

Part I. SHORT ANSWER QUESTIONS. To answer these questions you must identify (i.e., define) the listed concept and give its significance *to this course*. That is, many of these concepts may have been used in other ways in other courses, to receive credit for these questions your answers must be correct with respect to usage in this course. Fully correct answers do only this (Do not try to discuss the concept in detail). The answers to these questions can be given in four sentences or less. You will lose points for writing material unrelated to the answer so *think before writing*. **Credit: Answer 5 (eight) of the following for 10 points each** (50 total points). I will only grade the first eight answers, so do not answer more than eight.

1. *Principal supplier rule*: The principal supplier is the country that has the largest share of imports of a good into a particular importing country, among those exporters subject to MFN tariffs. It is customary in tariff negotiations, and to some extent mandated by WTO rules, that countries negotiate with their principal suppliers. By helping internalize exchange of concessions, the principal supplier rule supports reciprocity. As a result it is considered a key (procedural) *sovereignty norm*.

2. *Havana Conference*: 1948 conference in which the final draft of the agreement creating the International Trade Organization was written. A key moment in the attempt to create a law-based, Liberal international economic order.

3. *Ministerial conference*: The trade ministers of all members of the WTO meet, at least every two years, to set policy for the WTO. The highest decision making body of the WTO. Only the Ministerial Conference can launch new rounds or make authoritative interpretations of the various Agreements that make up the fundamental legal structure of the WTO.

4. *Reciprocity*: Trade bargaining in the WTO is based on the essentially mercantilist principle of *reciprocal exchange of concessions*. Under reciprocity, all participants in a trade negotiation are able to claim that, in exchange for their own “concessions” (in the form of lowered home trade barriers), they received “substantially equivalent benefits” (in the form of lower foreign trade barriers). While nowhere required in formal agreements, reciprocity is a key national sovereignty norm of the GATT/WTO system.

5. *Tariff bindings*: A commitment, under the GATT, by a country not to raise the tariff on an item above a specified level, called the bound rate. The submission of bound tariff schedules, under Article II, is part of the act of acceding to the WTO and implements the *liberalization norm* (one of the key interdependence norms).

6. *Section 301* (Trade Act of 1974): The section of US trade law dealing with *unfair trade practices*. Of particular importance because it is the domestic legal mechanism through which US citizens (corporate and otherwise) pursue Article XIX disputes under the WTO.

7. *Substantial cause* (in the context of an escape clause case): One of the burdens of proof in an escape clause case is that imports are causally related to injury. The nature of this causal burden

has been uncertain. Congress defined “substantial cause” as a cause which is “important and not less than any other cause”. This constituted a restriction relative to the earlier “primary cause” language.

8. *Reciprocal Trade Agreements Act of 1934*: Contained two major components: authority for the Executive to negotiate reciprocal trade agreements under generalized MFN; and created the ground rules under which administered protection operated. Thus, contained early versions of both the interdependence norms and the sovereignty norms that underlie the GATT. Not only permitted early negotiations reducing protection from the very high levels of the 1930s, but was the legislative basis for US participation in the GATT negotiations.

Essays: These questions ask you to develop an argument in some detail. Your answer must be logical, complete and grammatical (i.e., you must write in complete, well-constructed sentences and paragraphs). If you use graphical or algebraic analysis to support your argument, you must explain fully the elements of your formalism. Think before writing.

Part II. Essays. Answer 1 (one) for 25 points.

A. One of the main themes of this course has been that the international and domestic legal structures that regulate trading relations between nations must balance the gains from participating in the international division of labor against losses of national sovereignty.

a. Explain the general need for sovereignty norms in the context of a regime committed to liberalization. [5 points]

The entities which set national trading rules are the governments of sovereign nations. This is recognized in the fact that the membership of the WTO is made up of sovereign nations. Such entities cannot morally or logically agree to any commitments whose result is domestic economic or political disorder. More practically, the politicians representing the member nations would be unwilling to accede to, and/or meet the obligations of, an organization that did not recognize the occasional need to withdraw from commitments under emergency situations. Safeguard norms, including Article XIX, provide formal institutional recognition of this fact, in the context of the WTO.

b. In the context of your answer to the first part of this question, discuss the relationship of the Article XIX of the General Agreement on Tariffs and Trade to the overall legal structure of the GATT/WTO system. [10 points]

Article XIX is the central institutional embodiment of the safeguard norm. Specifically, it permits members, upon demonstration that increased imports cause, or threaten to cause, serious injury, to suspend such GATT obligations in respect of the injured industry for such time as necessary to prevent or remedy the injury. The importing nation must consult with members having a “substantial interest” as exporters. If agreement is not reached, exporting countries have a right to suspend substantially equivalent concessions, though this right has been weakened under the Uruguay round conditional on a

demonstration that there has been “an absolute increase in imports and that such a measure [i.e. the Article XIX protection] conforms to the provisions of this agreement”. Specifically, under these conditions there is no right of retaliation for 3 years. VERS are now ruled out as a response, but exporters may “administers quotas if that is mutually agreed”. Application of safeguard protection is generally limited to 8 years.

