

Hostage Taking & the Political Economy of Trade Warfare

Prepared for the WTO workshop sponsored by the

UW Jackson School of International Studies,

UW Department of Economics, and Hong Kong Economic Association

Seattle, Washington, USA

4 December 1999

Preliminary Draft

All Constructive Comments Welcome

Abstract: Countries injured by a partners trade practices choose their retaliation targets with the intent of altering the value their trading partner perceives of protecting markets from positive to negative rather than in strict reciprocation for what sector was damaged. Rather than being “irrational” and “inexplicable” as frequently described by skeptical journalists and outraged industry groups this practice makes perfect sense if it is assumed that both nations act to maximize their objectives.

Heather A. Hazard
International Economics and Management (INT)
Copenhagen Business School (CBS)
Nansensgade 19, 7
1366 KBH K DENMARK
Email: hh.int@cbs.dk
Tel.: (45) 40 38 35 85
Fax: (45) 86 65 85 45

International trade conflicts arise frequently. Elaborate, many-times-reformed mechanisms within the multilateral trading system exist to resolve them. Nonetheless, conflicts today are going unresolved with increasing frequency and are escalating and damaging trading relations. Countries injured by a partners trade practices choose their retaliation targets with the intent of altering the value their trading partner perceives of protecting markets from positive to negative rather than in strict reciprocation for what sector was damaged. Rather than being “irrational” and “inexplicable” as frequently described by skeptical journalists and outraged industry groups this practice makes perfect sense if it is assumed that both nations act to maximize their objectives.

If we assume a simple political economy set-up (a la Hoekman and Kostecki, 1995) where two countries are engaged in a game with a Prisoner’s dilemma hierarchy of payoffs to non-cooperative behavior, then we can characterize the hit lists as efforts to alter that pay-off hierarchy in the single shot game to yield a forced opening. This can also be thought of as an investment in reputation in case the system itself fails to enforce the repeated game set-up capable of producing a free trade equilibrium.

Goals and functions of conflict resolution in the multilateral trading system

Two overarching goals of conflict resolution in international economic organizations are to:

- achieve a reasonable degree of compliance with the obligations; and
- resolve conflicts (regarding obligations) so as to reinforce the integrity of the system.

In addition, some contracting parties to the WTO (i.e., the United States) would like to use the dispute settlement system to modify negotiated texts and establish a body of decisions with precedential value for resolving future conflicts.

More broadly, the multilateral trading system can be used to:

- 1) promote the working relationships necessary among nations for dealing with issues of global governance (e.g. security, environmental degradation, etc.);
- 2) constitute a forum where all members can be heard regardless of their economic power;
- 3) provide decisions based on the standards of fairness articulated in the system's charter agreement;¹
- 4) avert further disruptions to trading patterns, and most fundamentally,
- 5) promote continued trade liberalization.

Three basic functions have been assigned to international supervisory mechanisms: review, correction, and creation. To these we would add: deterrence, timely intervention, and restitution. Of these six potential functions, the WTO is most clearly oriented towards review and correction. If the WTO secretariat were allowed to operate pro-actively, it could provide deterrence and timely intervention, but it would require a major philosophical shift for the WTO to serve as a vehicle for creation and restitution.² Currently, the WTO takes no active steps to initiate mediation of conflicts and promote settlements. The system could be reformed, however, so that abuses of the WTO are reviewed and corrected in a timely manner. This would be a powerful deterrent to abuse.

How does the structure of the mechanism encourage self-punishing losses?

Imagine that we can describe the welfare of the parties to an international trade conflict (the respondent and the complainant) by using multi-attribute utility functions and that there is a Pareto frontier where neither of them can

¹ These standards are to identify whether there was a breach in the agreement and, if so, whether any injury resulted from the breach. If the answers to both questions are yes, then a complainant has the right to further claims against the respondent.

² By creation we mean the generation of solutions not previously prescribed by custom or law. Restitution is compensation for damages already inflicted.

improve their welfare without damaging the other ³. (See Figure 1.) Neo-classical economists are set apart from the rest of the world by the key assumption that society operates on this optimal frontier. Inequities in distribution are dismissed because (theoretically) they can be handled through informal transfers of wealth from one party to another (i.e. through side-payments). As soon as the optimization assumption is relaxed⁴, we can step into the intuitively more familiar, imperfect world. In this world, inefficiency abounds and negotiation over distribution never ceases.

Assume that we begin at some sub-optimal point, O. (See Figure 2) From O, the parties can undertake actions that increase their welfare either unilaterally (Zones B and D) or jointly (Zone C) given constraints of current technology, endowments, etc. Of course, the welfare of both could also deteriorate (Zone A). Again this not necessarily an “irrational” decision from the point of view of the trade aggressor and can result both from the structure of the external game and from internal negotiations and lobbying.⁵

Thinking about the multilateral trading system, imagine that one party violates existing WTO obligations. Presumably, it does so because the violation

³ The analysis is described with two parties but could easily be extended to cover more. If more than two parties are considered, it is critical to remember the strategic aspects of voting, coalition formation, reputation, etc.

⁴ Sub-optimal outcomes are a regular feature of modern economics and become manifest for a number of reasons including cognitive limitations, asymmetric information, transactions cost, market failures, etc.

