and Regional Trade Agreements

- In June 2016 the United Kingdom held a referendum to determine whether the United Kingdom should leave or remain in the European Union (EU). Fifty two percent of the people voted in favor of leaving the EU. The decision to leave was not popular in some parts of the United Kingdom. For example, 62 percent of people in Scotland, 56 percent in N. Ireland and 60 percent in London voted in favor of remaining in the EU. The withdrawal negotiations began in March 2017 and attempted to deal with the United Kingdom's exit conditions such as financial matters and the rights of EU citizens in the United Kingdom as well as the modalities of the United Kingdom's future relationship with the EU.
- After the implementation of the Uruguay Round, WTO members launched a subsequent Round in Doha, Qatar in 2001 to further reduce trade barriers. The focus of this Round has been on the reduction of trade-distorting agricultural subsidies provided by developed countries and the introduction of equitable trade rules for developing nations. The negotiations are at a complete stalemate with no prospect of success in spite of considerable progress on specific issues. In a multi-polar world, there are a number of power centers and a proliferation of national interests that erode international consensus across many areas. This is going to impede the development of international trade rules and standards and undermine the role of the WTO as a forum for trade negotiations.
- The current irreconcilable deadlock in the Doha Round has provided additional motivation for countries to engage in bilateral and regional trade agreements. Bilateral and regional agreements require less time to negotiate and provide opportunities for deeper trade policy integration. The United States, for example, has recently launched trade agreements with Japan and the United Kingdom. Many developing countries also perceive such agreements to be the most feasible means for gaining market access as the prospects for completing the Doha negotiations seem more remote. The share of trade among bilateral and regional trade partners is likely to grow in the next few decades.
- Many scholars believe that such bilateral/regional agreements are inferior to the multilateral, non-discriminatory approach of the WTO. Bilateral/regional trade arrangements discriminate against non-members and create a maze of trade barriers that vary for every exporting country: rules of origin, tariff schedules, non-tariff barriers such as quotas, etc. There are concerns that such agreements also work in favor of powerful nations that will sneak in reverse preferences such as protection of intellectual property rights or labor standards.

Global Trade Imbalances

- The U.S. current account deficit reached 2.87 percent of GDP in the last quarter of 2019. Imports exceed exports by about $616 billion (2019). At the same time, the East Asian economies (including Japan) held about US$5.0 trillion in official foreign exchange reserves out of a global total of $11 trillion in 2019. China's foreign currency reserves alone are estimated at US$3.11 trillion at the end of 2019. The Southeast Asian countries' heavy reliance on exports as a way of sustaining domestic economic growth, weak currencies, and high savings has resulted in unsustainable global imbalances. Global imbalances cannot diminish without, inter alia, reducing such excess savings through currency adjustments and/or increased imports in the surplus countries.
- Export-led growth in surplus countries feeds (and is dependent on) debt-led growth in deficit countries. It is impossible for all countries to run surpluses, just as it is impossible for all to run deficits. A country's trade balance is a reflection of what it spends minus what it produces. In surplus countries income exceeds their spending, so they lend the difference to countries where spending exceeds income, accumulating international assets in the process. Deficit countries are the flipside of this. They spend more than their income, borrowing from surplus countries to cover the difference, in the process accumulating international liabilities or debts.
- So long as trade deficits remain modest and economies invest the corresponding capital inflows in ways that boost productivity growth, such imbalances are sustainable. But the imbalances we see today are of a different character. First, they are much bigger. The most egregious is that between China and the United States, where China is running a huge trade surplus with the United States ($616 billion in 2019). Many of the other imbalances are between countries of broadly similar levels of economic development, such as those between members of the euro-zone, or that between Japan and the United States.
- Trade imbalances lead to destabilizing capital flows between economies. For example, the global financial crisis of 2007 and the subsequent euro-zone crisis were basically the result of capital flows between countries. Over-leveraged banks amplified the problem, but the underlying cause was outflows of capital from economies with excess savings in search of higher returns. The deficit countries that attracted large-scale capital inflows struggled to find productive uses for them: rather than boosting productivity, the inflows pumped up asset prices and encouraged excessive household borrowing.

Developing Countries in World Trade

- There has been a steady growth in the role of developing countries in world trade. Between 2000 and 2019, the value share of developed nations in world merchandise trade declined from 62 to 47 percent while that of developing nations increased from 29 percent to 53 percent. Over this period, China's share alone increased from 2.6 percent to 12 percent. The share of Latin America and the Caribbean also increased from 4.5 percent to 4.7 percent (WTO, 2020).

- China joined the WTO in 2001. Within three years, its exports doubled and the country is now the world's largest merchandise exporter ($2.5 trillion in 2019) and second largest importer of goods ($2.07 trillion in 2011).
- Only a few developing nations have managed to climb up the value chain and diversify their export base to cater to the expanding global market. About 83 percent of the increase in the share of developing countries' total trade (2010–2019) accrued to a small number of emerging economies: The BRICs (Brazil, Russia, India, and China), Mexico, and South Korea. India, China, and South Korea accounted for about one-third of world exports and about two-thirds of developing country exports in 2019.
- Such shifting patterns of trade and the increased demand for primary commodities from rapidly growing economies have strengthened South–South trade (trade among developing countries) and economic cooperation. South–South trade increased at a rate of 14 percent per year between 2010 and 2019 compared to the world average of 9 percent. During the same period, merchandise exports from the developing countries to the developed nations increased by 10 percent per year.

Transportation and Security

- About 60 percent (by value) of total world merchandise trade is carried by sea. In volume terms, 75 percent of world merchandise trade is carried by sea, whereas 16 percent is by rail and road (9 percent by pipeline, and 0.3 percent by air). Increases in fuel prices could act as a disincentive to exports by raising transportation costs. In air transportation (more fuel sensitive than shipping), rising oil prices could severely damage trade in time-sensitive products such as fruit and vegetables, or parts in just-in time production, etc. Faster economic growth in emerging economies is also putting pressure on the limited supply of other raw materials such as copper or coal.
- World air cargo traffic has grown during the past decade due to an increased trade in high-value-low-weight cargo, globalization, and associated just-in time production and distribution systems.
- In light of increasing threats of terrorism, countries have put in place procedures to screen cargo across the entire supply chain. There is an overall attempt to facilitate international trade without compromising national security.

CHAPTER SUMMARY

Major benefits of international trade	To acquire a variety of goods and services, to reduce cost of production, to increase incomes and employment, to learn about advanced technical methods used abroad and to secure raw materials.

