

THE STRATEGIC TRADE POLICIES: COMMERCIAL DISPUTES ON THE WORLD AIRCRAFT MARKET*

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Abstract: *The paper aims to illustrate how strategic trade policy is used by analyzing the concrete situation in the world aircraft industry, focusing on the case of the large civil aircrafts and on the regional jet aircrafts. We want to clarify which is the position of GATT / WTO regarding the strategic trade policy, what are the factors which made it possible to use strategic trade policy in the aviation industry and how the strategic trade policy was implemented by the four major market actors considered, the disputes that have arisen from the use of strategic trade policy and how these were resolved.*

Keywords: strategic trade policy, oligopoly, subsidies, multilateral system, countervailing measures
JEL classification: F12, F13, F14, F42, F53

INTRODUCTION

Within GATT and, later on, WTO a special attention was given to the regulations of subsidies and to how to control them, in order to avoid trade distortions (DeCarlo, 2007, p. 6), through the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement) for industrial products and the *Agreement on Agriculture* for agricultural products, this one being a more delicate subject among the multilateral negotiations. There is also a mechanism for solving the conflicts, in which the panel judges if the governmental policy is in accordance with the legislation and government measures designed to answer to trade distortions that take place due to such inadequate actions. Moreover, the Organization for Economic Co-operation and Development oversees the compliance with a commitment of 30 of its members which regulate the conditions and the rates used for financing the exports.

The concern regarding the implementation of this aspect in the multilateral negotiations and the regulations framework of international trade is an obvious one, taking into account the effects that this kind of public policies would have on international commercial flows. The importance of a

* ACKNOWLEDGEMENT: This work was supported by the European Social Fund in Romania, under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development 2007-2013 [grant POSDRU/88/1.5/S/47646, grant POSDRU/89/1.5/S/61755].

multilateral approach is even higher, as there is a trend to replace the trade barriers with this kind of more subtle ways of encouraging the domestic production, all kind of subsidies, from simple *ad valorem* payments based on the size of export turnover, until complex fiscal credit systems, loans, insurance and guarantee programs etc. (Conconi, 2001, p. 1)

1. THE STRATEGIC TRADE POLICY IN THE CONTEXT OF THE GATT/WTO MULTILATERAL SYSTEM

Within the Uruguay Round of the multilateral trade negotiations, the GATT code regarding subsidies was revised and the new negotiated agreement associated the subsidies with a different colour: green (permitted), amber (slow down, decreasing), red (forbidden). At least 34 countries agreed to gradually reduce the aids given to domestic producers in order to stimulate exports. To enter into an allowed subsidy category, a subsidy must not distort trade, or, at most, should affect it in a very small extent. Subsidies should be government funded and should not support the price directly, and it does not refer to subsidies that address a specific product or company, but are available to everyone.

Part I: Article 1 of WTO *Agreement on Subsidies and Countervailing Measures* defines a *subsidy* as the situation where (a) there is a financial contribution from the government or other public body or it is offered any form of income or price support (as art. XVI GATT 1994) and (b) that company is given a benefit. If point (a) takes place, financial contribution can be made by direct transfer of funds (grants, loans, equity infusion, etc.) or through potential direct transfers (loan guarantees) by giving up the budget revenue collection (like stimulate business through tax credit), except those related to the national territory good consumption through offering of goods and services by the state, other than general infrastructure, or through purchase of goods etc.

In the context of the subsidy definition, we can see that the classification procedure of a government support concerning the subsidies category is not straightforward. For example, the export credit support provided by an agency or government department or a private entity on behalf of the state, falls within the definition of financial contribution, but it is not required to provide a benefit. If the government provides a credit to an economic agent under the same terms as it would get from a private lender, we cannot speak about any subsidies. The notion of advantage is essential to determine whether a measure is a subsidy or not. (Berinde, 2004, p. 174)

In order to be penalized according to GATT provisions, a grant must be awarded with the *specificity* character to a company, an industry or to a group of firms or industries. According to

Article 2, a subsidy is specific if the paying authority or the law, under which the authority operates, explicitly limits the access to grant funding only to certain companies or industries. If the paying authority or its operating law establishes neutral eligibility criteria and objective, that do not favour certain firms, and they are of economic nature and horizontal as it concerns the application procedure (e.g., number of employees, firm size etc..) for the subsidies access and for the establishment of the financial support size, then the subsidy cannot be considered specific.

