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**NEGOTIATION IN THE SHADOW OF POWER AND DEPENDENCE:
PROBING THE PLAUSIBILITY OF A DEDUCTIVE BARGAINING MODEL
IN THE CONTEXT OF CANADA-CHILE FREE TRADE**

by

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**A thesis submitted to
the Faculty of Graduate Studies and Research
in partial fulfillment of
the requirements for the degree of
Master of Arts**

**The Norman Paterson School of International Affairs
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5 May 1999**

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of the requirements for the degree of Master of Arts.

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ABSTRACT

Conventional wisdom dictates that power and dependence determine the course of inter-state negotiation: the stronger, more dominant party is expected to leverage its power, forcing the weaker, more dependent party to submit. This thesis asks how and why weaker, dependent parties to a negotiation are sometimes able to overcome seemingly disadvantageous power asymmetries. To address this question, the paper develops a new deductive model of inter-state bargaining grounded in the theoretical framework of international relations theory and inspired by an existing social psychological model of asymmetric negotiation. The plausibility of this IR-derived model is probed and policy implications are examined using Canada-Chile Free Trade Agreement (CCFTA) negotiations as a case-study—specifically examining the Canadian concession on Chilean capital controls.

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PREFACE

"The strong do what they can, and the weak suffer what they must."

Thucydides (*The Peloponnesian War* 1951, 331)

Since the time of Thucydides, the classical argument has been that ". . . only when there is symmetry in power. . . is negotiation a phenomenon worth studying; only when power has been a decision-making tool of states. In all other cases—those of asymmetrical power—the stronger state, by definition, will win" (Habeeb 1988, 2-3). This thesis represents a departure from Thucydides and the classical approach by arguing that power asymmetries can produce forces favoring the more dependent party to a negotiation, a hypothesis supported by a deductive model of inter-state bargaining grounded in the theoretical framework of international relations theory (IR) and inspired by an existing social psychological model of asymmetric negotiation developed by Samuel Bacharach and Edward Lawler (1981). The plausibility of this IR derived (IR-D) model is probed using Canada-Chile Free Trade Agreement (CCFTA) negotiations as a case-study, specifically examining the Canadian concession on Chilean capital controls.

This project was developed to make four contributions: (1) to synthesize the international relations literature on dependence and power to construct a cohesive IR theoretical framework; (2) to use this framework to construct a new, IR-derived model suitable for explaining and predicting inter-state bargaining behavior; (3) to demonstrate how this model explains real-world negotiating behavior using the CCFTA as a case

study and (4) to explain the CCFTA negotiation process itself. The first three contributions pave a path for subsequent analyses of asymmetric inter-state bilateral negotiations, for there is no currently reigning paradigm specifically designed to explain inter-state bargaining in the context of power and dependence. Two theorists, William Habeeb and Maryse Robert, have each attempted to build their own power-based theories of inter-state negotiation, but neither model has been embraced by negotiation analysts or IR theorists—perhaps because both approaches suffer significant shortcomings.¹ By offering a sound alternative to Habeeb and Robert, this paper attempts to build upon a small but growing field of interdisciplinary research that makes strong connections between international relations theory, theories of bargaining, and case study analysis.

In contrast to the first three contributions' theoretical and methodological qualities, the fourth contribution is largely historical: this thesis represents the first comprehensive discussion and analysis of the CCFTA process. Since there is virtually no academic literature on the CCFTA, much of the case-study analysis draws on recent secondary sources, archival materials, and interviews with observers, stakeholders, and negotiators in Ottawa and Santiago.² Evidence gleaned from Chilean newspapers has been translated and made accessible to anglophone readers for the first time.

The paper is organized into five chapters. Chapter one reviews the bargaining literature, surveying six deductive theoretical approaches including the Bacharach and Lawler, Habeeb, and Robert paradigms. Chapter two explains the need for a new theory

¹ These shortcomings are discussed in chapter one's review of literature.

² Nine interviews were conducted between 1998-1999. All interviews were conducted on a not-for-

of negotiation and then introduces the IR-D model; first by discussing the IR theoretical framework, and then by building a new model within that framework. Chapter three introduces the Canada-Chile Free Trade negotiations and the capital controls issue, and then explains why the case was chosen. Chapter four uses the CCFTA as a case-study to probe the plausibility of the IR-D model. Chapter five concludes the thesis by briefly restating the argument, addressing potential criticisms of the argument and methodology, reviewing lessons learned about bargaining power, discussing the policy implications of the IR-D model, and suggesting paths for future research. Additionally, to fully explain the way that forces implicit within this model manifest themselves within a real-world context over time, Appendix A draws upon an inductive toolkit³ associated with the zone of agreement approach to form a more complete understanding of the CCFTA bargaining process. Appendix B follows with a copy of the final text of CCFTA Annex G-09.1, the terms both sides ultimately agreed to accept.

attribution basis to protect confidentiality.

³ Specifically, the toolkit is the zone of agreement framework associated with resistance points, reservation prices, and BATNAs (best alternative to a negotiated agreement). See Appendix A.

CHAPTER ONE: REVIEW OF LITERATURE

In 1982, Howard Raiffa published the first comprehensive synthesis of negotiation analysis, *The Art and Science of Negotiation*. Four years later Dean Pruitt observed that the discipline emphasized practicing the art more than understanding the science. He likened the field to 18th century medicine: "both. . . consist almost entirely of practitioners; training is heavily in the direction of the apprenticeship; practitioners operate. . . intuitively, each with a distinct individual style; and, the literature in both fields, to the extent it exists, derives mainly from the experience of practitioners and consists largely of aphorisms about appropriate action" (1986, 237). Pruitt challenged his readers to engage bargaining analysis scientifically, arguing that negotiation, like medicine, will mature from its "primitive" state as it becomes more theoretical and less a hodgepodge of heuristics mired in maxims (1986, 237). This chapter surveys six different deductive theories of negotiation (including the Bacharach and Lawler paradigm) to illustrate the variety of approaches accepted within the discipline of negotiation analysis and to set the stage for the presentation of an alternative IR-derived model offering superior heuristic power. To appreciate the value of deductive theories of negotiation, it is useful to first, very briefly, distinguish between theories and maxims.

Theory vs. Maxims

Maxims are prescriptive rules of thumb. The pithiest maxims tend to be clichés, "succinct statements about what to do and not do" that can become a mantra for the

professional practitioner: to always focus on interests, not positions, for example (Pruitt 1986, 237-8). Though maxims can be useful, they are no substitute for theory. Theory distinguishes itself by making propositions about causal linkages between variables and by explaining negotiated outcomes as a result of specific decisive factors. Maxims merely advise. Whereas a sound theory is able to explain the reasons some negotiations fail and others succeed, maxims entail dogmatic assertions about negotiation do's and don'ts. (Pruitt 1986, 238).

Theories also identify the moderator variables that determine relationships among other variables. These moderator variables are useful for understanding why the same strategy in different negotiations provokes different outcomes. For example, if both parties to a negotiation take a consensus-building approach, sharing information about core interests may prove to expedite an integrative outcome. If, however, one party takes an adversarial approach, it may not be wise to communicate core interests; to do so might provide that party with ammunition for contentious behavior and brinkmanship. The moderator variable in this example is the nature of the parties' orientation, consensus-building or adversarial (Pruitt 1986, 238-9).

The crucial distinction between theories and maxims pivots upon empirical testing. "A theoretical proposition is tested by manipulating or measuring the causal and moderator variables and examining their relationship to measures of the effect variable" (Pruitt 1986, 239). By this measure, maxims are completely deficient. Still, some theories are more testable than others. Human behavior is not mechanistic—theories of bargaining frequently consider intangible factors like self-image, fairness, and

relationships, and therefore the field of negotiation analysis will probably never be as deterministic as fluid dynamics or kinematics.¹ "Hence social science theory is limited to predicting probable effects and outcomes in the average case. . . the same is true of medicine. . .but to a lesser extent than is bound to be true in negotiation" (Pruitt 1986, 239).

Building a Theoretical Model of International Negotiation

There are certain features common to nearly all theories of bargaining. Most start from the fundamental premise that "bargainers need to reach some settlement but, at the same time, wish to settle on terms favorable to themselves" (Bacharach and Lawler 1981, 4). This premise defines what theorists call the bargaining problem and explicitly introduces the mixed-motive paradox: that if the two negotiating parties' interests were completely harmonious, bargaining would be unnecessary; yet, if interests were completely rival, bargaining would be impossible. The concept of a contract zone is also a common, foundational assumption. This zone is defined as the range of possible negotiated outcomes that, for both parties, are better than non-agreement; therefore, offers beyond the zone's boundaries do not produce an agreement, and the zone's extrema reflect the parties' opportunity costs of negotiation (Bacharach and Lawler 1981, 5).

Though theories of bargaining tend to share commonalities, there are very significant differences among the prevailing paradigms. This section briefly surveys six different deductive theoretical approaches and examines their strengths and weaknesses

¹ See Lax, D. K. and Sebenius, J. A. 1986, for an exploration of expansive conceptions of negotiator

in order to demonstrate how each asks and answers specific questions about the bargaining problem.

The Rational Choice Approach: John Nash

Historically, the rational choice school of analysis has assumed actors possess perfect information and behave rationally—to be rational is equated with choosing to accept the set of axioms that define utility maximization. Assuming perfect information implies "that each has full knowledge of the tastes and preferences of the other" (Nash 1950, 155). These assumptions allow for a determinate solution to specific bargaining problems. Sophisticated mathematical tools have somewhat liberated rational choice theorists from their perfect information assumption, but the school continues to focus on determinate outcomes. Nearly all game theoretic models are built upon John Nash's seminal work of the 1950s, which sought to understand how two utility-maximizing actors make decisions when the payoffs associated with their options are mutually dependent on each other's choices.

The most central idea in game theory is that solutions are based on the utility functions of each party. The utility functions represent that party's relative preference for payoffs from all potential outcomes. In bargaining games, whatever influence the bargaining context or environment might have on a party is assumed to be reflected in these relative preferences. Nash's solution . . . is deductively derived from assumptions about the nature of these utility functions (Bacharach and Lawler 1981, 9).

interests.

Nash's assumptions allowed him to generate mathematically neat determinate solutions that were expressed in terms of analytic geometry. However, his rational-choice paradigm fails to appreciate the complexity of a dynamic, real-world situation in which there is no common set of rules² governing behavior and information is far from perfect. In a real negotiation, information changes constantly in response to a variety of non-rational factors, including the cognitive biases of the negotiators themselves. Indeed, if negotiators enjoyed perfect information, back-and-forth bargaining would not occur because one party would make only one offer: the best one. Therefore, game theory is ill-equipped to describe the bargaining process itself, in that it leaves no room for information gathering, subjective utility judging, or tactical manipulation. At its best, the Nash approach merely proffers "clarification, namely of what it is that the problem involves, what obstacles stand in the way of solutions, [and] what special cases of the problem can be treated by what methods" (Rapoport 1966, 76).

The Contract-Zone Approach: Frederik Zeuthen

In 1930, Zeuthen developed a theory of bargaining founded upon the principle of the contract zone, "the zone of practicable bargains," proposing that the forces which establish the zone's boundaries also create tendencies towards specific outcomes which manifest themselves within the bargaining process (Zeuthen 1930, 105).³ In his model, the tendency to move toward particular outcomes is embedded within the bargainers' offers and counteroffers. The process of negotiation is conceptualized as a series of

² See Nash, J. 1950, for a look at his set of axiomatic rules.

successive decision points; bargainers have two options, to repeat their demands or concede.

The problem for Zeuthen is to find the criterion that rational bargainers use to make these decisions. The criterion is the risk of conflict, or more precisely, the risk that a party subjects itself to when it rejects the other's offer and remains firm on its own most recent offer. Zeuthen's basic proposition is that bargainers will not yield or make concessions unless or until the risk of conflict becomes unacceptable. The level of maximum acceptable risk is based on three pieces of information: the current offer of a bargainer, the current offer of an opponent, and the bargainer's conflict point (Bacharach and Lawler, 1981, 26).

Each negotiator's potential loss is determined by measuring the probability that not yielding will force negotiations to break down, and each negotiator's gain is determined by measuring the probability that refusing to yield will eventually force the other party to concede. Zeuthen did not intend to predict these inherently subjective probabilities; he did, however, assume that parties will make probability estimates and then calculate whether their probable gains are more or less than their losses (Zeuthen 1930, 115). Negotiators that decide their losses are greater than their gains will yield, and those who reach the opposite conclusion will behave in the opposite manner. Given both parties' maximum risks of conflict, the one with the higher tolerable risk can afford to be less yielding, forcing the other party to make a concession. Zeuthen's theory predicts who will make a concession at a given point, assuming that a party will make the smallest

³ Zeuthen's work owes much to A. C. Pigou. See Pigou, A. C. 1938.

concession necessary to make its opponent's maximum acceptable likelihood of risk less than its own (Bacharach and Lawler 1981, 29).

Unlike Nash's game theoretic model, Zeuthen is not primarily interested in the problems of information or determinate solutions; instead, he insists that the influence of exogenous forces on bargaining outcomes must be reflected in the process that produces those outcomes. Nevertheless, his solutions are strictly determined by the bargainers' conflict points and do require, implicitly or explicitly, stringent assumptions about rationality (Zeuthen 1950, 108). "Regardless of the parties' opening offers, who starts the bidding, or what values parties ascribe to their risk of conflict at any given point, Zeuthen's decision rules produce a settlement at the midpoint of the parties' conflict values. One can argue that Zeuthen's theory of bargaining process inadvertently makes the analysis of that process as superfluous as game theories" (Bacharach and Lawler 1981, 29). Still, Zeuthen's theory, with its emphasis on the bargaining process, opens the door to theories that are interested in more than just determinate solutions.

The Two-Level Approach: Robert D. Putnam

The two-level approach distinguishes itself by eschewing determinate outcomes and stringent assumptions about rationality. Robert Putnam's paradigm is radically different, in that it assumes negotiators simultaneously manage two different bargaining games: the game that takes place between negotiators at the bargaining table (Level I), and the game that takes place between negotiators and their constituents over ratification of the negotiated agreement (Level II). Putnam, who explicitly constructed his theory

within the context of international relations, argued that focusing on only one level provided only a partial equilibrium analysis and that more complete understanding required examining the way that negotiators play on both levels.

Each [negotiator] appears at both game boards. Across the international table sit his foreign counterparts. . . Around the domestic table behind him sit. . . parliamentary figures. . . representatives of. . . interest groups. . . The. . . complexity of this two-level game is that moves that are rational. . . at one board. . . may be impolitic. . . at the other. . . Any key player at the international table. . . dissatisfied with the outcome may upset the game board. . . conversely, any leader who fails to satisfy his fellow players at the domestic table risks being evicted. . . On occasion. . . clever players will spot a move on one board that will trigger realignments on other boards, enabling them to achieve otherwise unattainable objectives (Putnam 1988, 434).

Putnam's paradigm pivots upon the notion of the win-set, which is defined as "the set of all possible Level I agreements that would 'win' in an up or down vote" (1988, 434). The likelihood of an agreement at Level I is largely a function of win-set overlap; this overlap is determined by each side's win-set size. Win-set size is important because "the relative size of the respective Level II win-sets will affect the distribution of the joint gains from the international bargain. The larger the perceived win-set of a negotiator, the more he can be pushed around by the other Level I negotiators. Conversely, a small domestic win-set can be a bargaining advantage" (1988, 440). Win-set size is understood to be a function of three different factors: (1) Level II power, preferences, and coalitions; (2) Level II institutions and ratification mechanisms; and (3) Level I strategies.

Putnam's two-level approach generates its own set of hypotheses and maxims about the bargaining process. For example, bargainers are expected to try to maximize

their counterpart's win-set size in order to improve chances of agreement. Because it was designed to deal with the entanglement of international and domestic politics, the two-level approach does an excellent job of linking bargaining theories with theories of state institutions and constituent behavior. However, Putnam's emphasis on institutions in general, and ratification in particular, is what precludes his model from engaging a very basic and generally accepted concept within the bargaining literature: the opportunity costs of agreement. Putnam writes that "ratification pits the proposed agreement, not against an array of other (possibly attractive) alternatives [i.e., opportunity cost], but only against 'no-agreement'" (1988, 442). Nash and Zeuthen implicitly engaged the idea of opportunity cost within their rationalistic frameworks; the three approaches that follow are explicitly based on the primacy of assessing opportunity costs, but like Putnam's two-level game they are not concerned with assumptions of perfect information and determinate outcomes.

The Opportunity Cost Approach: Neil W. Chamberlain

Chamberlain's theory is based on the notion of bargaining power, which he defined as "the ability to secure another's agreement on one's own terms"—equivalent to the other party's inducement to agree (Chamberlain 1965, 170). To assess this inducement, Chamberlain divided the opponent's cost of agreeing on the party's terms by the opponent's costs of disagreement on these terms. Thus, one party's bargaining power increases as the other's cost of agreement decreases, and one's bargaining power decreases as the other's cost of disagreement decreases, *ceteris paribus*. "Only if the difference to

management between the cost of disagreement and agreement on labor's terms is proportionately greater than the difference to labor between the costs of disagreement and agreement on management's terms can one say that labor's bargaining power is greater than management's" (Chamberlain 1965, 171). Costs were assumed to be pecuniary, non-pecuniary, or both, and were able to be manipulated by both parties throughout the bargaining process.

Chamberlain's approach does not use the notion of a contract zone, so often found embedded within theories of bargaining. He proposed that assuming a contract zone was misleading, because the zone "implies that conditions which determine the outer limits of the zone are different from those that determine how bargainers act within a given range—that is, conditions that make disagreement more costly than agreement are different from the conditions that might make agreement equally or more costly than disagreement" (Bacharach and Lawler 1981, 37). Chamberlain's definition of bargaining power is inclusive enough to encompass the range of the contract zone, so separating these conditions is no longer necessary.

Chamberlain's approach is an important departure from the works of Nash and Zeuthen, in that (like Putnam's two-level game) it acknowledges the complexity of phenomenological factors. Chamberlain proposed that negotiators have difficulty interpreting costs, factors, and conditions. "The sort of balancing of costs which is contemplated in the definition of bargaining power just given does not require measurement of costs in any arithmetic sense, however. The balancing of

incommensurable items may be accomplished in the same way that oranges may be balanced against apples on a consumer's indifference map" (Chamberlain 1965, 171).

Another important difference between Chamberlain's approach and others is that he accepts both qualitative and quantitative factors. "Bargaining outcomes have not only quantitative effects on each party but also different qualitative effects on each party, and bargainers must translate these qualitative differences into common terms—be they utilities wage rates, dollars, ophelimities, or costs—that have meaning for both parties" (Bacharach and Lawler 1981, 38). Though Chamberlain's concept of costs is defined very broadly, the inclusiveness of the term allows him to account for tactical manipulation. "The very incommensurability of certain issues makes possible the changing of minds that might be unpersuaded if all significant issues could be reduced by an economic calculus to a numerical balance or imbalance" (Chamberlain 1965, 171). Chamberlain recognized that there were many ways that negotiators could define their costs, and therefore rejected an *a priori* logic for both parties.

As Bacharach and Lawler point out, the weakness of Chamberlain's theory is that it ignores the significance of the dependence relation that underlies bargaining power. Chamberlain's theory rests on a theoretical framework informed by a branch of social psychology known as exchange theory. Exchange theorists begin with the assumption of two conditions: "a scarcity of resources that fosters competition among those that need the resources and an uneven allocation of resources that creates the need for exchange between parties who need each other's different resources" (Bacharach and Lawler 1981,

39). Bargaining relationships are premised upon the idea that each party perceives the other as able to provide resources more readily or completely than others with whom they could alternatively negotiate. Given this framework, "bargaining is ultimately based on some level of dependence or interdependence in the social relationship [and] if bargaining is ultimately grounded in mutual dependence, then theories of bargaining power explicitly must address the dependence relationship" (Bacharach and Lawler 1981, 39).

