

Title

Prudence versus Predation and the Gains from Trade

Authors

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Abstract

The “Liberal” hypothesis on trade, which holds that countries that trade with one another today are less likely to go to war in the future, has been thoroughly examined across multiple literatures. However, the converse question—of how the likelihood of future war affects how countries make trade, arming, and investment decisions today—has yet to be explored. To examine this issue, we construct a dynamic, two-country model of trade and conflict where conflict occurs in the future with some positive (exogenous) probability. We characterize an equilibrium in terms of the different trade-offs each country must make in order to prepare for an uncertain future, weighing current consumption against competing investments in future military and productive capacities. Because these trade-offs balance differently depending on the initial distribution of resources, we find that asymmetries in military power need not depend linearly on differences in economic size. In particular, a higher probability of conflict always enhances the military advantage of the ex-ante disadvantaged player, enabling it to “prey” on the relatively more “prudent” behavior of its larger rival. Because the smaller country also generally enjoys relatively larger gains from trade, its larger rival will find it optimal to foreclose on trade in the present when the difference in ex ante resource wealth is sufficiently large and when the probability of future conflict is sufficiently high. We test our predictions regarding trade and conflict expectations by studying the period surrounding the end of the Cold War.