MBA Teaching Note 18-03
Imports, Exports, and Free Trade Agreements: The Truth

The world of international trade is complex, consisting as it does of thousands of companies operating in nearly 200 countries. The basic ideas behind international trade, however, are relatively simple, but they are inaccurately portrayed by the media, by economists, and especially by politicians. In this note, I shall clear up some of the misleading information you typically hear.

How International Trade is Supposed to Work

Honduras is a major producer of coffee and the United States is not. The climate and terrain are simply more conducive to growing coffee in Honduras. On other hand, the United States is a major producer of oil, and Honduras is not. Oil is plentiful in the U. S., and it is not in Honduras. So, the U. S. and Honduras can benefit from trade with each other. The Honduran currency is the lempira. When Honduras buys oil from the U. S., it pays in dollars. When the U. S. buys coffee from Honduras, it pays in lempira. If the U. S. pays Honduras more in lempira for coffee than it pays the U. S. in dollars for oil, the demand for lempira relative to the dollar will fall. Hence, the lempira will strengthen. Or, if Honduras pays more for oil than the U.S. pays for bananas, the demand for the dollar will rise relative to the lempira. Taking the first of those cases, if the lempira strengthens relative to the dollar, Honduran coffee will become more expensive to Americans and they will consume less coffee, while Hondurans will consume more U. S. oil. Eventually the reduced demand by Americans for Honduran coffee and increased demand by Hondurans for U. S. oil will result in a reduction in the exchange rate of the lempira relative to the dollar.

If the international trade were only that simple. Instead, there are multiple products that trade between the two countries, and the demand for these products also affects the exchange rate. Honduras is also a heavy producer of bananas. The increased demand by U. S. citizens for more expensive Honduran coffee can be partially offset by coffee bought from other countries, such as Uganda. Suppose Americans demand more Ugandan bananas and buy less Honduran coffee. This weakens the lempira. When U. S. oil is high due to a strong dollar, Hondurans might buy more oil from Venezuela. It is almost impossible to predict the net effects of increased or decreased demand and changing exchange rates, as there are so many products and transactions between countries.

Government Intervention

In addition, governments often intervene in international markets to manipulate exchange rates. Through their central banks, they can buy and sell their own currency in large quantities, thereby forcing exchange rates in a certain direction. In extreme cases, they might fix the exchange rate of their currency with another currency. It is well-known that China has held the yuan to an artificially low rate, which keeps Chinese goods at a competitive advantage over goods manufactured elsewhere. Hence, we get more “made in China” products, such as iPhones and Nikes.

Buy American = ??

Often we hear politicians, business leaders, and workers telling us to “Buy American,” meaning to buy products made in the USA. Since Americans will not assemble iPhones for the wages that Apple pays Chinese workers, iPhones are not made in the USA. Apple has determined that it can maintain absolute quality control with its Chinese assembly process. Those who argue for American citizens to buy American are arguing that iPhones should be made in the USA, and they lament the jobs that are exported when a high demand product is made in a foreign country.

In reality, Buy American = Pay More. This is generally true for simple-to-manufacture products such as cell phones and running shoes. The quality control is maintained by these American companies, but they can obtain the raw materials and the labor much cheaper in foreign countries. Politicians and others sound patriotic when they say "Buy American," but they look at only one side of the picture. Would Americans want to pay more just to be able to say they are buying American? Is our patriotism and desire to help those who will not work for Chinese-level wages strong enough to make us buy American and pay more? It is unlikely. In fact, buying non-American made goods is no less patriotic than shopping at Home Depot rather than the small locally-owned hardware store is any less loyal to a community. Continuing to support a business that provides the same product at a higher price is not loyal and patriotic: it is an inefficient use of resources, and it encourages waste. Those who have invested capital in the small local store would do better to be in a different line of business.

Tariffs

Another way in which governments attempt to intervene in international finance is by the use of tariffs. A tariff is essentially an import tax. If the U. S. government wanted to limit American consumption of Honduran coffee, it could impose a tariff, which is paid by the buyer, and effectively raise the cost of Honduran coffee.

When one government imposes a tariff, the other often responds by doing the same for one of its goods. Thus, if the U. S. put a tariff on Honduran coffee, Hondurans might put a tariff on U. S. oil. When countries retaliate in this manner, we often say that we are engaged in a trade war. Trade wars are usually big news. When President Trump announced that he would impose tariffs on Chinese steel, he was heavily criticized for provoking a so-called trade war. The news media enjoy stories like this. In fact, it was an overstatement, and trade wars are never started because they are ongoing.

In reality, there are thousands of tariffs in place on various goods. The United States International Trade Commission (USITC) maintains an Excel spreadsheet of all tariffs imposed by the U. S. at https://dataweb.usitc.gov/tariff. (Click on "Tarif Annual Data" and extract the spreadsheet, called "tariff_database_2018," or whatever year you are interested in.)

