

GEOPOLITICS AND THE WORLD TRADING SYSTEM

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Disclaimer: I wish to clarify that my comments at this event do not represent the positions or opinions of the WTO or its Members.

- We study the implications of geopolitical rivalry for trade cooperation
 - and for the purpose and design of the rules-based multilateral trading system
- We show how the world trading system can adjust to the geopolitical imperative

- The existing literature on the economics of trade cooperation and trade agreements, especially Bagwell and Staiger (1999)
 - The primary purpose of a trade agreement is to mitigate the effects of (terms-of-trade) externalities on trade policy choices
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- Geopolitics in the International Relations Literature
- The “realist school” of international relations argues that rivalry among countries is concerned with relative rather than absolute power (e.g., Mearsheimer, 2003)
 - *Saying that states are power maximizers is tantamount to saying that they care about relative power, not absolute power.*
- Albert Hirschman, in his 1945 book on National Power and the Structure of Foreign Trade
 - *Foreign trade would lead to relationships of dependence and influence between nations.*

- We focus on geopolitical rivalry as a quest for relative power and hence *dominance*, where the implications for trade cooperation are most novel
 - Rivalry does not undercut the case for trade cooperation
 - But the GATT/WTO was designed to solve a *different problem* than the problem created by the recent rise of geopolitical rivalry
 - To continue to serve as a forum for trade cooperation, the WTO may need to undertake measured adaptation of its key principles (the reciprocity norm and the nondiscrimination rule)
- These findings are robust to broader interpretations of geopolitics that include government concerns about *dependence* in addition to the quest for dominance

The Two-Country Model

- A Textbook 2x2 Neoclassical General Equilibrium trade model
- Two countries: Home (H, no *) and Foreign (F, *)
- Two goods:
 - x : Imported by Home
 - y : Imported by Foreign
- Tariffs:
 - H imposes τ on imports of x
 - F imposes τ^* on imports of y
- Prices:
 - Local relative prices in H ($p \equiv p_x/p_y$) and in F ($p^* \equiv p_x^*/p_y^*$)
 - "World" (i.e., untaxed) relative price $p^w \equiv p_x^*/p_y$ (terms of trade between H and F)
 - It follows that

$$\begin{aligned} p &= (1 + \tau)p^w \equiv p(\tau, p^w) \\ p^* &= p^w / (1 + \tau^*) \equiv p^*(\tau^*, p^w) \end{aligned}$$

with $p^w(\tau, \tau^*)$ decreasing in τ and increasing in τ^* under standard conditions

- Absent Geopolitical Rivalry, follow Bagwell and Staiger (1999)

$$W(\tau, \tau^*) \equiv W(p(\tau, p^w(\tau, \tau^*)), p^w(\tau, \tau^*)) \text{ with } W_{p^w} < 0$$

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- general objectives, but each gov cares only about own-success in achieving them
- e.g., each gov might seek to have a large shipbuilding industry (a Home preference over p , a Foreign preference over p^*)
- The rise of Geopolitical Rivalry introduces concern about *relative* success

$$G(\tau, \tau^*) \equiv W(\tau, \tau^*) + \rho \times [W(\tau, \tau^*) - W^*(\tau^*, \tau)]$$

$$G^*(\tau^*, \tau) \equiv W^*(\tau^*, \tau) + \rho^* \times [W^*(\tau^*, \tau) - W(\tau, \tau^*)]$$

- $\rho > 0$ and $\rho^* > 0$ signify geopolitical rivalry, with each gov now also caring about success relative to its rival
- Mirrors reduced form formalization of rivalry in the IR literature (Snidal, 1991); could be micro-founded with the addition of a second period where war is possible (Powell, 1991)

Possible Interpretations of Rivalry

- How should we interpret the rivalry between the home and foreign government embodied in

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- A rivalry over "potential power" in the form of economic size and influence (Mearsheimer, 2003, Viner, 1948)
 - if $W(\tau, \tau^*)$ and $W^*(\tau^*, \tau)$ are interpreted as real national income
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- A rivalry over "competing ideologies or political systems" (Mearsheimer, 2003, Lynch and Hoffman, 2020)
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- A rivalry over "actual military power" (Mearsheimer, 2003), e.g., over the size of their strategic sectors (semiconductors, shipbuilding, etc.)
 - if $W(\tau, \tau^*)$ and $W^*(\tau^*, \tau)$ are interpreted as government industry objective functions in a partial equilibrium setting
 - \implies absent geopolitics, each government maximizes its industry objectives with its tariff choice

