

## **BUSINESS AS USUAL?**

### **ECONOMIC RESPONSES TO POLITICAL TENSIONS**

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## **Abstract**

Do political tensions between states impact their level of economic exchange? The international relations literature presents alternative theories about the relationship between economic and political affairs, with well-known arguments that trade prevents war and that alliance relations motivate trade. Less is known about whether smaller shifts in bilateral political relations produce corresponding shifts in economic exchange. We fill this gap with a study of US-French and Sino-Japanese ties over the past decade --two case pairs that allow us to compare varying levels of political tension given high existing economic interdependence and different alliance relations. Our central finding is that political tensions did not spill over onto economic relations in either case and business continued unaffected by the sharp deterioration of political relations. This finding demonstrates that media hype exaggerates the power of boycotts. It also raises important questions about the microfoundations for both realist and liberal theories about economic interdependence. We show that in an era of globalization, actors lack incentives to link political and economic relations. We argue that sunk costs in existing trade and investment relations and the interdependence of bilateral economic ties make investors and consumers unlikely to change their behavior in response to publicity about political disputes. Nevertheless, we raise the possibility of a threshold beyond which economic ties are no longer insulated from foreign policy disputes.

## **Introduction**

Do political tensions between two countries have economic consequences? While the potential economic implications of negative opinion polls and public discord between top leaders capture headlines through sensational reports about boycott movements, they have not been the focus of scholarly research. The international relations literature presents alternative theories about the linkages between economic and political affairs, with well-known arguments that trade prevents war and that alliance relations motivate trade. Less is known about whether smaller shifts in bilateral political relations produce corresponding shifts in economic exchange.

This paper examines whether periods of heightened political tensions produce any observable effect on economic transactions – especially trade and investment. By political tensions, we mean hostility between leaders, which can be observed in critical public statements and decline of summit meetings, and rising negative sentiment in the general population, which is reflected in public opinion, demonstrations, and media coverage. We place bilateral political relations on a continuum from normal relations, political tensions, economic sanctions, threats of force, to war. While most analysis of conflict behavior in international relations focuses on the higher intensity conflicts represented by sanctions or militarized disputes, we analyze the shift at the lower level from normal relations to political tensions. Although the stakes are smaller and usually not distributional conflicts, political tensions represent a more frequent occurrence than conflict disputes. Moreover, few states will move from normal relations to war without passing through a period of political tensions.

It is important to understand the effects of political tensions both for policy evaluation and for exploration of the microfoundations of theoretical arguments. To the extent that political tensions form a component in a state's calculation about the likelihood of future conflict escalation with a country, it represents a variable underlying realist theory. At the same time, to the extent that political tensions act as a catalyst for business lobbying to improve relations, it represents a variable underlying liberal theory. The focus in the existing empirical analysis on explaining the pattern of direct conflict neglects the need to test the threshold at which causal mechanisms connecting political and economic outcomes come into operation. This paper takes

a first cut at this task by evaluating linkages between politics and economics at the lowest level of conflict escalation when bilateral relations move into a period of political tensions.

Examples of political animosity between two countries being translated into consumer boycotts abound. For instance, the publication of the infamous caricatures of the Muslim prophet in Denmark led in January 2006 to a boycott of Lego toys and Danish dairy products in Saudi Arabia.<sup>1</sup> In April 2007, Russians were advised not to purchase Estonian goods or to vacation in Estonia after the removal of a Soviet-era World War II memorial to Russian soldiers had created political tensions between the two countries.<sup>2</sup> In May 2008, a vibrant internet campaign encouraged Chinese youths to stop shopping at Carrefour stores in order to protest the treatment of the Olympic torch in Paris and French government criticism of Chinese policy in Tibet. The media and business widely refer to such episodes and predict that political tensions will harm economic interests. But beyond the specific boycotts, what are the overall effects of political tensions on the bottom line of a country's economic well-being?

To answer this question, we examine the economic relations of the United States and Japan as the two largest economies. We begin with analysis of how their aggregate trade and investment patterns respond to negative events. Here we follow the approach of previous literature to model conflict as a continuous event count variable while taking advantage of a new events dataset and quarterly economic data for more fine-tuned analysis. Then we closely examine specific incidents of political tensions in the bilateral relationships between the United States and France and between Japan and China from 1990 to 2006. This choice of cases allows us to evaluate the effect of political tensions during the post-Cold War period in two different security contexts: between allies and between regional rivals. We closely examine the timing of shifts in political relations to observe any impact on aggregate trends in trade and foreign direct investment (FDI), as well as on iconic industries such as French wine and Japanese autos, and we compare them with the political and economic relationship with third countries.

We find no observable evidence that political tensions harmed economic relations (after controlling for material factors unrelated to the political tensions, such as GDP and the exchange

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<sup>1</sup> See for instance Hassan M. Fattah, "Caricature of Muhammad Leads to Boycott of Danish Goods," *The New York Times*, January 31, 2006.

