Strategic Trade Policy, What's Next?

By Political & Economics Analyst Sheldon Birkett

THE INTERNATIONAL TRADE "WIN-SET"

As Canadian official tread lightly in latest round of NAFTA negotiations the United States is strategically "gaming" the odds in their favour. Developed from game theory, which each "state-actor" (or player) makes their optimal decision contingent other players actions, strategic trade policy applies trade barriers (technical and non-technical barriers) to optimize a state's domestic and international political position. More classically described as "win-sets," developed by political scientist Robert Putnam, determines the degree of policy options available within international negotiations given the domestic political constraints present.[i] A state, with a more complacent domestic population, entails that international negotiators would be able to consider more varied policy options when active in trade negotiations. Having more varied policy options occurs because political figures, under conditions of a complacent population, have less political capital to lose if negotiations turn sour. Meaning a larger variance in public opinion emerges because of a multiplicity of complacent attitudes. Therefore, the larger variance of public opinion, or lack thereof, would not hold political representatives to account if they get a maleficent deal. This is simply because domestic public opinion is not polarized to the extent that political representatives must appeal to certain sectors of the population to remain in power. On the other hand, a narrow "win-set" would mean that political representatives would have a scarcity of policy options to choose from in international negotiations.[ii] This is simply due to the fact that a less complacent, more polarized, domestic population would place strict (more directed) demands on political representatives to appeal to their agenda. Therefore, underlying a trade negotiator's role is the hawk of public opinion constraining the optimum trade policy option.

One might say, how is the notion of a "win-set" considered in reality when many factors are at play in modern trade negotiations. For example, if international negotiators more closely considered the elasticity of political demands of their constituents they would be better able to finetune the key points in negotiations. However, the example described above is an ideal "textbook" case when it comes to the breath of multinational trade negotiations at play. If you wanted a deeper understanding of why trade negotiations succeed, or fail in dismay, one needs to consider economic interdependence between countries. In other words, by calculating the marginal rate of substitution between two goods it is possible to estimate the likelihood of the good being imported (through trade) given its domestic cost in autarky. Needless to say, by calculating the first derivative at a given quantity for a particular good it is possible to estimate the value of a good relative to another good (assuming that changes in the market for the factors of production and socio-cultural preferences are accounted for). This same idea can be applied to a "good" such as a political demand making it possible to calculate the marginal rate of substitution between policy options, although a government's policy is an intangible good. Therefore, by aggregating all possible policy options' elasticities it would be possible to calculate the optimum trade policy option. As an idea it sounds good on paper, but we do not have the computational power necessary to calculate such an aggregate result. Even if we did have such a computer, the optimum policy at that given point does not take into consideration political-economic changes in the environment. The result calculated would not be dynamic over time. As shown in statistics, the more variables you consider in a model calculating an "optimum trade policy" the more factors you have to consider as the inaccuracy of the model grows exponentially. Therefore, the notion of a "win-set" proves useful in simplifying the factors to consider in free trade negotiations albeit it is an abstraction from reality. Thus, by examining dynamic cases it is possible to further understand the relative weights on the factors considered by lead negotiators.

THE AUGMENTED TRILEMMA

Before delving into specific cases of trade negotiations it is pivotal to situate the global trajectory of international economic integration. I believe the best way to conceptualize the trajectory of international trade since WWII is to situate it within Dani Rodrik's augmented political trilemma.[iii] Note that I am not saying Rodrik's framework is an exact science, but far from it, I am just using the augmented political trilemma to illustrate how international trade policy has developed. Similar to the macroeconomic "impossible trinity principle"[iv] the augmented political trilemma states that a country can only maintain two of the three characteristics between strong international economic integration, a sovereign nation-state, and mass politics.[v]

In the augmented political trilemma, a country has three broad economic policies to choose from. Firstly, the golden straightjacket maintains a country's national sovereignty while pursuing international economic integration. Under the golden straightjacket a government will practice small government economic policies, which advocate flexible labour legislation, privatization, and deregulation of capital markets. For example, most developing countries fall into the golden straightjacket trap because of their need to compete for foreign investment from larger "more robust" economies.[vi] In contrast to the golden straightjacket is global federalism (or supranationalism). Global federalism combines integrated international economies and mass politics at the expense of national sovereignty. Unlike the golden straightjacket, which sacrifices mass politics, global federalism embraces mass politics (e.g. European Union).[vii] Lastly, the Bretton Woods compromise combines national sovereignty and mass politics as its broad economic policy.[viii] The Bretton Woods compromise is reminiscent of the post-WWII international economic order when national economies were skeptical of complete economic integration and ad-valorem tariffs were permissible under GATT rules.