The Impact of Geopolitical Rivalry on Nash tariffs

- We first consider the impact of geopolitical rivalry in a world without trade cooperation
 - To this end, we solve for Nash tariffs as a function of ρ and ρ^*
- The Home and Foreign tariff reaction curves are defined by the respective FOCs

$$\begin{aligned}G_\tau &= W_\tau + \rho \times [W_\tau - W_\tau^*] = 0 \\G_{\tau^*}^* &= W_{\tau^*}^* + \rho^* \times [W_{\tau^*}^* - W_{\tau^*}] = 0\end{aligned}$$

- or equivalently

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- \implies **Proposition 1** *The rise of geopolitical rivalry raises the Nash tariff of at least one of the rivals. If tariff reaction curves are upward sloping, the rise of geopolitical rivalry raises the Nash tariffs of both rivals.*
- Intuition: Beginning from original Nash tariffs where each gov is indifferent to a small increase in its tariff, the introduction of rivalry causes each gov to want to increase its tariff further to hurt its rival

- **Efficient tariffs in the absence of Rivalry**

- In the absence of rivalry, gov objectives are

$$G(\tau, \tau^*) = W(\tau, \tau^*); \quad G^*(\tau^*, \tau) = W^*(\tau^*, \tau)$$

and efficient tariffs as judged by the objectives of the govs solve

$$\begin{aligned} & \max_{\tau, \tau^*} W(\tau, \tau^*) \\ \text{s.t. } & W^*(\tau^*, \tau) \geq W^{*E} \end{aligned}$$

where W^{*E} is any feasible level of W^*

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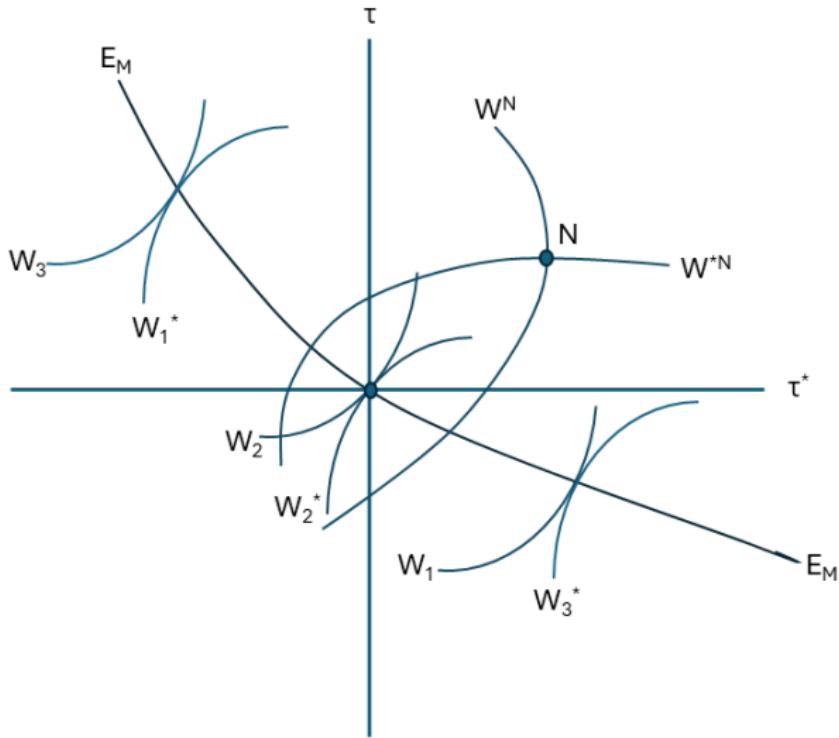
- Forming the Lagrangian, taking FOCs and eliminating the Lagrange multiplier yields

$$\frac{-W_{\tau^*}}{W_\tau} = \frac{-W_{\tau^*}^*}{W_\tau^*}$$

which for national-income-maximizing govs implies the Mayer (1981) locus of efficient tariff pairs

$$(1 + \tau) \times (1 + \tau^*) = 1$$

Figure 1: Internationally Efficient Tariffs in the Absence of Rivalry



The Impact of Geopolitical Rivalry on Internationally Efficient Tariffs

- Efficient tariffs in the presence of Rivalry
- In the presence of rivalry, gov objectives are