<sup>2</sup> Galina Stolyarova, "Estonian Goods Face Boycott," *The St. Petersburg Times*, May 4, 2007.

rate between the two currencies). Analysis of the years from 1990 to 2004 shows that the number of negative events reported in the media does not reduce the trade or investment flows for either the US or Japan in their economic relations with other countries. Neither have they suffered economic harm from high profile political tensions with leading economic partners. Franco-American political tensions peaked during the rift over Iraq in 2003. Nevertheless, in 2004, trade and investment between the United States and France, its nemesis in the United Nations over Iraq, grew as rapidly as U.S. trade and investment with Britain, its loyal partner in Iraq. And ironically, McDonald's had one of its best years ever in France, making France its second most profitable market in the world. Japan and China have confronted an increasingly hostile political atmosphere created by controversies over history, territorial disputes, and rivalry for influence in the United Nations Security Council. During the five years of the Koizumi Administration (2001-06), these tensions led to anti-Japanese riots and boycotts in China and the suspension of high level diplomatic meetings. At the same time, bilateral trade and investment flows grew at a rapid pace and in 2004 China surpassed the United States, the unwavering ally, as the top trade partner of Japan.

These are puzzling findings, which counter both public commentary and many theoretical studies that link political and economic relations. This paper attempts to explain the paradox of solid, and even stronger, economic ties in the face of weakened political ties. The first section lays out the existing arguments in the literature about the spillover from the political to the economic realms and introduces our revised liberal hypothesis about why, in an era of globalization, actors lack incentives to link political and economic relations. We argue that sunk costs in existing trade and investment relations and the interdependence of bilateral economic ties make states, firms, and consumers unlikely to change their behavior in response to political disputes. The empirical analysis proceeds in two steps. Section two examines the effect of negative events on trade and investment flows for the United States and Japan. Section three probes more deeply into the Franco-American and the Sino-Japanese cases, where we also find no significant spillover. The final section explores the conditions under which we expect such spillover could happen and raises the possibility of a threshold beyond which economic ties are no longer insulated from foreign policy disputes.

## Theoretical Perspectives on Economic Interdependence and Conflict

The business community has shown genuine concern about the economic impact of political tensions and the media gives sensational coverage to stories of boycotts. But from a theoretical standpoint, why is it puzzling that low-level political tensions between two countries would have limited impact on their economic relations? In this section, we survey how the link between politics and economics has been addressed in the International Relations literature. We first establish that both realist and liberal theories generate expectations for feedback, and then present our theory about how economic relations in an era of globalization act as a buffer to absorb political shocks.

### Politics first

From the realist perspective, any political factor that influences how a country's government estimates the likelihood of future conflict with another country will affect their economic relations. States concerned about survival and in competition over relative gains must be cautious about economic activities that could create vulnerability or strengthen a future rival. While recognizing complementarities of economic and political goals in the long run, realist theory suggests that states maximize security interests even when this leads to suboptimal economic outcomes.<sup>3</sup>

Several examples of prominent theories support this expectation for political relations to affect economic ties. Joanne Gowa and Edward Mansfield argue that interstate alliances determine the pattern of international trade because states will have less concern about a security externality produced by gains from trade if it helps strengthen an ally rather than an adversary.<sup>4</sup> The central point is that trade negotiations assess not only economic interests but also the status of political relations. Shifts in alliance stability are also expected to influence economic

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<sup>3</sup> Kirshner, Jonathan, "The Political Economy of Realism," in Ethan Kapstein and Michael Mastanduno ed. *Unipolar Politics*. New York, Columbia University Press, 1999, pp. 71, 75.

<sup>4</sup> Joanne Gowa, *Allies, Adversaries, and International Trade*. Princeton: Princeton University Press, 1994. Joanne Gowa and Edward D. Mansfield, "Power Politics and International Trade," *American Political Science Review*, Vol. 87, No. 2, June 1993. Joanne Gowa and Edward D. Mansfield, "Alliances, Imperfect Markets, and Major-Power Trade," *International Organization*, 58, Fall 2004, pp. 775-805.

relations.<sup>5</sup> Further cross-alliance variation would occur as states change the weight assigned to their allies.<sup>6</sup>

A related argument is that “trade follows the flag” because business actors closely observe political relations and update their expectations about future conflict. Brian Pollins argues that importers trade with friendly countries in order to manage risk and minimize potential economic disruption, knowing that ties with adversary nations might be ruptured by foreign policy.<sup>7</sup> Moreover, consumers “express goodwill or solidarity toward those whom they identify as friends, while shunning or punishing those they perceive as foes.”<sup>8</sup> As a result, bilateral trade is lower when the participants are engaged in conflictual than in cooperative political relationships. Referencing events such as Willy Brandt’s Ostpolitik and the growth of U.S.-Egyptian trade after the Camp David Accords, Pollins notes, “it is not only alignment and open conflict that can affect trade but the broad orientation of states’ foreign policies toward each other.”<sup>9</sup>

Similarities in political systems and foreign policy orientations are important determinants of trade flows. States holding similar policy positions on most global issues are more likely to trade.<sup>10</sup> Shared democratic institutions also affect trade flows positively. Exporters and importers find it less risky to deal with countries that have similar economic and political systems because they are more knowledgeable about consumer tastes, business trends, and government regulatory constraints and because they have less fear of trade disruption.<sup>11</sup> In addition to shared values and institutions, trust also matters. Even when controlling for standard

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<sup>5</sup> Differentiation between allies and adversaries in trade flows is most important during the stable alliances of bipolar periods, and not during multipolar periods when alliances were more fluid. Joanne Gowa, “Bipolarity, Multipolarity, and Free Trade,” *American Political Science Review*, Vol. 83, No. 4, 1989: 1245-1256.

<sup>6</sup> Gowa and Mansfield, “Power Politics and International Trade,” p. 417.