⁵ As a result of domestic negotiations where some groups wield more influence than others, actions can be taken that are also welfare-diminishing for the respondent. Consider voluntary export restraints in automobiles, for example. To account for the case of an initial loss by the respondent the absolute value of U_r is used in the remaining calculations.

increases its welfare by some amount, U_R .⁶ Unfortunately these acts are generally controversial because they are not Pareto-improving and thus come coupled with a decrease in the welfare of the trading partner by some amount, U_C . (Figure 3).

Under the WTO dispute settlement system, the party that believes itself to have suffered injury or the nullification of the value of previously granted concessions (the complainant) has the right to seek consultations with the alleged aggressor (the respondent), and if these fail to produce a resolution, to request adjudication. There is no restriction to how many complainants or respondents can be involved in a particular conflict but we can address the simple two party conflict with little loss in generality.

The complainant aims to overcome all procedural pitfalls (having the case stuck in the appellate review process, having its right to retaliate expire during review, etc.) and to win a finding in its favor authorizing retaliation. This retaliation allows the complainant to punish the respondent by withdrawing concessions towards liberalized trade of a value equal to U_C .⁷ After this punishment, $U_C = \mu |U_R|$, the respondent may still be better off than before it broke the agreement; if $\mu < 1$, then the violation will have resulted in a net gain in the static analysis. It is only if $\mu > 1$ that the respondent will suffer a net loss and, consequently, will be encouraged to rectify its violation. When $\mu < 1$ the chances of withdrawal depend on a more complicated dynamic calculation that includes considerations of reputation, the credibility of the system, moral suasion, etc..

⁶ All changes in welfare are conceived of as the net present value of an action from the time that it is implemented until it is withdrawn.

⁷ Equivalent value is taken to mean of equivalent absolute monetary value. Thus, any issues of the marginal value of the damage are not addressed.

Consider for a moment, however, the position of the complainant. Assuming that the original concessions were welfare-improving⁸, then withdrawing them means that the complainant is punishing themselves and loses an additional increment of welfare U_C . (See Figure 4.) Thus, punishing the respondent is rational only if there is sufficient probability that the respondent will rectify the violation⁹:

$$EV(\text{punishment}) = \text{pr}(\text{withdrawal})U_C - U_C, \text{ or}$$

$$EV(p) = \text{pr}(w)U_C - (\mu U_C) = (\text{pr}(w) - \mu)U_C.$$

A reasonable bivalent decision rule then is $EV(p) > 0$ punish; $EV(p) < 0$ don't punish. The complainant faces an unpleasant choice if the pay-off to punishment is negative because as long as dispute settlement is not reinforced at the system level it is the individual nation that carries the burden of enforcement. The complainant then has the option of not acting (the usual choice of small nations) or of engaging in retaliation. To make the retaliation effective, however, the complainant needs to be successful in manipulating the pay-offs to produce a net cost to defection. Targeting foreign exporting producers for retaliation motivates them to fight for the withdrawal of measures designed to protect import competing interests. By taking the innocent hostage the complainant recruits them to plead their case (i.e. the case of the hostage-taker) in order to win their release. The complainant seeks to transform the respondent's political payoff matrix and thus their dominant strategy. Assuming:

⁸ We assume that the lowering of import barriers was welfare improving for the complainant for the classic reasons.

⁹ The probability of withdrawal can also be expressed as a function of the degree of injury caused by the retaliation.

$$\left(\begin{array}{l} \text{Political benefits} \\ \text{of promoting} \\ \text{consumer and} \\ \text{certain producer} \\ \text{interests by} \\ \text{increased} \\ \text{openness} \end{array} \right) - \left(\begin{array}{l} \text{Political costs of} \\ \text{damaging labor} \\ \text{and certain} \\ \text{producer} \\ \text{interests by} \\ \text{increased} \\ \text{openness} \end{array} \right) + \left(\begin{array}{l} \text{Any negative} \\ \text{terms of trade} \\ \text{effects} \end{array} \right) > 0$$

To promote positive political profit (i.e. $b-c > 0$) then the policy maker faces three options:

- Increase b
- Decrease c
- Simultaneously increase b and decrease c

From easy to forced bilateral free trade

In an ideal world, both governments would accept traditional trade theoretic arguments and perceive a benefit to unilateral free trade. Their payoffs might be characterized as:

Country B		

Country A	Protection	Free trade

Free trade	(1,4)	(5,5)
Protection	(0,0)	(4,1)

Thus, acting independently they would achieve bilateral free trade, the outcome that they in fact both prefer easily. (See Figure 6)

If the governments were very sensitive to the damage to import-competing producers and threatened labor lobbies, however, they might perceive a cost to unilateral free trade. If they cannot secure insurance that their market

opening will be met with reciprocal openings then they will forgo the opportunity for bilateral free trade for the safety of protectionism. Facing a harsher set of pay-offs:

		Country B	
		Protection	Free trade
Country A	Free trade	(-1.4)	(3,3)
	Protection	(0,0)	(4,-1)

we anticipate a Smoot-Hawley world of bilateral protectionism. (see Figure 7). It is exactly this situation that first the GATT and now the WTO was intended to overcome by guaranteeing reciprocity. It is also the source of the conception of a trade-liberalizing measure as a “concession”. To the politician facing a concentrated and vocal set of damaged interests and a diffuse, quiet set of consumer interests the opening is a concession because it is politically costly. It is only the reciprocal “concessions” that motivate the support of the export producers to come to the government’s aid.