Determinants of trade	Major determinants of exports: Presence of an entrepreneurial class, access to transportation, marketing, and other services, exchange rates, and government trade and exchange rate policies. Major determinants of imports: Per capita income, price of imports, exchange rates, government trade and exchange rate policies, and availability of foreign exchange.
Value and volume of trade	1. World trade approached US$25 trillion in 2019. 2. Services trade accounts for about 20 percent of total trade. 3. Merchandise trade accounts for 80 percent of world trade. 4. The industrial market economies account for 47 percent of world merchandise trade.
Major developments in trade	1. The absence of any meaningful progress in the Doha negotiations of the WTO. 2. Proliferation of bilateral and regional trade agreements 3. Growing role of developing countries in world trade 4. The increasing US current account deficit and global imbalances. 5. Fast economic growth in many countries and pressure on limited resources. 6. Business adjustment to security costs after 9/11.

REVIEW QUESTIONS

1. Discuss the importance of international trade to national economies.
2. What are the major determinants of exports? Why do some countries trade more than others?
3. What is the volume and dollar value of world trade today?
4. What are some of the major developments in trade over the last few decades?
5. What are the implications of the increasing U.S. trade deficit for global production and exports?
6. What is the reason behind the increase in common markets and free trade areas over the last few decades?
7. What are the limitations of export-led growth?
8. Why are small countries more dependent on international trade than larger ones?

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International Trade Closing Cases and Discussions

1. The Limitations of Export-led Growth

International trade played an important role in the economic development of North America and Australia in the nineteenth century and that of East Asian economies in the second half of the twentieth century. East Asia's growth contributed to increased living standards and reduced inequality as the new prosperity was widely shared among its population. In Malaysia and Thailand, for example, the level of poverty was reduced from almost 50 percent in the 1960s to less than 20 percent by 2000.

Central to the success of these countries is the promotion of exports. Governments provided credits, restricted competing imports, and developed export marketing institutions. As they increased their exports to wealthy countries, their economies grew at 7 to 8 percent per year.

The export-led model may have worked for a few countries during the time when most developing countries pursued import substitution policies—substituting domestic production for imports of manufactured goods. There are a number of limitations to export-led growth when many countries including China begin to use it. Here are some of its potential limitations:

- It is difficult for all countries to increase exports by 8–10 percent per year when the world economy grows at 2 or 3 percent per year. It is not possible for every country to have a trade surplus. Every item that is exported by one country has to be imported by another. If every country adopts an export-led strategy, economic growth will be difficult to achieve since many countries try to export (attempt to reduce their imports) thus leading to a zero-sum game.

- The major importing nation, the United States, cannot continue to run large trade deficits. Its economy is debt saturated, Europe is constrained by fiscal austerity and Japan continues to suffer from weak internal demand and an aging population while also hooked on export-led growth. Other potential destinations for global exports, South Korea, Japan, and Germany, also rely on an export promotion policy to sustain economic growth and are not willing to run large deficits.
- China and other East Asian economies have not taken measures to open their markets in order to absorb increasing exports from the rest of the world. In the absence of other sources of economic growth, focusing on the U.S. market is unsustainable in the long run.
- Export-led growth is a strategy that is highly dependent on foreign demand. The satisfaction of this demand is contingent on access to foreign markets which may be impeded by various tariff and non-tariff barriers. Furthermore, if the products are geared primarily toward the foreign market, the country will be left with products or services that cannot be applied to domestic needs if the export market shrinks or closes off.
- In order to sustain export-led growth and remain competitive in foreign markets, countries must keep labor costs down. This curtails wage growth in export industries, thus exacerbating income inequality.
- Export-led growth exposes countries to commodity price volatility.

Questions

1. Do you agree with the author's view regarding the limitations to export-led growth?
2. What other alternatives are available to export-led growth?

2. The Impact of the Financial Crisis on International Trade

The world economy has experienced several financial crises over the last few decades: The European monetary crisis (1992–1993), the Mexican crisis (1994–1995), the Asian financial crisis (1997–1998) and the global financial crisis (2007–2008). Even though the pathology of these crises may vary, the adverse effects on international trade is not disputed.

There are two types of financial crisis: banking and currency crises. A banking crisis occurs when a large number of customers withdraw their deposits from a financial institution at one time due to lack of confidence in the bank. Banks play an important role in a country's economy, primarily through investment and lending. After a banking crisis, businesses that depend on loans struggle to raise the capital required to maintain and expand their businesses. The fall in liquidity and investment reduces employment, lowers state revenues, and reduces overall investor and consumer confidence. A banking crisis affects trade in a couple of ways:

- In the case of a bank run, depositors suffer losses and investments are often liquidated before maturity (lack of liquidity, lower demand for goods/services), leading to an overall decrease in exports and imports. As aggregate investment decreases, demand for foreign inputs drops, thus creating a negative long-term effect on imports.
- The reduction in trade finance, i.e., "the oil that lubricates the machinery of international trade," makes it difficult for businesses to finance their export–import businesses. Firms engaged in international trade are likely to be more reliant than domestic firms on working-capital financing to cover the costs of goods that have been produced but not yet delivered. Over 90 percent of trade transactions involve some form of credit, insurance, or guarantee issued by a bank or other financial institution. Given that banks are the principal suppliers of trade finance, the supply of such financing is likely to be closely tied to the health of the banks. In particular, as the health of banks deteriorates, these financial institutions find it increasingly difficult to raise funds either through interbank borrowing or through the issuance of new bonds or equity. In the 2008 crisis, the standard measure of the risk premium charged to banks (the difference between interbank offer rates charged to banks and the overnight indexed swap rate (OIS)) jumped sharply, reflecting higher bank borrowing costs. Eighty-eight banks in forty-four countries revealed that the average spreads on letters of credit, export credit insurance, and short- to medium-term trade-related lending rose by 70, 107, and 99 basis points, respectively in the second quarter of 2009 relative to the fourth quarter of 2007.

A currency crisis can occur in two ways. If a country is unable to control its budget deficit and prints money to finance its spending, it could trigger a currency depreciation (as in the case of Argentina, Brazil, and Mexico). Secondly, an external shock (in some cases, a currency crisis in another country) causes demand for local products to fall in the international markets (leading to price deflation in Thailand and Malaysia, for example). This affects trade in several ways. One is the adverse effect on exports and imports triggered by the lack of demand for local products in foreign markets. Consumers may also substitute local products for foreign ones (if the relative price of local products decreases).

Question

1. What is the effect of a financial crisis on exports?

CHAPTER 2

International and Regional Agreements Affecting Trade

LEARNING OBJECTIVES:

2.1 Describe the principles of GATT/WTO
2.2 Learn about the various GATT trade negotiations since 1947
2.3 Learn about the Uruguay Round negotiations and its significance
2.4 Understand regional trade agreements
2.5 Learn about the US–Mexico–Canada trade agreement (USMCA)
2.6 Describe the European Union and its institutions

International Trade in Practice

Likely Impact of USMCA on the U.S. Economy

The US–Mexico–Canada free trade agreement entered into force in July 2020. The US International Commission (USITC) recently made an assessment of the likely impact of the USMCA on the U.S. economy and industry sectors. The model estimates that, if fully implemented and enforced, USMCA would have a positive impact on U.S. real GDP and employment. Here are some of the significant highlights of the study.