If, despite the non-specificity resulting from the application of the two principles above, there are reasons to believe that the subsidy is specific, in this case, factors such as: the use of a subsidy program by a limited number of companies or mainly by certain companies, providing disproportionately large amounts of money to certain companies, the manner in which the financing decision of firms is made (the rejection or approval frequency of the subsidies, the criteria underlying these decisions and so on) may be taken into consideration. Likewise, the agreement states that an available subsidy to a limited number of firms located in a specific geographic area will be considered as specific. This is not the case for contributions and local taxes, determining their level being part of the attributes of the local authorities.

The agreement strictly regulates the reporting procedure of an existing category of actionable subsidy case, the compensatory measures being applied only if there has been a substantial increase in the imports of subsidized products, either in absolute value or as a percentage from production or consumption, if the prices of the subsidized goods decreased the domestic price of the goods or similar goods, if there is a causal determination between the import of subsidized products and a damage brought to the national economy etc. Over the time, the *Agreement on Subsidies and Countervailing Measures* underwent a series of changes and updates, bodies responsible for the enforcement of its provisions being put often in the position of solving this kind of commercial disputes.

The *Agreement on Subsidies and Countervailing Measures* recognizes the fact that the subsidies may contribute significantly to the development programs in the developing countries, due to the fact that this category of countries is provided with a special and different treatment, consisting in a postponement of the ban on subsidies use, settlement of the transitional period etc. However, the Agreement recognizes the special status of the countries that are undergoing a transition process, from a planned economy to a market economy, countries that could apply the programs and measures necessary for this transformation. (Berinde, 2004, pp. 179-180)

2. THE COMMERCIAL CONFRONTATION ON THE LARGE CIVIL AIRCRAFTS MARKET: BOEING VERSUS AIRBUS

The aircraft market might be explained through the oligopoly specific conditions, especially concerning the large aircrafts designed for passengers, the supremacy being disputed by two major producers: AIRBUS and BOEING. A third important manufacturer, MacDonnell Douglas (US), was purchased by Boeing in 1997. Airbus is a European airplane manufacturing company, founded as a result of an agreement among important European countries, such as: Great Britain, France, Spain and Germany, as a reaction to the American monopoly represented by the Boeing Company. The latest was created at the beginning of the 20th century and nowadays produces civil and military aircrafts and not only. Being close to a duopoly, the success on the market depends upon the decisions regarding the price product and the manufactured quantity of the competition. The big potential of this market and the importance of the both manufacturing large civil aircrafts companies are underlined through the evolution of the turnover obtained in the last 5 years.

Table 1 - The evolution of Airbus and Boeing revenues (civil aircraft)

Producer	2007	2008	2009	2010	2011
AIRBUS (billion EUR)	27,453	28,991	28,067	29,978	33,103
BOEING (billion USD)	33,386	28,263	34,051	31,834	36,171

Source: EADS (2011) *Revenues per division*; Boeing (2011) *Annual Report*.

Heymann (2007) underlines five features of this market which could explain why the influence of the government is so pronounced in this industry and it could help to understand the conflicts between the firms concerning subsidies. During the time, one of the most intense disputes between European Union and US, raised from the Airbus and Boeing conflict on large civil aircraft market, was founded on subsidies accusations of manufacturing these goods.

A prim factor refers to the entry barriers that are extremely strict for the market newcomers being impossible for them to successful compete with the ones that are already on the market. The main source of these entry barriers is represented by the economies of scale and the large necessities of capital, adding also the complexity of the final product which implies tremendous research – development costs, qualified human resources with engineer and scientific expertise. The huge value of the investment is also an exit barrier, because if a commercial failure takes place, it is very difficult to use the investment for other purposes. For example, Airbus A380 was purchased with 12 billion USD, and a Boeing 787 was also over 10 billion USD. (Economist, 2005a, 2005b)

The entry difficulty into this type of market is underlined and by the recent Russian – Chinese project that created a common company, through the association of OAK (the Russian holding that reunites the Russian aircrafts constructors' actives) and COMAC (the aerospace producer from China). If China will succeed ensuring her financing, the project will have over \$10 billion/budget, and will have as a starting point the Russian model Iliușin 96, which is a long course airplane available since 1993 especially in Russia, but, in order to answer the present standards and to be able to compete with the occidental airplanes, the model should be substantial modernized, especially in that what concerns the fuel consume. (Cojocaru, 2012)

