

Falling Dominoes? The Impact of the US Exit from Free Trade on the Sustainability of Trade Cooperation

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Discussants: Gene M. Grossman, George A. Alessandria

Guillermo Ordoñez began by noting that the game restricts each country's tariff choice to be the same across trading partners. He wondered whether it would be possible to introduce sets of tariffs that differ across trading partners. He noted that in the extreme case of bilateral tariffs, countries would have additional incentives to deviate from a cooperative arrangement, though he acknowledged that this would complicate the analysis. Next, he noted that the paper's approach treats the U.S. departure as an exogenous shock. He provided another possible interpretation of the U.S. exit: that it had an incentive to deviate, in which case understanding the reason for this deviation is important. Under the exogenous shock interpretation, however, he pointed out that countries in the game would internalize the probability that another country would experience such a shock and that this probability would enter the effective discount factor. He wondered whether the U.S. withdrawal may have provided information that other countries had also experienced such a shock. Finally, Ordoñez pointed out that the analysis restricts attention to deviations by a single country at a time. He wondered whether the authors had considered the full equilibrium in which coalitions of countries can deviate jointly.

Andrei A. Levchenko responded to Ordoñez's first comment by noting that the uniform Nash tariff follows from an assumption that when a country sets its tariff, it considers how its wage will move relative to the world wage but does not consider how other countries' wages will move relative to one another. He noted that they allowed countries to choose country-by-country tariffs in a simple version of their model but found that the deviations from the uniform-tariff benchmark were quantitatively small, supporting their decision to ignore this additional term in the first-order condition. Levchenko next moved to Ordoñez's third comment, noting that considering all possible coalitions would be technically very difficult, though he thought it might be feasible with a smaller set of countries. He described solving the full coalition problem as opening a Pandora's box. Levchenko then addressed Ordoñez's second comment, noting that it relates to the question of whether institutional changes might have accompanied the U.S. exit. He agreed with Ordoñez that it is possible that the U.S. exit sent a signal about other countries' preferences.

Veronica Guerrieri pointed out that an important missing margin from the model is country and product heterogeneity. She explained that if countries produce different goods, then the gains from cooperation and the incentives to impose tariffs could look different. Levchenko agreed with her comment, noting that in a richer version of their model with an input-output matrix and countries producing different goods, the optimal tariff falls substantially. He added that the finding that input-output linkages lower optimal tariffs has also been observed in other papers. He explained that while the required patience parameter rises slightly in this version of the model, it does not rise enough to overturn the conclusion that the U.S. departure does not have a large effect on the coordinated equilibrium. He wrapped up his response by noting that this richer model is not amenable to analytical analysis, making it difficult to gain intuition for these results.

Wendy Edelberg then asked what the paper and the discussions imply for advice to the next U.S. president if current trade policy were frozen for the next three years: What would optimal tariff

policy look like, what are the welfare gains from moving toward the optimum, and how credible is movement toward the Nash equilibrium in practice? Levchenko began his response by noting that the unilateral optimal tariff is positive in these models, echoing a point from George Alessandria's discussion. He then suggested that the advice to policymakers, at least from the perspective of a trade economist who believes in this class of models, would be not to raise tariffs, because retaliation by other countries would undo the gains. Drawing on another point raised in Alessandria's discussion, Levchenko acknowledged that there has not been much retaliation empirically, potentially reflecting forces outside the model, such as the U.S. defense umbrella. Edelberg followed up on this issue, asking whether the lack of retaliation implies that U.S. welfare in the model is now higher under the tariff increases, to which Levchenko agreed. Avi Lipton then asked whether the unilateral optimal tariff would fall if other countries held large foreign asset positions in the United States, and Levchenko agreed that this might be the case. Gene Grossman followed up on the earlier discussion by pointing out that although the model implies that the U.S. is better off when retaliation is muted, the data do not show an improvement in its terms of trade. Levchenko responded by noting that it may not be straightforward to measure and interpret changes in the terms of trade in the data.

Finally, Gianluca Violante asked Levchenko to comment on a point raised in George Alessandria's discussion: the trade elasticity affects the level of the optimal tariff substantially but does not change the patience parameter required to sustain cooperation very much. Levchenko replied that they had repeated their analysis with different elasticities, but the basic conclusions did not change by much.