- Parts of the agreement that have significant effects on the U.S. economy are:

  a. provisions that reduce policy uncertainty about digital trade; and
  b. certain new rules of origin applicable to the automotive sector.

  In the services sector, USMCA's new international data transfer provisions, including provisions that largely prohibit forced localization of computing facilities and restrictions on cross-border data flows will help reduce policy uncertainty.

- Given the fact that the North American Free Trade Area (NAFTA) has already eliminated duties on most qualifying goods and significantly reduced non-tariff measures, USMCA's emphasis will be on reducing remaining non-tariff measures on trade. It also addresses other issues that affect trade such as workers' rights, harmonizing regulations from country to country and deterring certain potential future trade and investment barriers, all leading to a positive effect on GDP and employment.
- USMCA strengthens rules of origin in the auto sector and increases regional value content (RVC) requirements. Even though there is likely to be a small increase in prices and a slight decrease in auto purchases in the United States, the new rules will enhance production and employment in the sector.
- USMCA prohibits restrictions on transfers of data, which will have a positive effect on a wide range of industries that rely on such transfers.
- The changes in the investor-state dispute settlement (ISDS) mechanism will probably reduce U.S. investment in Mexico but will increase domestic investment in manufacturing and mining.
- USMCA is likely to enhance labor standards and strengthen workers' rights in terms of collective bargaining and could lead to higher wages and better working conditions in Mexico.
- New intellectual property rights are likely to increase U.S. trade in technology-intensive industries.
- The Commission's model estimates that USMCA would raise U.S. real GDP by $68.2 billion (0.35 percent) and U.S. employment by 176,000 jobs (0.12 percent). The model estimates that USMCA will likely have a positive impact on U.S. trade, both with USMCA partners and with the rest of the world.
- U.S. exports to Canada and Mexico will increase by $19.1 billion (5.9 percent) and $14.2 billion (6.7 percent), respectively. United States imports from Canada and Mexico would increase by $19.1 billion (4.8 percent) and $12.4 billion (3.8 percent), respectively. The model estimates that the agreement will likely have a positive impact on all broad industry sectors within the U.S. economy. Manufacturing will experience the largest percentage gains in output, exports, wages, and employment, while in absolute terms, services will experience the largest gains in output and employment.

THE GATT AND THE WTO

The General Agreement on Tariffs and Trade (GATT) was established in 1945 as a provisional agreement pending the creation of an International Trade Organization (ITO). The ITO draft charter, which was the result of trade negotiations at the Havana Conference of 1948, never came into being due to the failure of the U.S. Congress to approve it. Other countries also declined to proceed with the ITO without the participation of the United States. Thus, the GATT continued to fill the vacuum as a de facto trade organization, with codes of conduct for international trade but with almost no basic constitution designed to regulate its international activities and procedures. The GATT, in theory, was not an "organization" and participating nations were called "Contracting Parties" (CPs) and not members (Jackson, 1992; Hoekman and Kostecki, 1995).

Since its inception, the GATT has used certain policies to reduce trade barriers between CPs:

- *Non-discrimination*: All CPs must be treated in the same way with respect to import–export duties and charges. According to the most favored nation treatment, each CP must grant to every other CP the most favorable tariff treatment (MFN) that it grants to any country with respect to imports and exports of products. Certain exceptions, however, are allowed, such as free trade areas, customs unions or other preferential arrangements in favor of developing nations. Once imports have cleared customs, a CP is required to treat foreign imports the same way as it treats similar domestic products (the national treatment standard).
- *Trade Liberalization*: The GATT has been an important forum for trade negotiations. It has sponsored periodic conferences among CPs to reduce trade barriers (see International Perspective 2.1). The Uruguay Round (1986–1994) gave rise to the establishment of a permanent trade organization (World Trade Organization or WTO). The most recent round (Doha Round) hopes to reach agreement on other trade distortions such as agricultural subsidies and trade barriers imposed by developing countries on imports of manufactured goods.
- *Settlement of Trade Disputes*: The GATT/WTO has played an important role in resolving trade disputes between CPs. In certain cases where a party did not follow GATT's recommendations, it ruled for trade retaliation that is proportional to the loss or damage sustained. It is fair to state that the existence of the GATT/WTO has been a deterrent to damaging trade wars between nations.
- *Trade in Goods*: The GATT rules apply to all products both imported and exported, although most of the rules are relevant to imports. It was designed primarily to regulate tariffs and related barriers to imports such as quotas, internal taxes, discriminatory regulations, subsidies, dumping, discriminatory customs procedures, and other non-tariff barriers. The Uruguay Round (1994) resulted in a new general agreement on trade in services, trade-related aspects of intellectual property (TRIPS), and trade-related investment measures (TRIMS). Thus, CPs have moved beyond the original purpose of the GATT to achieve unrestricted trade in goods, to reduce barriers to trade in services and investment, and to protect intellectual property (Collins and Bosworth, 1994).

INTERNATIONAL PERSPECTIVE 2.1

GATT Negotiations (1947–2001)

GATT Round	Explanation
Geneva (1947)	Twenty-three countries participated in establishing the GATT in 1947. Average tariff cut of 35% on trade estimated at $10 billion.
Annecy, France (1949)	Thirty-three countries participated in tariff reductions.

GATT Round	Explanation
Torquay, UK (1951)	Thirty-four countries participated in tariff reductions.
Geneva (1956)	Twenty-two countries participated in tariff reductions on trade estimated at $2.5 billion.
Dillon (1960–1961)	Forty-five countries participated in tariff reductions on trade estimated at $5 billion.
Kennedy (1962–1967)	Forty-eight countries participated in tariff reductions on trade estimated at $40 billion.
Tokyo (1973–1979)	Ninety-nine countries participated in reductions of tariff and non-tariff barriers on trade valued at $155 billion.
Uruguay (1986–1994)	Broadening of the GATT to include services, intellectual property, and investment. It also resulted in the establishment of the WTO. One hundred and twenty-four countries participated in reductions of tariff and non-tariff barriers on trade valued at $300 billion.
Doha (2001–)	Reduction of agricultural subsidies and other trade barriers on agricultural exports, broadening of international rules in services, lowering trade barriers by developing nations. More than 124 countries participate in this Round.

The Uruguay Round and WTO

In 1982, the United States initiated a proposal to launch a new round of GATT talks. The major reasons behind the U.S. initiative were 1) to counter domestic pressures for protectionism precipitated by the strong dollar and rising trade deficit, 2) to improve market access for U.S. products by reducing existing tariff and non-tariff barriers to trade, 3) to reverse the erosion of confidence in the multilateral trading system, 4) to extend GATT coverage to important areas such as services, intellectual property, and investment, and 5) to bring developing nations more effectively into the international trading system.

Despite the initial reluctance of many developing nations, the effort culminated in the conclusion of a successful trade negotiation (the Uruguay Round) in 1994. The results of the Uruguay Round can be summarized as follows.