According to Rodrik, global federalism is the inevitable end-goal in the long-run (over 100 years). However, given the short-term climate of rising protectionism Rodrik predicts the golden straightjacket to be the predominate broad international economic policy of the early twenty-first century.[ix] Therefore, if Rodrik's predictions are true about the future of international economic integration it would imply that the short-term future of international trade would follow a more protectionist (or cautionary) approach then at the start of the 2000's. As a result, the urgency to understand strategic trade policy in an age of protectionism is more relevant now then ever before.

THE CASE OF THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

The struggles of renegotiating the North American Free Trade Agreement (NAFTA) shows that the golden straightjacket policy is the predominate trade strategy in the twenty-first century. The United States demands to reject the current dispute-settlement (Chapter 19) procedure, in favour of domestic dispute resolution, and its insistence to increase patent protections on Canadian pharmaceuticals challenges Canada's "fireproof house" mentality. Considering NAFTA has been under an intense thirteen-month renegotiation period, with minimal success on the most pressing issues (i.e. dispute settlement, supply management etc.), it is fair to say that a complete United States-Mexico-Canada deal seems unlikely by then end of 2018. It is much more probable that the United States-Mexico deal will come into affect by early 2019, given that the outgoing Mexican administration under President Nieto (and the Trump administration) would like to sign a deal as a political statement. Meanwhile, the Canadian negotiators, under Foreign Affairs Minister Chrystia Freeland, have little leverage over the United States Trade Representative Robert Lightizer when it comes to the final negotiation issues. Under pressure from the American administration Mexico would likely sign a deal without Canada given the September 30th deadline is fast approaching.[x] However, with the United States and Canada in a political gridlock it is unlikely a tri-national deal would be agreed upon anytime soon. The reason for the United States reluctance to agree upon a deal is because the policy trade-off is simply too high. In other words, the marginal rate of substitution of American demands is simply too high of a cost when contrasted against Canadian preferences.

Even in a world burgeoning with political juxtapositions between nationalism and globalism the economic calculus does not lie. No matter how extravagant the Trump administration, or any other political party, would like to bring back the day when "America was great" it simply isn't going to happen. Even if Trump would willingly accept the fact that the manufacturing jobs of the 1960's will not come back, but still aim for a national policy targeting full-employment, free-market economists would surely object to such a policy at the expense of inflation. One only has to look at the 1973 OPEC crisis which was followed by a period of severe stagflation (inflation and lower output) to understand the costs of inflation.[xi] In a world where neoclassical economics has prevailed, and free-market ideology has been widely accepted amongst the world's top economists, it is likely that protectionism will not last long. The question is not if protectionism will prevail, but when will protectionism fail?

Lastly, trade is not a matter of political concessions for exchange of market access, rather, free trade is a matter of national welfare. Revisiting the fundamentals of the Ricardian model of international trade any student of economics will be familiar with the phrase that *"free trade is beneficial if the gains from the winners exceed the loss of the losers and the losers are compensated for their losses"*.[xii] Applying this redistributive principle to the NAFTA negotiations it is apparent that strategic trade policy is politically motivated, while the fundamentals of international trade are motivated by economics. I'd like to think that the economic calculus will always prevail against politically motivated policies, but only time will tell under auspicious protectionism.

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Citations

[i] Robert Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games," *International Organization*, 42, (1988): 427–460.
[ii] Ibid.
[iii] Dani Rodrik, "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives*, 14, no. 1, (2000): 177-186, http://bev.berkeley.edu/ipe/readings/How%20Far%20Will%20International%20Economic%20Integration%20Go.pdf.
[iv] Macroeconomic phenomenon that an open-economy can only maintain two of the three macroeconomic characteristics between an independent monetary policy, fixed exchange rates, and an open capital account.
[v] Dani Rodrik, "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives*, 14, no. 1, (2000): 177-186, http://bev.berkeley.edu/ipe/readings/How%20Far%20Will%20International%20Economic%20Integration%20Go.pdf.
[vi] Ibid.
[vii] Ibid.
[viii] Ibid.
[ix] Ibid.
[x] Alan Rappeport, "Trump Trade Negotiator Warns That Canada Is Running Out of Time," *The New York Times*, September 25, 2018, https://www.nytimes.com/2018/09/25/us/politics/trade-canada-lighthizer.html.
[xi] Michael Corbett, "Oil Shock of 1973-74," *Federal Reserve Bank of Boston*, November 22, 2013, https://www.federalreservehistory.org/essays/oil_shock_of_1973_74.
[xii] Paul Krugman, Maurice Obstfeld, and Marc Melitz, "International Economics: Theory and Policy Tenth Edition," *Pearson*.