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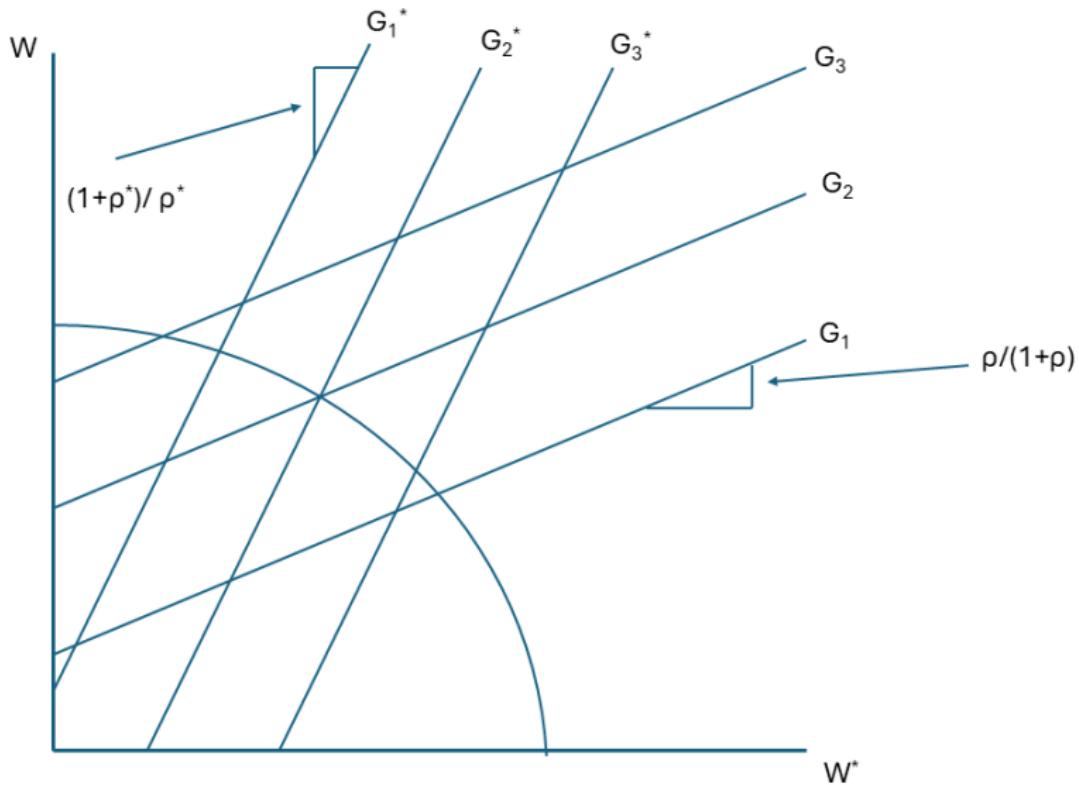
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- **Proposition 2** *The rise of geopolitical rivalry leaves the set of internationally efficient tariff pairs unchanged.*

Figure 2: The International Efficiency Frontier



A Role for Trade Policy Cooperation?

- There is a place for trade cooperation in the age of geopolitical rivalry unless *Nash tariffs are internationally efficient* when judged by the objectives of the govs
- When will Nash tariffs be internationally efficient?
 - Using conditions for Nash and internationally efficient tariffs, we have

$$\frac{-W_{\tau^*}}{\frac{\rho}{(1+\rho)} W_{\tau}^*} = \frac{-\frac{\rho^*}{(1+\rho^*)} W_{\tau^*}}{W_{\tau}^*} \iff \frac{(1+\rho)}{\rho} = \frac{\rho^*}{(1+\rho^*)} \iff \rho \rightarrow \infty \text{ and } \rho^* \rightarrow \infty$$

- Intuition: in the limit when $\rho \rightarrow \infty$ and $\rho^* \rightarrow \infty$, gov objectives are diametrically opposed, because the *only thing* each gov cares about is its position relative to the other