Another factor is related to the length of the investment cycles in the large civil aircrafts market area. A large number of a certain model of aircrafts has to be sold (at a price between 50 and 250 million USD) in order to recover the research – development and manufacturing spending belonging to that certain model. It has been estimated that a manufacturer has to sell around 500 – 600 aircrafts from a certain model (this action can extend to 10 years) in order to obtain profit. Therefore, there is an uncertainty concerning the success or failure when developing a new product, which, added to the amount of capital used, makes that a single misstep to endanger the existence of the entire company. (Caliskan, 2010, p. 1130)

A third factor refers to the fact that, although the aerospace industry, viewed as a whole, is a growing one, the airplane orders follow a cyclic evolution, which include large periods of time between the order placement, manufacture and shipment. These long periods of time make this type of airplane production to be affected by external shocks, e.g. Gulf War or September 11 attack, which may lead to annulments of previous orders.

Another important aspect is the duopoly structure. However, despite the asymmetric distribution between the two producers and the large number of customers, discounts have become a standard promotion sales instrument and a sign of rigid competition. This tight competition between the two producers is underlined by the continuing process of the ships quality improving, the comfort increasing and the fuel consumption and pollutant emissions and noise decreasing.

The last, but not the least, the argument related to the national security of supplying and protection of this kind of industry is one which refers to the tradition of both geographic areas. There is a strong connection between military and civil aircraft industry, each of the companies having a strategic importance for her own government. Therefore, the development contracts for the military part can induce positive effects in the civil part, in the same way that the sales of military aircrafts, offer a commercial success because it presents a bigger output and a reduced cyclicality. (Caliskan, 2010, p. 1130)

Public support and subsidies are the most contentious issues from the large civil aircraft area. Until now four international agreements concerning the subsidies regulation have been completed in this industry: OECD - 1978, GATT – 1979, EU - US – 1992 and WTO - 1994, although there are more specific rules, with multilateral character, concerning the different types of government support. By the late '70s, the American company Boeing was in a quasi-monopoly situation on this market, Airbus starting to compete only in the 80s. Since the beginning, the US was concerned with the European competition and the subsidies paid by European governments to develop the first Airbus models. To this problem, the concerns related to the European subsidies received by Boeing from military programs and those funded by NASA, were countered.

In the main round of confrontation between the two producers, both parties addressed to the World Trade Organization. WTO consultations have evolved by creating two panels, one for resolving the complaint from the European Union and one designed to resolve the complaint addressed by US, other countries (third parties) being also interested in the dispute: Australia, Brazil, Canada, China, Japan and South Korea. Because the initial complaints were not resolved, in June 2005 and January 2006 new complaints were filed.

Regarding the US complaint against the European Union and some of the member states (France, Germany, Spain, UK), the charges aimed over 300 specific situations covering a period of about 40 years in which the development subsidies, manufacture and sale of products by Airbus were claimed. These can be grouped into five aid categories: support for launch aid and funding from member states, loans from the European Investment Bank, grants for infrastructure and related matters, measures for company restructuring, financing research and technological development.

After analyzing the US requests the panel accepted the majority of the claimed situations as being specific subsidies prohibited by the international agreements, underlying the nature of some measures or limiting their action only for a certain period or for some certain models. The conclusion was that the panel subsidies granted to Airbus seriously damaged Boeing, because the public authorities or community took over a part of the risk incurred by the launch of new products. Airbus could not launch new products as they did before if the subsidies did not exist. Meanwhile, American exports were restricted on markets such as European, Australia, Brazil, China, Taiwan, South Korea, Mexico and Singapore, but also there were decreases in the overall sales, the increasing on the Airbus market share was made by damaging Boeing and due to the received subsidies. The panel recommended eliminating the negative effects of the measures taken or eliminating highlighted subsidies, decision that EU appealed.

After the appeal, the majority of the conclusions were maintained; the most important change was the research and development funding program elimination and the denial of Boeing removal from the market for the following countries: Brazil, Mexico, Singapore and Taiwan. A final decision was taken on June 1, 2011 when EU committed itself to respect and implement the report recommendations. But the process was time-consuming, US accusing EU of ill will and unleashing even a new arbitration procedure.