The Dependence Approach: Bacharach and Lawler

Bacharach and Lawler propose a theory grounded in the belief that negotiation is based on dependence. Their model rests on three assumptions: (1) bargaining should be understood in terms of power, which is defined in terms of dependence, (2) bargaining power is an inherently subjective construct based on objective realities, and (3) bargaining power drives tactical action in specific ways (1981, 42). The first assumption, rephrased, is that power is the essence of negotiation. Bargaining power is a "critical construct by which bargainers organize their experience in bargaining," a phenomenological entity that exists in the minds of negotiators who may not even be fully conscious of how or why they use it (1981, 43):

The phenomenological status of bargaining power should be viewed as a "schemata of interpretation" The schemata. . . is the conscious and unconscious framework within which bargainers organize and interpret their impressions of the. . . bargaining process. When bargaining, parties are often unable to reflect on the formal dimensions of their framework. Yet, their behavior and cognitive processes are constrained by the parameters of the unobserved schemata. . Arguments that bargaining is an art, not a science, illustrate ways of justifying the inability of those who

engage in bargaining to delineate the parameters governing their behavior and cognitions (1981, 43).

Bacharach and Lawler's second assumption, that bargaining power is inherently subjective in nature, is an extension of the idea that bargaining power is a cognitive construct. The authors' model differs from an economic, game-theoretic, or rational-choice approach because it does not equate power with control of "objective exchange commodities" (1981, 49). Economics, and to some extent social psychology, interprets subjective power as "a mere reflection of these objective conditions—unless of course, bargainers are misinformed, irrational, or stupid" (1981, 48). In contrast, the Bacharach and Lawler model assumes negotiators are able to manipulate the way that objective power realities are perceived, given structural realities. "Relationships among qualitatively different influences (weighing apples against oranges). . . involves subjective judgments. We can ignore. . . subjective judgments only [by assuming]. . . both parties make the same subjective judgments about the same objective information" (1981, 48).

Bacharach and Lawler's third assumption is that negotiation should be interpreted as a process of tactical action. Tactical action is defined as "the manner in which bargainers bluff, argue for their positions, attempt to deceive or manipulate each other, and make power plays to gain advantage" (1981, 42). Three basic types of negotiating tactics are commonly recognized by bargaining theorists: concessions making, contending, and problem solving. Concessions making (also known as yielding) is defined as the act of "changing one's proposal so that it provides less benefit to oneself"

(Pruitt and Carnevale 1993, 28). Problem solving (also known as mutual gains bargaining) is an approach that focuses on the parties' interests, not their positions, in an attempt to develop innovative ways of maximizing joint gains. If problem solving can be understood as an integrative way of creating value, contending, the act of "persuading the other party to make concessions or of resisting similar efforts by the other," can be equated with tough negotiator behavior representing a distributive way of claiming value (Pruitt and Carnevale 1993, 30).

Defining Dependence

Bacharach and Lawler base their definition of power on dependence: "The power of *A* is grounded in *B*'s dependence on *A*, while the power of *B* is based on *A*'s dependence on *B*" (1981, 60). Adopting Richard Emerson's definition of dependence from exchange theory,⁴ the authors suggest four variables with which to measure bargaining power: *A*'s alternatives, *B*'s alternatives, *A*'s commitment, and *B*'s commitment—vaguely defining commitment as "the importance ascribed to outcomes" (1981, 62). The moderating relationship between each variable and total bargaining power is explained by the following two hypotheses (1981, 63):

Hypothesis 1: The extent of each party's alternative outcome sources is inversely related to that party's dependence, and also inversely related to the other party's bargaining power.

⁴ See Emerson, R. M. 1972, for the original work, and Emerson, R. M. and K. S. Cook. 1987, for more information on exchange theory.

Hypothesis 2: The extent of each party's commitment to the outcomes is directly related to that party's dependence, and also directly related to the other party's bargaining power.

In other words: (1) as a party's alternatives increase, dependence on the opponent decreases, and the opponent's bargaining power decreases as well; and, (2) as a party's commitment increases, dependence on the opponent increases, and the opponent's bargaining power also increases.

Power and Tactics

Bacharach and Lawler take a variable-sum approach to power, which implies that increases in one party's power does not necessarily equate to decreases in the other's power. Therefore, total power can change over time and negotiators can enhance their bargaining power only by increasing the other party's dependence. Decreasing the other's power by reducing one's own dependence does not improve one's own power, except in relative terms (1981, 96).

Furthermore, each party's perception of the other's power determines how each negotiates. "When bargainers evaluate the expected utility of [negotiating] they are essentially anticipating whether and how the power relationship will actually be transformed into outcomes at the bargaining table" (Bacharach and Lawler 1981, 76). Their evaluations bridge the gap between potential bargaining power and outcomes, driving tactical actions intended to either change the dependence relation or fulfill negotiating objectives. (Bacharach and Lawler 1981, 76).

Tactical Behavior: Alternatives and Commitment

This chapter began with a discussion of theories, and the benefits they offer over maxims. Ultimately, Bacharach and Lawler's model is only useful to the extent that it facilitates the prediction of probable outcomes by making propositions about the causal linkages between variables and by explaining negotiated outcomes as a result of specific decisive factors. To these ends, Bacharach and Lawler link the alternatives dimension of dependence with tactical behavior (1981, 94):

Hypothesis 3: The extent of each party's alternatives is inversely related to that party's tendency to make concessions and directly related to that party's tendency to exhibit contending behavior.

This hypothesis suggests that, for example, a decrease in *A*'s alternatives would increase *A*'s dependence (increasing *B*'s power, from hypothesis 1) and correspond with a decrease in *A*'s toughness. Conversely, an increase in *A*'s alternatives would decrease *B*'s dependence (decreasing *B*'s power) and correspond to an increase in *A*'s toughness. These ideas imply that negotiators should strive to have as many alternatives as possible, an intuitive, common-sense maxim.

Defining the dynamics of the alternatives dimension is relatively easy.

Examining the implications of commitment, the other dimension along which Bacharach and Lawler measure dependence, suggests two possible approaches that pivot upon whether bargainers are acting on what the authors call "potential power implications" or

on "tactical effort implications" (1981). Potential power implications are reflected in the following hypothesis (Bacharach and Lawler 1981, 96):

Hypothesis 4: The extent of each party's commitment is inversely related to that party's tendency to exhibit contending behavior.

For example, as A's commitment rises and A's dependence increases, B's power increases (hypothesis 2) and A's toughness declines. Conversely, as A's commitment decreases, A's power decreases and A's toughness increases. This "potential power" hypothesis is based on the idea that greater commitment increases one's dependence on the other party and therefore gives that party greater potential power (Bacharach and Lawler 1981, 96).

In contrast to the potential power orientation, the tactical effort orientation argues that "a party with high commitment to the outcomes at issue has every reason to push strongly in the negotiations, while a party with less commitment might be more inclined to yield to a party with greater commitment to the outcomes" (Bacharach and Lawler 1986, 173). The following hypothesis formally restates this tactical-effort orientation (Bacharach and Lawler 1981, 97):

Hypothesis 5: The extent of each party's commitment is directly related to that party's tendency to exhibit contending behavior.

For example, as A becomes more committed A's dependence increases and B's power increases, yet A's bargaining toughness also increases. As Bacharach and Lawler point out, this hypothesis implies a counterintuitive result: that "a party with high power on the commitment dimension (meaning the opponent is highly committed to the outcomes at

issue) may have to yield more than otherwise during the negotiations" (1981, 97). The higher-power party is expected to yield to the strong pressure of the more committed party, who must compensate for the power disadvantage with stronger tactics. Bacharach and Lawler speculate that a party with higher-power on the commitment dimension (less committed) would yield in order to "convey an image of benevolence, reasonableness, or altruism, and thus improve the ongoing relationship of the parties and enable the higher-power party to exact concessions on other issues" (1981, 97).

The difference between the tactical-effort and potential power hypotheses demonstrates that there are important distinctions between measuring dependence in terms of commitment and alternatives. Having more power on the alternative dimension (having many alternatives) is always an advantage; having more power on the commitment side (being less committed) is disadvantageous from a tactical-effort standpoint. "The commitment dimension engenders conflicting tactical tendencies and the comparability of effects for commitment and alternatives is contingent on how parties deal with this conflict" (1981, 99). Bacharach and Lawler conclude that tactical-effort implications suggest bargainers should communicate high commitment levels "regardless of the negative effect this might have on the opponent's perception of the party's power," for "in the case of commitment, weakness may be strength" (1981, 99).

The Structural + Behavioral Power Approach: William Habeeb and Maryse Robert

The Habeeb (1988) and the Robert (1995) models are distinct, but resemble each other and the Bacharach and Lawler paradigm in that all three were designed to explain

negotiations marked by power asymmetry. What Bacharach and Lawler call bargaining power and assess on the basis of commitment and alternatives, Habeeb and Robert call issue-specific power and assess on the basis of commitment, alternatives, and control. Yet, Habeeb and Robert were not noticeably influenced by the contributions of Bacharach and Lawler; neither Bacharach nor Lawler's name appears in the bibliography of Habeeb's book, and Robert (whose work owes much to Habeeb) mentions the duo only briefly, in passing. Like Bacharach and Lawler, Habeeb and Robert cite the social psychology literature in general (and the work of Richard Emerson in particular) to explain what they call issue specific power. However, unlike Bacharach and Lawler, Habeeb and Robert also tie Emerson's ideas to IR theories of interdependence articulated by political scientists like David Baldwin, Robert Keohane, and Joseph Nye. Moreover, both Habeeb and Robert argue that deficiencies in one aspect of issue-specific power (like commitment, for example) can be compensated for by strength in another category (like alternatives); Bacharach and Lawler do not make these claims.

Habeeb and Robert differentiate themselves from Bacharach and Lawler by focusing on outcomes instead of behavior, by specifying the IR context of their negotiation model, and by identifying two new factors, aggregate structural power and behavioral power, which determine these outcomes. Aggregate structural power "refers to an actor's resources, capabilities, and position vis-à-vis the external world as a whole" (Habeeb 1988, 17). In the context of the nation-state, aggregate structural power means "total national resources, demographic, economic, and military" (Habeeb 1988, 17). Behavioral power is defined as the skill with which bargaining tactics are employed.

Habeeb's failure is that he does not clearly express the interrelationship of the three major sets of variables (aggregate power, issue-specific power, and behavioral power) that drive his model. First, Habeeb argues that structural power is composed of two components: aggregate structural power, and issue-specific structural power. Then, he argues that structural power can influence behavioral power to indirectly determine issue-specific power: "the resources of aggregate structural power, translated by the tactics of behavioral power, can indirectly serve to alter the issue power balance" (1988, 25). As mentioned earlier, this issue-power balance is directly altered by changes in a party's commitment, control, and alternatives—but, Habeeb does not suggest clear rules for tactical/behavioral implications of high or low levels of commitment or alternatives.⁵

The tangled web that results from Habeeb's theorizing is a jumble of independent and dependent variables that, as he himself admits, "renders the analysis of outcomes of negotiation relationships difficult" (1988, 26). In the final analysis, the Habeeb model is weak on heuristic power. It asserts only that aggregate power, issue-specific power, and behavioral power are significant determinants of negotiation outcomes; Habeeb concedes that his theory does not allow him to assess the extent to which "the nature of a particular-issue-power balance [is] independent of the aggregate power balance" or behavioral power balance between the actors (1988, 26). His model entails operational challenges as well. How is tactical skill assessed? As Habeeb himself asks, "Was a particular tactic a bluff, or was a credible resource backing it up? Which component of power was most

⁵ Bacharach and Lawler would concur with his ideas about commitment, but would dispute that "a lack of alternatives may increase an actor's motivation and therefore commitment" (Habeeb 1988, 21).

important in determining the outcome?" (1988, 26) This model's weakness is implicit in the fact that "answers to questions such as these can be found only in the case studies of actual negotiations" and are not suggested by the model itself (Habeeb 1988, 26).

The only significant difference between the Habeeb model and the Robert model is that the latter explicitly defines its two independent variables as behavioral power and issue-specific power. Robert used four issues negotiated within the North American Free Trade Agreement as case studies to test the following two hypotheses: "A state which possesses more resources and tactics will win in a negotiation with another state with fewer of these variables in a given issue area. . .[2] A]n actor will lose if he lacks one or both of these factors" (1995, 3). The complexity of working with these two variables, structural power and behavioral power, is reflected in the shortcomings of the hypotheses themselves. Both hypotheses taken together are not equipped to explain what happens when one party possesses much greater total power but completely lacks power in one of the two resource areas. In such a situation, the first hypothesis would suggest this negotiator should 'win'; the second hypothesis predicts the party will lose. Additionally, the hypotheses do not suggest a solution to the case of two negotiators with equal resources and tactics, nor to the case of two parties who both lack one or both of types of resources. The Robert model, like the Habeeb model it is built upon, drowns in its own cumbersome multivariate complexity.

Review and Concluding Remarks

This chapter has demonstrated that different bargaining paradigms ask and answer different questions. Some, like the Nash and Zeuthen models, make stringent assumptions about rationality and tend to be more concerned with determining outcomes than explaining the bargaining process. Others, like the Putnam, Chamberlain, Bacharach and Lawler, Habeeb, and Robert models, are not as concerned with assumptions of rationality or information and do not necessarily provide determinate bargaining solutions. Putnam's model pivots upon the concept of the win-set, whereas Chamberlain's is built upon the idea of opportunity costs; the Bacharach and Lawler approach deepens and broadens Chamberlain's model, accepting the implications of grounding the model within a sound theoretical framework. Of all six deductive approaches only the Bacharach and Lawler model is parsimonious enough to meaningfully explain how different degrees of bargaining power and dependence determine different tactical behaviors. However, Bacharach and Lawler built their model on a framework of social exchange theory that was not designed to explain international relations. The following chapter constructs a new model of inter-state bargaining inspired by the parsimony and heuristic power of the Bacharach and Lawler paradigm but built on the framework of IR theory in a manner reminiscent of the Robert and Habeeb models.

CHAPTER TWO: THE IR-DERIVED MODEL

The Bacharach and Lawler bargaining model is heuristically powerful, in that inputs (varying levels of commitment and alternatives) generate outputs (varying tendencies of bargainers to exhibit toughness). Nevertheless, the authors' model was not specifically designed to explain inter-state negotiations. Their book "illustrates the theoretical framework primarily with reference to and implications for labor-management relations" (1981 xiii). The Habeeb and Robert models reflect exactly the opposite priorities: their models' possess far less heuristic power but both authors draw heavily from the IR literature, emphasizing the distinctiveness of international negotiation—much in the same way that Putnam's model hinges upon domestic ratification and constituent coalitions. Harnessing the IR literature for modeling inter-state asymmetrical bargaining is useful for two reasons: (1) social psychology does not engage the distinctive characteristics of inter-state behavior, whereas international relations theory does; and (2) perhaps even more importantly, the IR literature makes meaningful contributions to concepts of dependence and power that are not present within the social psychology framework.

This chapter uses credible, established IR theories of power and dependence to develop a deductive IR-D model of inter-state bargaining that explains and predicts both tactical behavior and bargaining outcomes. Like the Bacharach and Lawler approach, this IR-D model explains and predicts tactical behavior by taking inputs from each party

(expressed as high or low power on commitment and alternative dimensions) and generating outputs (tendencies of each party to yield and contend.)⁶ In turn, these outputs are used to explain and predict bargaining outcomes: differences between parties' tactical tendencies suggest corresponding outcomes. For example, given a negotiation in which one party is judged likely to contend, and the other likely to yield, we would expect a relatively quick and asymmetrically distributed negotiated outcome. By ranking a finite set of possible parties ordinally from most contending to most yielding, it is possible to map the dyadic permutations on a table to show how differences in ordinality should correspond to variations in the ease and symmetry of negotiated settlement.⁷

Framework: International Relations Theory

International relations theory and meteorology share a common problem: both disciplines attempt to understand the workings of complex systems. Meteorologists study the weather, a system notoriously difficult to model, by creating intricate computer programs with thousands of variables. IR theorists attempt to explain the causes and implications of state and non-state interactions. Their systems are no less complex, but they have adopted the opposite approach: parsimonious IR paradigms try to explain as much as possible with the fewest variables, making assumptions that greatly simplify the workings of the real world.

⁶ Later in the chapter, we will see that the IR theory requires the commitment dimension to be disaggregated into two distinct dimensions.

⁷ As Dahl notes: "Measurement does not necessarily require an interval scale, the strongest form of measurement. . . . An extremely useful though weaker scale is an ordinal scale on which the units are not necessarily equal but items can be ranked as greater than, equal to, or less than others. A valid and reliable ordinal scale for comparing influence within a particular scope and domain would be extremely useful and

Theories of international relations situate inter-state behavior within the contexts of dependence and power. Different IR theories construct these concepts in various ways, depending on the assumptions and methodologies chosen. Before synthesizing a new IR-D bargaining model at the nexus of IR notions of power and dependence, it is important to briefly introduce the field of international relations theory to see how these issues have been addressed by the two leading rival paradigms, neorealism and neoliberalism. As the chapter unfolds it will become progressively more and more evident that the IR-D model shares neorealism's preoccupation with power, dependence, and vulnerability, but reaches conclusions about the potential for weaker states to out-negotiate stronger states that are consistent with the neoliberal framework of complex interdependence.

Neorealism

Neorealism assumes the primary actors in the international system are sovereign states, often metaphorically described as billiard balls, "identical, hard objects ricocheting off one another atop a smooth surface" (Banks 1986, 18). It is the distinction between strong and weak states (as measured in terms of aggregate military resources and economic capabilities) that determines outcomes of international relations. Strong states (big, fast-moving billiard balls) are expected to impact weak states (small, stationary balls). In a Hobbesian world wherein states "conduct their affairs within the brooding shadow of violence," neorealists believe nations must be prepared for conflict to occur

may be the most we can reasonably expect" (1991, 32).

anywhere between anyone at any time (Waltz 1983, 98). "Anarchy is the rule; order, justice, and morality are the exceptions" (Gilpin 1984, 304).

Assuming an anarchic world system provides a foundation for the remaining tenet of neorealism: the notion that state behaviors tend to be uniform regardless of domestic differences among states. Neorealists posit that states that make bad decisions do not survive over time. Contrariwise, states that do survive make are making good, rational decisions. In the long run, rationality is thought to compel successful states to behave similarly in environments of imperfect information and unpredictable externalities (Waltz 1983, 84-86). Within the neorealist paradigm, inter-state behaviors reflect the distribution of power across the international system. Indeed, international regimes are "only one small step removed from the underlying power capabilities that sustain them" (Krasner 1982, 7).

Neorealists argue for their anarchic world view by pointing out the absence of a supra-state institution able to maintain international order and protect states' rights (Banks 1986, 10). They distinguish the international "self-help" system as very different from the domestic system, in which a government protects the rights of citizens through the legitimate use of force that serves to protect established norms (Waltz 1983, 98). The term "self-help" implies that a state's survival rests solely upon its own power. As Morgenthau explains in his seminal realist text, *Politics Among Nations*:

International politics, like all politics, is a struggle for power. Whatever the ultimate aims of international politics, power is always the immediate aim. Statesmen and peoples may ultimately seek freedom, security, prosperity, or power itself. They may define their goals in

terms of a religious, philosophic, economic, or social ideal.

They may hope that this ideal will materialize through its own inner force, through divine intervention, or through the natural development of human affairs. They may also try to further its realization through non-political means, such as technical cooperation with other nations or international organizations. But, whenever they strike to realize their goal by means of international politics, they do so by striking for power (Morgenthau 1985, 31).