The situation becomes most challenging however when the perceptions of the governments are asymmetric. If only one government perceives a benefit to unilateral free trade then it can easily be trapped by its own preferences into accepting this outcome.

		Country B	
		Protection	Free trade
Country A	Free trade	(1,4)	(5,3)
	Protection	(0,0)	(4,-1)

Thus, it will choose unilateralism despite its strong preference for bilateral free trade (see Figure 8). The only choice becomes the manipulation of the pay-offs.

Changing the pay-offs and thus the preferences of a trading partner who is likely to opt for protectionism is the purpose of hostage-taking. Faced with protectionism, the free trade can target sectors that have nothing to do with the substance of the dispute but who are capable of making continued protectionism costly to the protectionist government and altering the dominant strategy.

		Country B	
		Protection	Free trade
Country A	Free trade	(1,2)	(5,3)
	Protection	(-1,-2)	(3,-1)

By doing so the free trader forces a market opening (See Figure 9).

The preference of the complainant for retaliation is reinforced, moreover, by the desire to avoid establishing a reputation (both in the eyes of the current violator and of other trading partners) as a sucker who will passively accept welfare-damaging trade aggression. Thus, the retaliator attempts to hedge against system failure by attempting to manipulate the pay-off matrix so that the one-shot gain also yields the desired outcome (the withdrawal of the offending measures)..¹⁰

Conclusion

¹⁰ This and other factors that increase the perceived cost of the violator's action (such as the United States' interest as a hegemon in building up the efficacy of the post-war system) can be incorporated into the cost term, U_c .

When the conflict-settlement mechanism does not resolve an issue, it has negative implications for the larger trading system, for the relationship of the disputants, and, most immediately, for the conflict at hand. The fate of the multilateral trading system is bound up with the performance of the conflict-settlement mechanism. The entire system is vulnerable to breakdowns that originate from the historic inability of the WTO to resolve conflicts. In addition,

- 1) the credibility of the agreement is eroded;
- 2) the relationship between the disputants is damaged; and
- 3) the conflict at hand is unresolved, and normal trading relations are threatened or deteriorate.

Each type of malfunction is important. The authority of the WTO will rest both on substantive consensus and on its ability to resolve disputes. The WTO's ability to promote and preserve liberalized trade depends on how effective the rejuvenation of the dispute resolution process is. Improvements implemented at the system level are sorely needed. Until they are, trading partners individually bear a significant burden in disciplining defections. For large nations this presents problems of internal negotiation resulting from an uneven distribution of damage and gains. For smaller nations this presents a task they cannot overcome due to lack of leverage and the inability to affect the aggressor's payoffs. The situation is particularly acute when the large aggress upon the small.

Overall, we can conclude that damaging yourself is not only rational, but credible; that a healthy system facilitates good behavior despite incentives to defect, and that retaliation targets are chosen both to force the withdrawal of the protectionist measures in the short run and as an investment in reputation in the long run.

References

- “Multilateral Trade Negotiations: Dispute Settlement.” in 74th Annual Meeting of the American Society of International Law in American Society of International Law Proceedings, , 129-145, 1980.
- Ahearn, Raymond J. Dispute Settlement and the General Agreement on Tariffs and Trade. Congressional Research Service, Library of Congress, 1985.
- American Society of International Law. “Can the WTO Resolve International Trade Disputes? (Summary of Remarks and Discussion)” in 77th Annual Meeting of the American Society of International Law Conference Proceedings , 287-292, 1985.
- Axelrod, Robert. The Evolution of Cooperation. New York: Basic Books, 1984.
- Camps, Miriam and William Diebold Jr. The New Multilateralism: Can the World Trading System Be Saved? New York, NY: Council on Foreign Relations, 1986.
- DeKeiffer, Donald E. “WTO Dispute Settlements: A New Beginning in International and US Trade Law.” Northwestern Journal of International Law and Business , 2.2, 317-333, 1980.
- Feenstra, R. C., G. M. Grossman, et al., Eds. (1996). The Political Economy of Trade Policy. London, England, The MIT Press.
- Garrett, G. (1992). “International Cooperation and Institutional Choice: The European Community's Internal Market.” International Organization 46(2 (Spring)): 533-560.
- Garrett, G. and P. Lange (1996). Internationalization, Institutions and Political Change. Internationalization and Domestic Politics. R. O. Keohane and H. V. Milner, Cambridge University Press: 48-79.
- Goldberg, Stephen B., Eric D. Green, and Frank E. A. Sander. Dispute Resolution. Boston, MA: Little, Brown and Company, 1985.
- Gould, D. M. and G. L. Woodbridge (1998). “The Political Economy of Retaliation, Liberalization and Trade Wars.” European Journal of Political Economy 14: 115-137.
- Greenwald, Joe, Daniel Tarullo, and Robert Herzstein. "Reform of the International Open Trading System (especially Dispute Settlement)". Vol. 84. Federal Rules Decisions, Washington, DC: 1980.
- Grossman, G. M. and E. Helpman (1995). “Trade Wars and Trade Talks.” Journal of Political Economics 103, no 4: 675-708