Trade Liberalization

Significant progress was made toward reducing trade barriers in the areas of agriculture and textiles that had long been resistant to reform. Tariff reductions of about 40 percent were achieved. The agreement also opened access to a broad range of government contracts (Government Procurement Agreement). It also provided for the liberalization of the textiles and apparel sector by the end of 2004. Textile quotas have been removed except for occasional safeguards used to protect a sudden increase in imports.

Trade Rules

The Uruguay Round added new rules relating to unfair trade practices (dumping, subsidies) and the use of import safeguards.

New Issues

The agreement broadened the coverage of the GATT to include areas such as trade in services (General Agreement on Trade in Services, GATS), trade-related aspects of intellectual property (TRIPS), and trade-related investment measures (TRIMS). The GATS established rules to liberalize trade in services, which in 2019 was estimated to be almost $6.0 trillion (WTO, 2019). The TRIPS agreement established new trade disciplines with regard to the protection and enforcement of intellectual property rights. TRIMS provided for the elimination of trade distorting investment requirements such as local content, limitation of ownership, or exports of certain shares of domestic production.

Institutional Reforms

In the area of institutional reform, the Uruguay Round strengthened the multilateral dispute settlement mechanism and established a new and permanent international institution, the World Trade Organization, responsible for governing the conduct of trade relations among its members. The new dispute settlement procedure instituted an appeals procedure, expedited decision making and encouraged compliance with GATT decisions. Members of the WTO are required to comply with the GATT rules as well as various agreements (rounds) negotiated under GATT auspices.

REGIONAL INTEGRATION AGREEMENTS (RIAS)

Members of the WTO are permitted to enter into RIAs under specific conditions. These agreements must be consistent with the WTO rules, which require that the parties to the agreement 1) establish free trade on most goods in the regional area within ten years and 2) refrain from raising their tariffs against countries outside the agreement.

The number of RIAs and their share in global trade has been steadily rising over the last decade (Table 2.5). As of September 2020 about 306 RIAs are in effect. A large percentage of these agreements (over 80 percent) are mostly bilateral free trade deals (free trade agreements) intended for market access and do not require a high degree of policy coordination between participating countries. Less than 10 percent of the agreements provide for high levels of integration as well as harmonization of trade policies (a customs union). Recent notifications of RIAs to the WTO include USMCA (2020), an EU–Vietnam trade agreement (2020), a Peru–Australia trade agreement (2020) and a Chile–Indonesia trade agreement (2020).

Small countries enter into RIAs not only for market access but also to deal more effectively with larger economies in multilateral trade talks and other areas. Although RIAs are not often considered a potential threat to multilateralism, some scholars believe that 1) they lead to large volumes of trade diversion often resulting in substantial welfare losses, 2) they create lobbies and interest groups against multilateral trade liberalization, and 3) their differing regulatory regimes including rules of origin pose a challenge to the multilateral trading system (Das, 2004).

The major drivers of RIAs are stated to be as follows:

- Consolidation of peace, regional security, and free market reforms in many countries.
- Promotion of deeper levels of economic integration than what is available under the WTO (issues pertaining to competition, investment, labor, and the environment).
- Market access and a means of attracting FDI. Discriminatory liberalization in favor of partner countries is likely to provide firms (from these countries) with competitive advantages.
- Sluggish progress in multilateral trade talks.

THE UNITED STATES–MEXICO–CANADA AGREEMENT (USMCA)

The free trade agreement between the United States, Mexico, and Canada came into effect on July 1, 2020 after ratification by the US Congress and approval by the Canadian and Mexican legislatures. The USMCA constitutes the largest free trade zone with a population of nearly 500 million people and a GDP of over US$24 trillion in 2020. It is also the first reciprocal free trade pact between a developing nation and industrial countries. Upon entry into force of the USMCA, the North American Free Trade Area (NAFTA) ceased to exist. The new agreement updates some of the existing NAFTA provisions and covers new areas such as digital trade, labor, and small enterprises (summarized in Table 2.1). Some of the NAFTA provisions have also been incorporated with limited or no modifications.

Negotiating Objectives

The United States

It was logical to embark on a free-trade arrangement with Canada and Mexico not only due to their geographical proximity but also because they are the most important trading partners of the United States. The United States is the destination for over 75 percent of Canadian and Mexican exports. Both countries also import about one-third of U.S. exports. The United States is also the largest investor in both countries. It was in the interests of the United States to maintain and expand existing trade and investment opportunities through a regional trade arrangement. However, the reasons behind the renegotiation of NAFTA stem from the U.S. government's concern over its rising trade deficit with the partner countries. Even though there was a sizable trade deficit with Mexico, the U.S. had a trade surplus, albeit small, with Canada. However, there was mistaken belief by the Trump Administration that there was a trade imbalance in favor of Canada at the time. The United States also wanted to tighten up the existing 62.5 percent auto rules of origin (to increase U.S. and regional content), reform NAFTA rules on safeguards and government procurement, and introduce free trade on e-commerce, improve protections for intellectual property

TABLE 2.1 Key USMCA modifications/upgrades from NAFTA

Agricultural trade	• Expands market access for certain agricultural products: dairy products, poultry etc.; Canada will eliminate discriminatory grading of U.S. wheat and wines • Creates new and enforceable rules to ensure that sanitary and photo-sanitary measures are science based
Auto and auto parts	• Establishes regional value content of 75% (versus 62.5% under NAFTA) to qualify for preferential treatment under USMCA • USMCA requires that at least 70% of a producer's steel and aluminum purchases originate in North America • Requires that a certain percentage of qualifying vehicles must be produced by employees making an average of $16 per hour
Digital trade	• Creates free trade (no tariffs and other restrictions) on digital products • Facilitates data transfer across borders and digital transactions by permitting use of electronic signatures, open access to public data • Guarantees enforceable consumer protections
Intellectual property	• Full national treatment for copyrights and related rights • Extends terms for the protection of copyright, industrial designs, and data protection for agriculture chemicals • Criminal penalties and civil remedies for satellite and cable theft • Enforcement measures for the digital environment
Energy and energy products	• Free trade (zero tariff) on energy exports • Creates new rules of origin certification requirements for oil and gas moving between the parties
Labor and environment	• Adoption of core labor standards • Prohibits importation of products using forced or child labor • Commits parties to enforce their environmental laws, protect coastal and marine environments, and improve air quality
Non-market practices	• Expands the definition of state-owned enterprises (SOEs) to include cases where the state owns a minority equity but exercises control • Prohibits distorting subsidies to SOEs • Prohibits competitive devaluations • Criminalizes acts of corruption by domestic and foreign government officials
Textiles and apparel	• Incentives for use of regional inputs • Updates rules of origin to provide flexibility • New enforcement procedures to prevent circumvention and fraud
Monitoring and enforcement	• Closes loopholes in the NAFTA state-to-state dispute settlement mechanism that allowed parties to block the formation of panels • Creates a labor rapid response mechanism to enforce labor rights in Mexico at particular facilities • Creates interagency monitoring committee to ensure that parties are living up to their environmental obligations

rights as well as incorporate labor and environment issues into the core text of the agreement to make them enforceable and subject to dispute resolution.