<sup>7</sup> Brian M. Pollins, “Does Trade Still Follow the Flag?” *The American Political Science Review*, Vol. 83, No. 2, June 1989.

<sup>8</sup> Brian M. Pollins, “Conflict, Cooperation, and Commerce: The Effect of International Political Interactions on Bilateral Trade Flows,” *American Journal of Political Science*, Vol. 33, No. 3, August 1989.

<sup>9</sup> *Ibid.*, p. 739.

<sup>10</sup> William J. Dixon and Bruce E. Moon, “Political Similarity and American Foreign Trade Patterns,” *Political Research Quarterly*, Vol. 46, No. 1, March 1993, pp. 5-25. James D. Morrow, Randolph M. Siverson, Tressa E. Tabares, “The Political Determinants of International Trade: The Major Powers, 1907-1990” *American Political Science Review*, Vol. 92, No. 3, pp. 649-661, September 1998.

<sup>11</sup> Harry Bliss and Bruce Russett, “Democracy and Trade: Ties of Interest and Community,” in Gustaaf Geeraerts and Patrick Stouthuysen eds., *Democratic Peace in Europe: Myth or Reality*, Brussels: Free University Press, 1998; James D. Morrow, Randolph M. Siverson, Tressa E. Tabares, “The Political Determinants of International Trade: The Major Powers, 1907-1990” *American Political Science Review*, Vol. 92, No. 2, pp. 649-661, September 1998.

predictors of trade levels in a sample of European states with common political orientation, states with higher trust measured by Eurobarometer surveys have statistically significant higher levels of trade, portfolio investment, and direct investment.<sup>12</sup>

These arguments agree on the central claim that improving political relations encourages more trade, while worsening political relations reduces trade. In short, to the extent that the policy differences over Iraq weakened U.S. confidence in France as a reliable ally, it would reduce U.S. support for expanding trade with France relative to expanding trade with its staunch alliance partners such as Britain and Spain. For Japan and China, worsening political tensions only served to highlight that each views the other as a potential rival. This should have heightened concerns about a security externality from trade and led states to take measures to reduce economic interdependence. From the perspective of private economic actors, political tensions would act as a signal of potential future disruption in relations that could threaten investments. All else equal, business would be expected to respond to political tensions by risk diversification and movement to markets where governments had more positive political relations.

We can derive from these realist arguments the *hypothesis of politics first*: Rising political tensions will make governments favor a reduction of economic interdependence and business actors respond to negative signals about future prospects for stable bilateral relations. This hypothesis suggests that political tensions would lead to a downward trend of economic exchange with that country relative to stable or increasing economic ties with other countries.

### **Economics first**

By contrast, liberal theories of international relations have long emphasized the commercial peace argument that economic interdependence creates vested interests opposed to conflict. From Montesquieu to Adam Smith to contemporary liberals, scholars have argued that free trade encourages peace. In other words, economics prevails over politics. These arguments are based on the premise that political conflict harms economic interaction.

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<sup>12</sup> Luigi Guiso, Paola Sapienza, and Luigi Zingales. "Cultural Biases in Economic Exchange," NBER Working Paper No. 11005 (2004)

The “commercial peace” literature offers two mechanisms to explain why economic relations inhibit interstate hostilities.<sup>13</sup> First, the traditional view has been an economic interest model. Economic exchange and military conquest are assumed to be substitute means of acquiring the resources necessary for growth and security so that economic interdependence renders military conflict obsolete.<sup>14</sup> Private actors who expect to benefit from continued commerce lobby to restrain the state from engaging in conflict.<sup>15</sup> Second, in information models economic interdependence promotes peace by deepening transnational ties. Gartzke, Li, and Boehmer argue that states with interaction through trade and capital markets have policy tools short of war by which to signal their dissatisfaction with another state and demonstrate their own resolve.<sup>16</sup>

Both versions of the commercial peace argument depend on the assumption that political conflict harms economic interaction. In the economic interest models, fear of economic harm from deteriorating political relations creates the incentives to support good political relations. In the information models, observable economic harm from political conflict is necessary to provide the costly signal of resolve. Thus even lower threshold political tensions are relevant. As noted by Gartzke, Li, and Boehmer, much of the signaling through changes of economic behavior occurs below the threshold of militarized conflict in the bilateral relationship.<sup>17</sup>

We can derive from these liberal arguments the *hypothesis of economics first*: Rising political tensions will have a negative impact on economic relations that motivates business

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<sup>13</sup> Katherine Barbieri, *The Liberal Illusion: Does Trade Promote Peace?* Ann Arbor, MI: The University of Michigan Press, 2002. Edward D. Mansfield and Brian M. Pollins eds., *Economic Interdependence and International Conflict: New Perspectives on an Enduring Debate*, Ann Arbor, MI: The University of Michigan Press, 2003.

<sup>14</sup> See for instance Solomon Polachek, “Conflict and Trade” *Journal of Conflict Resolution*, No. 24, 1980, pp. 55-78. John Oneal and Bruce Russett, “The Classical Liberals were Right: Democracy, Interdependence, and Conflict 1950-1985” *International Studies Quarterly*, 41, No. 2, pp. 267-295, 1997.

<sup>15</sup> Copeland, Dale (1996). “Economic Interdependence and War: A Theory of Trade Expectations,” *International Security*, Vol. 20, No. 4 (Spring): pp. 5-41. Paul Papoyouanou. “Economic Interdependence and the Balance of Power,” *International Studies Quarterly* 41 (1997). Edward Mansfield. *Power, Trade, and War* (Princeton: Princeton University Press, 1994).