- Harris, Kevin M. "The Post-Tokyo Round WTO Role in International Trade Dispute Settlement." *International Tax and Business Lawyer*, 1, 142-176, 1983.
- Hazard, Heather A. "Disputes in International Trade." Unpublished Ph.D. dissertation, Cambridge, Mass.: Harvard University, 1988.
- Helpman, E. (1995). *Politics and Trade Policy*. Cambridge.
- Hoekman, B. and M. Kostecki (1995). *The Political Economy of the World Trading System, From WTO to WTO*, Oxford University Press.
- Hilf, Meinhard. "Settlement of Disputes in International Economic Organizations: Comparative Analysis and Proposals for Strengthening the WTO Dispute Settlement Procedures". in *The New WTO Round on Multilateral Trade Negotiations, Economic and Legal Aspects*, ed. Ernst-Ulrich Petersmann and Meinhard Hilf. Netherlands: Kluwer, 1988.
- Hollering, Michael F. "Alternative Dispute Resolution and International Trade." *New York University Review of Law and Social Change*, 14, 785-795, 1986.
- Horlick, Gary N., Geoffrey D. Oliver, and Debra P. Steger. "Dispute Resolution Mechanisms". in *The Canada-United States Free Trade Agreement: The Global Impact*, ed. Jeffery J. Schott and Murray G. Smith. Halifax, Nova Scotia: The Institute for Research on Public Policy, 1988.
- Hudec, Robert E. "WTO Dispute Settlement After the Tokyo Round: An Unfinished Business." *Cornell International Law Journal*, 13.2, 145-203, 1980.
- Jackson, John H. "Strengthening the International Legal Framework of the WTO MTN System: Reform Proposals for the New WTO Round." Mimeo, London: Royal Institute of International Affairs Conference on the New WTO Round, 1987.
- Kalla, Patricia. "The WTO Dispute Settlement Procedure in the 1980's: Where Do We Go from Here?" *Dickinson Journal of International Law*, 5, 82-101, 1986.
- McGovern, Edmond. "Dispute Settlement in the WTO - Adjudication or Negotiation?" in *Studies in Transnational Law: The European Community and the WTO*, ed. M. Hilf, F. Jacobs, and E.U. Petersmann. The Netherlands: Kluwer, 1986.
- Patterson, Gardener. "The WTO and the Negotiation of International Trade Rules" in *Negotiating World Order: The Artisanry and Architecture of Global Diplomacy*, ed. Alan K. Henrikson. 1986.

Petersmann, Ernst-Ulrich. "Strengthening WTO Procedures for Settling Trade Disputes." *World Economy* ,11.1, 1988.

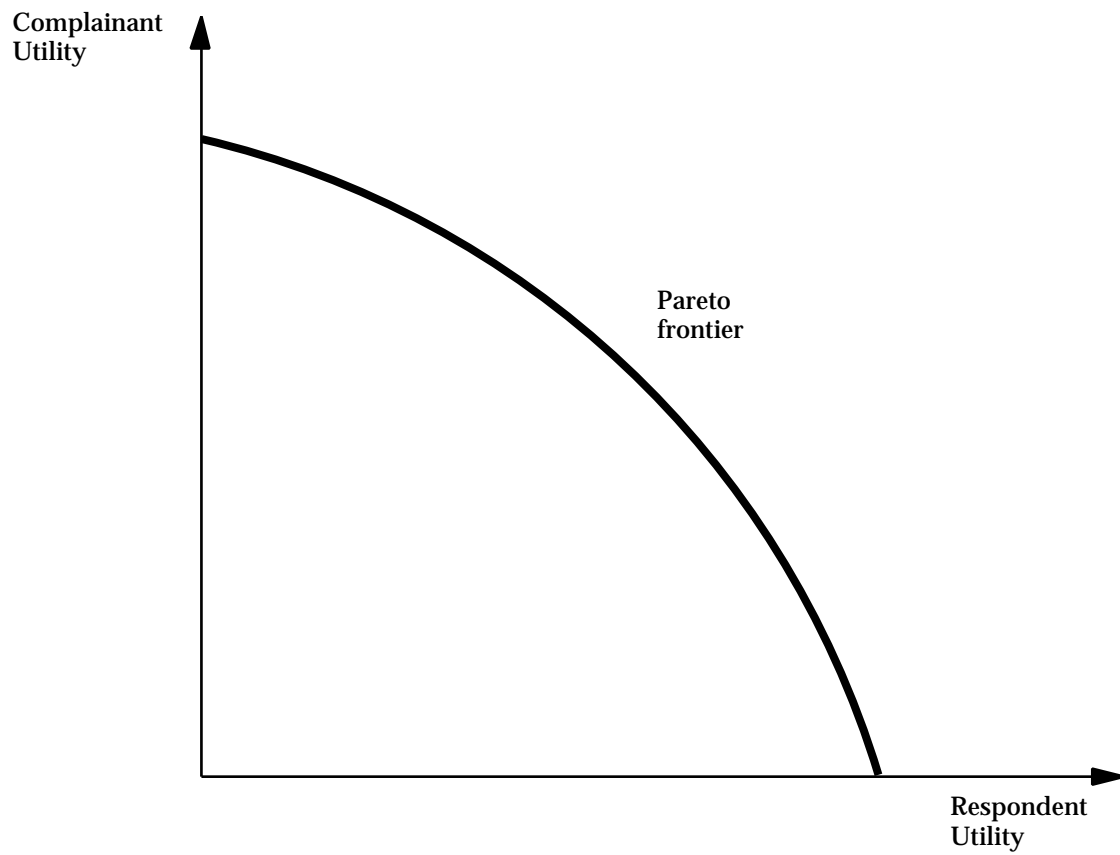
Raiffa, Howard. *The Art and Science of Negotiating*. Cambridge, MA: Belknap, 1982.

