Statement of Research Interests

James Lake

My research focuses on understanding the incentives that drive the formation of international trade agreements and the theoretical and empirical implications that follow. An oft–quoted anecdote in economics is "one thing that all economists agree on is the superiority of free trade". However, while all economists recognize the public angst towards free trade, many economists are unaware of the subtle debate amongst international trade economists. My dissertation focuses on these subtleties from the perspective of an international trade theorist with an eye for observable implications and empirical strategies to test these implications. In future research, I plan to investigate the distributional inequalities perceived by the public.

International Trade Agreements as Dynamic Farsighted Networks

Prior to the mid 1980's, global trade liberalization largely progressed through nondiscriminatory multilateral tariff reductions. These reductions were nondiscriminatory because they were governed by the "Most Favored Nation" principle, which says that every country receives most favored nation status. However, the use of Preferential Trade Agreements (e.g. NAFTA) has expanded exponentially since the mid 1980s. Since these agreements are discriminatory by nature, a long standing debate among international trade economists revolves around whether the path towards global free trade is strengthened or threatened by the rapid evolution of such agreements. An important focus of my research is the application of network theory and empirical network methods to understand this issue.

My job market paper, currently under revise and resubmit at the *Journal of International Economics*, develops a novel dynamic network model in which countries are farsighted and asymmetric in terms of market size. Like Saggi and Yildiz (2010), I investigate whether Preferential Trade Agreements strengthen or threaten the possibility of attaining global free trade given the existence of the Most Favored Nation principle. The novelty of my model lies in the new dynamic equilibrium concept that endogenously determines the order of negotiations. Because countries are farsighted and the model is dynamic, countries fear any preferential access gained in a Preferential Trade Agreement may be short-lived because their partner may form future agreements. This fear of preference erosion can undermine formation of further Preferential Trade Agreements and therefore the attainment of global free trade. Indeed, the fear of preference erosion partly underlies developing countries resistance to the Doha Development Round because they enjoy significant preferential access under policies such as the EUs Eveything But Arms initiative.

My model predicts empirically observable phenomena. In particular, preference erosion should be less important if the negotiating countries already have agreements with common third parties because there is less scope for formation of future agreements. Indeed, Chen and Joshi (2010) find empirical evidence that supports this hypothesis. My model also makes the following prediction about the formation of Preferential Trade Agreements: when two countries have a Preferential Trade Agreement, the smaller country initiates negotiations with a third party country before the larger country does even though the larger country concludes the agreement before the smaller country. This prediction characterizes the recent US–Canada–Colombia and the recent US–Canada–Korea trade negotiations.

Only recently has empirical work investigated whether the network structure of the global trade network influences formation of Preferential Trade Agreements (e.g. Chen and Joshi (2010)). My second paper (in progress) extends recent developments in the empirical network estimation literature by Christakis et. al.

(2010) to a setting of repeated network observations. After estimating parameters governing how the network structure affects the attractiveness of Preferential Trade Agreements, the model can predict the future state of the global trade network. I can also consider counterfactual states of the global trade network, such as the absence of NAFTA.

Many questions, both theoretical and empirical, remain unexplored in this area. From a theoretical perspective, there are two types of Preferential Trade Agreements: Free Trade Agreements and Customs Unions. Unlike Free Trade Agreements, Customs Unions require members to maintain common tariffs on nonmembers. While this allows members to internalize any externalities when setting tariffs on nonmembers, it restricts individual members from pursuing Preferential Trade Agreements with nonmembers. How these incentives lead countries to choose a particular type of Preferential Trade Agreement and the implications for whether Preferential Trade Agreements strengthen or threaten the achievement of global free trade is unknown. However, the model I develop in my job market paper can be directly applied to this question. The model can also be directly applied to a setting where there are more than three countries, which is another unanswered question.

An exciting line of research, which I am starting to explore, is extending recent empirical network estimation techniques to allow for farsighted players. Recent advancements analyzing dynamic discrete choice problems in the structural IO literature by Arcidiacono et. al. (2010) provide a useful tool for modeling international trade networks, in which countries make discrete choices about whether to form a Preferential Trade Agreement.

Why do countries set upper bounds on tariffs?

While countries negotiate over upper bounds on tariffs in the WTO, countries routinely set actual tariffs below their WTO commitments. This practice is known as binding overhang and has received little attention in the literature. My third paper, joint with Maia Linask (U of Richmond), is a dynamic lobbying model in which we view government as being captured by importers or exporters. The group in control of tariff setting, i.e. importers or exporters, may be happy with an intermediate tariff level because of the threat of lobbying by the opposing group. Because of time varying opportunity costs of lobbying, our model provides empirical predictions that relate the average tariff and the variance of the tariff to the ease of lobbying and the size of the economy.

Given the empirically testable predictions provided by our model, we plan to carry out an empirical project. While real GDP is an obvious proxy for the size of the economy, finding a proxy for the ease of lobbying is more difficult.

Distributional consequences of trade agreements

McLaren and Hakobyan (2011) have recently shown the existence of significant distributional effects of NAFTA despite the modest aggregate welfare effects that exist in the literature. They find adverse effects on wages for blue collar workers in NAFTA vulnerable industries. However, they also find adverse effects on wages in NAFTA vulnerable geographic locations even for workers in non–tradable industries. Nevertheless, these OLS results are average effects. As such, I plan to use quantile regression analysis to investigate how, for given observable characteristics, NAFTA has affected wages at various quantiles of the wage distribution. This has the potential to reveal a significant amount of information about the distribution of effects induced by NAFTA rather than just average effects.

Cited works

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