<sup>16</sup> Gartzke, Li, and Boehmer (2001), “Investing in the Peace: Economic Interdependence and International Conflict,” *International Organization* 55, no. 2: 391-438. For related arguments see Patrick McDonald, “Peace through Trade of Free Trade?” *Journal of Conflict Resolution*, Vol. 48, No. 4, August 2004, Paul Papoyouanou. *Power Ties: Economic Interdependence, Balancing, and War*. Ann Arbor: University of Michigan Press, 1999.

<sup>17</sup> *Ibid.*, p. 405.

actors to lobby their governments and signals high resolve to the opponent. Improvement of political relations would be expected to follow.

### **Economic ties absorb political shocks**

Both of these simplified versions of realist and liberal views on economic and security linkages are based on an image of state-society relations that no longer fits the current era of globalization. The “politics first” arguments portray the state having substantial control over economic actors while the “economics first” portray economic actors with substantial influence over political leaders. Yet debates on comparative political economy point to the need for a more nuanced approach to the balance between states and markets.<sup>18</sup> On the one hand, governments retain some autonomy to select how they respond to market pressures and interest group demands. On the other hand, the development of a global economy with low trade barriers, capital mobility, and multinational firms has constrained the ability of states to direct trade or investment flows to meet national goals. World trade rules allow for economic sanctions in the case of national security or international emergency, but raising tariffs over smaller political differences could lead to potential challenges and retaliation in WTO dispute settlement.<sup>19</sup> Governments that are competing to attract investment may be unwilling to intervene in economic affairs for fear of losing confidence of investors. Trade rules and capital mobility increase the cost of unilateral government actions to restrict commerce. We offer a revised version of a liberal hypothesis.

Instead of responsive linkages between economic and political trends, we may observe path dependence of economic relations as businesses consider sunk costs in existing trade and investment flows. Economists have developed theoretical models to show significant hysteresis exists in bilateral trade flows and empirical evidence indicates that firms export decisions are influenced substantially by consideration of these costs.<sup>20</sup> Once firms have established exports

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<sup>18</sup> Berger, Suzanne (2000) “Globalization and Politics” *Annual Review of Political Science* 3: 43-62. Keohane, Robert and Helen Milner ed. *Internationalization and Domestic Politics* (Cambridge University Press, 1996). Kahler, Miles and David Lake. *Governance in a Global Economy* (Princeton University Press, 2003).

<sup>19</sup> States can invoke GATT Article XXI national security clause to justify discriminatory trade barriers for either “time of war or other emergency in international relations.”

<sup>20</sup> Baldwin, Robert (1988) “Hysteresis in Import Prices: The Beachhead Effect,” *American Economic Review*, LXXVIII, 773-785. Dixit, Avinash (1989). “Hysteresis, Import Penetration, and Exchange Rate Pass-Through,”

to a particular market, they do not quickly change their trading patterns. FDI presents even greater sunk costs. The relationship-specific sunk costs of both trade and investment relations resist fluid adjustment by economic actors to changing political circumstances. Their estimate of political stability in the relationship occurs at the time of initial investment based on observable characteristics such as alliance relations that influence expectations of war. Subsequent events that adjust the expectations of war would be discounted by the sunk cost in existing economic relations. Firms are aware of the high penalties governments face from arbitrary intervention in the economy, which makes them relatively sanguine about the likelihood of politicized economic policies. As a result, weakening alliance ties or increasing animosity between rivals would not produce a parallel shift in economic ties.

The growth of transnational business also reduces the incentives for private actors to respond to political trends. Firms that are engaged in regional production networks that subcontract essential components of the manufacturing process may not easily find replacement suppliers. Those that sell to their own foreign affiliates have little reason to punish their own subsidiary for the policies of the foreign government. Consumers may be unable to express political preferences in ways that would connect with national origin of goods because leading American, European, and Japanese brands increasingly are attached to goods made elsewhere. Indeed, firms can manipulate consumer perceptions through marketing strategies that adapt to changes in the appeal of national identity. Advertisements using a national image to sell the product can be replaced with more localized appeals that disguise national identification.

Such stickiness in economic transactions works against any reversal prompted by realist concerns, but also undermines the credibility of the commercial peace mechanism – if everything goes forward with business as usual regardless of politics, there is no pressure applied for improving political relations. Businesses will fail to lobby, and no costly signal communicates preferences. Politics and economics are separate.

We can derive from these arguments the *hypothesis of separation of politics and economics*: Government actors will be reluctant to directly intervene in economic affairs for

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*Quarterly Journal of Economics*. CIV, 205-228. Roberts, M. and Tybout, J. (1997) "The Decision to Export in Colombia: An Empirical Model of Entry with Sunk Costs," *American Economic Review* LXXXVIII, 545-564.

political reasons, and private actors will be slow to change trade and investment patterns in response to worsening political relations. This hypothesis suggests that political tensions will have little effect on market interactions. On the one hand, the stability of economic relations in the face of political shocks may help to calm tensions. On the other hand, only states on the verge of war would experience economic damage and it is unlikely at that stage that economic interests will matter. This argument points to a different mechanism for liberal interdependence in which economic ties promote peace as a shock absorber of low level tensions rather than as a trigger for lobbying by vested interests or as a costly signal of preferences.