Self-help systems tend toward balances-of-power, regardless of the intentions of the individual state actors, because "nobody wants anyone else to win; none of the great powers wants one of their number to emerge as the leader. . .in a competition for the position of leader, balancing is sensible behavior where the victory of one coalition over another leaves weaker members of the winning coalition at the mercy of the stronger ones" (Waltz 1983, 127). In other words, balances-of-power encourage stability and forestall hot wars, but realists have no theoretical basis for explaining mutual gains cooperation.

Indeed, realists like Joseph Grieco have argued that states' self-help context requires them to adopt a "defensive positionalist" approach, wherein actors are "interested in achieving and maintaining relative capabilities sufficient to remain secure and independent in the . . .context of international anarchy" (Hopmann 1995, 24). The self-help nature of an anarchical system implies that a state is expected to worry about a division of possible gains that may favor others more than itself.

Neoliberalism and Complex Interdependence

Whereas the neorealist definition of international political structure suggests that states are only concerned with their relative security in a hostile world, neoliberalism modifies the realist model to better account for international cooperation, interdependence, and diversity of issue areas. In 1977, Robert Keohane and Joseph Nye published *Power and Interdependence*, introducing a stream of neoliberalism they called complex interdependence. Keohane and Nye acknowledged that states are the most important units in the international political system (1977, 20), but relaxed neorealist assumptions about states as the only units by acknowledging the roles of transgovernmental and transnational actors (1977, 33-36). Michael Banks clearly expresses the larger implications of these neoliberal notions:

Rather than. . . assume that security can only be achieved by the threat of force, [neoliberals] put forth the idea that integration may be an equally effective, perhaps much more effective, means of achieving the same objective. Contrary to the realist doctrine that states are always masters of their own destiny where international law is concerned, they have begun to tabulate and spell out the contemporary existence of international [institutions] involving collaboration and agreed procedures (1986, 20).

Keohane's *International Institutions and State Power* divides all such institutions into three categories: formal intergovernmental organizations, regimes, and conventions. Intergovernmental organizations are "bureaucratic organizations" responsible for "monitoring activity and reacting to it" (1977, 3-4). Regimes and conventions define the set of formal and informal principles, norms, rules, and decisionmaking procedures that

affect state behavior (Keohane 1984, 42-46). Conventions and regimes, since they include norms, may include cultural constructs.

Accepting the significance of regimes radically alters the calculus of international political structure. State behavior becomes less deterministic and more voluntaristic, more a function of institutions that can be designed, developed, and destroyed by individuals as well as states. The relevant ordering principle also changes. International political structures are no longer assumed to be purely anarchic, because regimes can take the form of supra-state institutions that foster hierarchies of system-level authority (Keohane 1989, 7). Regimes also differentiate state functions across the system since they are concerned with a plurality of issues and are complex enough to account for a significant diversity of national priorities and actors (Keohane 1984, 57-60).

Keohane and Nye's theory of complex interdependence contributes much to the IR-D model's theoretical framework. The word "dependence" derives from the Latin *dependere*, meaning to hang or be suspended from, and the Latin suffix *entia*, denoting action, process state or quality. Therefore, "dependence" means "the process or state of hanging from" (Duvall 1978, 61). This word's IR definition has splintered into two usages that correspond with Keohane and Nye's distinction between sensitivity interdependence and vulnerability interdependence. Sensitivity interdependence is the degree to which parties in a relationship are affected by changes in that relationship, whereas vulnerability interdependence reflects the costs (specifically, the opportunity costs) that would be incurred by parties as a result of these changes (1973, 124). The key

distinction between the two meanings is that the latter stresses the costs of ending the exchange relation.⁸

Asymmetric vulnerability interdependence is what James Caporaso refers to when he writes of "dependence as external reliance on other actors" and of a dependence "orientation. . . seeking to probe and explore the symmetries and asymmetries among nation-states" (Caporaso 1978, 1-2). This orientation must not be confused with a "dependency" approach focused on developing countries' incorporation into the global capitalist system and the structural distortions that result, or a *dependencia* approach that seeks to explain the periphery's integration into the core by assessing the consequent developmental effects (Caporaso 1978, 1-3).

In an effort to build a rigorous IR definition of dependence, Caporaso begins where Emerson left off: *A*'s dependence on *B* is directly related to "the magnitude of *A*'s motivational investment in goods controlled by *B* and inversely related to the opportunity to achieve these goals outside the *A-B* relationship" (Caporaso 1978, 21). *A*'s power is the degree of *B*'s resistance which can be potentially overcome by *A*. However, Caporaso notices three problems with this typology : (1) there is no space for consensual asymmetric relations based on legitimacy in a formulation that sets power equal to resistance; (2) the core relationship between power and dependence is made an axiomatic, definitional entity, and (3) important factors—like the extent of a good's substitutability

⁸ Dependence has meant "vulnerability," referring to a subordinate exchange relation in world affairs, since at least the 1600s, when the term was used to refer to "the effect of depending upon foreign countries for hems" (Baldwin 1980, 476).

and the characteristics of markets extant between alternative suppliers—are not disaggregated (1978, 21).

Caporaso addresses these shortcomings in a new typology that still interprets dependence in terms of the opportunity costs of breaking a relationship, but determines the degree of dependence by measuring the following three variables: (1) the extent to which the interest at stake is dependent upon the negotiated item (x), i.e., x 's place on the necessity-luxury continuum; (2) the extent to which the interest at stake is dependent upon the other negotiating party; and (3) the extent to which there are other negotiating items or other parties that present alternative ways of fulfilling the interest, which reflects the transaction costs of moving from one relation to another (1978, 21-2).⁹ Once each of the three values is assessed for each actor, the signed difference between the two sets of structural conditions provides a measure of structural dependence. Structural dependence is high when A relies on B for large quantities (as a fraction of total consumption) of important, irreplaceable goods that are unavailable from other sources while B is receiving only a few nonessential, replaceable goods easily found elsewhere (Caporaso 1978, 22).¹⁰

⁹ On p 22, Caporaso notes: ""Substitutability, as conceptualized here, includes the substitution costs incurred when switching suppliers as well as the costs of doing without a good. It also includes the total costs involved in substituting one commodity for another."

¹⁰ This typology is not an exact restatement of Caporaso's original formulation, but rather an interpretation of his remarks consistent with his framework and use of examples. For instance, in an example Caporaso uses to illustrate his definition of structural asymmetry, he asserts that oil is a necessity for the buyer country in a hypothetical oil negotiation. Why? Because he is assuming his reader will recognize that the buyer country's interest is to establish an inexpensive and reliable source of fuel. Therefore, oil (the negotiated item) reflects the key interest at stake. In other words, oil is a necessity if it fulfills the interest at stake. Incidentally, framing the negotiation in the context of specific interests suggests the concept of issue-specific power, a concept hinted at in the following paragraph and discussed in detail on page 36.

Caporaso's approach owes much to the neoliberal framework, in spite of the fact that the dependence orientation shares the neorealist focus on power and relational inequalities of capabilities within the global system, identifying actors as internally unified states (Caporaso 1978, 2). Indeed, Caporaso's dependence orientation rests upon the neoliberal idea that "outcomes of political bargaining. . . vary by issue area . . . [and] differentiation among issue areas in complex interdependence means that linkages among issues will become more problematic" (Keohane and Nye 1977, 31).¹¹

The IR-Derived Model

The IR-D model builds directly on Caporaso's dependence orientation, sharing the same level of analysis (the nation-state), and assessing country *A*'s power versus country *B*'s power. However, the IR-D model also recognizes that the negotiations themselves take place on an interpersonal level, and that the learning that occurs at the bargaining table significantly affects the bargaining process. Therefore, it is useful (and consistent with IR theory) to assume that the negotiators are agents of the state. Raymond Aron, in *Peace and War*, addresses this idea in the introduction to his classic tome:

Inter-state relations are expressed in and by specific actions, those of individuals whom I shall call symbolic, the diplomat and the soldier. Two men, and only two, no longer function as individual members but as representatives of the collectivities to which they belong: the ambassador, in the exercise of his duties, is the political unit in whose name he speaks. The ambassador and the soldier live and symbolize international relations which, insofar as they are inter-state relations, concern diplomacy and war. It follows that, in this abstract sense, the

¹¹ Assessing dependence in the context of specific interests presupposes issue-specificity.

statesmen, Ministers of Foreign Affairs, Prime Ministers and heads of state are also, in certain of their actions, ambassadors. They represent the political unit as such (1960, 5).

The IR-D model acknowledges the usefulness of examining negotiator behavior and phenomenological factors, with the caveat that both are shaped by forces of power and dependence that are best understood on the level of the nation-state and in terms of the IR framework.

Dependence

Caporaso's IR definition of dependence was shown to have improved on Emerson's work by suggesting the disaggregation of the commitment dimension into two distinct parts, and also by suggesting that the alternatives dimension be disaggregated to distinguish between alternative parties to negotiation as well as alternatives to the object of the negotiation itself. His typology implies that six data are needed to assess bargaining power: the extent to which A's interests are dependent upon the item under negotiation (x), the extent to which B's interests are dependent upon x , the extent to which A's interests are dependent upon B, the extent to which B's interests are dependent upon A, the ability of A to substitute for x or for B, and the ability of B to substitute for x or for A. Six corresponding hypothesis are suggested:

Hypothesis 1: An increase in A's dependence on x to fulfill A's interests increases B's bargaining power

Hypothesis 2: An increase in B's dependence on x to fulfill B's interests increases A's bargaining power

Hypothesis 3: An increase in A's dependence on B to fulfill A's interests increases B's bargaining power

Hypothesis 4: An increase in B's dependence on A to fulfill B's interests increases A's bargaining power

Hypothesis 5: A decrease in the extent of A's alternative outcome sources increases B's bargaining power

Hypothesis 6: A decrease in the extent of B's alternative outcome sources increases A's bargaining power

Caporaso defines structural dependence as the signed difference between the two sets of structural conditions. In a free trade context, Caporaso's definition of dependence implies asymmetric structural dependence would be highest when *A* relies on *B* for disproportionately large quantities of relatively scarce and non-substitutable trade and investment in strategic sectors. Improving on Bacharach and Lawler by replacing Emerson's four-hypothesis system with Caporaso's six-hypothesis system is equivalent to exchanging a four cylinder engine for a six cylinder engine; the result is a more sophisticated model with more (heuristic) power.

Power

The six hypotheses above imply that one party's bargaining power can change independent of the other party's, reflecting a variable-sum approach to power consistent with the neoliberal framework. This variable-sum orientation is also consistent with the Bacharach and Lawler argument that "bargainers can most easily interpret and manipulate their own dependence, [and therefore] one reasons that they base their own tactical action more on their own dependence (that is, the opponent's power) than on the opponent's dependence (that is their own power). Bargainers should feel they have greater control over information on their own alternatives and commitment" (1981, 92). This variable-sum orientation suggests that states can enhance their bargaining power only by increasing the other's dependence. Decreasing the other party's power by altering one's own dependence does not improve one's own power, but does change the structural dependence of the dyadic relationship.

In IR theory, as in exchange theory, social scientists have struggled to define power and explain its distribution across the global system. Keohane and Nye suggest that a parsimonious way of understanding power "is to regard [it] as deriving from patterns of asymmetrical interdependence between actors in issue-areas in which they are involved with one another" (1973, 122). As James Baldwin has noted, definitions of power are prone to being tautological (1980, 501). By defining dependence relations in terms of the relative power distribution of the actors, Caporaso is in danger of defining distributions of power resources in terms of distributions of power resources. There is a

way out of this philosophical fallacy: the key is to make the critically important distinction between actual and potential power:

The distinction between actual and potential power is essential but often confusing. Both are relational concepts in that one refers to actual social relations while the other refers to potential social relations; and both vary in scope, weight, and domain. The primary difference concerns the motivation of the actual or potential power wielder. The distinction allows for the common phenomenon of unused power resources; an actor may have the ability to get *B* to do *x* but lack the desire to do so. The distinction between actual power and potential power is helpful in understanding [dependence] because vulnerability dependence implies potential power but not necessarily actual power (Baldwin 1980, 498).

Orthodox neorealism presupposes that "powerful states make the rules," (Keohane and Nye 1977, 42) but the theory of complex interdependence is consistent with the idea that "the aggregate power position of a state cannot be directly translated into relevant and available power in any particular situation" (Zartman 1971, 5). Accepting a distinction between actual and potential power implies that power resources sometime go unused—and explaining variations in the distribution of actual power in terms of variations in the distribution of potential power resources is not tautological. Furthermore, it is not tautological to suggest that one form of influence may be the power resource that causes another type of influence (Baldwin 1980, 501-502). In other words, dependency (when restricted within a certain scope and domain) can be a power resource (within a specific scope and domain).

Delimiting the scope and domain of a power relationship suggests the utility of thinking in terms of issue-specific power, a term used by both Robert and Habeeb that

stems from Keohane and Nye's theory of complex interdependence. Keohane and Nye argue that "unlike the overall structure explanation, issue structuralism does not predict congruence of power across issues" (1977, 50). Therefore, issue structuralism takes into account the fact that "power resources in one issue lose some or all of their effectiveness when applied to others" (Keohane and Nye 1977, 50). Although most economic power resources can easily be converted into other kinds of economic power resources, in politics there is no real equivalent to money. "The lack of fungibility of political power resources, together with the multidimensional nature of power relations, increases the probability that an actor may control large amounts of potential power with respect to some scopes but relatively small amounts of potential power with respect to other scopes" (Baldwin 1980, 502). Theorists who accept the notion of issue structuralism note that "force is rarely an option. . . . Linkages reliant on force or coercion are thus ineffective" (Robert 1995, 12). Indeed, one of the basic assumptions implicit within complex interdependence, and the IR-D model, is that issue-linkage does not work.

Distinguishing between potential and actual power and accepting the relative insignificance of both force and issue-linkage leaves the door wide open to understanding how dependent countries can offset their potential power deficit by being more strongly motivated than the dominant country—thereby manifesting more actual power. Albert Hirschman has proposed that the very existence of an asymmetric dependence relation can generate countervailing, dialectical forces that favor the more dependent party (1978, 45).

Linking Power with Tactical Behavior

Ever since the publication of David Ricardo's *Principles of Political Economy and Taxation* in 1817, "gains from trade" has been a conceptual cornerstone of classical economics. In 1945, Hirschman showed that these gains from trade can create dependence when a given volume of trade between two countries *A* and *B* may be much more important for *B* than for *A*—in the case of a trade relationship that represents the bulk of an LDC's trade but only a small fraction of a rich country's trade, for example (1945). In such a case, the obvious inference is that the rich country would dominate the LDC by threatening to reduce or end the relationship. Yet, Hirschman rejects this inference and questions the stability of the dependence relation.

As Robert Dahl has noted, ". . . the subtlety and complexity of power relations are often best portrayed in works of fiction" (1991, 34). It is no surprise that Hirschman cites *War and Peace* to make his point:

Tolstoy stresses fighting spirit and morale as an often more decisive factor [than quantifiable elements]. . . This thought has an obvious relevance here. The ability to inflict deprivation is more easily quantified than the willingness to accept it for the sake of, say, freedom from domination, and in the recent past there have been several important episodes where this willingness has been underestimated, with disastrous results for those who thought that "objectively" they were bound to prevail (1978, 47).

If we assume the case of two countries in the trade relation described above, the LDC is bound to be uncomfortable with its dependence on the large, rich nation, and may be assumed at some point to "devote its attention with single-minded concentration to this

uncomfortable situation and. . . attempt to loosen or cut these ties" (Hirschman 1978, 47).

Meanwhile, the rich country that carries out only a small fraction of its trade and investment with the LDC is more concerned with its relations to the other large powers. Therefore, structural economic dependence can create a "disparity of attention, or at least of high-level attention to use the language of bureaucratic politics, and this disparity now favors the dependent country; that country is likely to pursue its escape from domination more actively and energetically than the dominating country will work on preventing this escape" (Hirschman 1978, 47).

Hirschman contends that the extent of this attention disparity is, like the extent of dependence and domination themselves, a function of the asymmetrical trade and investment percentages (1978, 48). Dependent countries are expected to exploit this disparity of attention, making the most of the space they have to maneuver while working to widen this space. "Within limits that are often uncertain and constantly changing, the dominant country is unlikely. . . to make the effort needed to counter or effectively rein in dependent countries straining to achieve a greater degree of autonomy" (1978, 48).

Hirschman's ideas are supported by a wealth of academic literature on the power of the relatively small-sized state. Annette Baker Fox, in her discussion of IR and World War II, echoes Hirschman's argument about asymmetries of attention and desire.

The primary difference [in perspectives between great powers and small powers] was the scope of their attention. Great power leaders had to broaden their gaze to sweep the whole international arena, and thus their focus upon a particular small power tended to be fleeting and not especially directed to the particular interests of that state. The leaders in the latter, on the contrary, were primarily

concerned with their own state, regardless of the larger constellations of power over which they could have no control. The diplomatic task of the small power leaders was thus much easier than that of the great powers in one respect. . . their practical objective was simple and clear. . . and they could attend to this task with great concentration and intensity. . . while the great power might be almost the whole concern of the small state, the latter was only a small part of the concern of the great power (1959, 181).

Erling Bjøl also argues that small states can successfully resist the demands of stronger powers, because "the great powers are in their relationships with small states inhibited by a variety of considerations which have little or nothing to do with the dimension of strength" (1971, 36). Bjøl suggests that states have myriad rival national interests represented by different organizations that compete with one another. "This may open a considerable scope of operation for the small state. . . even in an extreme situation of dependence there may be room for maneuver" (1971, 36). Bjøl concludes that "the keyboard on which diplomacy can be played is quite extensive: the multilateral concerns of the great power, the competing types of interests, rival organizations, etc." (1971, 36).

Although the ideas of Hirschman, Fox, and Bjøl are all explicitly expressed in the context of great power-small state interaction, it is vitally important to remember that their arguments are really about relative power asymmetry—not the characterization of states as intrinsically or even relatively great or small. Dependence relations are commonly a distinguishing characteristic of great power vs. small power interactions. However, bringing the concept of issue-specific power into Hirschman's theory suggests that these ideas are applicable to any dyadic relation in which one power is more

committed and dependent upon the issue in question—even if that relation is between two states (like Denmark and Belgium, for example) that would normally be associated with similar sizes or levels of aggregate power. These IR ideas are really very similar to Bacharach and Lawler's tactical effort argument about states with high commitment and low power who are driven to engage in tough negotiating behavior. Recall that Caporaso disaggregated commitment into the first two dimensions of dependence¹²; for the moment, imagine a reaggregation. The IR-D model's theoretical framework demands the acceptance of the hypothesis below:

Hypothesis 7: The extent of each party's commitment (represented by the first two dimensions of dependence) is directly related to that party's tendency to exhibit contending behavior

(See Figure 1).

Linking the remaining dimension of dependence, the alternatives dimension, to tactical behavior is simple. Bacharach and Lawler's view of the alternatives dimension is consistent with IR theory and common sense. *Ceteris paribus*, countries with more alternatives to the negotiation will be tougher negotiators. The following hypothesis is a formal restatement (1981, 94):

¹² See page 31.

Hypothesis 8: The extent of each party's alternatives is directly related to that party's tendency to contend, but is not related to the other party's tendency to contend. (See Figure 2).

In other words, parties with many alternatives are less likely to make concessions than parties with few alternatives.