Canada and Mexico

The USMCA permits Canadian and Mexican firms to achieve economies of scale by operating larger and more specialized plants. It also provides secure access to a large consumer market. Even though tariff rates between the United States, Canada, and Mexico have declined over time, there had been an increase in protectionist sentiment and use of aggressive trade remedies to protect domestic industries in the United States. These measures created uncertainty for producers with respect to investment in new facilities. A free trade agreement reduces this uncertainty since it provides rules and procedures for the application of trade remedies and the resolution of disputes. For Mexico, trade liberalization has been considered as an effective means of fostering domestic reform and consolidating its export-led growth strategy by improving secure access to the U.S. market. Furthermore, both countries wanted to address issues pertaining to security, narcotics, and immigration. Canada was also interested in amending the provisions dealing with binational panel arbitration given its involvement in several trade disputes with the United States over the years.

Overview of the USMCA

Market Access for Goods

The USMCA incorporates the basic national treatment obligation of the GATT. This means that goods imported from any member country will not be subject to discrimination in favor of domestic products. The 1994 NAFTA provided for a gradual elimination over fifteen years of tariffs for trade between Mexico and Canada as well as Mexico and the United States except for certain agricultural products. Under the Canada–U.S. Free Trade Agreement (1989), tariffs between the two countries were eliminated in January 1998.

Free trade in goods had been largely achieved under NAFTA. It is fair to state that almost all North American trade in goods became duty free by 2008. The USMCA also prohibits the use of export duties, taxes, and other charges and the waiver of specific customs processing fees. It adds new provisions for transparency in import and export licensing procedures, prohibits parties from requiring the use of local distributors for importation and from applying restrictions on the importation of commercial goods that contain cryptography.

To qualify for preferential market access, however, goods must be wholly or substantially made or produced within the member countries. For example, farm goods wholly grown or substantially processed within the USMCA region would qualify for duty-free treatment. The rules of origin under NAFTA have been largely retained except for autos and auto parts, which require a regional value content of 75 percent (versus 62.5 percent under NAFTA). It also requires that at least 70 percent of a producer's steel and aluminum purchases must originate in partner countries. It also promotes greater use of USMCA fibers, yarns, and fabrics in the production of apparel and other finished products to qualify for trade benefits.

Services

The USMCA covers trade in services in general and devotes certain chapters to the regulation of specific services such as telecommunications and financial services. It retains the principle of national treatment (services and service providers must be extended a treatment no less favorable than that provided to its own services and service providers) and most-favored nation treatment (services and service providers of another party to be accorded no less favorable treatment than that extended to services or service providers of another party or non-party) found in NAFTA. The market access provision prohibits any party from imposing limitations on the number of service providers including the total number of employees as well as the total value or number of service transactions. It also prohibits requirements for local presence in order to provide a service. An important provision relating to the movement of labor encourages parties to recognize the experience and education of foreign service providers which may be achieved by harmonization and other agreements. The agreement attempts to enhance commercial opportunities in services for small and medium-sized enterprises (SMEs) such as direct selling and protect them from fraudulent practices. There are annexes that deal with specific services: delivery services, transportation services, professional services, programming services, and guidelines for mutual recognition of professional services.

The chapter on financial services updates the NAFTA provisions. It recognizes the importance of maintaining regional macroeconomic stability through market-determined exchange rates (such as refraining from competitive devaluations). It requires parties to provide access to payment and clearance systems operated by public agencies, allow for transfer of information and data into and out of the host country, and refrain from requiring local presence as a condition for conducting computing services.

The USMCA also covers telecommunications services. It retains the NAFTA provisions that commit members to impose no conditions (i.e., reasonable and non-discriminatory terms) on access to, or use of, public telecommunication networks unless they are necessary to safeguard the public service responsibilities of the network operators or the technical integrity of the networks. It contains provisions applicable to mobile service providers, major suppliers of public telecommunications services, value-added services, and technology neutrality (prohibiting requirements that force technology choices). It requires major suppliers of public telecommunications services to extend the national and most-favored nation standard to suppliers of such services from other parties.

The agreement also restricts Mexican-based carriers from operating beyond the border commercial zones. It creates a review process to identify and remove Mexican-based operators that cause material harm to U.S. truckers (by not being subject to the same U.S. safety regulations and receiving lower wages, which could have a negative impact on wages in the U.S. trucking industry).

Investment

Investment includes majority-controlled or minority interests, portfolio investments, and investments in real property from member countries. The USMCA retains NAFTA provisions that 1) provide national and most-favored treatment to investors from member countries throughout the lifecycle of the investment; 2) prohibit the imposition and enforcement of certain performance requirements in connection with the conduct or operation of investments, such as export requirements or domestic content; 3) require each party to give investments “treatment in accordance with customary international law,” i.e., fair and equitable treatment within the minimum standard accorded to aliens under customary international law; 4) limits expropriation only for a public purpose and requires it to be done in a non-discriminatory manner with prompt, adequate, and effective compensation.

Canada and the United States removed the availability of arbitrations to resolve investor–state disputes. United States and Canadian investors alleging a violation of the USMCA by their host government would only have recourse to domestic courts or other dispute resolution mechanisms. The USMCA retains investor–state dispute settlement under NAFTA but investors could only bring claims alleging breach of national or MFN treatment or for direct expropriation. Such claims could still be undertaken through USMCA state-to-state dispute settlement measures. Breaches of national treatment dealing with respect to establishment, acquisition, or indirect expropriation will no longer be covered.

Intellectual Property and Digital Trade

With regard to intellectual property and digital trade, NAFTA had become outdated since the agreement was negotiated during the time when the Internet was in its infancy and trade secrets had limited importance. The USMCA retains some of the NAFTA provisions but also makes significant innovations. It extends the terms for copyright (seventy years after the author’s death or publication plus seventy-five years for companies who own these rights), trade marks (initial registration to be for a term of at least ten years), and industrial designs. It mandates patent term extensions for unreasonable patent office and regulatory delays. In the area of digital trade, the USMCA prohibits the imposition of tariffs and other measures on digital products (e-books, videos, software, and games) and facilitates digital transactions by promoting the use of e-signatures while safeguarding confidential personal and business information. It provides for enforcement procedures including civil and criminal penalties.

Agriculture

NAFTA did not eliminate all tariffs on agricultural trade between parties. Under the USMCA, parties agreed to reduce the use of trade-distorting policies such as subsidies, strengthen disciplines for science-based sanitary and photo-sanitary measures, and prohibit barriers for the sale and distribution of wines and spirits. The agreement will open up the market for dairy, poultry, and sugar products in partner countries.