### **First Test: Measuring Political Tensions with Event Count Data**

Political tensions are more challenging to measure than war or sanctions because by definition they are less high profile and more frequent. Moreover, rather than having a definitive start and end date, tensions ebb and fade gradually in some cases or spike quickly in others. Previous literature has analyzed events data to measure levels of conflict and cooperation in dyadic relations among states, and we use this as our starting point. The Conflict and Peace Data Bank (COPDAB) was used by Pollins in his classic article showing the effect of political relations on bilateral trade relations.<sup>21</sup> This data series coded diplomatic events and was later extended by other studies. Joshua Goldstein introduced a weighting scale to facilitate aggregation of events in time-series analysis by weighting events according to significance.<sup>22</sup> The most recent and comprehensive events dataset for the period of our study extends on the approach of these earlier surveys using computer-coding of media reports.<sup>23</sup>

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<sup>21</sup> Pollins (1989) "Conflict, Cooperation, and Commerce."

<sup>22</sup> For example, an event categorized as a "call for action" would receive the smallest weight of 0.1, while an event that involved a formal complaint or protest would be weighted 2.4, a threat with force specified would be weighted 7, and military conflict would receive the maximum weighting of 10. Goldstein, Joshua (1992), "A Conflict-Cooperation Scale for WEIS Events Data," *Journal of Conflict Resolution*, Vol. 36 No. 2 (June): 369-385.

<sup>23</sup> The coding program reads daily Reuters news reports to extract a list of events that identify the actors involved, date, and type of event according to cue words (i.e. complain, demonstrate, seize). The program filters out routine updates such as stock reports or sporting events and has been shown to be as accurate as human coders. Gary King and Will Lowe, "An Automated Information Extraction Tool for International Conflict Data with Performance as Good as Human Coders: A Rare Events Evaluation Design," *International Organization* 57 (Summer 2003): pp. 617-642.

In regression analysis we examine the effect of negative events between the US and its partners on their level of economic exchange measured as exports, imports, and FDI outflows. A parallel analysis is conducted for negative events between Japan and its partners. The events data is available for the period 1990 to 2004 and we include all partners (152 countries). We implement a gravity model of trade to estimate bilateral export and import flows when controlling for the variables that provide a baseline expectation for trade levels between two countries. This specification explains the log value of trade as a function of the log of the joint income of two countries and the log of the distance between them.<sup>24</sup> We estimate the models with ordinary least squares and include the standard set of “resistance” factors such as geography (islands trade more, landlocked states trade less), trade agreements (GATT/WTO and PTA), alliance ties, and common language. We also add a control for the exchange rate, since shifts in currency values change the relative prices of imports and exports and therefore affect their demand and supply. A similar model is used to examine FDI outflows, with the addition of a control for the presence of a bilateral investment treaty between the two countries.<sup>25</sup>

We add to the standard specification an independent variable for political tensions, which is coded as the sum of negative events with either government or citizen level origin between two countries.<sup>26</sup> We also include a variable measuring the proportion of all events between the two countries in a dyad that involve high hostility levels, which uses the cutoff of events coded as more serious than a threat or warning, i.e. those involving demonstrations, formal reduction of relations, expulsion, seizure, or force.<sup>27</sup> Using quarterly trade data and summing events data for each quarter allows us to give more fine-tuned analysis. We examine the effect of negative events lagged by one period to account for the likely delay of response. Each model is estimated

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<sup>24</sup> For a theoretical discussion see James Anderson and Eric van Wincoop, “Gravity with Gravitas: A Solution to the Border Puzzle,” *The American Economic Review*, 93, no. 1 (March 2003): 170-192. For a well known recent application, see Andrew Rose, “Do We Really Know that the WTO Increases Trade?” *The American Economic Review*, 94, no. 1 (March 2004): 98-114.

<sup>25</sup> The specification for FDI differs from the gravity model because the dependent variable takes both positive and negative values and so cannot be analyzed in log form.

<sup>26</sup> The events data are available at <http://GKing.Harvard.edu>, and we use the variable that codes events with negative Goldstein scores. We sum the negative Goldstein scores for the dyad in each quarter.

<sup>27</sup> Iraq is omitted from the analysis because it has very limited data availability (GDP data is only available for 1990 to 1993) and highly skewed values of the “negative events” count (a mean of 394 with standard deviation of 623 compared with the sample mean for all other countries of 6.31 with standard deviation of 35). Kuwait is also omitted for lack of data availability on economic variables and skewed negative events scores. Our goal is to examine tensions rather than conflict, and so the omission of these two cases should not affect our conclusions.

first with quarter fixed effects to control for common shocks to the economy across periods and including the standard gravity model variables to explain country variation. A second estimation drops the time-invariant variables and uses country fixed effects to control for country specific features. This specification analyzes how variation of events over time within a particular dyad relationship influences their economic exchange.

The results shown in table 1 and 2 indicate that there is no significant relationship between negative events and economic relations. Since both variables measure negative events, the existing literature would expect the measure of political tensions and hostility to have a negative effect on economic flows. In none of the U.S. models (table 1) do political tensions measured by the negative events score of the dyad or hostile events as proportion of total events reach standard significance levels, and the sign is in the wrong direction for the models that do not include country fixed effects. Further analysis suggests there may be a negative effect on U.S. exports, but the results are sensitive to specification and substantively small.<sup>28</sup> US imports and FDI flows appear completely impervious to an increase of tensions and the relative level of hostility. The Japanese evidence is even more surprising – looking at the data one would have to conclude that Japanese exports and FDI increase as a result of tensions! Since the events data are lagged, it seems unlikely there is reverse causation where an increase of FDI or exports causes negative events. Increasing the lagged period for events variables does not substantively change the conclusion. The effect of negative events on economic relations for these two major economies appears to be minor.