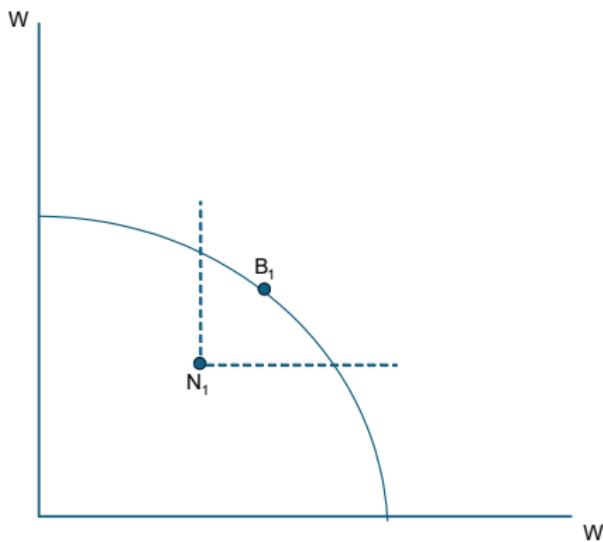
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- **Proposition 3** *A role for trade policy cooperation persists in the presence of geopolitical rivalry unless domination becomes the sole objective of each rival.*

- What do Propositions 1-3 imply about trade cooperation and negotiations?
- Suppose that geopolitical rivalry erupts after Home and Foreign have already negotiated to the efficiency frontier
 - Our noncooperative selves want to *raise tariffs further* in the presence of rivalry to hurt our rival (Proposition 1)
 - But our cooperative selves should *avoid giving in* to this new temptation (Proposition 2)
 - because trade cooperation is still possible in the presence of rivalry except in the limiting case (Proposition 3)
- Can tariff negotiations as traditionally conceived allow rivals to maintain cooperative trade relations in this environment?

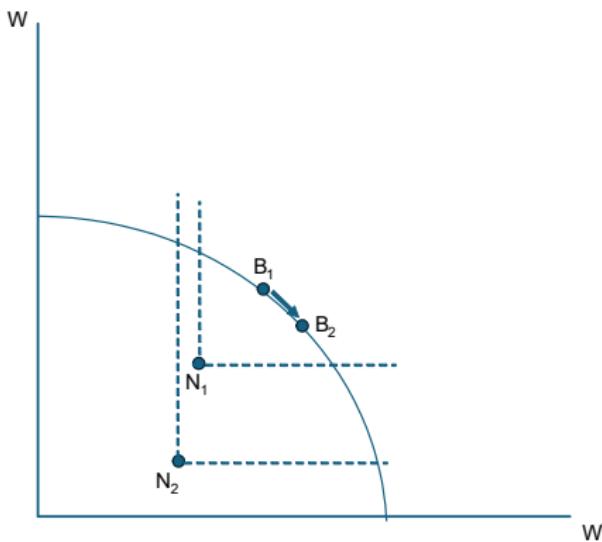
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- Can tariff negotiations as traditionally conceived allow rivals to maintain cooperative trade relations in this environment?
- This will be challenging, precisely because
 - rivalry will alter the Nash threat point (Proposition 1)
 - but *not* the set of internationally efficient tariff pairs (Proposition 2)

Responding to the Rise of Geopolitics (Nash Bargaining)



- **Proposition 4** *To maintain cooperation when geopolitical rivalry erupts, governments must find a way to move along the international efficiency frontier and implement tariff changes that are not pareto preferred relative to the status quo.*

Responding to the Rise of Geopolitics (Nash Bargaining)



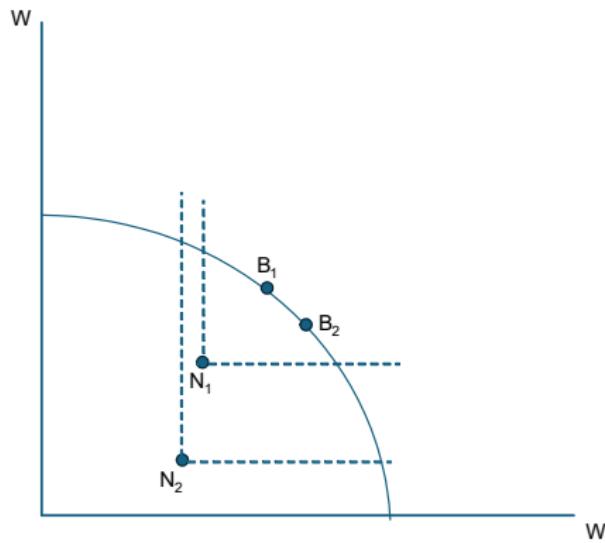
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Geopolitical Adjustments to the Nash Bargain

- Figure 3 suggests two possible paths of adjustment if geopolitical rivalry erupts when rivals are already on the efficiency frontier