The complaint from the European Union at the United States, was referring to the following ten categories of measures that represented subsidies given to the large civil aircraft division of Boeing aircraft company, as opposed to the Agreement on Subsidies and Countervailing Measures: the Washington State and the Everett authorities have granted tax and non-tax incentives to the company, especially in connection with 787 model from Everett; Wichita City (Kansas) provided discount taxes for the property and sales while Kansas State subsidized some of the loans interest, fiscal and non-fiscal incentives offered by the state of Illinois, Chicago authorities and those of Cook County, once with the head office relocation of Boeing; NASA has made payments to Boeing and offered access to government facilities while equipment and employees of Boeing under research and development contracts were included in eight research and development programs in aeronautics area funded by NASA, Department of Defense made payments to Boeing and gave access to some government facilities while Boeing equipment and employees under research and development contracts were included in 23 programs of research, development, test and evaluation; Department of Commerce made payments to Boeing and granted access to government infrastructure while the Boeing equipment and personnel was offered to joint ventures where Boeing participated in an Advanced Technology Program, transfers of some intellectual property rights acquired under contracts and agreements with NASA or with the Ministry of Defense, amounts reimbursed by NASA and the Ministry of Defense, Ministry of Labour awarded Boeing with employee training grants, exemptions from payment of fees related to sales made in foreign companies etc.

The European Union estimations for the whole subsidies equalled \$19, 1 billion which were given to Boeing by the Americans between 1989 and 2006. Half of this money, around \$10, 1 billion comes, from a European Union point of view, from NASA's subsidies for research development activities. In March 2011, however, the panel in charge with analyzing the EU complaint, realized that only some of the measures implemented by Washington, Kansas, Illinois and cities within them, concerned with the promotion of NASA's research and development, Ministry of Defense, etc. can be considered special subsidies, the total amount for the 1989-2006

period was for at least \$5.3 billion, all this having a serious harm effect on EU interests through the restriction of Airbus entry on third markets and a significant decrease price and sales volume. Also, the panel noticed that USA violated the 1992 agreement recommending that all measures to be taken in order to eliminate all the negative effects and the subsidies withdraw.

Both parties appealed the panel report, the appealing organism offering a reply in March 2012. Therefore, the report made by the panel offered a number of modified conclusions, but the conclusion that stated that the subsidies that were covering the research and development in the aeronautics area brought drastic harm to the European Union interests, decreases in sales and prices, but also the exit from the market, as in Kenya, Iceland, Ethiopia (especially the aircrafts with 200 – 300 seats) was maintained. Adopted on 23rd March 2012, the report was accepted by the US (measure accepted also by the EU), which accepted to implement this recommendations within six months as stipulated in the Agreement on Subsidies and Countervailing Measures.

3. THE COMMERCIAL CONFLICT ON THE MEDIUM AIRCRAFT MARKET FOR REGIONAL AIR TRANSPORT: BOMBARDIER VERSUS EMBRAER

The conflict between Brazil and Canada appeared once with the aeronautic market: jets with less than 100 seats which used to operate regional flights on distances smaller than 1000 km and flights that lasted around one hour. These jets replaced propeller aircrafts in routes that merged isolated communities to important transport nodes or in those that merged two cities directly, trying to avoid the main hubs. When the fuel price was acceptable, airlines companies were seeking for solutions to expand the transport services that they offer. These kinds of aircrafts were an optimal solution that was easy to use.

The first conflict between these two countries has Canada as complainant and Brazil as a defendant. The case started from PROEX, the Brazilian financing export agency which offered credit to Brazilian exporters through direct financing or through interest equilibration. After a series of protests expressed since 1996 within WTO, Canada disputed the subsidies given by PROEX to Embraer foreign buyers between 1998 and 1999. Upon request, the WTO dispute settlement body established a panel which was meant to analyze the complaint, something that made both, EU and US, to be interested. After analyzing both sides, the panel decided that these are against what is stippled in the Agreement on Subsidies and Countervailing Measures, decision that is appealed without success by Brazil, Canada ending up winning. Although Brazil declared that implemented the necessary measures in order to avoid the 90 days deadline, Canada complained in November

1999 that, in reality Brazil did not take the measures, observation that was also noticed by the dispute settlement body. Therefore, Canada requested in May 2000 the approval for taking compensatory measures in accordance with GATT provisions and agreements, equalling \$700 millions/year. This sum is contested by Brazil, the final amount established at the end being \$344, 3 million/year plus Canada's right to suspend tariff concessions and other obligations assumed by Canada from Brazil. However, Canada insisted on finding a negotiation solution, without hurrying in applying the compensatory measures. Brazil defended herself all the times sustaining that this is similar to the \$1, 2 billion loan that the Canadian government gave to Northern Airlines Company in order to buy Bombardier airplanes. Through interest equalling, Brazil offered to the third financing party an equivalent payment that could cover the difference between the established interest with the purchased and the cost of finding those money.