*Tables 1 and 2 here*

These results are surprising and may suggest simply problems in the measurement of political relations. One can be skeptical about whether coding media reports and using a scale of events significance will capture the kind of political tensions that would be expected to have any effect on economic relations. The mean negative score for relations between the US and Japan (71) is higher than the score for relations between the US and Russia (47), which suggests that some issues such as tensions over economic relations are also captured as negative events. Media coverage may be more comprehensive for relations with certain countries. The mean negative events score between the US and Australia (16.5) is higher than with New Zealand (3.1), even

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<sup>28</sup> The negative events coefficient only becomes negative and significant for the fixed country effects model of US exports when dropping the control for hostility. The coefficient is -0.015 (standard error 0.007, p-value 0.025).

though Australia has enjoyed a particularly close relationship with the United States as they have joined forces in two conflicts in the Gulf and signed a PTA in 2004. The low score for New Zealand may simply be a function of little media coverage of issues between the two countries. These concerns all highlight the need to look more closely at specific cases of political tensions where one can identify the exact timing and nature of the shock to political relations and follow the reactions of states and private actors.

## **Evidence from Two Recent Instances of Political Tensions**

The Franco-American and Sino-Japanese bilateral relationships over the past decade provide two recent instances of political tensions arising between states with deep economic ties. We define political tensions as a period of sharply worsening bilateral relations at the government and public level. The observable evidence of political tensions includes negative statements by government leaders, decline of high level diplomatic meetings, negative public opinion, boycotts inspired by various groups, and wide media exposure and commentary about such boycotts. The differences between the two case pairs permit exploration of the three hypotheses with variation in security relations as we compare political tensions between two allies and between two regional power rivals. Through interviews, newspaper articles, polling data, and analysis of business surveys, we examine the timing of shifts in political animosity and link them to any potential impact on their economic relations. In both cases, we find very little overall impact, in spite of sensationalist media reports about consumer boycotts and concerned statements by the business community.

### **The Franco-American Dispute over Iraq**

Observing political tensions. Political relations between France and the US became tense in the fall of 2002 over the proposed invasion of Iraq. This Franco-American rift reached its apex in March 2003, when France publicly opposed the American decision to go to war and mounted an antagonistic campaign in the United Nations. The height of the tension can be dated from January 2003 to June 2003, but ill political feelings lingered until the end of the year. Such acrimony took place against a background of increasing mistrust between France and the U.S. throughout the late 1990s and early 2000s, mostly over the issue of American unilateralism, as

illustrated in climate change, the International Criminal Court, and trade disputes. Yet the time-series of quarterly events data shown in figure 1 illustrates that clearly 2003 represented an extreme increase of negative events relative to the past decade. Whereas the average Goldstein-scaled negative event count was 35, the negative scores began to increase in the last quarter of 2002 and spiked to 124 during the first quarter of 2003. By 2004 the scores had returned to below average levels.

*Figure 1 here*

Public opinion surveys and media coverage reflected the rise of political tensions. In the spring of 2003, half of the French who had said they favored the United States the previous summer changed their mind and those with positive views dropped from 63 to 31 percent.<sup>29</sup> In the United States, only 34% of Americans had a favorable view of France and French-bashing became the ubiquitous fodder for comedy show jokes.<sup>30</sup> On May 15, 2003, French ambassador in the U.S. Jean-David Levitte formally delivered a letter to administration officials and members of Congress, complaining about a series of false stories that had appeared in the U.S. media over the past nine months, undiplomatically referred to as part of an “ugly campaign to destroy the image of France” by anonymous administration officials.<sup>31</sup> At the same time, the French media had an increasingly anti-American tone.

Diplomatic tensions also escalated as the U.S. felt that French policymakers had “cornered” Secretary of State Colin Powell in January 2003. Franco-American diplomatic tensions reached an apex in March 2003, when French diplomacy actively tried to prevent the U.S. from obtaining a resolution from the United Nations and Americans portrayed the French as an overt enemy of the United States.<sup>32</sup> Bush and Chirac did meet at the Evian G8 summit in June 2003, breaking the icy cold diplomatic relations of the previous three months, but the tone of the meeting was far from cordial and Chirac was certainly not invited to President Bush’s Crawford

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<sup>29</sup> Richard Kuisel, “What do the French Think of Us? The Deteriorating Image of the United States, 2000-2004.” *French Politics, Culture and Society*, Fall 2004 22(3), pp. 91-119.

<sup>30</sup> “Americans Say Iran Biggest Enemy”, Associated Press, February 24, 2006. For a “French-bashing timeline” in the American media and a collection of many American comedians’ French-bashing jokes, see <http://www.miquelon.org/timeline.html> (last accessed May 1, 2007).

<sup>31</sup> See for instance Karen DeYoung, “France Says it is Target of Untruths”, *The Washington Post*, May 15, 2003.