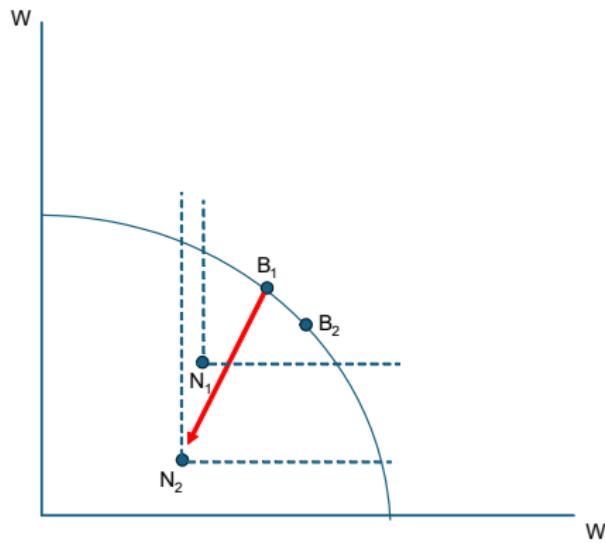
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- A first path, “(trade) war and redemption,” takes countries from B_1 to N_2 to B_2
 - The movement from B_1 to N_2 would represent the unraveling of liberal trade policies and reversion to the new Nash equilibrium
 - But starting from N_2 , the movement to B_2 would correspond to classical negotiated tariff changes that are reciprocal and lead to mutual benefits for each country



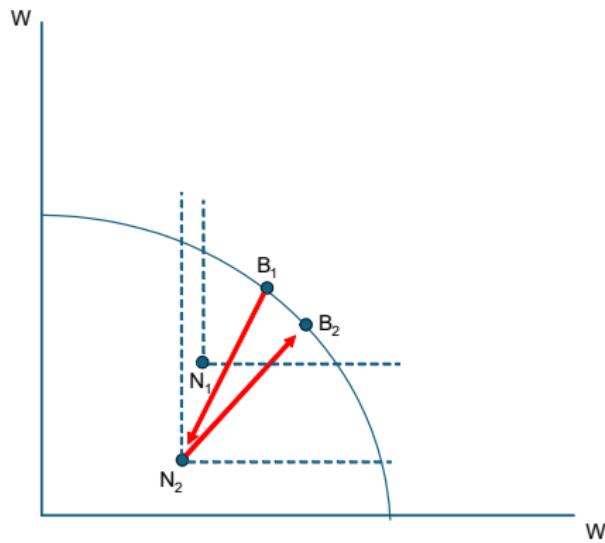
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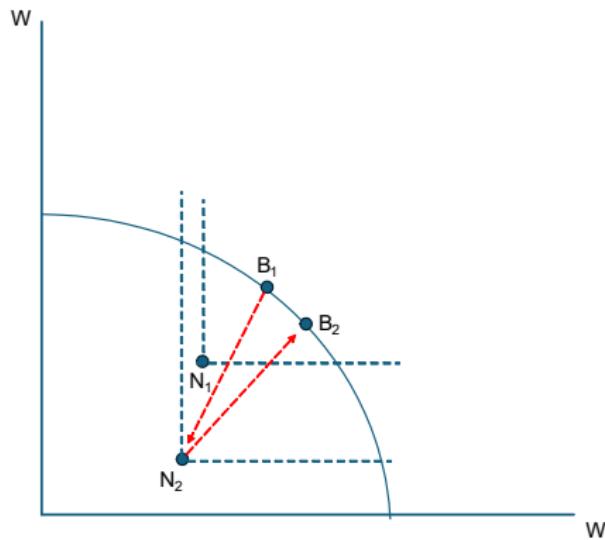
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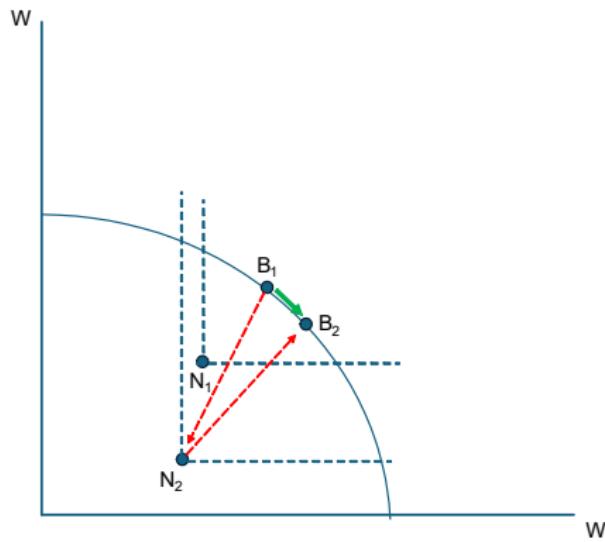
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- A second path has countries directly negotiating from B_1 to B_2
 - The movement from B_1 to B_2 avoids the unraveling of liberal trade policies
 - But it entails negotiated tariff changes that are neither reciprocal nor mutually beneficial