The 2018 spreadsheet has 13,200 lines, each representing a product. Notice the first line, which is "Live purebred breeding horses," shows that these items have no tariff. In the second line, however, it indicates that "Live horses other than purebred breeding horses," are also tariff-free. In contrast in the third line, we find that "Live asses" carry a 6.8% tariff rate, but they are tariff-free if from certain countries. So as far as tariffs are concerned, certain types of horses are free, but asses can cost you more. [1] As another example of this point, we find that "Men's or boys' underpants and briefs, of textile mats (except cotton), cont 70% or more wt of silk or silk waste, not knitted/crocheted" has a 1.7% tariff, but if the underwear is "Men's or boys' underpants and briefs, of textile mats (except cotton), cont under 70% by wt of silk or silk waste, not knitted/crocheted," then the tariff is 10.5%. Why the difference? In all likelihood, some lobbyist or trade association that has a vested interest in silk that is used in men's and boys' underwear has convinced the government to tax the use of silk. For one more example, "Blankets (other than electric blankets) and traveling rugs, of wool or fine animal hair" have no tariff, but "Blankets (other than electric blankets) and traveling rugs, of cotton," have a tariff of 8.4%. The U. S. cotton industry clearly wants to encourage U. S. citizens to buy U. S. made cotton blankets instead of importing them. These tariffs raise some revenue, but more importantly, they distort the workings of the free market.

Of the 13,200 items listed in the spreadsheet, Excel counted 4,137 that showed the word "Free." Thus, there are approximately 9,000 items that carry tariffs of some form. So, the next

[1]This is not intended to be a joke. An ass, also known as a donkey, is a close relative of a horse. The U. S. government could have called it a donkey, but it chose not to.

time someone says that a new tariff will start a trade war, ask them how the war is going with the 9,000 other tariffs already in place.

As an international traveler, you might be familiar with the notion of "duty free purchases." The appendix explains what this is, in the context of tariffs.

Free Trade Agreements

Much has been written about free trade agreements. The most famous was probably NAFTA, the North American Free Trade Agreement between the U. S., Mexico, and Canada, which was passed in 1994 under the Clinton administration. In September, 2018 the Trump Administration renegotiated NAFTA. Another well-known and so-called free trade agreement was the Trans-Pacific Partnership, which is between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the U. S. It was signed into law in the U. S. in early 2016, but the U. S. has since withdrawn and the other countries entered into a revised agreement called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Free trade agreements have the ability to reduce if not eliminate some tariffs, but they do not create free trade, because they do not eliminate all tariffs. If tariffs are eliminated on some goods, then those goods are now open to free market competition between the companies in the respective countries. But if all tariffs between the two countries are not eliminated, then other goods are not open to free market competition. The tariff-free goods are not necessarily directly competitive with the goods that still have tariffs, but all goods compete with each other for the consumer's dollar. Hence, though television sets and sporting goods are not typically thought of as substitutes, they are both forms of recreational items and, as such, they compete for the time and money consumers spend on recreation. If one has a tariff and the other does not, the market is distorted, and there is no real free trade.

Free-trade agreements are essentially forms of government intervention whereby governments establish policies that carve up the market. When companies do this, we call it a cartel and we make it strictly illegal, as it is anticompetitive. Yet, when governments do this, it is perfectly legal.

At the G-7 summit in Quebec, Canada in June of 2018, President Trump suggested to the leaders of the other six countries (Canada, France, German, Italy, Japan, and the U. K.) that these seven countries drop all tariffs and trade barriers. The other leaders were incredulous at the suggestion. They actually thought he was kidding.

Appendix: What does Duty Free Mean in an Airport?

If you are leaving a country and are at the airport past the final security check, you will usually have access to a duty free shop. This type of business sells a variety of products, some of which are made in the country you are leaving and some of which are made elsewhere. Because you are leaving the country, you presumably would not be consuming them in the country you are leaving. Hence, the store is allowed to sell them to you without having paid the tariff it would pay to import the goods into the country you are leaving for the purpose of their being consumed in that country. For example, suppose you are shopping in the heart of London and you pass a chocolate store and go in and buy some Lindt chocolates. Lindt is a Swiss chocolate company. Let us assume the U. K. imposes a tariff on the importation of Lindt chocolates. You would pay that tariff as part of the price.

Suppose instead that you wait until reaching the airport. Now, assume you have passed through security and on the way to the gate you see a duty free store. You go in there and buy Lindt chocolates. Because you are presumably leaving the country, you will not be charged the U. K. tariff for importing Lindt chocolates. Interestingly, you also bypass the tariff that might be imposed by the country you are flying to. How do they know you will consume the chocolate in the country you are traveling to instead of the country you are in? They hold your package and deliver it to your gate. You will pick up your package typically in the jet bridge as you board your flight. That is why you see what often looks like gift bags in the jet bridge, and you wonder why you did not get a parting gift.

The duty free stores are all visually quite appealing. Consumers feel they are getting a great deal. Though some tariffs can be fairly significant, it may be quite likely the case that you are buying something that you do not need. In addition, you cannot be sure that the item could not be bought cheaper in your own country. For example, most goods that can be bought in the U. K. can be bought cheaper in the U. S. Most goods that can be bought in the U. S. can be bought cheaper in some areas of the U. S. than in others. And finally, in this day and age, most foreign goods can be bought on the Internet from distributors in the U. S., so there is ample opportunity to shop around.

In short, duty free shopping is not likely to save you much money, but you will return with a nice shopping bag and a story to tell, however dubious, about how you got such a good deal on those Swiss chocolates in the duty free store at London's Heathrow airport.