

# FRBSF WEEKLY LETTER

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## Gaiatsu

How should the United States respond to the trade and industrial policies of other countries? The flare-up this spring in the smoldering trade conflict between the U.S. and Japan has once again brought this question to the fore. From day one, the current administration's answer has been to "try to pry open" foreign markets through an aggressive policy of *gaiatsu*, meaning "foreign pressure." This pressure comes in the form of a threat—namely, that foreign producers will be denied access to the lucrative U.S. market unless their governments mend the folly of their (supposedly) protectionist ways. Leaving aside the specifics of the recent debate over autos, and the question of whether in fact Japan is more protectionist than other countries, this *Letter* outlines some general principles of a *gaiatsu* trade policy. I begin with two well known statements representing opposing viewpoints. I then employ some basic concepts from game theory to outline the conditions under which such a policy is likely to succeed. Finally, I turn to empirical evidence on the ability of threats and retaliation to achieve their desired end.

### Pros and cons of unilateral free trade

Despite the usual caricature portrayed in the popular press, economists are not, and never have been, dogmatic advocates of free trade. As evidence, I will employ the time-honored rhetorical device of "appeal to authority." Just as psychologists cite Freud and biologists cite Darwin to buttress their arguments, I will cite the founder of economics—Adam Smith—to support my claim that economists have always had a broader and more open-minded view of international trade policy than is often attributed to them. Consider the following quote from the *Wealth of Nations*, which, more than 200 years later, is still relevant to current policy debate:

"The case in which it may sometimes be a matter of deliberation how far it is proper to continue the free importation of certain foreign goods, is, when some foreign nation restrains by high duties or prohibitions the importation of some of our manufactures into their country. Revenge in

this case naturally dictates retaliation, and that we should impose the like duties and prohibitions upon the importation of some or all of their manufactures into ours.

There may be good policy in retaliations of this kind, when there is a probability that they will procure the repeal of the high duties or prohibitions complained of."

Although economists have long recognized the potential benefits of *gaiatsu*, it is true that a consensus in favor of unilateral free trade gradually solidified during the 19th century. This consensus, however, was based more on experience than on theory. Again and again, experience taught that well intentioned government policies had an unfortunate tendency to get captured and subverted by special interests. Naturally, the disastrous trade wars of the 1930s reinforced these beliefs, so that by the middle of this century it is fair to say that the following quote by Robinson (1947) expressed the view of most economists:

"The popular view that free trade is all very well so long as all nations are free-traders, but that when other nations erect tariffs we must erect tariffs too, is countered by the argument that it would be just as sensible to drop rocks into our harbors because other nations have rocky coasts."

In other words, rather than "leveling the playing field," a *gaiatsu* trade policy may simply produce an equally bumpy field for everyone!

The difference between Smith and Robinson lies in their implicit assumptions about the ability of threats and retaliation to influence the policies of foreign governments. Smith recognizes the possibility, while Robinson regards foreign trade barriers as a *fait accompli*. No doubt, the truth lies somewhere in the middle, depending on a host of case specific circumstances, and the challenge to effective policy is to understand and recognize in each case the conditions conducive to success.

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## Threats and retaliation in theory

As everyone knows, a successful threat is never carried out. So what ensures that a threat will not have to be carried out? The classic work of Schelling (1960) links success to *credibility*. A threat is credible if others know that it will be in your interests to carry it out if they fail to act accordingly. For example, announcing that I will shoot myself unless you give me \$100 is not a credible threat, for certainly it will not be in my interests to carry out the threat if you do not hand over the money. Thus, the art of diplomacy comes in making sure that others know (or at least have the impression) that you will carry out the threat, *even though it is known that you would like to renege if you could*. (Clearly, if carrying out the threat causes you no pain, there is no strategy involved—you simply do what you want to do.) As a result, diplomats and trade negotiators work hard to convey the impression that they are “tied to the mast.”

Given that the successful practice of *gaiatsu* hinges on the ability to make credible threats, what sort of political institutions facilitate commitment and credibility, and are these institutional features present in the United States? Dixit (1987) outlines several ingredients in the formation of credible commitments. Among the most important are the following—Speed, Irreversibility, Clarity, and Randomness.

“Speed” refers to the fact that there are often “first-mover advantages” in situations of strategic interaction. After all, the whole point of strategy is to influence the actions or beliefs of others. Obviously, the ability to do this requires quick and preemptive action. “Irreversibility” is the essence of credible commitment, and in a political context refers to the advantages of embodying threats in constitutional provisions that are difficult to change or back out of. “Clarity” is a particularly important issue in the case of U.S.—Japanese trade relations. As stressed by Schelling, vague threats are likely to be unsuccessful. For example, threats designed to deter foreign actions will be whittled away by small encroachments on the zone of ambiguity. (Schelling calls this “salami tactics.”) Similarly, threats designed to compel foreign actions will elicit the most minimal and marginal responses. Thus, it is crucial to be clear about what constitutes compliance or transgression. However, there is a type of vagueness that can actually be advantageous. Specifically, a certain amount of controlled “Ran-

domness” can usefully be deployed in a policy of “brinkmanship.” Threatening to drop “The Bomb” is so draconian that in most instances it would not be a credible threat. However, if the policymaking process contains a *random element* that delivers even a small *probability* of a draconian response, then this effectively scales down the threat and makes it more credible.