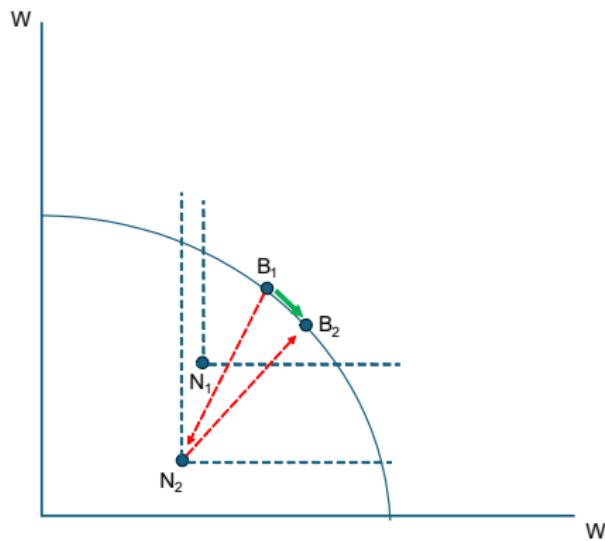
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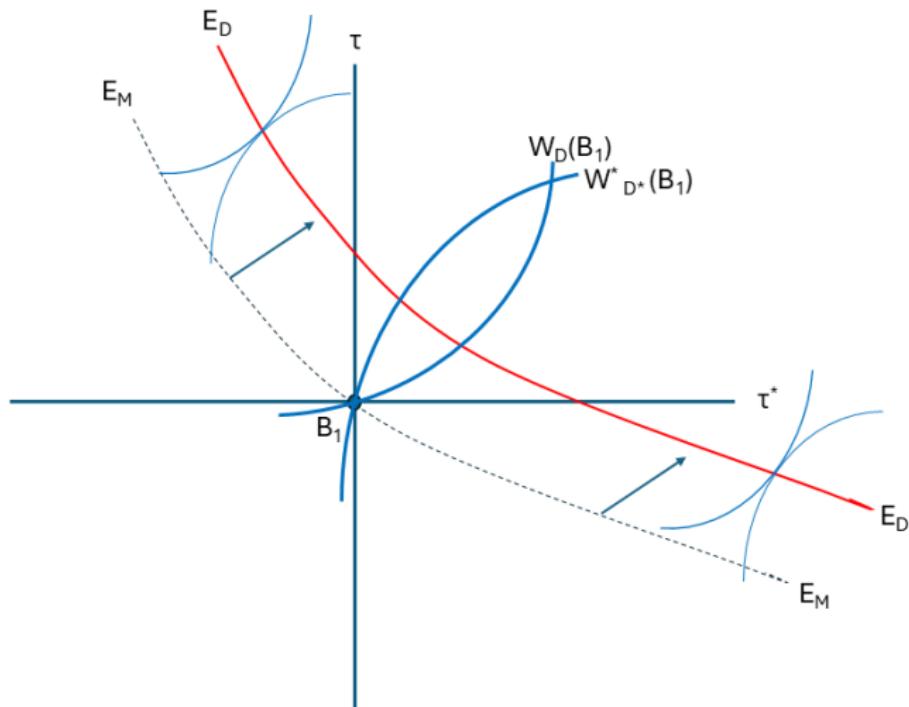
- The second path is clearly preferable, but may pose special challenges for the WTO because it goes against the essence of the “reciprocal and mutually advantageous” tariff reductions that GATT’s Preamble describes

Heightened Concern for Dependence

- What if geopolitics is about both dominance and heightened concern for dependence?
 - Our conclusions are preserved provided that the dependence effect is not so large as to swamp the dominance effect