<sup>32</sup> Thomas Cantaloube and Henri Vernet, *Chirac contre Bush: L’Autre guerre*. Paris: Jean-Claude Lattès, 2004.

ranch. The Defense Department announced publicly that they had decided to snub the Paris Air Show in June.<sup>33</sup>

Expected economic effects of political tensions. Many commentators, both in the popular press and in the business community, expected political tensions to spill over into the economic realm. On both sides of the Atlantic, the media reported widely on instances of consumer boycotts. Anecdotal evidence indicated that European consumers transferred their hostility to the U.S. position on Iraq to American products: some stores in Germany stopped selling Budweiser, Coke and Marlboro cigarettes and would not let customers pay with their American Express cards; German bicycle maker Riese une Mueller cancelled all business deals with American suppliers; French youths vowed to stop eating at McDonalds; websites called for European boycotts of American companies, from Microsoft to Kodak; the list goes on.<sup>34</sup> Indeed, as the *Washington Post* warned, “the boycotts and the surrounding avalanche of negative publicity are a storm warning of what may lie ahead.”<sup>35</sup>

Similarly, Americans manifested their displeasure of the French “betrayal” by boycotting its national products, symbolically pouring French wine down the drain, and changing their travel plans.<sup>36</sup> In the United States, the most visible figure was conservative media personality Bill O’Reilly, who launched a “Boycott France” campaign on the air in March 2003. As he wrote a year later to justify the continuing boycott: “So no more brie for me. No more Evian, Air France, Provence and no more escargot, which I don't like anyway. As a free American, I am using my economic choice to send the French government a message. I am boycotting French goods and services and hope you will do the same.”<sup>37</sup>

The overall impression in the transatlantic media around the time of the Iraq crisis, as summarized by *The Washington Post*, was that “the animosity that has flared of late appears

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<sup>33</sup> See for instance “Franco-American Relations Deteriorate”, Associated Press, May 16, 2003.

<sup>34</sup> See for instance Noelle Knox and Theresa Howard, “Anti-war protesters take aim at American brands,” *USA Today*, April 4, 2003. Will Hutton, “Goodbye, Coke. Hello, Mecca-Cola,” *The Washington Post*, April 20, 2003.

<sup>35</sup> “Goodbye, Coke. Hello, Mecca Cola.” *Washington Post*, April 18, 2003.

<sup>36</sup> Indeed, it was reported that 41% of Americans with French travel plans in the spring 2003 chose to modify them as a result of the Franco-American disagreements over the war. Bruce Horowitz, “Boycott grinds on against French food, wine, travel,” *USA Today*, May 1, 2003.

<sup>37</sup> Bill O’Reilly, “No More Brie for Me,” BillOReilly.com, July 21, 2004. O’Reilly formally lifted his boycott of France on May 7, 2007, the day after the election of French president Nicolas Sarkozy.

almost certain to seep into transatlantic trade and investment issues”<sup>38</sup> Certainly the transatlantic tensions, and the resulting consumer boycotts, “have all the potential, if unchecked, to have ugly economic consequences.”<sup>39</sup>

The transatlantic business community also predicted that the diplomatic rift would poison economic ties. In Europe, business leaders worried about the economic impact of transatlantic tensions on specific sectors, such as the food and wine industry, the luxury goods sector, and airlines. Europeans were further alarmed when the Bush administration retaliated against France and Germany by excluding their companies from Iraqi reconstruction.<sup>40</sup> As for American companies, many publicly worried that Europeans would focus their ire on business as a proxy for hurting governments and that big American consumer brands would be paying the price for the unpopularity of American foreign policy.<sup>41</sup> A December 2004 survey by Global Market Insite showed that 20% of European consumers polled said they were consciously avoiding American products because of recent American foreign policy.<sup>42</sup>

In addition to consumer boycotts, U.S. corporations became concerned about the erosion of trust in American brands and the rising costs of security.<sup>43</sup> In January 2004, a group of business executives formed a group called Business for Diplomatic Action (BDA), designed to mobilize the U.S. business community in addressing and responding to rising anti-Americanism.<sup>44</sup> Since then, BDA, whose motto is “Anti-Americanism is bad for business,” has been quite active in emphasizing to American companies how foreign animosity could hurt businesses in the U.S. and in engaging their members to take some action. Otherwise, the overall picture presented by BDA is bleak: “The costs associated with rising anti-American sentiment are exponential. From security and economic costs to an erosion in our ability to engender trust

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<sup>38</sup> Paul Blustein, “Anxiety over trade rift grows,” *The Washington Post*, March 23, 2003.

<sup>39</sup> Will Hutton, “Goodbye, Coke. Hello, Mecca-Cola,” *The Washington Post*, April 20, 2003.

<sup>40</sup> Elisabeth Bumiller, “Bush defends barring nations from Iraq deals,” *The New York Times*, December 11, 2003.

<sup>41</sup> Richard Tomkins, “Anti-war sentiment is likely to give fresh impetus to the waning supremacy of U.S. brands,” *Financial Times*, March 27, 2003.

<sup>42</sup> [www.worldpoll.com](http://www.worldpoll.com).

<sup>43</sup> Keith Reinhard, “Testimony before the House Subcommittee on National Security, Emerging Threats, and International Relations,” August 23, 2004.