If each dimension of dependence is limited to being high power (H) or low power (L), the three dimensional IR-D model allows for eight possible permutations of potential power: HHH, LLL, LHH, HHL, LHL, HLH, HLL, and LLH. As before, the first dimension of dependence assesses the extent to which the interest at stake is dependent upon the negotiated item, the second dimension reflects the extent to which the interest at stake is dependent upon the other negotiating party, and the third dimension reflects the extent to which there are other negotiating items or other parties that present alternative ways of fulfilling the interest. For example, HHH signifies: (1) high power on the first dimension (fulfilling the interest does not depend upon the item being negotiated); (2) high power on the second dimension (fulfilling the interest does not depend upon the other country with which negotiations are transpiring); and (3) high power on the third dimension (the country has many alternative ways of fulfilling its interests aside from negotiating that particular issue with that particular party.)

Since the IR framework assumes a system in which states are concerned about their own survival, it follows that the most important dimension of dependence would be the first: the extent to which fulfilling the interest depends upon the item being negotiated. In a system wherein survival is of paramount importance, it may be assumed that states will always be more committed to negotiations involving key issues than to negotiations involving relatively unimportant issues, regardless of the status of the second and third dimensions of dependence. This assumption prompts the following proposition:

Hypothesis 9: In a negotiation between two states with unequal power in the first dimension of dependence, the state that is negotiating over necessities (with low power in the first dimension) will tend to be more committed and less yielding than the other state, regardless of the values of the other dimensions of dependence.

The IR-D model's nine hypotheses suggest that it is possible to code countries as being either high (H) or low (L) power on each of the three dimensions, and that it is then useful to link the code to certain tendencies toward tactical behavior. For example, given hypothesis 8, high power on the alternatives dimension is associated with contending, whereas low power on this dimension is associated with a tendency to make concessions, *ceteris paribus*. Hypotheses 7 asserts that high power on the first two dimensions is associated with yielding, whereas low power on these dimensions is associated with contending. From these propositions it follows that HHL is the permutation associated

with the greatest tendency to make concessions. Conversely, a country characterized by LLH is associated with the least tendency to make concessions.

It is impossible to rank unambiguously all eight permutations ordinally between these two extrema because two dyadic cases (LLL vs. LHH and HHH vs. HLL) are impossible to rank relative to each other.¹³ However, each of these four permutations do possess ordinality relative to the other seven permutations, and therefore it is possible to make four different rankings of six permutations each. The first ranking, in order from most contending to most yielding, is LLH, LLL, LHL, HLH, HHH, and HHL.¹⁴ The second ranking is LLH, LLL, LHL, HLH, HHH, and HHL.¹⁵ The same reasoning generates the third ranking (LLH, LLL, LHL, HLH, HLL, and HHL) and the fourth (LLH, LHH, LHL, HLH, HHH, and HHL).

These rankings demonstrate that four sets of six power permutations possess unambiguous ordinality, as measured in terms of the tendency to make tactical concessions. The magnitude of the asymmetry of structural dependence (SD) between any two permutations may be defined simply as the difference in ordinalities.¹⁶ This difference is reflected in table 1, wherein the numbers (termed SD numbers) represent the difference between the ordinalities of any two permutations.

¹³ In other words, It is impossible to know whether LLL is more or less likely to be yielding than LHH; the same is true for HHH vs HLL.

¹⁴ Given the two extrema, LLH, and HHL, LHL tends to be more concessions-making than LLL because LHL's commitment (measured looking at the first two dimensions) is weaker and therefore more yielding; HLH tends to be more concessions-making than LHL because of Hypothesis 9; and, HHH tends to be more concessions-making than HLH because HHH is less committed.

¹⁵ This ranking's rationale begins by asserting the two extrema, and then arguing that LHL tends to be more concessions-making than LHH because LHL has fewer alternatives; that HLH tends to be more concessions-making than LHL because of Hypothesis 9; and, that HLL tends to be more concessions-

Table 1. Asymmetry of Dyadic Structural Dependence

	LLH	LHH	LLL	LHL	HLH	HHH	HLL	HHL
LLH		1	1	2	3	4	4	
LHH	1		N/A	1	2	3	3	4
LLL	1	N/A		1	2	3	3	4
LHL	2	1	1		1	2	2	3
HLH	3	2	2	1		1	1	2
HHH	4	3	3	2	1		N/A	1
HLL	4	3	3	2	1	N/A		1
HHL		4	4	3	2	1	1	

The highest SD number on the table is five and it corresponds to LLH vs. HHL, in which the former has very strong tendencies to contend, and the latter has very strong tendencies to concede. A '0' corresponds to situations in which the two parties are likely to exhibit the same tactical behavior, like HHH vs. HHH. An N/A denotes an ambiguous relation. Numbers on the table are shaded to separate them into three groups: the highest SD number (5), mid-level SD numbers (1-4) and the lowest SD number (0).

Assuming that all negotiations represented on table 1 culminate in agreement, the

making than HLH because HLL has fewer alternatives.

¹⁶ This definition was chosen in the spirit of Caporaso's definition of structural dependence, page 31.

diagonal row of zeros represents outcomes expected to manifest high distributional symmetry. As we move across the table, perpendicular to this diagonal line toward the upper right and lower left corners, distribution of gains from negotiation are expected to become more and more asymmetric. These upper right and lower right corners are associated with relatively rapid negotiations, since one party is contending and the other is yielding; this table's lower right corner is also associated with relatively quick and easy settlements since both parties are expected to be relatively yielding. Conversely, negotiations corresponding to the upper left corner are expected to be the most contentious, since both parties tend toward contending behaviors. These ideas are encapsulated in the following formal propositions:

Hypothesis 10: The highest SD number (5) tends to be associated with relatively quick negotiations in which one party (the one with higher power on the first two dimensions of dependence) concedes and the other "weaker" party contends, resulting in high distributional inequality of outcomes favoring the low-power party.

Hypothesis 11: Negotiations culminating in agreement that correspond to the lowest SD number (0) tend to manifest relatively symmetric negotiated outcomes. An SD number of 0 is more likely to be associated with extreme degrees of contending (suggesting protracted negotiations) or yielding (suggesting quick and easy negotiations) the closer these relations are to the upper-left or lower-right corners of the table, respectively.

Hypothesis 12: Mid-range SD numbers (1-4) tend to be associated with more protracted, contentious negotiations, in which one side (the side that would rank as more yielding) ultimately makes more of the concessions and therefore relinquishes more of the gains from negotiations. Distributive asymmetry of outcomes is expected to increase as the SD number increases.

These hypotheses define the interrelationship between: (1) SD number; (2) distributive symmetry of negotiated outcome; and (3) speed (or ease) with which a settlement is reached. This interrelationship is illustrated in figure 3 by the shaded plane ABC.

In figure 3, SD number varies from 0 to 5, and the other two dimensions (symmetry and speed) vary between zero and 'high'. When the SD number is low, the plane defines points at which symmetry is high and speed is indeterminate (varying between extremes, points A and B).¹⁷ As the SD number approaches its maximum of 5, symmetry decreases and speed of settlement increases. Point C represents an SD number of 5, where symmetry is at its minimum, and speed is at its maximum.¹⁸

Concluding Comments

In the interest of developing a deductively based theory of bargaining, this chapter has constructed a model that assumes negotiation is based on power and that bargaining should be interpreted as a process of tactical action. The IR-D model rests upon two additional IR-derived assumptions: (1) dependence should be defined across three dimensions; and (2) the nature of the international system requires states to weight the first dimension of dependence more than the other two dimensions. These assumptions, along with an acceptance of the tactical effort implications of dependence, drive the IR-D model. By limiting the value of each dimension of dependence to low or high power, the permutations were ranked in order from most yielding to most contending, and dyadic

¹⁷ Here, speed is indeterminate because line AB corresponds to table 1's row of zeros; zeros in the table's upper left corner are associated with relatively difficult and slow negotiations, whereas zeros in the lower right are associated with relatively easy negotiations since both sides tend to yield.

¹⁸ Figure 3 is only meant to be a graphical representation of the interrelationship between the three factors. Additionally, since it based on an ordinal system of values, the shaded planar region should not be interpreted as drawn to scale.

relations among the permutations were ranked in terms of their tactical asymmetry by SD number. Constructing the table of SD numbers led to the generation of three hypothesis that link each number's value and position to corresponding expectations about bargaining behavior and the distributional asymmetry of negotiated outcomes.

The fundamental idea of this IR-D model is that issue-specific power resources can serve as an independent variable to determine tactical behavior (a dependent variable), which in turn can determine outcomes (another dependent variable.) This view would be sharply criticized by theorists like Habeeb who emphasize that bargaining skill (i.e., tactics, or behavioral power) is a distinct variable in its own right that combines with structural power resources to determine outcomes. Other scholars, like John Odell, have also emphasized the significance of tactical sophistication in the analysis of bilateral trade relations in specific cases (1980). Christer Jönsson expresses the same basic idea by comparing negotiation to a card game: successful players use their skills as well as their cards to maximize chances of winning (1988).

Jönsson's analogy is excellent. It is logical to assume that tactical bargaining skills would affect the process and outcomes of negotiations. However, taking on the additional independent variable creates significant problems. How would behavioral power be operationalized? How would relationships between independent and dependent variables be defined? It is difficult enough to work with one independent variable along three dimensions of dependence. Chapter one's analysis of Habeeb and Robert's models demonstrated that assessing a state's behavioral power and aggregate structural power and

then identifying the moderator variables among these factors makes for complex and dubious analysis.

In an effort to keep the IR-D model relatively parsimonious and the hypotheses straightforward and consistent, only one set of independent variables is utilized: the three dimensions of dependence. Bacharach and Lawler inspired this approach by linking behavior to power and dependence. The work of Caporaso, Hirschman and others helped to redefine and refine these notions within the IR context in a logical manner that prompted clear hypotheses about behavior and outcomes. All that remains is to probe the model's plausibility and assess its heuristic power using the CCFTA as a case-study.

CHAPTER THREE: INTRODUCING THE CASE-STUDY

The prior chapter developed an IR-D model of asymmetric bargaining linking the three dimensions of dependence to bargaining power, and then linking bargaining power to tactical action, tactical action to the extent of structural dependence, and then ultimately linking the degree of structural dependence to the distribution and ease of negotiated settlement. It is beyond the scope of this paper to conduct a rigorous test of chapter two's concluding hypotheses. Testing would require surveying a range of diverse negotiations, assessing each negotiation along each dimension of dependence, and then assessing each outcome in terms of distributional asymmetry. Data required for such an undertaking is simply not available. Instead of comprehensively surveying a diverse group of negotiations, this paper probes the plausibility of the IR-D model's general implications about asymmetric bargaining using the case of the Canada-Chile Free Trade Agreement (CCFTA); in so doing, this plausibility probe also demonstrates a particular methodology that could be utilized for more comprehensive hypothesis testing. This chapter introduces the context of the CCFTA, and then discusses the reason that it was chosen to probe the IR-D model's plausibility.

Canada-Chile Free Trade in Context

In January 1996, Canada sought a temporary agreement that would build a bridge toward bringing Chile into the North American Free Trade Agreement (NAFTA) by comprehensively liberalizing bilateral trade and investment. Yet, when the CCFTA was

signed the following November, Canadian negotiators accepted Chilean capital controls.¹⁹

These controls ran counter to NAFTA regulations and the liberal ideology that undergirded other contemporaneous free trade agreements (FTAs), and imposed costs on Canadian investment in Chile. Why was Canada willing to make this concession? One high-level Canadian trade official had a very simple answer: "In the words of Mick Jagger and Keith Richards, 'You can't always get what you want'" (Interview #1 1998). In other words, on balance the CCFTA was good for Canada, and therefore the capital controls issue was not a dealbreaker. Though this revealed-preferences argument makes sense, its rationale provides no insight into the parties' bargaining power or tactics as they evolved throughout the agreement's eleven month gestation period.

The Canada-Chile Free Trade Agreement

When the Canadian and Chilean teams sat down to negotiate free trade in January 1996, the Canadian goal was an interim agreement that would liberalize trade and investment and thereby facilitate Chile's full accession to the North American Free Trade Agreement. With the U.S. Congress and President Clinton dithering over fast-track negotiating authority, Canada decided it could not wait for the U.S.—even though U.S. Trade Representative Mickey Kantor promised to deliver fast-track approval and urged both sides to drop their bilateral process (Morton 1995, 3). The Canadian government had already investigated Chile's readiness to join NAFTA and concluded that Chile would only have to make a few changes to its financial regime before it could become a

¹⁹ See Appendix B.

full-fledged member. These changes were "...an extension of patent protection to 17 from 15 years; elimination of a one-year restriction on repatriation of foreign capital, inclusion of improved trade remedy rules; and harmonized procedures for enforcement of environmental standards" (Fagan 1995, B6).²⁰ Of all these issues, the most controversial was the Chilean restriction on foreign capital.

Capital Controls

Eleven months after negotiations began, Canadian Prime Minister Jean Chrétien and Chilean President Eduardo Frei signed the Canada-Chile Free Trade Agreement in Ottawa on November 18, 1996. The CCFTA was no longer just an interim, temporary agreement. A Canadian government press release issued the day of the signing emphasized that parts of the Agreement had been modeled on the NAFTA, but reported that Chile had managed to retain its capital controls. The Canadian press statement proudly proclaims, on its front page, that negotiators had won "significant new protection for Canadian investment in Chile" (Canada. DFAIT 1996). However, on page four, the press release explains that the CCFTA allowed Chile to maintain existing capital control measures (1996).

It is widely recognized that capital controls were the most contentious element of the CCFTA negotiations. Alejandro Jara, deputy chief negotiator for Chile, had been directly ordered by President Frei to keep capital controls off the bargaining table, even if

²⁰ See also the NAFTA, section 1109 (on capital transfers) and section 1410 on prudential capital-investment measures.

that meant scuttling the agreement. In September 1996, the Chileans refused to budge and negotiations were halted. On September 19, President Frei canceled a planned four-day September 30 visit to Ottawa. "Bilateral dialogue continued behind-the-scenes because there was a strong commitment to the process by the leadership on both sides" (Interview #2 1998). Negotiations remained uncertain until October 28, when Canada publicly recanted its position against the controls. Talks resumed, the Canada-Chile Free Trade Agreement was quickly completed, and Frei's trip and the signing ceremony were rescheduled for mid-November (Feschuk 1996, B1).

Throughout the negotiations, stakeholders throughout the hemisphere had been watching the U.S. Congress and calculating the odds of President Clinton receiving fast-track negotiating authority. Fast-track allows U.S. negotiators to submit trade agreements for ratification to Congress "under procedures that require expeditious action on legislation that is not subject to amendment. . . fast track provisions ensure that [an] agreement concluded by negotiators will not be subject to renegotiation (unless the Congress rejects the deal in its entirety)" (Schott 1995, 24). Conventional wisdom dictates that countries will only negotiate with the U.S. if the President possesses fast-track authority. In the fall of 1995, pundits were predicting that fast-track would be approved before the end of the year, or soon after. One year later, observers could see that fast-track was not going to be on the near or mid-term Congressional agenda, which had profound implications for NAFTA expansion, the CCFTA, and the issue of capital controls.

Chile's Capital Control Regulations

From 1988 through first quarter 1991, Chile enjoyed a surge in short-term private capital. Chilean authorities responded by initiating a 20 percent non-interest bearing reserve requirement on foreign credits. In January 1992, the reserve requirement was broadened to include foreign currency deposits, and in May of that year the Central Bank raised the reserve level to 30 percent (Laban and Larrain 1994, 137). Additional disincentives to short-term capital inflows included a 1.25 percent annual tax on domestic credits for operations of up to one year, a dirty float foreign exchange management system, and the use of a basket of currencies (the U.S. dollar, the German mark, and the Japanese yen) as a reference for the peso's value (Aninat and Larrain 1995, 8). The Chilean intention was to raise the cost of short-term investments, since both the reserve requirement and the tax had marginal costs of zero if held for more than one year. Whereas short-term inflows had averaged approximately \$110 million from 1989 through 1991, they fell to only \$40 million thereafter (Laban and Larrain 1994, 137). It is no surprise that capital controls are most effective at managing speculative flows, which are defined as "short-term (less than one year) capital, with the exception of loans to finance foreign trade" (Choudhri and Sharma 1996, 5). It is also no surprise that these flows are far more difficult to measure than foreign direct investment, since speculation can be disguised in a variety of ways. Speculative capital can enter surreptitiously, masked by investors who underinvoice imports, overinvoice exports (like tourism), and dissemble with leads and lags in international trade payments. Hot money also sneaks in through the informal foreign exchange market, where speculators bet on interest rate differentials

between the Chilean peso and the U.S. dollar, as well as expectations of the peso's appreciation or depreciation (French-Davis, Agosin, and Uthoff 1995, 114).²¹

In Chile, some economists have opposed the use of controls on inflows, suggesting that the authorities should rely on more aggressive and widespread elimination of controls on capital outflows. In fact, Chilean policies have been the reverse; though impediments were placed on inflows, authorities have actually removed obstacles to outflows. Those who criticized capital controls and encouraged the rapid liberalization of outflows based their argument on the presumption that free capital mobility is optimal. These arguments are also premised on the notion that regulators lack the capacity to credibly control capital in a globalizing world that links economies across eroding national boundaries (Laban and Larrain 1994, 138).

Since 1991, Chile has taken steps to introduce greater mobility to capital outflows and to facilitate early repatriation of capital as a means of alleviating appreciation pressures on the exchange rate. For example, Chilean authorities have reduced the minimum allowable terms for capital repatriation or remittances of investments through equity swaps. Repatriation or remittance is also possible by paying a commission on the original investment or on capital gains. Additionally, Chile's Pension Administration Funds (AFPs) and Chilean banks have received new authorizations allowing them to invest a proportion of their investment funds abroad (Aninat and Larrain 1995, 9). In April 1991, Chile legalized the sale or purchase of foreign exchange in the informal

²¹ Capital controls are often proposed as temporary measures because their effectiveness decreases over time as evasive techniques become more sophisticated (Choudhri and Sharma 1996, 19-20).

market, as long as there was notification of the Central Bank. In April 1995, the Central Bank liberalized export returns. "Previously, an exchange restriction required the return and liquidation in the formal market of 50 percent of the foreign currency resulting from the exports of goods and services, with a maximum of US \$50 million per annum per exporter. Under the new regulations, an exporter became able to access the entire amount of its profits thus generated, with no maximum" (Aninat and Larrain 1995, 10).

Canadian negotiators fought for the elimination of Chile's *encaje* (deposit) rule that imposed two separate restrictions on both foreign and domestic investors, raising the cost of investment in Chile. The first restriction required investors to "maintain deposits without any interest payments, equal to 30 percent of (the external portion of) their investment or pay an equivalent financial cost (through an alternative arrangement" (Choudhri and Sharma 1996, 24). This reserve was only applicable to the foreign credit portion of foreign direct investment, and most investors chose to pay up-front. The second restriction was that, though there were no impediments to remitting foreign profits overseas, capital was required to remain in Chile for at least a year before it could be repatriated (Choudhri and Sharma 1996, 24).

Two types of investment were subject to the *encaje*: (1) foreign exchange of more than US \$10,000 entering Chile as investment, equity contributions, and foreign exchange borrowings, as specified under Chapter XIV of Chile's investment regime, and (2) foreign exchange in excess of US \$25,000 entering as tangible assets, technology, related credits, capitalization of external credits and debits, and capitalization of profits, as specified under Chilean Foreign Investment Statute DL 600 (Canada. DFAIT, 1996b).

DL 600 was far more popular than Chapter XIV because it afforded special privileges and protections like preferential tariff rates, locked-in tax rates, and more favorable conditions for foreign exchange access (Choudhri and Sharma 1996, 24).

As of December 1995, Canada had invested US \$47 million under Chapter XIV and US \$2.1 billion under DL 600. The *encaje* restriction did not apply to investment in shares of Chilean corporations and the issuance of securities traded on foreign stock exchanges (ADRs). Foreign capital investment funds investing in local Chilean capital markets were also not subject to the *encaje* (Canada. DFAIT 1996b).