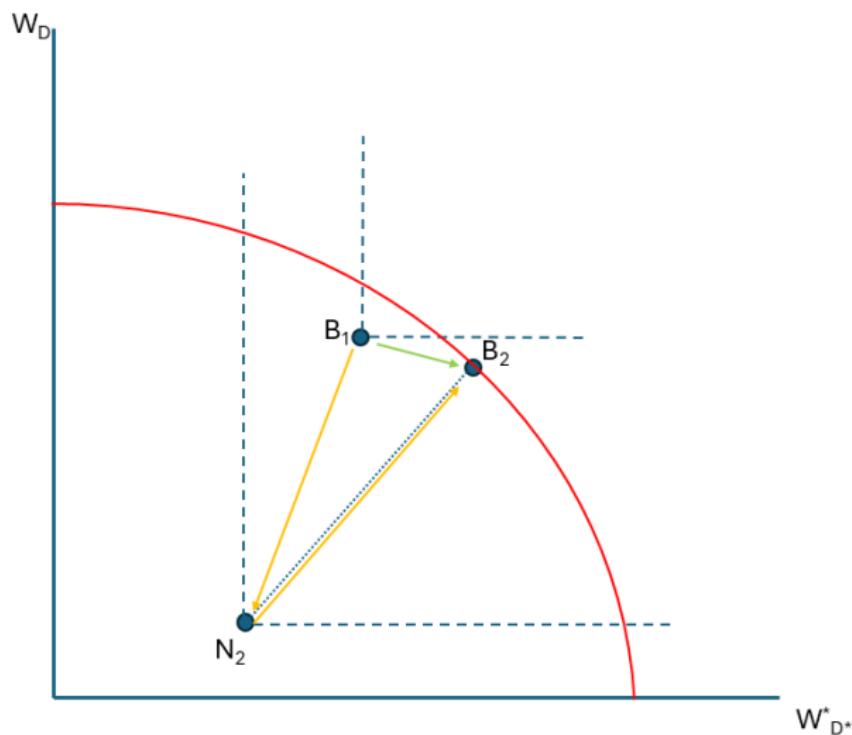
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- Figure 4: New Concerns Over Dependence reflected in W_D and W_D^*



Heightened Concern for Dependence

- Figure 5: Responding to the Rise of New Concerns Over Both Dominance and Dependence
 - The status quo B_1 is no longer on the efficiency frontier, but movement from B_1 to B_2 still non-reciprocal and non-pareto-improving as long as dominance effect is not swamped by dependence effect



- Bilateral rivalry in a multicountry world raises a new issue: How to transfer surplus between rivals without impacting trade relations with neutral third parties?
- **Proposition 8** *It is not possible for two rival countries to make non-discriminatory tariff adjustments that transfer surplus between them without altering the surplus of the neutral third country, but this would be possible if the rival countries could make use of discriminatory tariff adjustments.*

- The results from our Two-Country Model imply the following:
 - **Corollary** *The rise of geopolitical rivalry will confront the world trading system with a choice between two uncomfortable alternatives: adjustment to the new cooperative outcome in the presence of geopolitics requires either a temporary unraveling of existing liberal trade policies, or a departure from the principle of reciprocity in negotiated tariff changes.*
 - A real-world example: the US-China “Phase 1 Agreement”
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Implications of Geopolitics for Trade Rules

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 - A real-world example: the US-China “Phase 1 Agreement”
 - Suggests the potential attractiveness of a conditional MFN exemption for geopolitical rivalry
- These challenges arise only when geopolitical rivalry erupts or intensifies after countries have already bargained to the efficiency frontier (rivalry itself does not change the purpose of a trade agreement)
 - Unfortunately for the existing world trading system, that may be a reasonable approximation of the situation the world now confronts

- Until the beginning of this century, the GATT/WTO system worked
- Economic research provided a compelling explanation
 - It showed that if governments maximize the well-being of their own countries broadly defined, GATT/WTO principles would facilitate mutually beneficial cooperation over their trade policy choices
- Now heightened geopolitical rivalry seems to have undermined the WTO
- A simple transposition of the previous rationalization suggests that geopolitics and trade co-operation are not compatible
- We show that this is only true if rivalry eclipses any consideration of own country well-being
 - In all other circumstances, there are gains from trade cooperation even with geopolitics
- Furthermore, the WTO's relevance is in question only if it adheres too rigidly to its existing rules and norms
- An important unanswered question: "Why now?"
 - A possible answer suggested by the observations of Mearsheimer (2003): The intensity of geopolitical rivalry today may be the result of the United States no longer enjoying hegemonic status