How do U.S. political institutions rate along these dimensions? First, the emphasis in the U.S. on “due process” produces lengthy policy debates that make U.S. policy slow-of-foot relative to other countries. (Of course, this doesn’t mean due process is bad. It just means that legalistic proceedings are not favorable to strategic trade policy.) Second, most aspects of trade policy are not embedded in the constitution and are easily changed by Congress. In fact, U.S. trade law underwent major changes in 1974, 1979, 1984, and again in 1988. Third, U.S. trade law has been notoriously unclear about what it expects of other countries, partly because trade is only one facet of a complex multidimensional relationship that includes security, environmental, and other considerations. These other considerations can be played off against trade issues. In the end, randomness is the only aspect of U.S. trade policy that favors *gaiatsu*. Dixit notes that U.S. trade negotiators often use the threat of Congressional action to precipitate agreement, arguing that, “unless you agree, this is going to end up in Congress, and who knows what will happen then!”

While these features of the U.S. political landscape cast doubt on the potential success of strategic trade policy, ultimately this is an empirical question. Therefore, it is useful to move beyond general conjectures and look at the actual historical record on the use and effectiveness of threats and retaliation.

## Threats and retaliation in practice

Multilateral agreements (like the new World Trade Organization) attempt to contain bilateral/*gaiatsu* trade policies. However, by definition nations are sovereign, and each maintains explicit opt-out provisions in its trade laws. In the U.S., this takes the form of Section 301 of the Trade Act of 1974. In principle, the purpose of 301 is to enable the U.S. to respond to “unfair” foreign trade practices. Technically, the President (via the U.S. Trade Representative) is supposed to retaliate against foreign practices that are “unjustifiable” or “unreasonable.” Of course, these are terms

that only lawyers can define, and accordingly 301 proceedings are highly bureaucratic and legalistic.

Supporters of 301 view it as a "crowbar" that enables the U.S. to "pry open" foreign markets. Critics argue that because the U.S. decides unilaterally what is fair and what is unfair, the law enables the U.S. to act as judge, jury, and executioner in its own kangaroo court of trade crimes.

In the past, these two camps have simply talked past each other. Each has a valid point, and the real issues are whether the U.S. has abused its ability to define unfairness unilaterally, and whether 301 actions have in fact opened foreign markets. These are empirical questions that no one had investigated. Fortunately, Bayard and Elliott (1994) recently provided a service to the profession by collecting and analyzing data on actual 301 cases. They study 72 cases that took place between 1975 and 1993. These range from high profile cases (e.g., Japanese semiconductors) to obscure cases (e.g., Indonesian pencil slats).

Bayard and Elliott don't worry about whether the U.S. uses 301 to levy false charges of unfairness. Instead, they focus on whether 301 actions are "successful," where success is defined in terms of a negotiated settlement that leads to increased U.S. access, as measured by quantitative indicators like sales or market share. Surprisingly, they find that 301 actions were "successful" in about half the cases (i.e., 35 out of 72). Their statistical analysis points to three main success factors: (1) the importance of the U.S. market to the foreign country, (2) the existence in the foreign country of a political constituency that will benefit from the market opening, and (3) transparency (e.g., intellectual property cases are less transparent than those involving explicit import quotas).

Bayard and Elliott conclude that 301 has been more successful than most economists suspect. At the same time, they argue that 301 has probably outlived its usefulness. Now that the WTO is in place, and the foundation is set for an effective multilateral dispute resolution and enforcement

mechanism, all countries—including the U.S.—should take advantage of this new institution in pressing on with the job of market liberalization.

### Conclusion

The U.S. seems committed to a *gaiatsu* trade policy. In principle, this could be beneficial to both the U.S. and foreign countries. Most economists remain skeptical, however, due to potential capture by special interests, and because U.S. political institutions seem ill-equipped to make credible threats. On the other hand, threats have been reasonably successful at breaking down foreign trade barriers.

One factor missing from the above discussion of the determinants of successful threats was the relative size or bargaining strength of the opposing parties. In the past the U.S. could extract concessions from other countries simply because it could impose large costs on them while suffering only minor costs itself. However, this power asymmetry is diminishing. Moreover, the excuse the U.S. has used for unilateral action—namely, that GATT couldn't handle the problem—seems less compelling in light of the new WTO. For both reasons, the U.S. should forsake unilateralism and give the WTO a chance.

**Kenneth Kasa**  
Economist

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