According to a Canadian government press release, the CCFTA "significantly improved the overall regime applying to Canadian investors in Chile by providing them with additional benefits and guarantees unprecedented outside the NAFTA context" (Canada. DFAIT 1996, 4). Two key benefits were the successfully negotiated most-favored nation clause that ensured Canadian investment would receive benefits equivalent to those Chile might grant to other countries in future agreements, and the clause that prevented Chile from imposing more restrictive rules against Canadian investors in the future. This guarantee capped the reserve requirement at 30 percent (though for other foreign investors it could constitutionally be as high as 40 percent), limited the reserve to a maximum 2-year period (although the reserve was then only one-year in duration), and limited the restriction applicable to repatriation of investment in Chile to one year. In other words, the CCFTA froze the Chilean investment regime at its current level while ensuring that Canadian investors would benefit from any future liberalization (Canada. DFAIT 1996, 4). Both Canadian and Chilean officials stressed in personal interviews that

these benefits tempered the magnitude of the Canadian concession (Interview #1, Interview #3, 1998).

Additionally, there were other miscellaneous benefits the CCFTA provided investors. The Agreement carefully limited the conditions of expropriation and guaranteed fair and adequate compensation if expropriation were ever to occur. Canadian investors were also granted the advantage of investor-state dispute settlement provisions that ensured they would not be subject to screening mechanisms that could block entry or impede Canadian commercial interests (Canada. DFAIT 1996, 4). Although these benefits reflect negotiating successes for the Canadian team, Canada's concession on capital controls remains a significant and indisputable event.

Choosing the CCFTA as a Case Study

The *encaje* case was chosen to probe the plausibility of the IR-D model because quantitative and qualitative data were relatively unambiguous in the CCFTA context. Trade and investment figures suggested tremendous asymmetry. Furthermore, Canada-Chile negotiation was undertaken for clear-cut reasons articulated by leadership on both sides, and therefore national negotiating interests were relatively easy to identify. Also, in the spirit of Hirschman's theory, the two countries involved were of unequal economic and political stature: Canada, a G-7 country, and a NAFTA member, was actively involved in APEC, FTAA, and OAS leadership roles, whereas Chile's niche economy was small and Chilean international responsibilities were trivial compared to Canada's.

All of these factors suggested that it would be relatively easy to assess various dimensions of dependence for both countries.

Not only were the model's independent variables (the dimensions of dependence) relatively straightforward in the CCFTA context, but the *encaje* case also provided straightforward data about the dependent variables (behavior and outcomes) as well. The CCFTA manifested an unambiguous outcome that was driven by clear-cut forms of negotiating behavior. The two countries began negotiations by contending. As negotiations wore on, Canada weakened its negotiating position while Chile maintained its aggressive posture. The Canadian concession that ultimately occurred in September 1996 is an indisputable fact, recognized by many Canadian trade policy analysts (though only rarely mentioned in the popular press or the academic and professional literature).

CHAPTER FOUR:

CASE STUDY ANALYSIS

The IR-D model measures dependence along three dimensions by asking three questions: (1) To what extent is the interest at stake dependent upon the negotiated item? (2) To what extent is the interest at stake dependent upon the other negotiating party? (3) To what extent are there other negotiating items or other parties that present alternative ways of fulfilling the interest? This chapter identifies and discusses Canada's interests and then assesses Canadian bargaining power as high or low along each dimension for each interest. Identical methodology is followed for Chile. This empirical analysis allows for a measurement of Canada-Chile structural asymmetry, which is reflected in table 2 at the end of the chapter. Implications of Canada-Chile structural asymmetry are discussed at the chapter's conclusion.

In this chapter, intrinsic interests should be understood to mean those directly relevant to the current issues under negotiation, whereas instrumental interests relate to future negotiations (Lax and Sebenius 1986, 78-79). The majority of interests in all negotiations are both intrinsic and instrumental; nevertheless, the distinction offers valuable heuristic power. In the CCFTA, Canada and Chile both had three major negotiating interests that were virtual mirror images of each other. Both had an intrinsic business interest in the other's market, an intrinsic ideological interest linked to national notions of free and fair trade, and an instrumental strategic interest associated with maneuvering vis-à-vis the U.S. The structure of the IR-D model demands that each

interest be independently assessed along the three dimensions of dependence.

Admittedly, this methodology would lead to tremendous complexity and ambiguity if different interests reflected conflicting levels of power and dependence. However, in the case of CCFTA *encaje* negotiations, as this chapter demonstrates, each country's three assessments of bargaining power were identical.²²

Canada

Canada had three major interests undergirding its negotiating position: (1) the interests of Canadian businesses seeking opportunities in Chile, which were largely intrinsic to the trade and investment relationship under negotiation; (2) the ideological interests of Canadian negotiators in promoting neoliberal economic reform, which were also largely intrinsic to the free-trade context of the negotiation; and, (3) the larger, strategic instrumental interest of Canada vis-à-vis the U.S. in the context of NAFTA and the FTAA.

Intrinsic Canadian Business Interests

Intrinsic Canadian business interests were very straightforward: Canadian firms wanted to maximize their profits in Chile. Nevertheless, Canada-Chile commerce has historically been insignificant relative to Canada's other bilateral relationships because Chile is a niche market, with an economy only 25 percent of Quebec's and a population of less than 15 million (Paskey and Sepulveda 1996, 3). In 1995, Canada-Chile exports and imports represented less than 1 percent of Canadian totals (Canada. DFAIT 1998, 8).

²² These results are clearly illustrated on table 2 at the end of this chapter.

Still, bilateral trade was growing dramatically throughout the 1990s and was expected to keep accelerating. Chile, with its rich ore deposits, plentiful salmon stock, and huge virgin forests was an obvious potential partner for the many Canadian firms with expertise in these resource-intensive sectors. In 1995, Canadian exports rose to a new record of US \$350 million, an increase of more than 10 percent over 1994 and more than 65 percent over 1993.

In the mid 1990's Chilean investment in Canada was inconsequential (less than US \$500,000) but Chile's transparent business environment and relative lack of corruption were attractive incentives for Canadian investors (Kohan 1995). From 1990 through 1994, Canada's actual and expected investment in Chile grew to about US \$7 billion, representing about 2 percent of total Canadian investment abroad (Kohan 1995 and Canada. Statistics Canada. 1997, 32).²³ The bulk of Canadian capital flowed into the mining sector, with other funds invested in forestry, fish farming, banking, and financial services (Bailey 1995, 99). The Canadian mining sector was particularly interested in geographically diversifying operations and seizing investment opportunities in Chile. This sector, which accounted for less than 5 percent of Canada's GDP, was "exasperated with what it [saw] as punitive government rules in Canada" (Paskey and Sepulveda 1996, 18). New Canadian legislation required mining companies to comply with a complex system of regulations each time they wanted to open or close a mine. From 1991 through 1995, Canada had fallen from first to fourth place in attracting mining foreign direct

²³ There is a draft DFAIT document suggesting cumulative investment materialized as of December 1995 was US \$2.1 billion (Canada. DFAIT 1996b).

investment and had lost 6,500 jobs since 1990. Chile welcomed mining with a relative simple approval process for direct investment and favorable regulations. Corporate taxes were also lower (Paskey and Sepulveda 1996, 18).

Canadian firms were important stakeholders throughout the bargaining process. These firms supported the elimination of Chilean capital controls—up to a point. According to a high-ranking Canadian official, "the whole agreement was designed to accommodate our business interests. We checked with the business lobby, and they said the *encaje* was a nuisance, but that they could live with it. They don't see it as a reason not to invest in Chile. . . it's just another transaction cost, and a not a prohibitive one" (Interview #1 1998). This view was confirmed by another Canadian official, who acknowledged ongoing consultation with businesses represented within International Trade Committees (Interview #2 1998). The Canada–Chile Chamber of Commerce, established in Santiago in 1991 and dominated by the mining sector, was the primary vehicle through which Canadian firms represented their interests to the Canadian embassy in Chile (Bailey 1995, 103).

James Drake, President of the Chilean-Canadian Chamber of Commerce and general manager of Cominco Ltd.'s Quebrada Blanca copper mine, confirmed that the *encaje* raised the cost of investment in Chile, but was not a significant problem. Drake approximated that Cominco had to pay an additional 1.5 percent in financing costs in the first year for its 76.5 percent stake in the \$400 million Quebrada Blanca development: "It is an annoyance we don't like to see, but it really doesn't effectively impede any long-term investments" (McCarthy 1998, B3). A Canadian official estimated that the capital

controls generally raised the cost of financing by 1.5 to 3 percent (depending on the details of the specific project) by requiring a charge of LIBOR (the London Interbank Borrowing Rate) plus an additional 1 to 2 percent (Interview #1, 1998).

It was clear to Canadian negotiators that their firms did not like the *encaje* regime, but that the firms had intrinsic interests in a successfully negotiated agreement. Canadian firms recognized that the Chilean trade regime was already considered relatively transparent and non-discriminatory, and the CCFTA was expected to provide additional formal guarantees against any future back-sliding towards discriminatory practices. In this way, the CCFTA acted as a kind of insurance policy (Christie 1995, 21).

The Canadian business lobby also supported the agreement because they knew that the CCFTA would give them an 11 percent tariff advantage over U.S. competitors. Anecdotal evidence of the fruits of this advantage can be found in the Canadian business press. Nova Corporation, the Calgary pipeline and petrochemical firm, announced that it would lead a five country consortium to build a \$560 million natural gas line across the Andes, and attributed its success in this venture to the CCFTA's preferential treatment. Peter Charbonneau, president of Canada's Newsbridge Corporation, stated that the CCFTA allowed his company to bid for contract more competitively than American competitors like Cisco Systems (Urquhart 1997, B11). A source confirmed that the CCFTA gave Nortel the edge over U.S.-based Lucent Technologies in a multi-billion dollar contract (Interview #1, 1998). U.S. Trade Representative Charlene Barshefsky acknowledged the extent of the CCFTA's benefits, criticizing the U.S. Congress for not

granting fast-track and forcing her team to "[sit] on the sidelines spotting Canadian competitors an 11 percent price advantage" (Urquhart 1997, B11).

Assessing Bargaining Power

The first dimension of dependence: To what extent did the fulfillment of Canadian business interests depend upon the *encaje*'s elimination? The previous analysis clearly showed that firms affected by the controls saw the *encaje* as a nuisance, but nothing more. Eliminating the *encaje* was not a necessity, given the interests of the business community, signifying that Canada enjoyed high power along this dimension.

The second dimension: To what extent did the fulfillment of Canada's business interests depend upon the relation with Chile, as opposed to other ongoing relations with other countries? This question is easy to address. Canadian trade and investment directed toward Chile was truly insignificant when compared with total Canadian commerce, or even when compared with the Canada-U.S. relationship. The lack of significance along this dimension also equates to high power for Canada .

The third dimension: To what extent did other issues or other countries offer alternative lucrative opportunities to Canadian business interests? Canada enjoyed high power along this dimension as well. There were a host of other non-*encaje* issues (like labor and environmental standards, standards, intellectual property rights, and dispute settlement mechanisms) that were negotiated to promote business interests and lock-in significant reforms (Ibanez and Larrain 1994); there were also other countries in Latin America like Brazil and Argentina that were interested in promoting free trade

negotiations (and with whom Canada planned to negotiate) that offered larger potential markets and larger ongoing business relationships (Canada. DFAIT 1997c, V-VIII).

Canada's status in the context of this interest was HHH, or high power across all three dimensions of dependence.

Intrinsic Canadian Ideological Interests

Aside from the intrinsic interests of Canadian business, there were also intrinsic ideological interests at work. In fact, much of the negotiation was organized around ideological principles of trade theory—after all, it was DFAIT's mandate to support both trade and investment liberalization. In the annual Ministerial review, DFAIT's one-sentence summations of its "International Business Development Objectives" and "Trade and Economic Policy Objectives" included liberalizing capital and trade flows around the world "based on clear and equitable rules" (Canada. DFAIT 1997b, 6).²⁴

Canada knew that many countries around the world had shifted away from using capital controls and had opened their capital accounts, embracing the tenets of economic neoliberalism. In the few cases where governments had recanted, reintroducing controls, authorities had stressed the temporary nature of their activities. At the time of the CCFTA negotiations, conventional wisdom was that the capital controls' utility had eroded due to the forces of globalization, the rapid expansion of international financial markets and the increasing number of globally configured multinational enterprises.

²⁴ The date of publication strongly suggests it was written in late 1996 and reflects DFAIT priorities contemporaneous to CCFTA negotiations.

The Canadian argument against capital controls was made most convincingly by Ehsan Choudhri and Prakash Sharma, hired by DFAIT to develop a position paper on the issue. Much of the Choudhri-Sharma discourse is in line with Lawrence Summers's comments as cited in *The Economist*:

The emergence of modern financial markets is like the invention of the jet airline. We can go where we want to go much more quickly, we can get there more comfortably, more cheaply, and most of the time more safely. . . capital liberalization is basically a good idea, allowing emerging economies to import. . . capital. . . ideas and technology. Emerging economic financial crises, Mr. Summers argued, stem from policy mistakes, such as poor supervision. Just as countries can gain more from lengthening runways to handle jet planes than from banning jets, so they are better off improving their financial systems rather than restricting the inflow of capital (Of take-offs and tempests 1998, 88).

Choudhri and Sharma argued that restrictions on capital flows reduce economic efficiency because they interfere with optimal decisions regarding trade and investment while simultaneously promoting inefficient evasion-related activities. They began with the Chilean rationale, that the controls drive a wedge between foreign and domestic financial markets, thereby releasing the authorities from the constraints of the interest parity condition (Choudhri and Sharma 1996, 21). Chilean defenders of capital controls argued that the *encaje* restrictions limited the likelihood and magnitude of speculative currency attack, a very important and well-studied macroeconomic problem. Foreign investment taxes and non-interest bearing reserve requirements²⁵ are intended to raise the cost of betting on the Chilean interest and exchange rates, thereby creating disincentives

²⁵ The two policies are practically identical.

for volatile hot money flows. However, the authors note that when devaluation is imminent, speculators often have ample opportunity to make large profits that would far exceed the costs incurred by capital controls. For example, if a 10 percent devaluation is expected with one week with a probability of 0.1 percent, return on investment would be 1 percent for that week, or over 50 percent on an annualized basis.²⁶

According to Choudhri and Sharma, attacks tend to be associated with investor perceptions; when investors believe that a country's macroeconomic policies are inconsistent with the exchange rate, they sell that country's currency. Though the authors agreed that capital controls could have an affect on a speculative attack, after surveying the literature²⁷ they found no evidence that controls prevent attacks, though they did find that controls may lengthen the life of an inefficient regime favoring inconsistent policies (1996, 21).

The 1995 attack on the Mexican peso has often been discussed as a situation in which capital controls would have been very useful. But Choudhri and Sharma argued that "Given the severity of the [currency] attack, it is unlikely that restrictions on capital flows would have allowed Mexico to delay the collapse of the peso" (1996, 4). Choudhri and Sharma, looking at Chile, also noted that the bulk of investment in Chile targeted the mining sector and was almost exclusively investment of a long-term nature. Since capital

²⁶ This example is based upon one found on page 21 of Choudhri and Sharma.

²⁷ A literature review appears in Michael P. Doooley's "A Survey of Academic Literature on Controls over International Capital Transactions," National Bureau of Economic Research Working Paper no. 5352, November 1995.

controls tend to be primarily intended to curtail inflows short-term hot money, these restrictions would have an unintended negative impact on beneficial mining-related FDI.

Capital control advocates would argue that there is value in delaying speculative attacks, since extra time could allow authorities to improve inefficient or inconsistent policies. Choudhri and Sharma expressed an alternate political economy perspective, arguing that "the political and economic pressures that lead to inconsistent policies are unlikely to be diminished by the availability of extra time" (1996, 21). The implication here is that the monetary policy protections these controls afford constitute a movement away from market forces, and would therefore actually reduce incentives for monetary discipline. If this hypothesis were true, and a country's commitment to monetary discipline was not credible, exchange rate volatility could actually increase (Choudhri and Sharma 1996, 22).

Many observers assert that Chile's success in the 1990s has largely been attributed to sound and consistent macroeconomic policy and a gradual reformist trend toward increased liberalization. Choudhri and Sharma argued that capital controls have not been a significant ingredient of this policy. After appraising the utility of the Chilean *encaje*, the authors found that the controls "exerted only a marginal effect on the variability of the exchange rate, and are not essential to maintaining a stable exchange regime" (1996, 22). Indeed, they maintained that controls inhibit economic efficiency and thereby contribute to costs and augment disequilibrium.

Still, the Choudhri and Sharma paper does not reflect the whole story. In the latter part of the negotiations, Canadian negotiators began to appreciate the Chilean

perspective. The negotiation was a learning process for Canadian negotiators during which they came to appreciate the Chilean point of view (Interview #7, 1999). According to one of the Canadians close to the negotiations, "the controls were a controversial issue, in that some economists were saying capital controls were helpful for developing countries like Chile, especially when the country in question was, like Chile, moving away from the controls" (Interview #6, 1999). Months into the negotiations, after listening to the exhortations of Chilean central bankers and reading numerous academic arguments for the *encaje*, Canada began to see capital controls less as a threat to its ideological interests and more as a practical safeguard needed by a prudent developing country. The day after the agreement was signed, Trade Minister Art Eggleton was quoted in the Chilean press saying that Canada had "learned the value of the *encaje* for the security of the monetary policy and stability of the peso, and the overall economic security of Chile" (Aumentarian inversiones 1996, 8).

Assessing Bargaining Power

The first dimension of dependence: To what extent did the fulfillment of Canada's ideological interest in promoting neoliberal economic reform depend upon the *encaje*'s elimination? Two points are critical here: (1) The *encaje* represented a departure from traditional economic neoliberalism, but Chile was able to convince Canada that the *encaje* served a useful purpose, and (2) the agreement, on the whole, was consistent with the Canadian ideological orientation. To explain the second point, it's noteworthy that the CCFTA created immediate duty-free access for 75 percent of Canadian exports and

the elimination of Chile's 11 percent import duty on almost all remaining industrial and resource-based goods over five years. Additionally, the agreement allowed for much better access for a range of agricultural goods. For example, tariffs for durum wheat, which represented 35 percent of Canadian exports in this sector, were eliminated immediately (Canada. DFAIT 1996). And, as mentioned in Chapter three, Canada did manage to score some neoliberal victories in the capital account as well.²⁸ In sum, Canadian ideological interests in promoting liberalization did not depend upon eliminating the *encaje*, signifying that Canada's power on this dimension was high.

The second dimension: To what extent did the fulfillment of Canada's ideological interest depend upon this relation with Chile, as opposed to other ongoing relations with other countries? DFAIT's *1995-96 Estimates Report* makes Canadian priorities perfectly clear:

1. Canada's overriding trade . . . priority remains . . . management of its . . . relationship with the United States. Figuring significantly in that relationship are the NAFTA Trade Remedy Working Groups; 2. The department continues to seek improved access to international markets for Canadian goods and services and to participate in efforts to broaden and deepen international trade disciplines and . . . the WTO remains Canada's preferred means for achieving its objectives; 3. Canada is party to an interim multilateral agreement . . . on market liberalization in financial services; 4. Priority has been given throughout the year to negotiations on the accession of China, Taiwan, the Russian Federation, Saudi Arabia, and Ukraine to the WTO (Canada. DFAIT 1996, 26-27).

²⁸ see page 58 for CCFTA benefits to investors.

It is only after these myriad fora and countries that there is finally a mention of Chile (amid many other policy priorities all lumped together under a single bulleted paragraph): "Other trade policies include: advancing NAFTA accession negotiations with Chile, ratifying the [Canada-Israel] FTA; furthering, principally through APEC, the process leading to free trade and investment in the Asia-Pacific region;. . .achieving an FTAA by 2005; and reviewing Canada's transatlantic economic and trade links" (Canada. DFAIT 1996, 27).