Government Procurement

Purchase of goods and services by government entities in member countries is estimated at over one trillion dollars. NAFTA extended the national treatment standard (equal treatment to all member country providers) for all goods and services procured by federal government entities above a set monetary threshold (unless specifically exempted). It allowed parties to provide preferential treatment for small and medium-sized enterprises. The USMCA provisions only apply to US–Mexico procurement, while Canada remains covered by the recent WTO rules, which have a higher monetary threshold.

Labor and the Environment

Unlike NAFTA, the labor and environment provisions constitute part of the core agreement, fully enforceable and subject to dispute resolution. With regard to labor, the USMCA requires parties to adopt and maintain core labor standards as recognized by the International Labor Organization (freedom of association, right to strike, etc.), restrict importation of products using forced or child labor, and ensure that migrant workers are protected under these laws.

The environmental provisions require parties to promote air quality, protect coastal and marine environments, and ensure market access for environmental technologies.

Dispute Settlement

Disputes arising over the implementation of the agreement may be resolved through 1) consultations; 2) mediation, conciliation, or other means of dispute resolution that might facilitate an amicable resolution; or 3) a panel (if consultations fail to resolve the matter). Once a panel report determines that the responding party has violated the agreement, the parties are expected to resolve the dispute within forty-five days or compensation or retaliation may result. The USMCA essentially retains NAFTA's provisions on trade remedies pertaining to antidumping, countervailing duty determinations (binational panels), and safeguard actions. Unlike NAFTA, each side cannot block the process by refusing to name panelists.

Preliminary Assessment of USMCA

Overall Increase in Trade between Members

There has been a marked increase in trade among the three member countries since the first trade agreement went into effect in January 1994 (Table 2.2). Intra-USMCA trade jumped from $304 billion in 1993 to $1.3 trillion in 2019 compared to USMCA's trade with the rest of the world, which increased from $536 billion to $2.24 trillion during the same period. An increasing portion of Canadian and Mexican trade is conducted with the United States. The United States accounted for 75 percent of Canadian exports (64 percent of its imports) and 76 percent of Mexican exports (55 percent of its imports) in 2019. During the same year, the two countries accounted for about 33 percent of U.S. exports (18 percent for Canada and 15 percent for Mexico).

Increase in the U.S. Trade Deficit

The U.S. merchandise trade deficit with Canada and Mexico has quadrupled since the establishment of NAFTA. United States merchandise (services) exports to

TABLE 2.2 Merchandise Exports, 1993 and 2019 (US$ billion)

Source	Destination	1993	2019
US exports to	Canada	100	292
	Mexico	42	256
Canadian exports to	USA	117	337
	Mexico	0.64	5.5
Mexican exports to	USA	42	358
	Canada	1.57	14.3
Total intra-NAFTA trade		303.82	1257
NAFTA trade with rest of world		535.68	2237

Source: U.S. Census Bureau (1993–2020)

Canada and Mexico grew from $142 (27) billion in 1993 to $548 (101) billion in 2019. However, this was not sufficient to offset the growing merchandise trade deficit with both countries. The U.S. merchandise trade deficit with Canada and Mexico stands at US$45 and 106 billion, respectively, in 2019. A substantial part of the deficit is attributed to imports of mineral fuels, vehicles, machinery, and equipment from Canada and Mexico. In services, the United States has a trade surplus of $38 billion (with Canada) and $3 billion with Mexico.

The Trade Agreement's Impact on Jobs is Uncertain

There is no conclusive evidence on the effect of NAFTA/USMCA on jobs. There are certain indications, however, that the agreement may have had a negative effect on jobs. Between 1994 and 2002, the U.S. Department of Labor certified 525,000 workers for income support and training due to loss of jobs arising from shifts in production to Mexico or Canada. In view of its narrow eligibility criteria, the program covers a small number of workers who lost their jobs due to NAFTA/USMCA. The Economic Policy Institute contends that 682,900 U.S. jobs have been lost or displaced due to NAFTA/USMCA and the resulting trade deficit (Scott, 2011). Most of the job dislocations appear to be concentrated in the apparel and electronic industries. This may be attributed to the growing trade deficit with both countries that often leads to declines in production and employment. There are also some studies that show its negative effects on agricultural employment and real wages in manufacturing in Mexico. The Canadian Center for Policy Alternatives states that the Canadian government reduced social spending (such as the qualification for unemployment insurance) to enhance competitiveness (Campbell, 2006).

A U.S. Chamber of Commerce 2012 study, however, showed that trade with the two countries supported nearly 14 million jobs of which 5 million are attributed to the increase in trade generated by NAFTA/USMCA. The U.S. International Trade Commission's report (ITC, 2019) on the likely impact of USMCA on the U.S. economy indicates that the agreement will have a positive effect on real GDP and employment.

Substantial Increase in Foreign Investment in all Countries

Since NAFTA, there has been a substantial growth in inward FDI in member countries (Table 2.3).

TABLE 2.3 Gross Inward FDI Flows 1994 and 2019 (US$ billion)

Country	1994	% of world FDI flows	2019	% of world FDI flows
Canada	8.2	3.2	50.33	3.26
Mexico	10.64	4.2	33.00	2.14
USA	45.1	17.6	246.22	15.97

Source: UNCTAD, 2020

INTERNATIONAL PERSPECTIVE 2.2

Stages of Economic Integration

Preferential Trade Arrangements: Agreement among participating nations to lower trade barriers. *Example*: British Commonwealth preference scheme, 1934.

Free Trade Area: All barriers are removed on trade among members but each nation retains its own barriers on trade with nonmembers. *Example*: The European Free Trade Area (EFTA) formed in 1960 by Austria, Denmark, Norway, Portugal, The United Kingdom, Sweden, and Switzerland.

Customs Union: In addition to an agreement to lower or remove trade barriers, members establish a common system of tariffs against nonmembers (common external tariff). *Example*: The Andean Common Market, MERCOSUR.

Common Market: A common market includes all the elements of a customs union and allows free movement of labor and capital among member nations. *Example:* The European Union achieved common market status in 1968.

Economic Union: Economic Union goes beyond a common market and requires members to harmonize and/or unify monetary and fiscal policies of member states. *Example*: Benelux, which includes Belgium, The Netherlands, and Luxembourg, formed in the 1920s and also forms part of the EU; the European Union.

THE EUROPEAN UNION

The EU is the oldest and most significant economic integration scheme involving twenty-seven Western and Eastern European countries: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. The United Kingdom left in January 2020. One of the most important developments was the EU enlargement from fifteen to twenty-five countries in May 2004 with the admission of Cyprus, Malta, and eight East European countries. In January 2007 Bulgaria and Romania also joined the EU, increasing the number to twenty-eight countries until the United Kingdom's departure. Turkey and other East European countries will be considered for admission in the coming years based on certain criteria such as stable democratic institutions, free markets, and their ability to assume EU treaty obligations (Van Oudenaren, 2002; Poole, 2003).