c. How are the Article XIX rights and obligations implemented in US law? A complete answer to this question discusses both the statutory basis of that implementation and the functioning of the administrative mechanism created by the relevant statute. [10 points]

Section 201-204 of the Trade and Tariff Act of 1974 (as amended by later legislation) implement Article XIX rights in US trade law. Prior to the 1974 Act, a complainant was required to show a causal link between GATT concessions and increased imports, but this requirement was dropped in 1974. Under this law, an Escape Clause petition is filed with the U.S. International Trade Commission for a determination on the question of serious injury. If the ITC finds affirmatively (by majority or tie vote), the petition is forwarded to the President with a recommended action. The President, however, has considerable discretion and may decide to act differently, including doing nothing at all. By a 2/3 majority, Congress may pass a law requiring the President to follow the ITC’s recommendation.

B. The new dispute resolution mechanism is considered one of the major accomplishments of the Uruguay Round.

a. Describe the structure and operation of the dispute resolution mechanism. [10 points]

Stage I: consultation and mediation. Stage II: Request for a panel. Stage III: Panel process (examination of facts, meetings with interested parties, interim review, drafting conclusions and recommendations, and panel report issued). Stage IV: adoption of decision or appeal (to appellate body which reports to DSB). Stage V: Implementation (change in policy, compensation, or suspension of equivalent concessions).

b. The Banana case has been seen as a major test of the new dispute resolution mechanism. Describe the main issues in the case. [5 points]

The banana case emerges as a result of the adoption of a single market in bananas in the EU. Prior to the single market, a number of regimes, from highly protected (e.g. France and the UK) to quite liberal (e.g. Germany) existed. To create a single market, a single EU-wide regime had to be created. Consistent with the CAP, a quota regime was created with preferential allocation of quotas to ACP countries, resulting in a substantial loss of market share by Caribbean banana producers. A related case was filed by the EU against the US with respect to its threat of retaliation against the EU prior to a finding by a dispute resolution panel.

c. Compare the outcomes in the Banana case under the GATT-1947 dispute resolution

mechanism with that under the WTO mechanism. In particular, comment on the extent to which the latter: 1) produced different outcomes relative to the former; and 2) the extent to which the latter suggests a more legalistic basis for resolving trade policy conflicts. (Note: complete answers must provide explicit argument supported by evidence from the Banana case, not simply assert a conclusion.). [10 points]

Under the GATT-1947 regime, panels found twice against the EU, but the acceptance was blocked under the practice requiring consensus to accept a report. Under the post-WTO regime, the report was accepted and the EU has sought to adjust its banana regime to compliance. Thus, the new WTO dispute resolution rules clearly produced a different outcome within the system—i.e. a report was accepted, where this had not been the case in the past. However, the changes did not occur quickly, nor did they occur completely. The remainder of an answer to this question requires a clear characterization of legalistic versus pragmatic positions and an argument for how this case fits into that context. In particular, some consideration of what might have occurred if the US had not been a participant along with the Caribbean producers. In this context, some discussion of the weakness of Ecuador's retaliatory threat should be addressed.

Part III: Answer 1 (one) for 25 points.

C. Consider the case of an economically small country which produces two goods under perfect competition in both sectors. Furthermore, suppose that there are increasing opportunity costs in transforming one good into the other (i.e. there is a “bowed-out” production frontier).

a. Graphically illustrate and explain why free trade is, at least potentially, Pareto superior to autarky. [10 points]

See annex 2.1 of Hoekman/Kostecki.

b. Explain why the qualifier, “at least potentially”, is necessary. [5 points]

The Pareto rule requires that a policy change be adopted only if no one is made worse off by the change, and at least one person is made better off. It is generally the case that liberalization, in addition to raising national welfare/income, redistributes income and imposes adjustment burden. Since some people will generally lose from liberalization, without explicit redistribution from gainers to losers, liberalization cannot satisfy the Pareto rule.

c. From the equilibrium with free trade, illustrate the effect of a tariff. Use your illustration to show that a tariff can be decomposed into a production effect (that can be induced using only a production subsidy) and a consumption effect (that can be induced using only a consumption tax). [10 points]

One approach would follow annex 2.2 of Hoekman/Kostecki to provide an analysis of the effects on production, consumption, and trade; and the producer gain, consumer loss, and

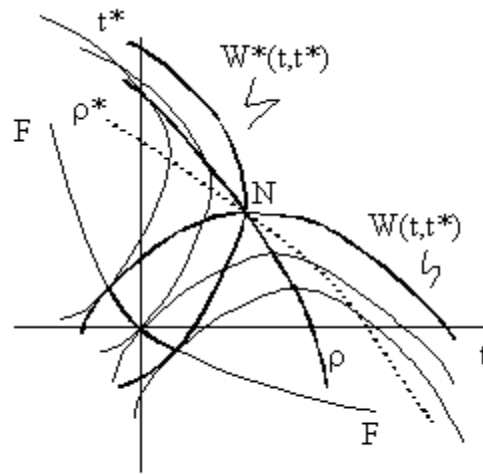
deadweight losses associated with those outcomes. This would be followed with a discussion of deadweight losses associated with production subsidies and consumption taxes as policy options instead of tariffs.