Rappaport, Antol. "Conflict Resolution in the Light of Game Theory and Beyond". in *The Structure of Conflict*, ed. Paul Swingle. New York: Academic Press, 1970

Rodrik, D. (1995). *Political Economy of Trade Policy*. *Handbook of International Economics*. G. M. Grossman and K. Rogoff. Elsevier. 3: 1457-1494

Whitt, Richard S. "The Politics of Procedure: An Examination of the WTO Dispute Settlement Panel and the Article XXI Defense in the Context of the US Embargo of Nicaragua." *Law and Policy in International Business* 19 (1987): 603-631.

Figure 1: Utility space and the Pareto frontier



Note: In international economic conflicts pursued in legal fora (such as the WTO), the party who believes themselves to be injured is referred to as the complainant and the party alleged to have perpetrated the injury is referred to as the respondent.

Figure 2: Sub-optimality and welfare gains

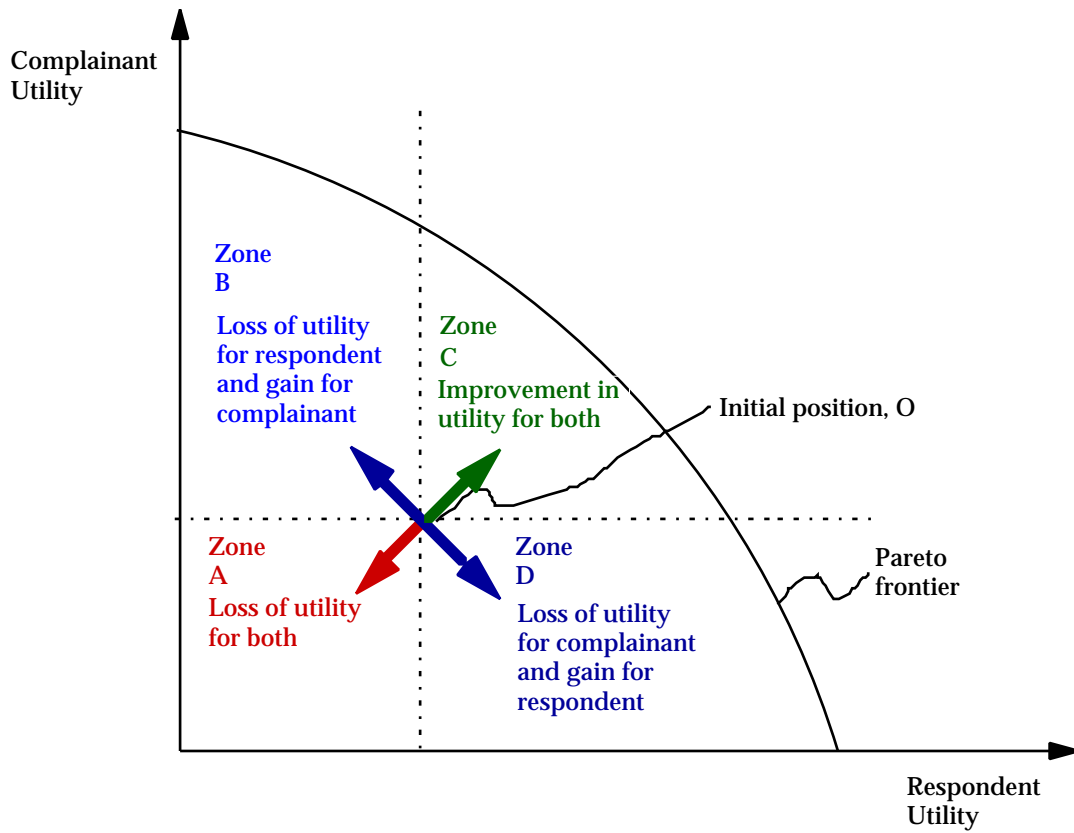
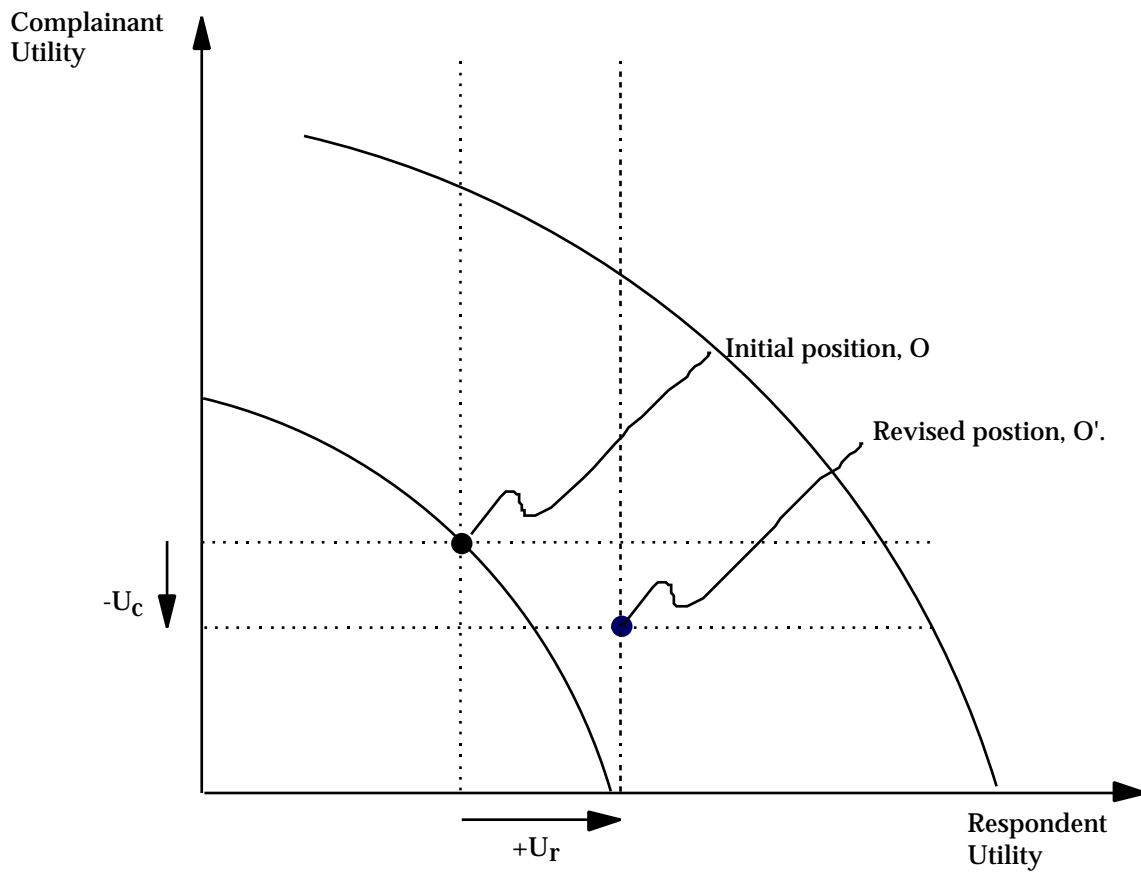
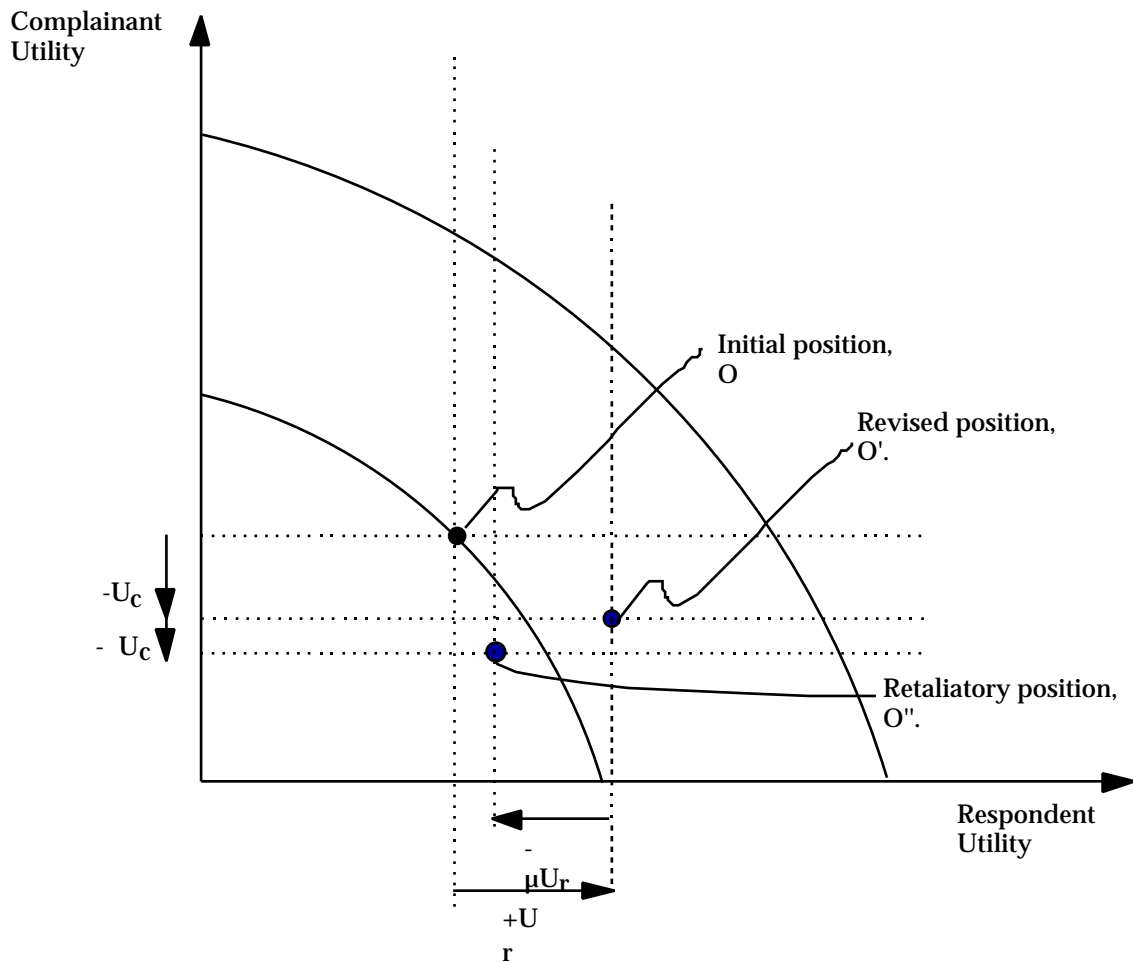


Figure 3: Breach and injury



Note: A net welfare gain for the respondent is shown for the purposes of exposition but a net welfare loss for the respondent is also possible as a result of internal negotiations and lobbying as Gould, Grossman, Helpmann and others have demonstrated.