Based on this argument, the implication similarity of the both governments, the second commercial conflict appeared between these two countries, having Canada as a defendant, conflict triggered by the competition between the two firms in order to obtain the supply contract of 75 medium airplanes for Wisconsin Airlines passengers, one of the United Airlines branch. On 10th January 2001, the Canadian government accepts to give to this company a loan up to \$1, 1 billion dollars, with reduced interest in order to help Bombardier to ensure its contract. Immediately, the Brazil Foreign Minister responds with a threat of retaliation, saying that by offering the loan, Canada accepts what she always denied, that provides illegal subsidies. Canada responded by insisting that it's just a measure of financing counter below price market which Brazilian government offers to Embraer, so it is a mirror subsidy. And, as Judge Michael Hart, a former Canadian trade negotiator affirmed, the Canadian government did not violate any laws or international trade rules, the multilateral agreement allowing to grant such subsidies as granted by other competitors. (Lau, 2001)

But, in February 2002, the WTO dispute settlement body adopted a report stating that the help granted by the Canadian government in order to support the aircraft selling's produced by Bombardier were an illegal subsidies form, as it was the offering of the subsidies to the purchaser of this kind of planes. Also, in 2003, WTO gives Brazil the right to impose penalties as a response to the subventions offered by Canada, to a \$250 million level, much less as the requested level, \$3, 36 billion. In this case, also the governments of both countries re-affirmed the preoccupation for finding a negotiation solution, which would permit to avoid the imposition of financial penalties. (Doh, 2003, p. 11)

The conflict between Brazil and Canada regarding the support offered by both states for the producing firms of propeller aircraft, Bombardier and Embraer, brought in front debates concerning export loans and underlined the WTO role in the international trade relations. Brazil not being a member of the Organization for Economic Cooperation and Development, Canada could only appeal the measures taken by this state.

Brazil countered, claiming Canada for using some export support measures, the same as it was used in the body called *Canada Account - Export Development Canada*. On the web page, it is clearly mentioned the role of this institution: to support, among other things, those export operations considered by the Ministry of Foreign Trade as being of national interest. In the offered list, that contained the 17 transactions supported until today, there is listed the support of aircraft exports of Bombardier towards Northwest Airlines, (2002), Air Wisconsin Airlines Corporation (2001), Comair (2004 and 2005), SAS AB (2009), the value of financed transactions being around \$1 billion.

In the case solving, the panel and the body had to define exactly the mean of provisions concerning the interest rate in report with the commitment. The panel appreciated that the credits for the export can be protected by the provisions of section k, if they take the direct financing loan shape, refinancing or supporting the interest rate and applies to the interest rate established in OECD agreement, like other clauses therefore.

This assessment may have strong implications over the pure hedging (e.g., the insurance that some export credit agencies offer against political risks and/or commercial, that do not involve the participation or financial support) that would not benefit from the extent permitted status, but would fall under the agreement. From WTO's point of view it is not important whether the institution or the program pays the fees or not, rather if the support offered is more generous than the one offered by the private sector.

CONCLUSIONS

The subject tight with strategic trade policy application has not been omitted from the list concerning the multilateral regulation of international trade. As the barrier tariffs concerning the movement of goods were eliminated or reduced as importance, there was a shift for the utilization of non-tariff protectionist policies nature, more subtle and more difficult to identify and combat. In the same range the strategic trade policy is also included. Given the impact that such export promotion tools can have on international trade, it is not hard to understand why it was initiated

within GATT / WTO, signed by the member states and why an Agreement on Subsidies and Countervailing Measures implemented.

This is the trial of any dispute, claim or complaint of WTO's member states regarding other governments measurement application that promote exports through various mechanisms to subsidize domestic firms. The aircraft industry is an example to easily illustrate the impact that strategic trade policy may have on profits division in an oligopolistic market or to show how a near-monopoly company can be shaken by such measures. Both segments analyzed in this paper, the large civil aircraft and the jet aircraft for regional transport, offer basic information on how firms interact in such a market, the available tools they have available in order to support national firms, the effects of these measures on the market share and profits size etc.

The topics discussed above also bring to foreground important elements regarding the ways in which firms and competing countries can react to measures which would disadvantage through complaints brought at the Dispute Settlement Body within WTO. Due to this completed procedure, there were captured important reasoning behind the panel decisions that was called in these files and the final decisions that remain after each one of them appealed. An interesting element are the analyzed countries involved in trade disputes although they obtain this right on decisions based on ability forum, they did not use compensatory measures, and they preferred dialogue and the negotiation for solutions avoiding trade retaliation.

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