An alternative would be to show the same effects in general equilibrium.

D. Trade conflict can be particularly damaging to the countries involved and to the trading system as a whole. As a result, the GATT/WTO system has been constructed in such a way as to limit the likelihood of trade war among members.

a. Using a non-cooperative framework, illustrate how a trade war produces outcomes inferior to free trade. Given that this is the case, explain why free trade might not result from the decision-making of rational governments. [10 points]

Any large country has an optimal tariff. In trading relations between two large countries, each will be tempted to levy the optimal tariff consistent with rational behavior by the other country. Consider the diagram drawn in tariff policy-space. For each country I have drawn several iso-utility curves, $W(t, t^*)$, associated with various mixes of trade policy. Any given curve shows the combinations of Home and Foreign tariff policy, (t, t^*) , that yield the same level of welfare to the given country. The optimal response for the Home country to any given level of Foreign tariff is found at the highest valued policy utility curve consistent with this tariff—i.e. the rest point (i.e. point of zero slope) of such a curve. The locus of all these points is a reaction function for the Home country— ρ . The Foreign country's curve, ρ^* , can be derived in the same way.



In a one-shot, noncooperative game between these two countries, there is a unique Nash equilibrium (marked N in the diagram). However, both countries would prefer any point bounded by their Nash policy-welfare curves. In particular, the countries prefer any point on the locus of tangencies of their policy welfare curves (the “contract curve”) to any other point in this area. Suppose, because it has attractive focal properties, that we focus on free trade (i.e. the origin). Both countries clearly prefer this point to the Nash point (it is on higher valued policy-welfare curves for each country), but this point is not an equilibrium because if, say, the Foreign country played this point, the Home country would be tempted to get the even higher valued optimal tariff. This situation is, thus, a prisoners’ dilemma. That is: $W(t^{opt}, 0) > W(t^C, t^{C*}) > W(t^N, t^{N*}) > W(0, t^{opt*})$, and $W^*(0, t^{opt*}) > W^*(t^C, t^{C*}) > W^*(t^N, t^{N*}) > W^*(t^{opt}, 0)$, yielding the payoff matrix:

	Cooperate	Defect
Cooperate	$W(t^C, t^{C*}), W^*(t^C, t^{C*})$	$W(0, t^{opt*}), W^*(t^{opt}, 0)$
Defect	$W(t^{opt}, 0), W^*(t^{opt}, 0)$	$W(t^N, t^{N*}), W^*(t^N, t^{N*})$

b. It has been argued that repeated interaction can help countries overcome the implicit prisoners' dilemma in the previous question. Explain the logic of this argument. [10 points]

In a repeated context, the expected loss of future gains from cooperation (i.e. free trade) acts as a barrier to current deviation from cooperation (i.e. imposing the optimal tariff) as long as:

$$\sum_{t=1}^{\infty} \alpha^t W_t^C > W_1' + \sum_{t=2}^{\infty} \alpha^t W_t^N$$

$$\frac{\alpha}{1-\alpha} [W^C - W^N] > W' - W^C,$$

where t is the time period, α is the discount factor, and W' is the one period payoff from defecting while the other country cooperates. The *folk theorem for repeated games* states, essentially, that any payoff at least as good as the Nash payoff can be supported by repeated interaction under the above condition. Among such payoffs is the fully cooperative (free trade) payoff.

c. What role does an institution like the WTO play in encouraging cooperation in this context? [5 points]

First, the WTO provides a number of forums involving repeated interaction (negotiations, dispute resolution, etc.). In addition, in a realistic, stochastic, environment, cooperation is eased by the provision of reliable public information. Clearly one important role played by the WTO is the provision of such information. Similarly, genuine misunderstandings can lead to trade wars that could be avoided. The dispute resolution mechanism helps in this regard. Finally, by empowering trade Liberal elements in society, the WTO may even change the payoffs facing governments by raising the domestic political payoffs to the cooperative outcome.

	Short Ans.	Essay A	Essay B	Essay C	Essay D	Total	Norm Tot.
Mean	34	15	16	10	15	62	70
Median	39	16	17	7	17	61	69
Std.Dev.	10	5	2	7	4	14	16
Minimum	13	10	13	4	8	35	40
Maximum	45	22	20	22	18	88	100

Normalized total gives scores as a percentage of the maximum actual score.