"Investments in the Shadow of Conflict" by Harshal Zalke

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QUESTION

Does economic interconnection decrease conflict?

- Yes: it increases the cost of war.
- No: economic agents can anticipate the possibility of conflict and leave, so interconnection doesn't matter.

This paper.

- Coordination game. We get a unique equilibrium (well...) by modeling it as a global game, similar to Shadmehr 2019.
- If firms are large, they internalize their effect on the chances of conflict, and may decrease it.

The Model

Agents: n investors with $\frac{1}{n}$ units of capital.

Timing:

1. Nature draws $\theta \sim U[\underline{\theta}, \overline{\theta}]$, the benefit of war.
2. Investors privately observe a signal $x_i \sim U[\theta - \sigma, \theta + \sigma]$ and simultaneously choose domestic investment k_i; they invest the rest abroad.
3. War if $\theta > K \equiv \sum_{i=1}^{n} k_i$.

Domestic returns are R under peace, 0 under war.

Returns abroad are $r < R$ under peace, δr under war, $0 < \delta \leqslant 1$.

Results

Proposition. There is a symmetric equilibrium in threshold strategies: if $x_i \leqslant x^*$, invest all at home, if $x_i > x^*$, invest all abroad.

Interesting observation. The incentive to invest at home increases in x_i right before the threshold (then it disappears) due to pivotality.

If n and σ are small there can be multiple equilibria.

Conjecture. The probability of war increases with n.

Questions

1. Why war?

– If war is due to bargaining failure (Fearon) because of private information, then what matters is not θ per se but how much uncertainty there is. More economic agents (greater n), more information aggregation, less chances of war?

– If war is due to misaligned incentives of political leaders (Jackson and Morelli), more investment at home may attract attacks by foreign states instead of reducing conflict.

Questions

2. What about interdependence?

– Investments from country A to country B should affect the incentives of *both* countries to engage in conflict. Investments from a neutral country C should have a smaller impact.

3. Why are returns not equal at home and in foreign markets?

– The microfoundation (be it private information, increasing returns to scale, lack of property rights, barriers to entry, or just the possibility of conflict) may have implications for the analysis.

Questions

4. What about policy?

– The government may want to use subsidies to correct for underinvestment due to uncertainty. Foreign states may threaten to use, e.g., trade policy to deter conflict. This can interact with or directly target investment decisions.

5. How to think about market structure (n)?

– More developed economies $\rightarrow$ more industries $\rightarrow$ greater n? Or only some key industries matter?

Conclusion

Important question: how to think about the effect of economic interconnection when capital allocation is decentralized?

Idea: this is a coordination game, and the distribution of information can pin down the equilibrium.

New insight: the number of economic agents and how much information each one has can affect the chances of interstate conflict.

Exciting project, many directions to take it.