The APEC-related goals were especially significant in November 1996, as Canada-Chile negotiations were drawing to a close. During that November, Canadian Prime Minister Jean Chrétien was preparing for an APEC leaders meeting in the Philippines, after which he was going to visit China and Japan. In Manila that year, APEC members presented action plans "which provided details on each member's current trade and investment regimes as well as specific measures for further liberalization," and as incoming chair Canada was to be responsible for overseeing implementation of this liberalization (Canada. DFAIT 1996c, 4). These government statements reflect that Canada was actively working to promote neoliberal ideological interests on many fronts besides Chile, signifying high power along this dimension as well.

The third dimension: To what extent did other issues or other countries offer alternative means of fulfilling Canadian ideological interests? Again, the government's own statement says it all:

The Trade and Economic Policy [division] will continue to promote Canadian economic and financial objectives in the G-7 and other international forums in support of non-

inflationary growth, fiscal consolidation. . . investment and capital flows, environmental protection, nuclear safety, and economic relations with developing and transitional economies. These objectives will be advanced at the annual G-7 Summit; by ensuring that Canadian policy priorities are reflected at the OECD, European Bank for Reconstruction and Development, in APEC, and in work of international financial institutions (IFI); and by deploying resources to support our foreign policy priorities. The UN and IFI reforms launched at the G-7 Summit in Halifax and those underway at the OECD are integral to these objectives (Canada. DFAIT 1997b, 19).

This wealth of alternatives equates to high power along the third dimension. Canada's status in the context of this interest was HHH, or high power across all three dimensions of dependence.

Canadian Instrumental Interests vis-à-vis the U.S.

The largely instrumental interests of Canadian governmental authorities were different from their more intrinsic business and ideological interests. For Canadian officials, the CCFTA was very much a way of jockeying for strategic position vis-à-vis the U.S. As long as the CCFTA really seemed to be leading toward Chilean accession, the agreement held potential for improving the Canada-U.S. commercial regime. Canada's first strategic goal for the CCFTA was to use it to facilitate Chilean accession into NAFTA, thereby strengthening NAFTA and improving the security of access to the United States. "By making the U.S. part of a larger trading bloc, with clear rules, the ability of American protectionism to control the trade agenda would be diluted" (Interview #4 1998). In the 1990s, the bilateral U.S.-Canada relationship accounted for the overwhelming majority of Canada's total international trade. Almost 80 percent of

Canada's exports went to the United States. Widening NAFTA was expected to increase the multilateral regime's strength and flexibility, simultaneously diminishing the U.S.'s ability to bully its trade partners with unilateral actions.

Furthermore, Canada hoped that the specific terms of the CCFTA would send a strong signal to the United States establishing precedents for subsequent accession negotiations. According to a senior Canadian official, the U.S. did not approve of negotiations because Canada was favorably positioned to set the terms of free trade: "Canada has long been trying to get the U.S. to take seriously the issue of trade remedies on softwood lumber, for example. The U.S. does not adhere to that. We felt we could send a strong message by signing specific rules into the agreement" (Interview #1 1998). A high-ranking Canadian official, and an officer at the Chilean embassy in Ottawa both seconded this opinion, heralding the CCFTA's precedent-setting trade remedy provisions as the crowning achievement of the Canada-Chile negotiation effort (Interview #1, Interview #5 1998).²⁹

Inside U.S. Trade published an article that explicitly spelled out this Canadian intention:

The commitment by Canada and Chile to stop using antidumping investigations against each other's exports under their bilateral trade pact is part of a broader Canadian strategy aimed at achieving a similar deal for its trade with the U.S. 'We were hoping this will have a demonstration effect with the United States. . .and that when they do get

²⁹ In the CCFTA, Canada and Chile agreed to disallow the application of anti-dumping duties, a guarantee that Canada has long sought with the U.S. The Canadian government's CCFTA press release asserted that this measure was "consistent with minimizing and eventually eliminating the use of anti-dumping duties within NAFTA." (Canada. DFAIT 1996, 5).

involved in NAFTA accession [for Chile] this provision will be debated in the U.S. and . . . that debate will improve the possibility of us getting some type of deal. . . ' the official said. 'That was our overall goal, and that remains our overall goal.' He said Canada's hope is it will generate sufficient debate among opposing groups in the United States next year, and that this will give Canada a leg up in its continuing pursuit of this vis-à-vis the U.S. (Canada seeks replication 1996).

It is well accepted among Canadian policymakers that Canada, as a small, trade dependent economy that has traditionally relied upon foreign investment, benefits from the establishment of international regimes. According to the Canadian Minister for International Trade during CCFTA negotiations, "Canada's success in the global marketplace depends upon its ability to maintain and expand the framework of international trade and investment rules" (Canada. DFAIT 1997a).³⁰ These views were shared by Keith Christie, Canada's chief negotiator for the CCFTA:

The rule of law is critical to ensuring civilized behavior both within and among nations. . . Proposals to extend free trade through the Americas comprise yet another initiative attempting to define and extend the rules more clearly. My view is that. . . as with the negotiation of the NAFTA and its side agreements and the Chilean accession process, Canadians can continue to be key shapers of the results if we wish. . . To remain a central player capable of shaping results in the national interest, we must be active (Christie 1995, 29-30).

Closely related to Canada's instrumental interest in expanding NAFTA was the instrumental Canadian interest in using the CCFTA to catalyze FTAA liberalization

³⁰ *Canada's International Market Access Priorities*. url: <http://www.infoexport.gc.ca> or <http://www.dfait-maeci.gc.ca>.

throughout the hemisphere, which in turn would provide opportunities for Canada to reduce its trade dependence on the U.S. (Paskey and Sepulveda 1996, 4).³¹ One year before CCFTA negotiations began, thirty-four heads of state from the western hemisphere had met in Miami to discuss a future Free Trade Area of the Americas. These Presidents and Prime Ministers had agreed to create an FTAA by 2005, pledging to work for "concrete progress toward attainment of this objective by the end of this century (Christie 1995, 21). It was at this Miami Summit that Canadian Prime Minister Jean Chrétien had stood with his American, Mexican, and Chilean colleagues, saying, "Now we are the four amigos" (1995, 21).

Strengthening western hemispheric regimes had become a Canadian policy initiative in the 1990s—Canada joined the OAS in 1990, signed NAFTA in 1993, and established peacekeeping operations in Central America (Klepak 1994, 5). The 1990s were a time of democratization and development for Latin American countries who were seeking "clear, balanced and enforceable rules of the game that often coincided with Canadian views," and who could help to enhance and secure Canadian access in these markets (Christie 1995, 7-8).

Canadian trade strategists hoped a Chilean accession would be perceived by other developing countries in the hemisphere as a reward for, and a recognition of, successfully implemented neoliberal economic reform. This recognition was hoped to spark a domino effect, first broadening MERCOSUR and then spreading free trade throughout the

³¹ The idea of expanding trade with Latin America to reduce dependence on the U.S. has been referred to as a modern version of former Prime Minister Pierre E Trudeau's Third Option, though the ideological

continent (Christie 1995, 7-8). There was thought to be enormous potential for developing the Latin American market for goods and services. By 2025, Latin America's population was expected to reach nearly 700 million, making it one of the largest markets in the world. Canadian negotiators intended the CCFTA to serve as a template for subsequent negotiations with Brazil and Argentina (Klepak 1994, 19).

When CCFTA negotiations began, an anonymous Canadian trade official was quoted making this argument in the financial press: "If we get Chile right, NAFTA can be used as one of the dynamic tools to reach an Americas free trade agreement by 2005. If we get it wrong, it will have just the opposite effect. If we can't have clear accession with Chile, we can't have it with anyone" (McKenna 1995, B1). These views were echoed in an October 1995 DFAIT policy paper written by Canadian chief negotiator Keith Christie. Christie's negotiating position and strategic interests were foreshadowed by the paper's title: *The Four Amigos and Beyond: Towards the Free Trade Area of the Americas*.

This paper was written by Christie immediately prior to the start of negotiations and therefore may be assumed to accurately reflect the contemporaneous Canadian negotiating perspective. In his essay, Christie explained that it was essential to promote Chilean accession because "Chile is a test case of the capacity of NAFTA to reinvent itself into a dynamically outward-looking instrument with a central role in achieving an FTAA" (1995, 2). Christie also made a case for the building blocks (as opposed to stumbling blocks) argument for regional trade arrangements: "With an increasing number

connection between the two is tenuous.

of policy issues in play, and more countries prepared to engage, the multilateral game has become more difficult to sustain without creative regional efforts that seek to go further faster, thereby goading the global system as a whole into action" (1995, 2). Christie continued, arguing that "countries that are in a position to negotiate must move forward forcibly. . . in order to create a concrete free trade dynamic that will echo back positively into the broader FTA process" (1992, 24).

Given that Canada's chief negotiator held these views in October 1995, it is not surprising that the Canada-Chile FTA was motivated by instrumental interests and originally intended as an interim agreement. But, while CCFTA negotiations progressed, fast-track approval seemed less and less likely to be approved by the U.S. Congress. Fast-track is considered a prerequisite for trade negotiation with the U.S. and was operational during negotiations of the U.S.-Canada FTA, the NAFTA, and the Uruguay Round of the General Agreement on Tariffs and Trade (GATT).

President Clinton had not received fast-track approval in 1995, but in October of that year pundits were predicting that the next attempt would be postponed until after elections in November 1996—on the heels of a completed CCFTA (Chile in NAFTA, 1995, 30). By February 1996 the outlook for fast-track dimmed considerably. Thelma Askey, Republican staff director of the House of Representatives Ways and Means Committee's trade subcommittee, was quoted as "pessimistic about moving a fast-track bill forward. . .[because] Republicans in Congress and administration officials have been unable to work out compromise language over contentious labor and environmental issues" (Almost no chance 1996). Phil Crane, chairman of the House trade

subcommittee, had given up on getting administration agreement between the House and Senate (Almost no chance 1996). According to a top Chilean negotiator, uncertainty associated with fast-track approval significantly influenced CCFTA negotiations: "As negotiations proceeded and we, Chileans and Canadians, saw that fast-track was becoming less likely, we began to change our ideas. . . we began to see more and more worth in an agreement that could stand on its own" (Interview #3 1998).

Assessing Bargaining Power

The first dimension of dependence: To what extent did the fulfillment of Canada's interest in enhancing its strategic position vis-à-vis the U.S. depend upon the *encaje's* elimination? This question must be answered first in the context of NAFTA-related interests, and secondly in the context of FTAA related interests. Firstly, it is clear that Canadian interests in strengthening NAFTA did not depend on the elimination of the *encaje* regime. The probability of Chilean accession to NAFTA was determined by the prospects for fast-track authority—not the prospects of eliminating the *encaje*. Given the poor prospects for fast-track's passage in Congress, Canadian policymakers were satisfied with the knowledge that their efforts would eventually facilitate Chile's accession because the CCFTA was a comprehensive FTA that had been negotiated with a NAFTA template in mind (Interview #6 1999). According to a Canadian official, Canada and Chile both knew that the U.S. was not hinging its trade decisions on the status of Canada-Chile *encaje* negotiations (Interview #1 1998). Moreover, capital controls were not a strategic issue in the U.S.-Canada context.

Secondly, in the context of FTAA interests, the *encaje* was also not crucial. What was crucial was promoting the spread of FTAs in the hemisphere that promoted key Canadian issues like antidumping. Canadian chief negotiator Keith Christie believed his CCFTA would be a building block to the FTAA, connecting MERCOSUR and NAFTA countries for the first-time, with or without the *encaje*.

In sum, instrumental Canadian strategic interests did not depend upon the *encaje*, and therefore Canada enjoyed high power along the first dimension.

The second dimension: To what extent did the fulfillment of Canadian strategic interests depend upon this relation with Chile, as opposed to other ongoing relations with other countries? This question is easy to address, since the CCFTA process was (at best) an indirect way of achieving these strategic interests. Canada's interests (strengthening its roles in NAFTA and the FTAA) were being fulfilled more directly served in each forum; NAFTA interests within the context of Trade Remedy Working Groups, the FTAA interests within the context of the Hemispheric Ministerials. Canada's ongoing relations within other fora reflect high power along this dimension as well.

The third dimension: To what extent did other issues or other countries offer alternative means of fulfilling Canadian strategic interests? According to a Canadian government press release, the CCFTA contained "a full-scope exemption for cultural industries; the broadest possible carve-out for social services, including health services; the exclusion of over-quota tariffs for supply-managed products; and an agreement on competition policy" (Canada. DFAIT 1996, 3). These specific issues reflected high

priority negotiating positions that Canada had taken with the U.S.; these chapters of the CCFTA were an alternative means of fulfilling Canada's strategic interest.

Assessing alternatives to negotiating with Chile requires another two-part answer, separating NAFTA-related and FTAA-related interests. In terms of Canada's NAFTA-related interests, Mexico was the only real alternative to Chile. Canada could have worked with Mexico to strengthen NAFTA rules and challenge U.S. unilateralism and hegemony. Outside of Mexico, no country but Chile offered opportunities to fulfill NAFTA-related objectives. Chile was next to join NAFTA; therefore negotiating with, say, Argentina or Brazil would not have reverberated as effectively within the NAFTA context. However, in terms of FTAA-related interests, countries like Argentina and Brazil were real alternatives to Chile. Canada's trade minister had publicly announced his intention to catalyze the FTAA process by negotiating with these countries.

Therefore, all the evidence suggests Canada could have fulfilled its strategic objectives using other issues and other countries, signifying high power along the third dimension of dependence.

Canada's status in the context of this interest, as in the other two interests, was HHH, or high power across all dimensions of dependence.

Chile

Chile had three major interests undergirding its negotiating position: (1) the intrinsic Chilean business interest in expanding Canadian financial opportunities; (2) the intrinsic Chilean ideological interest in maintaining control over the peso and the

economy as a whole; and (3) Chile's instrumental interest in positioning itself strategically to negotiate a free trade deal with the United States.

Intrinsic Chilean Business Interests

Chile's intrinsic interest in expanding Canada-Chile commerce did not rest on trade, for trade with Canada amounted to an inconsequential 3 percent of total Chilean exports and imports.³² It was Canadian investment that was crucial for Chile. Though second to the United States in total investment, Canada was the largest source of new foreign investment in 1992, 1994, and 1995. As of mid-1995 when prenegotiations began, actual and planned Canadian investment had totaled US \$7.5 billion, or 18 percent of total foreign investment in Chile. That year, Canadian investment flows accounted for a third of all authorized foreign investment, an increase of almost 200 percent over 1994 (Canada. DFAIT 1996d, I).

Although Canadians were investing in forestry, fish farming, banking, and financial services, Canada invested more in mining than any other sector. Some of the most important mining companies in Canada, like Placer Dome, Rio Algom, Falconbridge, Cominco, and Lac Minerals were heavily involved in the exploitation of copper, gold, and silver. By 1995, there were over 32 mining companies operating in Chile, and another 10 with Chilean representatives. Indeed, Canada was Chile's largest investor in the mining sector from 1992-1995, and at the time of negotiations this investment was expected to increase because there were several new projects in copper,

³² Data supplied by the Chilean Trade Commission, Toronto Office.

silver and gold mining underway (Canada. DFAIT 1996d). In the 5 years leading up to the CCFTA, Canadian investment in mining businesses had increased from US \$401 million to \$4 billion which, as reported in the Chilean press, "directly contributed to the Chilean mining sector experiencing a growth of 74 percent" (Comercio con Canada 1996).

Mining is Chile's most important business sector. During CCFTA negotiations Chile was the world's largest copper producer and exporter, accounting for 27 percent of total Western production, and was also the largest producer and exporter of potassium and sodium nitrate. In the mid-90's, the share of mining products in total Chilean exports neared 50 percent (Canada. DFAIT 1996d). Moreover, a portion of profits from mining funded public works projects and a law imposed under General Pinochet directed a portion of mining moneys to the Chilean military budget.

Assessing Bargaining Power

The first dimension of dependence: To what extent was the fulfillment of intrinsic Chilean business interests dependent upon capital controls? Ample evidence clearly shows that the Chilean people believed in the power of the *encaje*. In the midst of the negotiations, the chief Chilean negotiators were telling their counterparts that the *encaje* was a high salience issue for everyday Chileans: "Chileans know that this is what is keeping their economy safe" (Interview #6 1999). Therefore, Chile's business community felt they needed the *encaje*, corresponding to low power along this dimension.

The second dimension: To what extent did the fulfillment of intrinsic Chilean business interests depend upon this relation with Canada, as opposed to other ongoing relations with other countries? This question relates directly to the share of foreign investment in Chile originating in Canada. Clearly, Canada, the largest source of new foreign investment in 1992, 1994, and 1995 and the largest investor in the mining sector, was the most important investor in Chile. This equates to low power along this dimension as well.

The third dimension reflects the extent to which there were other negotiating items or other parties that presented alternative ways of fulfilling these Chilean intrinsic interests. Observers reported that there simply were not other negotiating items that could have been substituted for the *encaje*; the Chilean people were loathe to lose their capital controls (Interview #6, 1999). The question of whether there were other countries that could have replaced Canada at the negotiating table is somewhat more difficult to answer. An FTA with the U.S., Chile's largest investor, was not an option because of the lack of fast-track negotiating authority. On June 21, 1996, Chile had signed a vague "framework of understanding" with the European Union, Chile's largest trading partner, which was intended to be a foundation for future deeper agreements (Hornbeck 1997, 14). It is safe to say that although there may have been alternatives to negotiating with Canada, there were no obvious alternatives that could match Canada's large investment contributions in key sectors, or Canada's readiness to negotiate. Therefore, this dimension is assessed as low power as well.

Chile's status in the context of this interest was LLL, or low power across all dimensions of dependence.

Intrinsic Chilean Ideological Interests

The intrinsic ideological reason for protecting the *encaje* regime was very simple: to legitimize the regime as a prudent way of protecting the integrity of the Chilean currency and economy. Chileans have long argued that "some types of capital can flow out even more quickly than they flowed in, causing serious economic harm" (Of take-offs and tempests 1998, 88). A colorful case for capital controls in the Chilean context was made by Joseph Stiglitz, chief economist at the World Bank, who compared industrializing economies to rowboats on a tempest-tossed sea:

Although an ill-repaired boat is more likely to sink, the force of powerful waves can cause even a perfectly sound vessel to founder. So, while a mismanaged emerging economy is bound to hit trouble in international capital markets, even a well-managed but small economy might be overpowered by the force of vast international capital flows. Some limits on such flows, particularly the most volatile and pernicious short-term kind, might therefore be warranted (Of take-offs and tempests 1998, 88).

The clearest recent example of an emerging economy that was wrecked on the shores of financial flight was Mexico in 1995. As an OECD member, Mexico had relinquished its capital controls. After joining NAFTA Mexico suffered a financial rout that sapped the government of its foreign reserves, decimated the value of the Mexican peso, and ultimately required a multibillion dollar U.S.-led bailout. Chile watched and learned from Mexico's experience.

The Chilean government was sensitive to investment flows because capital has played an important role in the country's recent economic history. From 1982 through 1987, Chile suffered from a lack of foreign capital aggravated by a domestic debt crisis. Since 1987, the Chileans had been dealing with the exact opposite problem, a surplus of foreign exchange. Total net capital inflows grew from an average of \$1 billion from 1985-1987 to \$3 billion in 1990, to an average of \$2.4 billion for 1990-1992 (Laban and Larrain 1994, 118). This turnaround was associated with a variety of internal and external factors. Internally, Chile could lay claim to the most liberal trade and investment regime in Latin America, a sharply reduced debt burden, strong macroeconomic fundamentals, and a return to democracy. Externally, Chile benefited from relatively low world interest rates, relatively low growth rates in developed countries, and larger poolings of international capital. All of these factors contributed to a reduction in the risk premium foreigners required to invest in Chile (Laban and Larrain 1994, 118).