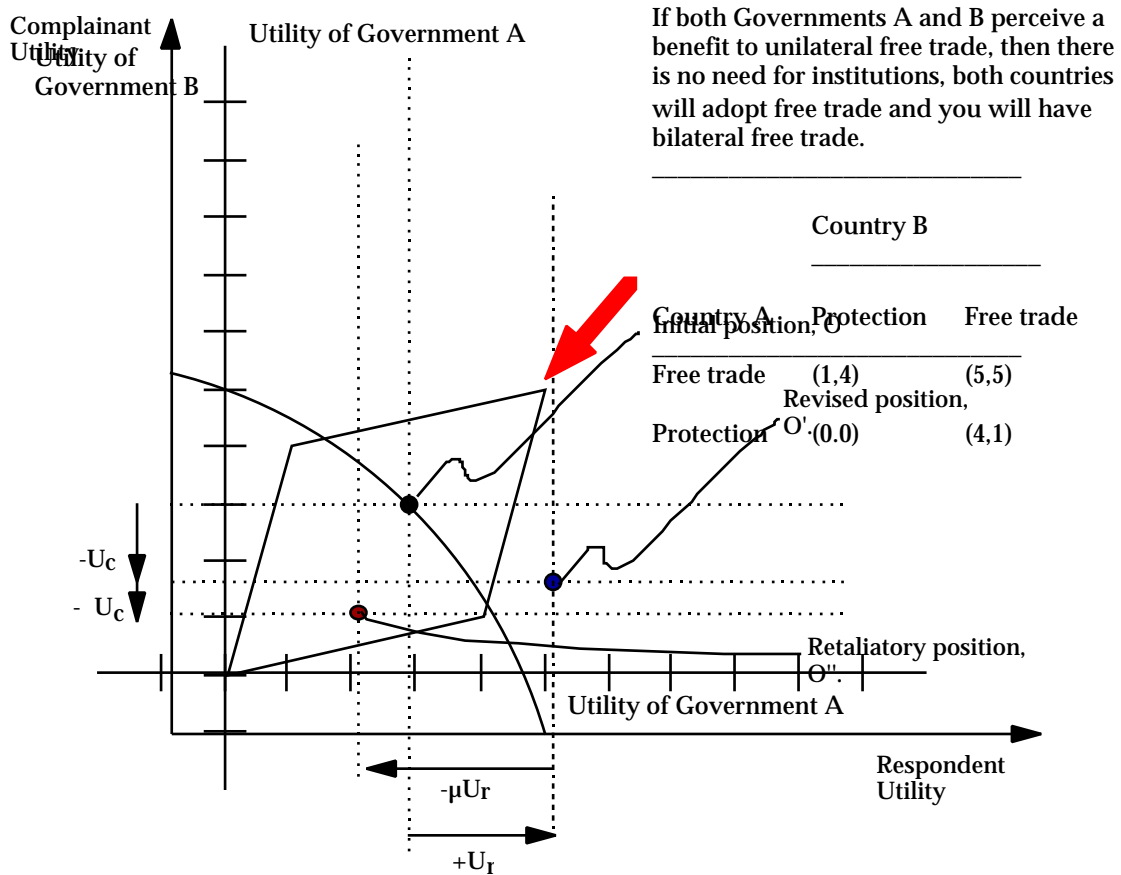
Figure 4: Punishment and self-punishment



Note:

After the respondent takes an action that reduces the welfare of the complainant, the complainant may be authorized to withdraw concessions previously granted to the respondent as a form of punishment. Since the “concessions” were trade creating actions, however, the complainant simultaneously hurts themselves. Thus, punishment is also self-punishing in this context.

Figure 6: Easy Bilateral Free Trade
Figure 5: Take hostages to increase costs of protectionism



Targeting foreign exporting producers for retaliation motivates them to fight for the withdrawal of measures designed to protect import competing interests. By taking the innocent hostage you recruit to plead the case of the hostage-taker in order to win their release. You transform their political payoff matrix and thus their dominant strategy.

