Setting a Precedent: Negotiations with Somali Pirates

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Abstract

This paper provides a theoretical and empirical investigation on bargaining for ransom with modern-day Somali pirates. Motivated by the institutional background of negotiations on the ship owners’ side, we investigate a model featuring a sequence of bargaining situations with independently drawn buyer valuations, in which independently of realized value, the buyer in each bargaining situation faces a budget constraint, set by a third party (insurance companies). However, this constraint is initially privately known by the buyer, introducing reputational concerns for being budget constrained, and the seller needs to learn about it over time. The model has the feature that within each negotiation the offered price is weakly decreasing, but once a given price is accepted, all offered prices in subsequent negotiations are weakly higher than the former price. In short, accepting a given price reveals that the buyer’s type is not lower than that price, and creates a precedent for the future. The seller eventually approximately learns the budget constraint, but learning can be slow, and the rate at which the ultimate price level is approached is nonmonotonic over time. In the empirical investigation we use a unique dataset of 131 Somali hijackings. We find that the main qualitative predictions of the model hold: prices are drifting upward over time, for comparable ships. Moreover, higher past peak ransom amount per size of the ship (measured either in cargo capacity or size of the crew) is positively correlated with subsequent ransom amounts for per size, consistent with the prediction that past prices create a precedent, by eliminating the possibility of types with lower budget constraints. These results stay intact even when controlling for a wealth of ship characteristics.