Foreign capital is commonly understood to be desirable for developing countries. Inflows augment domestic savings, which tend to be small in the developing world, thereby encouraging long-term capital formation and sustained economic growth. International capital can also increase foreign reserves, which serve to protect a country from external shocks while simultaneously helping to stabilize fiscal policy (Laban and Larrain 1994, 118). The foreign investors who generate the inflows tend to defend international capital mobility on two grounds: (1) mobility allows investors to satisfy their risk preferences more satisfactorily through greater diversification, and (2) mobility is efficiency-improving world-wide, since capital flows allow savers in developed

countries to reap high returns on investment while simultaneously boosting investment and income in developing countries (Aninat and Larrain 1995, 2). Nevertheless, an abundance of inflows can be a mixed blessing.

The potential for peso appreciation posed the most serious problem for Chilean authorities. Since the late 1980s, Chile's development strategy was premised upon export expansion and "efficient" import substitution; keeping the exchange rate steady was a means to that end (Laban and Larrain 1994, 132-133). Exchange rate appreciation would have seriously compromised the competitiveness of Chilean exporters in the short-term while promoting a long-term reallocation of resources between tradable and nontradable sectors. This reallocation would have had a consequent negative effect on Chile's growth rate (Ffrench-Davis, Agosin, and Uthoff 1995, 134). However, in a small open economy like Chile, maintaining a stable exchange rate in the midst of large foreign capital flows tends to constrain the government's ability to regulate asset market equilibrium. This problem is exactly what is predicted by the classic Mundell-Fleming model, which states that "with a fixed exchange rate, perfect asset substitution, and free capital mobility, domestic authorities in a small economy lose total control over monetary policy" (Laban and Larrain 1994, 132). In Chile's case, Mundell-Fleming presented a serious policy problem: Chile's interest rate needed to be close to the world rate to prevent speculative capital inflows and the resultant appreciation, but the interest rate also had to be high enough to keep inflation in check.

Macroeconomic theory dictates that there may be an optimal government policy able to effectively maintain a desirable monetary equilibrium while simultaneously

mitigating unwanted exchange rate volatility. These theories are predicated upon assumptions of sticky prices, dynamic comparative advantages in the tradable sector, and the absence of a market in which to price the option to wait and see given irreversibility of decisionmaking (Laban and Larrain 1994, 132). Chilean authorities decided to implement the *encaje* to drive a wedge between national and foreign markets, thereby stabilizing the exchange rate while allowing for some supervision of monetary policy (Choudhri and Sharma 1996, 10).

The official government rationale for Chile's position on capital account intervention (and the *encaje* regime in particular) was carefully outlined in a 1995 paper authored by Chilean Finance Minister Eduardo Aninat and Chilean economist Christian Larrain. Aninat and Larrain argued that Chilean financial and capital markets were not perfectly efficient when left unregulated, and therefore tended to manifest externalities—disparities between social and private valuations—which suggested the possibility of optimal government policies to regulate capital inflows to reinforce the positive effects and minimize the negative effects. A fundamental principle of welfare economics is that every competitive equilibrium is Pareto-efficient given the assumptions that information is exogenous (unaffected by actions of market participants) and that a complete array of markets exist. Aninat and Larrain argued that neither of these assumptions obtained in the case of Chile's financial market. The two economists explained that all markets produce their own endogenous data streams, which are then fed back into the market dynamic. They also noted that many if not most financial investments are uncovered, implying a lack of completeness in the market (1995, 3).

Aninat and Larrain argued that these market flaws give rise to externalities which have real-world implications in the Chilean context. For example, a foreign bank that loans money to a Chilean entrepreneur values its return on investment more than it values that total rate of return of the entrepreneur's business. Projects that promise to be most profitable for a lender, and therefore most likely to obtain funding, will not necessarily be those that are most profitable overall. Additionally, the problem of incomplete information raises the specter of another type of externality: In credit markets, those who are "disposed to pay more may not be those believed by the lender to promise a higher expected return. . . expected returns may fall if interest rates rise, since default percentages tend to increase accordingly. . . rationing of credit may occur; therefore, even when excess demand for credit exists, lenders may avoid raising interest rates" (1995, 3).

Aninat and Larrain identified one additional type of externality associated with price imperfections. They argued that prices in financial markets do not always reflect accurate valuations over the medium or long term; "that is to say. . . market prices do not correctly reflect the actualized value of the flows which the asset in question would tend to generate rationally over time" (1995, 4). This externality implies that unregulated financial markets may attract suboptimal levels of investment that do not correspond with anticipated future rates of return. Chilean authorities appreciated the benefits of external savings but believed that these funds were being invested in a less than ideal manner; Chile wanted investment that would promote tradable goods. The unique dangers of external portfolio investment were also discussed in the Aninat and Larrain manuscript. Whereas direct foreign investment and loans granted by banks or other institutions are

long-term and negotiated, portfolio investments may be liquidated at a moment's notice. The potential for very short-term reversals in portfolio markets fosters uncertainty and volatility, especially in developing countries that are still constructing an informational infrastructure. When portfolio flows are high, volatility in portfolio investment can infect exchange rates and interest rates, creating larger, more serious macroeconomic disruptions and fostering the development of long-term disincentives for both foreign and domestic investment (1995, 3-4).

Aninat and Larrain concluded by arguing that imperfections in financial markets are exacerbated by the uncertainty of ever-changing external conditions. Fluctuations in world savings or interest rates impact the influx of international capital in ways that are difficult to predict, and may ultimately provoke severe economic adjustments. When faced with unfavorable external conditions, developing countries are frequently forced to take radical action. For developing countries that are still building their international reserves, any decline in capital inflow has an immediate impact on domestic spending, which will have spillover effects on the current account and the balance of payments. A drop in capital flows will likely hurt domestic production "given the natural rigidity which hampers the reallocation of resources" that can provoke a longer-term spiral toward lower investment (1995, 4). Larrain and Aninat pointed to the Latin American adjustment of the 1980s, specifically the adjustments undertaken by Argentina and Mexico, as events associated with these kinds of dynamic external factors.

Assessing Bargaining Power

The first dimension of dependence assesses the extent to which Chilean intrinsic ideological interests were dependent upon eliminating capital controls. All available information underscores the fact that Chilean negotiators and policymakers believed in the power of the *encaje*; indeed, Chilean government officials were upholding their regime as a model for other developing countries to imitate. At an IMF-World Bank meeting in Washington D.C. in October 1996, Finance Minister Aninat publicly admonished developing countries to wait to open their capital accounts until their economic structures, their legal systems, and their regulatory supervisory capacities were all sufficiently mature (Troncoso R. 1996). The very fact that the Chilean Finance Minister co-authored the definitive treatise defending capital controls regime demonstrates just how important the ideological *encaje* interest was to the Chilean leadership. Therefore, this dimension is assessed as low power.

The second dimension: To what extent did the fulfillment of Chilean ideological interests in legitimizing the *encaje* depend upon this relation with Canada, as opposed to other ongoing relations with other countries? Chile's constitution precludes preferential treatment investment provisions. Therefore, whatever terms Chile negotiated with Canada would automatically become law for all investors in Chile. Clearly, Chile's interests in keeping its *encaje* was completely dependent upon this negotiation with Canada, equating to low power along the second dimension of dependence.

The third dimension reflects the extent to which there were other negotiating items or other parties that presented alternative ways of fulfilling these Chilean intrinsic

interests. Evidence shows that Chileans were unwilling to substitute other instruments for the *encaje*. Only Canada was starting from a NAFTA template that called for complete capital account liberalization—the U.S. did not have fast-track, and the Chile-Mexico FTA had not been modeled on the NAFTA. In sum, Chile had few alternatives, corresponding to low power along the third dimension of dependence.

Chile's status in the context of this interest was LLL, or low power across all dimensions of dependence.

Instrumental Strategic Chilean Interests

Establishing preferential trade agreements, especially with the United States, had been a long-standing political and economic Chilean objective. The Chilean leadership was interested in demonstrating that it could maintain impressive levels of export-led growth while eschewing the political isolation of the Pinochet era.

The Chilean government dearly wanted a trade deal to demonstrate Chile's value as a partner of the United States.

It was assumed that such a free trade deal would also forestall any attempts by elements in the military and their right wing supporters in the business community to return to power. More importantly, however, it would signal to Washington the irreversibility of Chile's economic restructuring and reforms, considered the most advanced in Latin America; demonstrate to potential investors the stability and future of Chilean prosperity; and would be an important message to the largely right-leaning Chilean business community that the government was able to deliver the goods (Bailey 1995, 100).

During negotiations, Canadian negotiators speculated that Chile was holding firm to the *encaje* to retain a bargaining chip for subsequent negotiations with the U.S.

According to a Canadian official close to the negotiations, "we thought maybe they didn't want to give everything away to us, so there would still be something left to trade off during NAFTA talks" (Interview #7, 1999). Chilean Treasury Minister Christian Larrain acknowledged the significance of the CCFTA in general, and the *encaje* in particular, in the context of future negotiations with the United States: "On the *encaje* issue, negotiating with Canada set an important precedent in that a member of NAFTA accepted that Chile maintain regulations crucial for its economy. . . this has been accepted by Canada, and therefore sets a precedent for any negotiations and future extensions of financial service negotiations in the future of NAFTA" (La oferta chilena 1996).

Assessing Bargaining Power

The first dimension of dependence: To what extent did the fulfillment of Chile's strategic interest in positioning itself for a free trade agreement with the U.S. depend upon the *encaje*'s elimination? The quote by Larrain underscores the importance of Chile's strategic interest in this area. Both sides recognized the value of the *encaje* as a crucial bargaining chip. This evidence suggests Chilean low power along the first dimension.

The second dimension: To what extent did the fulfillment of Chilean interests in positioning itself for a free trade agreement with the U.S. depend upon this relation with Canada, as opposed to other ongoing relations with other countries? Chile could do no more to facilitate its NAFTA accession than to negotiate the CCFTA with Canada. Although Chile was establishing itself in other multinational fora like the Cairns group

and APEC, signing the CCFTA was a key means of preparing to becoming a NAFTA member. This equates to low power along dimension 2.

The third dimension: To what extent were there other negotiating items or other parties that presented alternative ways of fulfilling these instrumental interests? There was no other party besides Canada with which to negotiate such a NAFTA-stepping stone agreement. The FTA with Mexico had already been signed and the two countries had already dismissed the idea of re-negotiating their agreement to make it more NAFTA-ready (Interview #7 1999).

In terms of other negotiating items, there were, to some extent, alternatives. According to the U.S. Congressional Research Service's Report to Congress (CRSRTC), the CCFTA "treats some areas differently than the NAFTA such as services, investment [*encaje*], and some rules of origin" (Hornbeck 1997, 14). However, of these three issue areas, only the *encaje* was a bargaining chip based upon key Chilean interests—the other issues reflected Canadian interests. The CRSRTC goes on to explain that "the one critical issue that developed in the negotiations was Chile's controls on foreign capital. . . Canada, however, accommodated Chile's need to manage capital flows. . . These and other issues mentioned above may be the subject of active debate should NAFTA accession move forward in the United States" (1997, 14). Given the lack of alternatives to negotiating with Canada, combined with the fact that the *encaje* stood out as the one, critical Chilean bargaining chip useful for negotiating future NAFTA accession, Chile should be considered to have had low power along this third dimension of dependence.

Chile's status in the context of this interest, as in the other two interests, was LLL, or low power across all dimensions of dependence.

Concluding Remarks

Canada registered HHH, high power across all interests and dimensions. Chile's status, LLL, was exactly the opposite. These results are illustrated in table 2, below.

Countries & Interests	1st Dimension	2nd Dimension	3rd Dimension
Canada's Intrinsic Business Interest	High Power	High Power	High Power
Canada's Intrinsic Ideological Interest	High Power	High Power	High Power
Canada's Instrumental Strategic Interest	High Power	High Power	High Power
Chile's Intrinsic Business Interest	Low Power	Low Power	Low Power
Chile's Intrinsic Ideological Interest	Low Power	Low Power	Low Power
Chile's Instrumental Strategic Interest	Low Power	Low Power	Low Power

According to table 1, HHH vs. LLL equates to an SD number of 3, corresponding to a mid-level degree of structural dependence. Given this SD number, hypothesis 12 of the IR-D model predicts that if parties are bargaining distributively over the division of a fixed pie (eliminating chances for creative problem-solving approaches) negotiations will tend to be protracted and contentious. The country corresponding to HHH (Canada) is expected to make most of the concessions, and the other party (Chile) is expected to enjoy a disproportionate share of the negotiated outcome. This characterization perfectly describes the CCFTA *encaje* situation. Canada and Chile were fighting over the *encaje*,

each pursuing gains at the expense of the other in a largely zero-sum competition. The negotiation was clearly contentious, but in the end, Canada yielded. Though the magnitude of the Canadian concession was somewhat mitigated by the Chilean guarantees mentioned in chapter three, the distribution of the negotiated outcome clearly favored Chile. The result is exactly what the IR-D model would predict.

How sensitive is the IR-D model to changes in data? To what extent do the model's outputs change as the inputs change? A quick survey of alternate hypothetical situations demonstrates the model's robustness across a range of possible variations. For example, if, after conducting the interviews and collecting the evidence, Canada had been found to correlate with (LLL) and Chile with (HHH), the IR-D model predicts Chile would have yielded almost all of its *encaje* protections to a firm, unyielding Canada after protracted negotiations. If instead, the Canada-Chile relation had been, say LLL vs. LLL (with an SD number of 0), the IR-D model would predict Chile and Canada to reach a quick and friendly compromise. HHH vs. HHH (again, an SD number of 0) would have corresponded to very bitter negotiations ending in a similar 'split-the-difference' outcome, assuming a settlement was reached at all. If the Canada-Chile relation had equated to 5 (HHL vs. LLH, for example) the IR-D model predicts very speedy, easy negotiation marked by total capitulation by Chile.

This analysis demonstrates that, had it been possible to gather adequate data on both countries at the onset of negotiations, it would have been possible to predict the negotiated outcome finalized eleven months later. Of course, problems of data collection are significant, especially while negotiations are underway. Uncovering the necessary

information *ex ante* would have been a formidable research challenge. Nevertheless, the IR-D model, and its complementary methodology, does at least provide a heuristically powerful tool for explaining and predicting negotiating behavior and outcomes.

CHAPTER FIVE:

CONCLUSION

This paper began by asking how asymmetries of power and dependence determine bargaining behaviors and outcomes. Asking this question provoked a survey of the literature, which revealed that there was no adequate, robust model of inter-state bargaining explicitly predicated upon the significance of power and dependence. Yet, power and dependence are commonly-used words in international relations literature, and the terms are conventionally used in a bargaining context as well. To fill the void in both fields, a framework was built from IR theory, and an IR derived model was constructed within that framework. This model generated three concluding hypotheses. To put the model through its paces and probe its plausibility, it was subjected to case study analysis within the context of CCFTA *encaje* negotiations. The IR-D model's hypotheses were found to match the actual CCFTA negotiated outcome; rationale was consistent with reality.³³ This chapter concludes the thesis by addressing some of the problems and criticisms that could be raised with this study, reviewing lessons learned about bargaining power, discussing the policy implications of the IR-D model, and suggesting paths for future research.

³³ To further plumb the depths of the negotiation process, Appendix A shows how the inductive zone of agreement approach may be utilized to more fully explain the way Canadian and Chilean power and dependence relations evolved over time to produce the agreement.

Problems and Criticisms

A problem often associated with political science frameworks in which statistical information is largely absent is that it becomes virtually impossible to assess the explanatory power of the components of the independent variable. Another problem stems from the fact that all variables other than the independent variables are assumed to be held constant when trying to explain behavior and outcomes. Though it is theoretically necessary to hold other factors constant when analyzing an argument's heuristic power, *ceteris paribus* does not necessarily reflect the state of the real world.

Moreover, one might argue that this study offers a very narrow view of bargaining behaviors and outcomes, since only one set of independent variables is identified. Does this imply that no other variables are important, or that they are all aggregated under the rubric of the one independent variable identified? It is possible that other significant variables exist and remain unknown (Robert 1995, 301).³⁴ Additional work is necessary to isolate and test more comprehensive bargaining models that add heuristic power without unduly encumbering the methodology.

Another possible criticism of the model relates to issue-linkage. This thesis assumes there was no linkage of issues, and that the negotiations in the *encaje* area was self-contained. To the extent that there are linkages of issues, this model's explanatory power is definitely reduced. In the CCFTA context, sources told the author there were no linkages between the *encaje* and other areas, which may prompt one to question the

³⁴ This idea of indirect influences is the reason for including Appendix A; the passage of time is exactly one of these influences, though the personality of negotiators is another possible indirect influence that

accuracy of the anecdotal data and interview information collected and utilized herein. It is true that some of the interviewees may have attempted to misrepresent the facts. However, by interviewing multiple people from each of the two countries involved and using resources published by institutions in both countries, the author attempted to minimize this risk and confirm all information as well as possible.³⁵

Lessons Learned

On its most fundamental level, the IR-D model really pivots upon the age-old questions. *Cui bono?* Who benefits—and even more importantly, who loses? The first two dimensions of dependence (and the first dimension even more than the second) really drive the model, and represent nothing more than a sophisticated method of assessing how much each party stands to lose on a particular negotiating item. The country with more to lose is the one who is more likely to be a tougher negotiator. Ergo, the outcomes hypothesized in chapter two. The counterintuitive element of the model stems from its implications about the link between dependence and outcomes. Countries that are significantly dependent upon certain negotiating outcomes are ascribed relatively low levels of potential bargaining power, but high levels of actual bargaining power—and are predicted to enjoy asymmetrically large gains from negotiation. Countries that are less dependent on specific outcomes are ascribed relative high levels of potential bargaining power, but are expected to expend little effort and therefore exhibit commensurably low levels of actual bargaining power—these nations are not predicted to perform very well.

could also help to explain a negotiation outcome.

As Hirschman suggests, these kinds of relationships are expected to arise when small countries are bargaining with larger, more worldly nations. But issue-specific dependence is not limited to great power-small power relations, though it is a common characteristic of this kind of bilateral interaction. The lesson here is not about a nation's absolute size, or even its relative size—the lesson is about issue-specific dependence, namely that these types of relations spur the relatively dependent party to maximize all power at its disposal, while the relatively domineering party does not.

That said, there is nothing necessarily inefficient, mistaken, or even embarrassing about conceding. Though yielding is commonly associated with moving away from a favorable position, there are situations in which it makes sense for negotiators to back down.³⁶ Indeed, yielding is frequently the rational, appropriate, and efficiency-improving response when negotiators find themselves playing a chicken game, realigning interests and positions, or reacting to new information. In the CCFTA example there is evidence to suggest the presence of all three situations. On a slightly different, but related, note, just as the theory of rational ignorance suggests it may be smart to be ignorant of unimportant information, the IR-D model hints that it may be a waste of resources for countries with important, complex, and numerous international obligations to focus carefully on relatively insignificant negotiations with dependent countries.³⁷

³⁵ Robert (1995) was used as a model for this section.

³⁶ Appendix A takes a closer look at this issue.