Although European economic integration dates back to the Treaty of Rome in 1957, the EU is the outcome of the Maastricht treaty in 1992. The European Union has an aggregate population of about 447 million and a total economic output (GDP) of US$18.8 trillion in 2019, and involves the largest transfer of national sovereignty to a common institution (see International Perspective 2.3). In certain designated areas, for example, international agreements can only be made by the EU on behalf of member states (Wild, Wild, and Han, 2006).

The pursuit of such integration was party influenced by the need to create a lasting peace in Europe as well as to establish a stronger Europe that could compete economically against the United States and Japan (Table 2.4). Since the countries were not large enough to compete in global markets, they had to unite in order to exploit economies of large-scale production.

The objectives of European integration as stated in the Treaty of Rome (1957) are as follows:

- To create free trade among member states and provide uniform customs duties for goods imported from outside the EU (common external tariff).
- To abolish restrictions on the free movement of all factors of production, that is, labor, services, and capital. Member states are required to extend the national treatment standard to goods, services, capital, etc. from other member countries with respect to taxation and other matters (non-discrimination).
- To establish a common transport, agricultural, and competition policy.

A number of the objectives set out in the Treaty of Rome were successfully accomplished. The Common Agricultural Policy (CAP) was established in 1962 to maintain common prices for agricultural products throughout the community and to stabilize farm incomes. Tariffs between member nations were eliminated and a common external tariff established in 1968. However, efforts to achieve the other objectives, such as a single internal market (elimination of non-tariff barriers), the free movement of services or capital, and so forth, was slow and difficult. Coordinated or common policies in certain areas such as transport simply did not exist (Archer and Butler, 1992).

The European Commission presented a proposal in 1985 to remove existing barriers to the establishment of a genuine common market. The proposal, which was

TABLE 2.4 USMCA and EU: Major Differences

USMCA	EU
USMCA does not provide for a common external tariff	EU has a common external tariff
USMCA has no provision for economic assistance or economic/monetary union	EU provides for economic assistance to members and economic/monetary union
USMCA does not provide for free movement of labor	EU allows for free movement of labor

adopted and entitled The Single European Act (SEA), constitutes a major revision to the Treaty of Rome. The Single European Act set the following objectives for its members:

- To complete the single market by removing all the remaining barriers to trade such as customs controls at borders, harmonization of technical standards, liberalization of public procurement, provision of services, removal of obstacles to the free movement of workers, and so on. In short, efforts involved the removal of physical, technical, and fiscal (different excise and value-added taxes) barriers to trade.
- To encourage monetary cooperation leading to a single European currency. The Maastricht Treaty of 1992 further reinforced this and defined plans for achieving economic and monetary union.
- To establish cooperation on research and development (R&D) and create a common standard on environmental policy.
- To harmonize working conditions across the community and improve the dialogue between management and labor.

The Single European Act established a concrete plan and timetable to complete the internal market by 1992. It is fair to state that most of the objectives set out under the SEA were accomplished: border checks are largely eliminated, free movement of workers has been achieved through mutual recognition of qualifications from any accredited institution within the EU, free movement of capital (banks, insurance, and investment services) has been made possible with certain limitations and the single currency (the euro) was introduced in 1999. The euro has helped reduce transaction costs by eliminating the need to convert currencies and made prices between markets more transparent. There still exists a number of challenges in completing and sustaining the single market, expanding EU policy responsibilities in certain controversial areas such as energy policy, and undertaking appropriate structural reforms to take advantage of the economic and monetary union.

INTERNATIONAL PERSPECTIVE 2.3

Institutions of the European Union

The European Council: Composed of representatives (Ministers) of member states, the council sets out the general direction of the union. The council approves legislation and international agreements, acting on a proposal from the commission and after consulting with the European Parliament.

The European Commission: Members of the commission are chosen by the mutual agreement of national governments and serve four-year terms. Larger nations appoint two while smaller nations appoint one commissioner. They neither represent nor take orders from member states. The commission initiates policies and ensures members' compliance with the EU treaty.

The European Parliament: Composed of 732 representatives directly elected, the European Parliament supervises the commission, adopts the community budget, and influences the legislative process. Any agreement concerning international cooperation must be reviewed and accepted by parliament before it is concluded. The parliament, however, does not have express legislative powers.

The Court of Justice: Settles disputes arising from the EU treaty (i.e. interprets and applies the treaty). The judges are appointed by mutual agreement of member states and serve six-year terms. The court ensures uniform interpretation and application of community law, evaluates the legality of legislation adopted by the council and the commission, and provides rulings on community law when requested by national courts in member states.

TABLE 2.5 Other Major Regional Trade Agreements

Africa Continental Free Trade Area (AfCFTA, 2019)	*Members:* 30 African countries have ratified the agreement that allows for free trade in goods, services, and dispute settlement. It will also include agreements on investment, intellectual property, and competition
The European Free Trade Association (EFTA,1960)	*Members:* Iceland, Liechtenstein, Norway, Switzerland *Objectives:* Removal of customs barriers and differing technical standards. Free trade with EU strictly limited to commercial matters
The Preferential Area for Eastern and Southern American Common Market (MERCOSUR,1991)	*Members:* Argentina, Brazil, Paraguay, Uruguay, Venezuela. Chile and Bolivia joined as associate members *Objectives*: Free trade and industrial cooperation
The Central American Common Market (CACM,1960)	*Members:* Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua *Objectives:* Free trade and a common external tariff
The Andean Pact, 1969	*Members:* Bolivia, Colombia, Ecuador, Peru, Venezuela *Objectives:* Free trade and industrial development
The Association of Southeast Asian Nations (ASEAN,1967)	*Members:* Brunei, Cambodia, Indonesia, Laos, Malaysia, Mynamar, Philippines, Singapore, Thailand, Vietnam *Objectives:* Reduction of trade barriers, industrial cooperation
The Caribbean Common Market (CARICOM, 1973)	*Members:* Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Haiti, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, Suriname *Objectives:* Political unity, economic cooperation
The Southern African Customs Union (SACU, 1969)	*Members:* Botswana, Lesotho, Namibia, South Africa, Swaziland *Objectives*: Free movement of goods, common external tariff

(*continued*)

TABLE 2.5 Cont.