Figure 7: Bilateral Protectionism

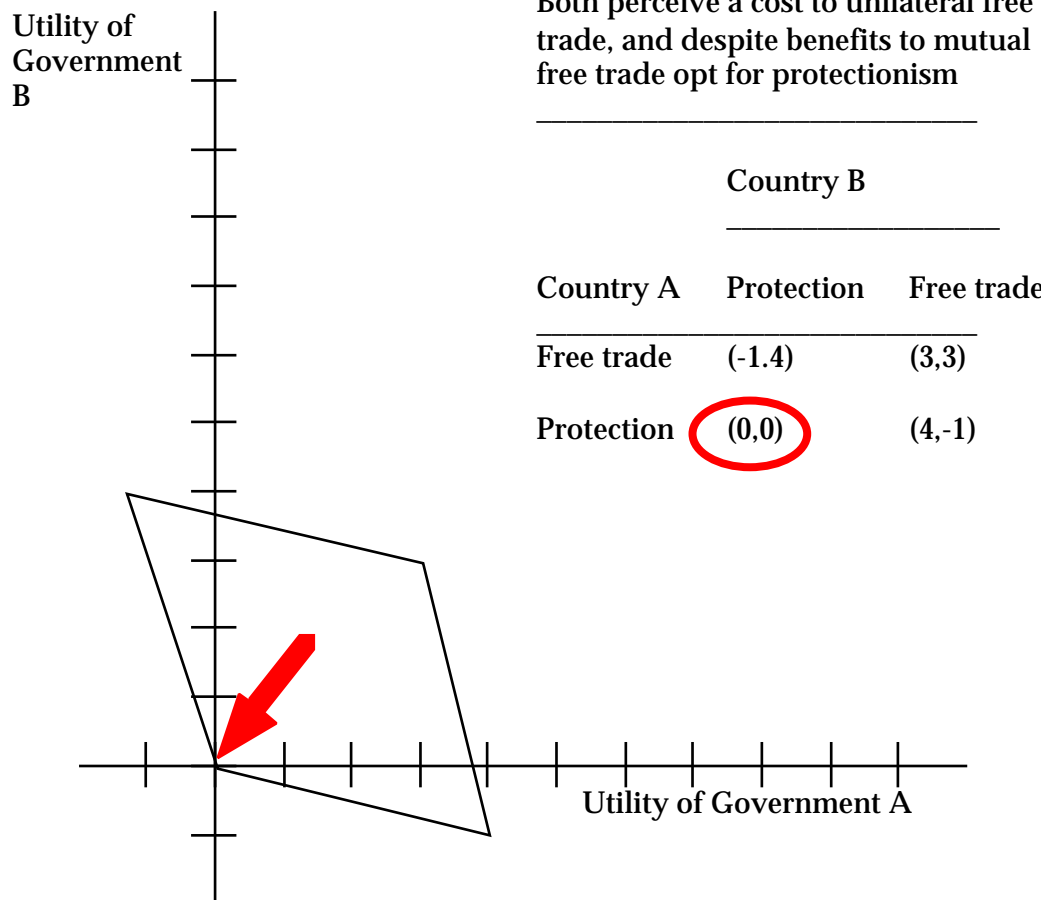
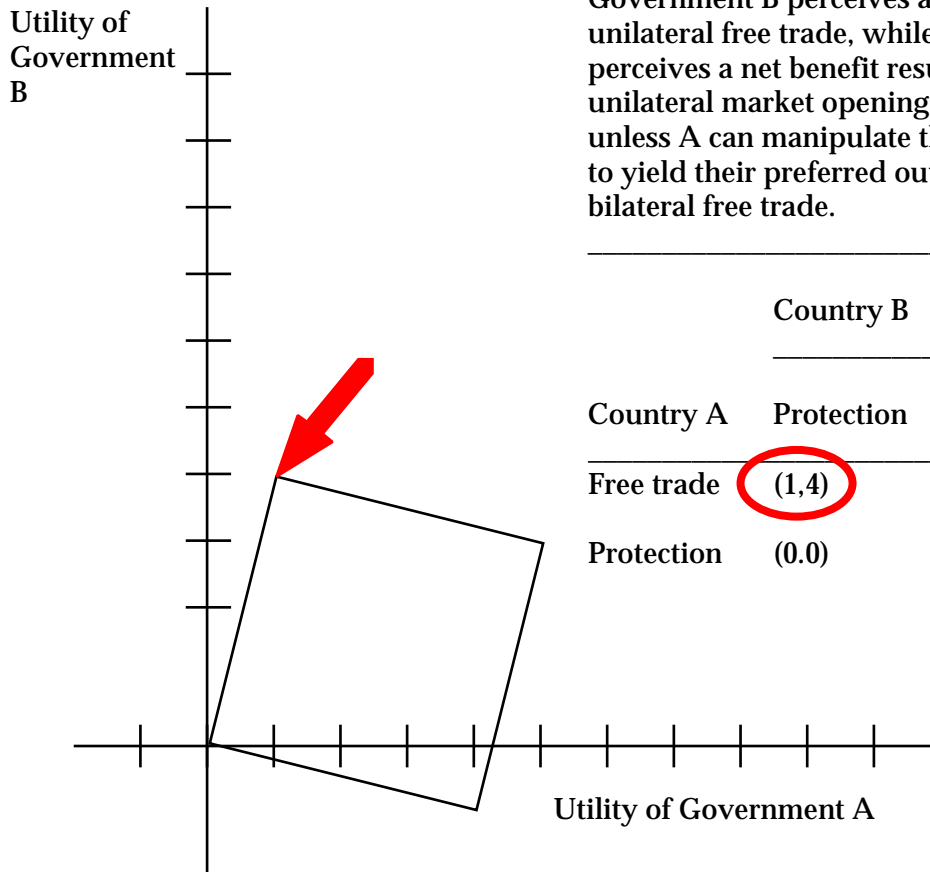


Figure 8: Unilateral Free Trade



Government B perceives a cost to unilateral free trade, while A perceives a net benefit resulting in a unilateral market opening by A unless A can manipulate the pay offs to yield their preferred outcome of bilateral free trade.

		Country B	
Country A	Protection	Free trade	
Free trade	(1,4)	(5,3)	
Protection	(0,0)	(4,-1)	

Figure 9: Forced Bilateral Free Trade