³⁷ One final lesson is suggested by the zone of agreement framework explored in Appendix A: namely, that tendencies to concede or contend may be enhanced over time as reservation prices rise and resistance points vary in response to ever-changing external factors. In the Canada-Chile context, rising endogenous costs of negotiation compelled each side to justify its position to itself throughout the process. The Chileans had no problem justifying their tough stance because their position was based on core interests

Policy Implications

The policy implications of these lessons are rather obvious. Small countries, take heart! Indeed, there is much hope for all countries that feel relatively powerless and dependent upon their counterparts across the bargaining table. Asymmetries of attention and desire are likely to favor the underdogs, the relatively dependent nations; the bigger and more powerful the adversary, the more likely that the adversary will be distracted by other responsibilities and entanglements.³⁸

For the big, strong countries, the advice is different. Relatively dominant, powerful countries (powerful in the three-dimensional sense of the word) should know their strength may well be a weakness. These countries are unlikely to commit much of their potential power to achieving their negotiating objective, especially if the process drags on and negotiations threaten to break down. Furthermore, when these powerful countries negotiate with weaker, dependent opponents, they should be expecting their counterparts' maximum effort. The IR-D model implies that countries with lots of bargaining power have a tendency to underestimate their counterparts and overestimate what they likely believe to be their vast structural advantage. The old cliché rings true for dominant, relative powerful countries: Never underestimate the enemy.

and high commitment. Moreover, the Chileans also had no real alternatives. Canada's reservation prices were very responsive to the passage of time precisely because the country was not as committed, enjoying high power along all three dimensions of dependence.

³⁸ Assuming that high commitment does not imply some special need for a speedy settlement, this analysis also implies that time tends to be on the side of the more committed country (see Appendix A).

Paths for Future Research

Chapter two's SD table and its corresponding three concluding hypotheses offer interesting paths for future research. It would be useful to test these hypotheses by collecting data on a wide range of negotiations, assessing structural dependence for the various bilateral relationships, and noting behaviors and outcomes. This could be done within the context of Canada-U.S. FTA (CUSFTA) negotiations, assessing the SD numbers on an issue-by-issue basis. CUSFTA talks would be an ideal vehicle with which to test the IR-D model because there is a wealth of information on the bargaining process as well as the bargaining outcomes. In the CUSFTA case both parties had relatively clear negotiating interests which are well-documented in both the academic and the mainstream literature. Additionally, interviewees are likely to be cooperative and candid when discussing the CUSFTA, since its function and its significance has been eclipsed by the NAFTA. By going chapter-by-chapter, negotiating item-by-negotiating item, it should be possible to test the IR-D model's three concluding assumptions. It would also be very interesting to apply the IR-D model to negotiations undertaken in the context of military conflict. The military realm is not commonly associated with the neoliberal framework of complex interdependence; yet, there is reason to believe that the IR-D model's heuristic realm may be useful in this context as well. The historical record is dotted with examples of times when small but determined nations negotiated successfully, withstanding military threats posed by more powerful adversaries. The U.S.-Vietnam conflict might be a good place to begin; the post-Gulf War negotiations between Iraq and the United Nations could also be investigated. By breaking down each

party's interests and items at stake, it should be possible to assess behavioral tendencies and generate outcomes.

Negotiation has been an important part of international relations for thousands of years. Yet, modern negotiation analysis has been heavily influenced by the Cold War. Most traditional analyses have dealt with cases marked by a symmetry of bargaining power between two actors, reflecting the U.S.-Soviet stalemate. Now, in the post-Cold War era, symmetric bi-polarity is an archaism. As Habeeb (1988, 2) notes, modern inter-state structure is characterized by an asymmetrical multipolarity defined by new centers of power and new issues—all of which combine to make it increasingly vital to utilize tools like the IR-D model to better understand the dynamics of negotiating in the shadow of power and dependence.

APPENDIX A: CONTRIBUTIONS FROM THE INDUCTIVE APPROACH

This paper began in chapter one by comparing negotiation analysis to medicine. Extending this metaphor, if the case-study is likened to a murder victim and the IR-D model is likened to the coroner who determines time and cause of death using deductive medical methods, then the purpose of this appendix is to adopt the role of the detective, who is able to explain the murder by combining deductively-derived forensic information with additional circumstantial evidence. Appendix A is more explanatory than analytic. It is based on an inductive tool of negotiation analysis known as the zone of agreement, which is akin to the idea of the contract zone briefly mentioned in chapter one. The zone of agreement approach, a classic concept within the bargaining literature, is used to provide a more complete, explicit explanation of how the passage of time (heretofore a force implicit within the IR-D model) worked to benefit the weaker country, thereby facilitating the negotiated outcome accurately predicted by the model.

Foundations of the Zone of Agreement Framework

A fundamental premise of bargaining analysis is that successful negotiation occurs when it can offer greater benefit than alternatives to negotiation. The subjectively determined value of no-agreement is assumed to delimit a negotiator's bottom line, the least that one is willing to accept. BATNA (the best alternative to a negotiated agreement) is related to, but does not quite equate to, propitious times for negotiation.

BATNA and an assortment of cognitive factors that change over time are assumed to work together to determine whether a particular negotiated outcome will be favorable (Blount and Neale 1991, 386).

Negotiation analysis traditionally assumes a zone of agreement that is defined by the negotiators' overlapping acceptable outcomes. The zone's boundaries are delimited by resistance points which determine whether negotiation will occur. Successful negotiations ultimately depend on these resistance points. Low resistance points are equivalent to a wide zone of agreement. Given a hypothetical situation in which a negotiated settlement would be better than all alternatives to negotiation, resistance points would not exist. In many situations, resistance points exist and are affected by the best alternative to a negotiated agreement (Blount and Neale 1991, 382).

But BATNAs cannot be assumed to be equivalent to resistance points. BATNAs are exogenous to the costs and benefits of the actual negotiating process itself, and the very act of negotiating can entail costs (in terms of time, principal-agent fees, reputational blemishes, etc.) which change as negotiations progress. If those costs are viewed as investments in negotiated outcomes, and if one equates negotiated agreement with the return on that investment, then return on investment is zero when negotiations fail to achieve a settlement. Enter the concept of reservation price; reservation prices include BATNA but also factor in the costs of non-agreement that are endogenous to the negotiation itself (Blount and Neale 1991, 381-383).

Since reservation prices offer a BATNA-superior representation of the dynamically driven subjective value accorded to non-agreement, it would be easy to

mistakenly assume that reservation prices equal resistance points. While there is evidence to suggest that reservation prices help to determine resistance points, the two values are not always identical. This inequality is due to the fact that a negotiator's judgment of alternatives to agreement is not just a function of BATNA and the real-time transaction costs of negotiation. Rather, resistance points are a function of BATNA, reservation prices, and the cognitive psychological and social effects of learning, biases, and time inconsistencies that result from interactive bargaining (Blunt and Neale 1991, 381-383).

Although the IR-D model recognizes the role played by cognitive factors, the zone-of-agreement framework emphasizes these factors' evolution over time. The IR-D model hypothesizes about behavioral tendencies rooted in structural dependence; the zone-of-agreement framework explains the way these tendencies manifested themselves over the course of negotiations to ultimately allow for an agreement. Therefore, the two approaches ask different, but not inconsistent, questions about the negotiation process. Do different approaches mean different units of analysis? Not necessarily. Though the zone-of-agreement approach does work with cognitive phenomenological factors, the unit of analysis is still assumed to be the nation-state, as it was within the IR-D model. This is because in both approaches all cognitive factors are implicitly aggregated out of the individual context and attributed to the country as a whole. In the context of the CCFTA case this kind of aggregation is an honest and realistic simplification. Mainstream Canada paid no attention to the CCFTA negotiations, and therefore the only Canadian entities with strong opinions were the government (DFAIT) and the domestic businesses involved

in the Chilean market—evidence and common sense strongly suggest the government's opinion was consistent with the interests of its business constituency. In Chile the CCFTA enjoyed a much higher profile, but again the government's interests reflected the concerns of its populace, a citizenry that was well apprised of the value of the *encaje* regime.

In the following section, the zone-of-agreement framework will examine the evolution of Canadian and Chilean national interests over time using the idea of resistance points to explain more about how and when the settlement was reached, and to show how the passage of time served the interests of the more vulnerable, dependent Chilean negotiators.

CCFTA Negotiations

When CCFTA negotiations began in January 1996, Canadian newspapers predicted that an agreement would be achieved quickly and easily. In actuality, the process took 11 months and almost broke down over the critical *encaje* issue. Agreement was reached only after the Canadians made a major concession. How can the zone of agreement framework help to explain the bargaining process?

At any given time the CCFTA's zone (or lack of a zone) of agreement was defined by the negotiators' range of acceptable outcomes, which were in turn delimited by their resistance points. Resistance points were a function of negotiators' BATNAs, reservation prices, and cognitive biases. In January 1996, when Canada and Chile first sat down at the bargaining table, Canadian and Chilean BATNAs were the pre-CCFTA status quo:

for Canada, this meant a functioning Chilean capital control regime, an 11 percent Chilean tariff, and the absence of a bilateral bridge to NAFTA or the FTAA. The concept of reservation price had little applicability at this early point in the negotiations, but cognitive biases were present on both sides.

The Canadian team possessed two significant cognitive biases. Firstly, Canada's intrinsic ideological interest in promoting free trade and investment was premised on the cognitive understanding that free trade meant liberalization of both current and capital accounts. The second significant Canadian cognitive bias related to the fast-track debate and Canada's instrumental strategic interest in using a NAFTA template to negotiate the CCFTA so as to assure a relatively easy Chilean accession. According to one source, "the idea was that if the CCFTA were identical to the NAFTA it wouldn't require modification when Chile ultimately became a NAFTA member" (Interview #6 1999). At this early stage in the negotiation it was impossible to predict whether Congress would approve fast-track. Nevertheless, Canadians were hoping that by the conclusion of the CCFTA process Clinton would have the necessary Congressional authority. This hope is a significant cognitive phenomenon.

Chile did not share these biases and would have preferred the BATNA of a pre-CCFTA status quo to an agreement that eliminated the *encaje* regime. As negotiations continued, Canada tried to convince Chile to relinquish its capital controls but Chile could not be persuaded. The Chilean authorities firmly believed that eliminating the capital controls would seriously threaten the security of their domestic economy.

Mexico's peso crisis in 1995 had demonstrated the risks of joining NAFTA and liberalizing capital flows. Chile's fears were also a significant cognitive phenomenon.

The Chilean strategy, a commitment to unyielding, presented Canada with a choice: yield or continue to contend. Yielding and contending are the two behaviors that move negotiators' resistance points forward and backward along the zone of agreement. An unyielding bargaining strategy makes successful agreement harder to achieve, but ensures that settlements that are reached remain near the negotiator's initial position. Yielding accomplishes the opposite effect; when negotiators make concessions they are improving the probability of a negotiated settlement while moving away from their positions. These verities do not necessarily imply that the softer a party acts, the less the chances of achieving a favorable agreement. There may be risks associated with outcomes achieved via contending, and there are times when unilateral concessions-making may be an optimal strategy.

Conventional wisdom dictates that unilateral yielding would probably promote relatively unfavorable outcomes in a real world bargaining situation, but the humble chicken game provides a counterfactual scenario. This behavioral model, which takes its name from a game played by two drivers racing their cars directly towards each other, assumes two rational negotiators who can choose to be either completely yielding or completely unyielding. Yielding is equated with swerving one's car off the road, whereas unyielding may be understood as throwing the steering wheel out the window. The defining quality of a chicken game is that the worst possible outcome results when both parties exhibit unyielding behavior. In other words, when playing a chicken game it is

better for one party to yield once the other has committed to a strategy of contending (Pruitt and Carnevale 1993, 23).

Positional movement along a zone of agreement can also reflect a realignment of interests with positions; when negotiators' positions do not accurately reflect their interests, those positions should be realigned accordingly (Fisher and Ury 1984, 1-14). Therefore, if yielding corresponds to aligning interests with positions, concessions-making may actually be beneficial to both sides. Extending this reasoning confirms that it is wrong to casually dismiss concessions-making as equivalent to a move away from a favorable position. Equating yielding with losing fails to consider the benefits of learning through the course of negotiations, and therefore assumes a very static situation in which exogenous and endogenous factors are unchanging and both parties have access to perfect information (Underdal 1991). These assumptions are highly likely to be unrealistic, especially in a protracted negotiation.

Canada tested Chilean commitment to the *encaje* by adopting an equally unyielding position on the issue, but when talks broke off in September it was clear that there was no overlap between the zone of outcomes acceptable to Chilean and Canadian negotiators. The Canadians responded, within their own cognitive frame, by reviewing their interests. At this point Canada's BATNA was still the pre-CCFTA status quo, but by then Canadian negotiators had a reservation price as well. Nine months of effort had been invested in the process and the public relations risks had increased. Numerous news article, pamphlets, and press releases had been commissioned by the Department of Foreign Affairs and International Trade (DFAIT), in addition to the Choudhri-Sharma

paper and a *CanadExport* periodical issue dedicated to Chilean business opportunities. Endogenous costs of non-agreement associated with time and potential reputational blemishes contributed to Canada's ever-expanding reservation price. And, as Canada's reservation price grew, the Canadian resistance point fell, increasing the odds for a successful zone of agreement.

Canada's cognitive biases had also evolved in response to changing external factors. The Canadian team had grown to understand and appreciate the Chilean perspective, and was in the process of changing its mind about the importance of complete capital account liberalization for a developing country like Chile. Furthermore, Clinton's odds of receiving fast-track authority had worsened significantly in the nine months since talks had opened. Political developments in the U.S. killed hopes for a quick fast-track approval after the CCFTA's passage. Both cognitive shifts decreased the significance of the two corresponding interests, leaving Canada's intrinsic interests in promoting Canada-Chile commerce as the only objective unchanged over the passage of time. After polling the Canadian business lobby and confirming that the *encaje* was really no more than a nuisance, Canadian negotiators saw the *encaje* situation as a chicken game where the stakes for losing were high, and the benefits of winning (intimidating Chile into yielding) were relatively low. Canada decided, logically, that it could accept the *encaje* if Chile offered additional protections in other investment-related areas and promised to move its regime ever-forward towards greater liberalization—at its own pace, of course. Chile was ready to comply, because the Canadian request was actually consistent with Chile's national interest in moving prudently towards a more

open financial system. Within the context of the zone of agreement framework, the two cognitive shifts combined with the ever-increasing reservation price lowered Canada's resistance point until it overlapped the Chilean resistance point, creating a shared acceptable outcome. Once the overlapping zone of agreement was identified it was relatively simple for both sides to set a date for the signing ceremony.

Concluding Comments

The Canadian concession demonstrated the significance of cognitive development, the importance of the concept of a reservation price, the dynamic nature of bilateral negotiations, and the potential for unilateral concessions-making to improve negotiated outcomes for both sides. Moreover, the passage of time created forces that exploited Canada's low commitment to the *encaje* issue. As reservation prices increased and cognitive factors changed, Canada found itself jeopardizing the entire CCFTA negotiation process over (what was for them) a non-essential issue that their own business constituencies were not overly concerned about. Their resistance point sunk low and overlapped the Chilean position—which had not changed precisely because Chile's commitment was so high and, correspondingly, because its bargaining power was so low. The zone of agreement approach is useful here because it provides a textured, nuanced account of the CCFTA bargaining process that is consistent with the IR-D model. Furthermore, this approach teaches new lessons about the role of time in negotiation and the way that time and commitment interrelate to provoke outcomes.

APPENDIX B:
CANADA-CHILE FREE TRADE AGREEMENT--ANNEX G-09.1

Canada-Chile Free Trade Agreement
Annex G-09.1

1. For the purpose of preserving the stability of its currency, Chile reserves the right:
 - (a) to maintain existing requirements that transfers from Chile of proceeds from the sale of all or any part of an investment of an investor of Canada or from the partial or complete liquidation of the investment may not take place until a period not to exceed
 - (i) in the case of an investment made pursuant to Law 18.657 Foreign Capital Investment Fund Law ("Ley 18.657, Ley Sobre Fondo de Inversiones de Capitales Extranjeros"), five years has elapsed from the date of transfer to Chile, or
 - (ii) Subject to subparagraph (c)(iii), in all other cases, one year has elapsed from the date of transfer to Chile;
 - (b) to apply a reserve requirement pursuant to Article 49 No. 2 of Law 18.840, Organic Law of the Central Bank of Chile, ("Ley Organica del Banco Central de Chile") on an investment of an investor of Canada, other than foreign direct investment, and on foreign credits relating to an investment, provided that such a reserve requirement shall not exceed 30 percent of the amount of the investment, or the credit, as the case may be;
 - (c) to adopt
 - (i) measures imposing a reserve requirement referred to in (b) for a period which shall not exceed two years from the date of transfer to Chile,
 - (ii) any reasonable measure consistent with paragraph 3 necessary to implement or to avoid circumvention of the measures under (a) or (b), and
 - (iii) measures, consistent with Article G-09 and this Annex, establishing future special voluntary investment programs in addition to the general regime for foreign investment in Chile,

except that any such measures may restrict transfers from Chile of proceeds from the sale of all or any part of an investment of an investor of Canada or from the partial or complete liquidation of the investment for a period not to exceed 5 years from the date of transfer to Chile; and

- (d) to apply, pursuant to the Law 18.840, measures with respect to transfers relating to an investment of an investor of Canada that
 - (i) require that foreign exchange transactions for such transfers take place in the Formal Exchange Market,
 - (ii) require authorization for access to the Formal Exchange Market to purchase foreign currency, at the rate agreed upon by the parties to the transaction, which access shall be granted without delay when such transfers are:
 - (A) payments for current international transactions,
 - (B) proceeds from the sale of all or any part, and from the partial or complete liquidation of an investment of an investor of Canada, or
 - (C) Payments pursuant to a loan provided they are made in accordance with the maturity dates originally agreed upon in the loan agreement, and
 - (iii) require that foreign currency be converted into Chilean pesos, at the rate agreed upon by the parties to the transaction, except for transfers referred to in (ii) (A) through (C) which are exempt from this requirement.

2. Where Chile proposes to adopt a measure referred to in paragraph 1(c), Chile shall, to the extent practicable:

- (a) provide in advance to Canada the reasons for the proposed adoption of the measure as well as any relevant information in relation to the measure, and
- (b) provide Canada with a reasonable opportunity to comment on the proposed measure.

3. A measure that is consistent with this Annex but inconsistent with Article G-02, shall be deemed not to contravene Article G-02 provided that, as required under existing

Chilean law, it does not discriminate among investors that enter into transactions of the same nature.

4. This Annex applies to Law 18.840, to the Decree Law 600 of 1974 ("Decreto Ley 600 de 1974") to Law 18.657 and any other law establishing a future special voluntary investment program consistent with sub-paragraph 1(c)(iii) and to the continuation or prompt renewal of such laws, and to amendments to those laws, to the extent that any such amendment does not decrease the conformity of the amended law with Article G-09(1) as it existed immediately before the amendment.

5. For the purposes of this Annex:

Chilean juridical person means an enterprise that is constituted or organized in Chile for profit in a form which under Chilean law is recognized as being a juridical person;

date of transfer means the settlement date when the funds that constitute the investment were converted into Chilean pesos, or the date of the importation of the equipment and technology;

existing means in effect on October 24, 1996;

foreign credit means any type of debt financing originating in foreign markets whatever its nature, form or maturity period;

foreign direct investment means an investment of an investor of Canada, other than a foreign credit, made in order:

- (a) to establish a Chilean juridical person or to increase the capital of an existing Chilean juridical person with the purpose of producing an additional flow of goods or services, excluding purely financial flows; or
- (b) to acquire equity of an existing Chilean juridical person and to participate in its management, but excludes such investment that is of a purely financial character and that is designed only to gain indirect access to the financial market of Chile

Formal Exchange Market means the market constituted by the banking entities and other institutions authorized by the competent authority; and

payments for current international transactions means "payments for current international transactions" as defined under the Articles of Agreement of the International Monetary Fund, and for greater certainty, does not include payments of principal pursuant

to a loan which are not made in accordance with the maturity dates originally agreed upon in the loan agreement.

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