The Economic Community of West African States (ECOWAS, 1974)	*Members:* Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, the Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo *Objectives:* Economic and monetary union
Asia Pacific Economic Cooperation (APEC, 1989)	*Members:* Australia, Brunei, Canada, Chile, China, Japan, South Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Peru, Russia, Singapore, Taiwan, Thailand, USA, Vietnam *Objectives:* Strengthen the multilateral trading system, simplify and liberalize trade and investment procedures among members

CHAPTER SUMMARY

The GATT/WTO	*Principal objectives of the GATT:* Non-discrimination, trade liberalization, and settlement of trade disputes between members
The Uruguay Round of the GATT and the birth of WTO	*Important results of the Uruguay Round trade negotiations (1986–1994):* Reductions in tariffs, adoption of new trade rules on unfair trade practices, GATT coverage extended to trade in services, intellectual property, and trade-related investment measures, the birth of WTO.
The United States–Mexico–Canada Free Trade Agreement (USMCA)	*Scope of coverage:* Market access for goods, services, investment, protection of intellectual property, government procurement, safeguards, standards, dispute settlement
USMCA: Preliminary assessment	*Benefits:* Increases in overall trade between members, increase in the U.S. trade deficit on merchandise trade with members, and a rise in foreign investment
The European Union (EU)	*Major objectives of the EU:* To create free trade and a common external tariff between members, to abolish restrictions on the free movement of all factors of production, to establish common policies in the area on transport, agriculture, competition, etc. *Institutions of the EU:* The European Council, the European Commission, the European Parliament, the Court of Justice
Other Regional Trade Agreements	Africa Continental Free Trade Area (AfCFTA, 2019), The European Free Trade Association (EFTA), MERCUSOR, The Central American Common Market (CACM),The Andean Pact, The Association of Southeast Asian Nations (ASEAN),The Caribbean Common Market (CARICOM), The Southern African Customs Union (SACU), The Economic Community of West African States (ECOWAS), Asia Pacific Economic Cooperation (APEC, 1989)

REVIEW QUESTIONS

1. What were the major achievements of the Uruguay Round of the GATT/WTO?
2. Distinguish between the most-favored nation and the national treatment standard in international trade.
3. Discuss the major drivers of regional trade agreements.
4. Compare and contrast the negotiating objectives of Canada and Mexico behind the USMCA.
5. Discuss the USMCA pertaining to services and investment. Has it increased trade between the member countries?
6. What are the various stages of economic integration?
7. What are the objectives of European integration? Which countries joined the EU in 2004?
8. Discuss the major differences between the USMCA and the EU.
9. What were the major achievements of the Single European Act?
10. What is the role of the EU Commission?

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World Wide Web Resources

The European Union

Information on the EU and its institutions: https://europa.eu/european-union/index_en

NAFTA: Economic and Commercial Information
NAFTA: the complete agreement: www-tech.mit.edu/Bulletins/nafta.html

USMCA
https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement

World Trade Organization

Basic information about the WTO, its agreements and activities: www.wto.org

International Trade Closing Cases and Discussions

1. The Euro Crisis and Implications

Serious intraregional divergences in competitiveness and the related build-up of regional imbalances have been the root cause of the crisis in the euro zone. The Maastricht treaty of 1992, which created the European Union and led to the creation of a single European currency (the euro), established criteria for EU member states that included the following conditions: Inflation rates below 1.5 percent, budget deficits not to exceed 3 percent of GDP, and public debt not to exceed 60 percent of GDP. Since wages are an important determinant of prices, wage rates corrected for productivity growth (unit labor costs) were expected to remain aligned to keep the union in a sustainable position.

While Germany restrained wages, other member countries such as Greece and Portugal failed to limit the continued rise in wages and inflation which affected their overall competitiveness. Trade imbalances built up as low inflation countries began to gain in competitiveness over those with high wage price inflation. Trade deficits in crisis affected countries were financed by debt as banks in surplus countries such as Germany lent to borrowers and spenders in deficit countries. Borrowed funds were used to finance consumption and speculation (house building) and not to improve productivity or competitiveness.

When the investors who bought the bonds to finance the loans to these countries realized that these countries were unable to repay the loans, they became nervous and started to sell off the bonds. Government bonds that were considered risky were subject to speculative attack and their risk premiums rose dramatically. This rendered commercial banks whose balance sheets were loaded with these bonds insolvent. The banking crisis morphed into a sovereign debt crisis. Banks began to demand higher interest rates to lend to weaker countries. *Rising borrowing costs for weaker countries and trouble for banks that loaned money to these countries constitute the root causes of the crisis.*

In essence, all new initiatives continue to follow the old blueprint. Measures are mainly focused on strengthening the so-called Stability and Growth Pact and aligning policies with the latest version of the EU's long-standing structural reform agenda—the Europe 2020 strategy. Europe continues to ignore the vital issues of domestic demand management and proper policy coordination for internal balance including the need for upward adjustment of wages and prices in surplus countries.

Questions

1. What are the major causes of the euro crisis?
2. To what extent does international trade play a role in the crisis?

2. BREXIT: Withdrawal of the United Kingdom from the EU

In a referendum held in June 2016, the United Kingdom voted in favor of leaving the EU. It was a close vote and those who voted to leave the EU won by a thin margin since the option to leave was not popular in some parts of the country. While England (53.4%) and Wales (52.5%) voted to leave, Scotland and N. Ireland voted to remain in the EU (62% and 55.8% respectively). The parties (United Kingdom and EU) have negotiated the exit conditions and the United Kingdom's future relations with the EU. The UK and EU have now concluded a Trade and Cooperation Agreement which has entered a period of provisional application in January, 2021. Free trade between the parties will continue with new rules of origin set out in the agreement. There will be new customs, border, and immigration rules. Separate provisions apply to trade with N. Ireland.

Observers provide a number of reasons that gave rise to the United Kingdom's decision to leave the Union:

- The United Kingdom is one of the biggest contributors to the EU budget (US$11–17 billion a year). Even though it does reap some benefits from its financial contributions, some people feel that they pay more than they receive in tangible benefits. They believe that these contributions could be better used to build schools, hospitals, and other infrastructure that is sorely needed than providing it to the EU.
- The EU countries are highly regulated from Brussels and withdrawal gives the country an opportunity to take back control of its laws and policies such as immigration. Leaving allows the United Kingdom to deregulate its economy and strike agreements with other countries. It is not clear whether the existing arrangement within the EU prevents the United Kingdom from undertaking further deregulation. It remains to be seen whether the new trade arrangements with the United States and other countries compensate for lower U.K.–EU trade.

There are potential consequences for such a decision. The United Kingdom will be a new actor in international economic relations. It has to establish a new framework for its bilateral and international relations. There will be substantial costs involved to settle financial obligations arising from its withdrawal that are estimated at US$43–51 billion. It also entails further costs relating to replacing all existing EU laws and undertaking further negotiations to define its future status with the EU.

The United Kingdom's economic performance since joining the European Common Market in 1973 has been quite impressive. Since 1973, its GDP per capita has doubled and the Human Development Index that measures overall standards of living shows the United Kingdom outperforming other member countries (except Germany). Presently, the EU accounts for 44 percent of U.K. exports and 53 percent of its imports. Exports from the United Kingdom to the EU account for 12 percent of U.K. GDP while U.K. imports from the EU account for 3 percent of EU GDP. Furthermore, U.K.–EU trade is 3.2 times larger than the United Kingdom's trade with the United States, its second-largest trading partner. There are concerns that withdrawal from the EU will weaken its economic position (lower trade, lower FDI inflows) and social cohesion (for example, Scotland seeking independence from the union).