<sup>44</sup> Business for Diplomatic Action, <http://www.businessfordiplomaticaction.org/index.php> (last accessed October 18, 2005).

around the world and recruit the best and brightest, the U.S. stands to lose its competitive edge if steps are not made toward reversing the negativity associated with America.”<sup>45</sup>

Assessing the economic consequences of political tensions. Over the past decade, transatlantic trade and investment has grown steadily, apparently unaffected by the political tensions that surrounded the launch of the Iraq war in 2003. In particular, trade and investment between France and the U.S. seems to have grown at a comparable rate as the one between the U.S. and other European countries. O’Reilly’s assertions of boycott success notwithstanding, consumer boycotts on both sides of the Atlantic remained largely symbolic.<sup>46</sup> At the aggregate level, the economic relationship between France and the U.S. is stronger than ever –whether it is measured in trade, in foreign investment, or in foreign affiliate sales.

Figure 2 shows data on U.S. total trade with European partners on both sides of the Iraq debate. While the Iraq war occurred in the middle of a downturn in transatlantic trade, the start of the decline in 2001 precedes the Iraq war and the recovery of trade flows begins in 2004 while political tensions remain high, and is most likely a reflection of the business cycle slowdown experienced by the respective economies after 9/11. Most importantly, there is no evidence of a shift in trade that differentiated among European partners, including some that adopted political positions essentially aligned with those of the US on Iraq. Further, these countries either shared a common currency with France (Italy, Spain) or have not experienced large shifts in the relative value of their currency (UK) during that period, which might have explained some of the difference. On the contrary, it is indeed quite striking how similar has been the evolution of American trade with France and the UK, in spite of their divergent positions on Iraq in early 2003. The trade figures for 2003 and 2004 do not mimic the political coalitions that formed at the time of the Iraq invasion. To the contrary, U.S. trade increased less with Spain, a loyal member of the “coalition of the willing,” than with Germany and France, the backstabbers from Old Europe.

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<sup>45</sup> <http://www.businessfordiplomaticaction.org/who/index.html> (last accessed October 18, 2005).

<sup>46</sup> On April 27, 2004, O’Reilly asserted that the boycott had cost France billions of dollars, according to the *Paris Business Review*. However, the media watchdog group Media Matters for America investigated this claim and found not only that French exports to the U.S. had increased during that period, but also that there was no evidence of a publication named the *Paris Business Review*. See Media Matters for America, “O’Reilly boycotts truth to spin French boycott,” <http://mediamatters.org>.

*Figure 2 here*

To probe the effect on trade flows, we conduct a regression analysis that allows us to control for other factors that affect bilateral trade. Essentially, this analysis allows us to predict the amount of trade that would have occurred between the two countries irrespectively of their degree of political animosity. We can then examine whether the period where that animosity was most acute coincides or leads into any significant deviations from the regression's predictions, which are based on non-political factors. As in the analysis of events data, we use a gravity model specification to estimate quarterly data on bilateral U.S. trade flows. Whereas the events data ended in 2004, for this analysis we extend to cover the period from 1990 to 2006, which includes both a substantial period before the Iraq war spike of tensions and three years after a return to normal relations in 2004.

Table 3 presents the results for analysis of U.S. trade. First, in model 1 we look at the time series of U.S.-France exports and imports (67 observations of quarterly data), using only the time variant factors GDP and exchange rates as explanatory variables and an indicator variable for the period of political tensions. Next, in model 2 and 5 for exports and imports respectively, we examine U.S. trade with all of its trade partners. Finally, models 3 and 6 shows estimates when including both country and time fixed effects while dropping variables that do not vary by country.

*Table 3 here*

We measure political tensions as an interaction between the specific trade partner and the period of time in which political tensions were high. The variable *Iraqpt\*France* measures the period of high political tensions between France and the United States over the invasion decision beginning with the final quarter of 2002 and continuing through the end of 2003. In the cross-national sample, the *Iraqpt* interaction term for Spain and the UK provides a benchmark for comparison by looking at the same period of time with two other European countries that had low political tensions with the United States as members of the U.S. coalition in Iraq.

The first model, looking at the time series of quarterly data for U.S. imports and exports from France, appears to show a strong pattern of trade following the flag. There is a negative and

significant coefficient for the effect on trade. Yet the hypothesis of politics first has implications for differentiation of trade among allies and adversaries which suggest a need to compare with other countries. In the cross-national analysis of U.S. trade, we find that there was a negative but not statistically significant effect on U.S. exports to France and U.S. imports from France. The model tells us that when conditioning on country, time, and standard variables used to explain trade patterns, trade with France was no different during the period of political tensions than if there had not been political tensions. More surprising is the finding of a significant and large negative effect for U.S. exports to Spain and the UK respectively during this same period. A significant negative effect on U.S.-France trade in the cross-national sample appears when we estimate a lagged invasion effect for the quarter after the U.S. invasion (July-September 2003, results not shown). But again, U.S. exports with allies in the Coalition of the Willing experienced a *larger* decline. Although we hesitate to put any causal interpretation to these results or conclude that we have proven zero effect, the analysis shows that there was no substantively important differential effect on trade from the heightened political tensions in a standard regression model of trade.

Since this null finding could reflect the aggregate nature of trade data, we also examined industries that would most likely be subject to boycott effects due to their association with national origin and their substitutability. Using annual industry data (5 digit SITC industries), we tested the same model on U.S. imports of five luxury products that are frequently associated with France: blue cheese, champagne, wine, leather handbags, and perfume. None of these products experienced a decline of imports from France during 2003 to 2004 relative to the previous two years. Table 4 shows the results from regression analysis. The interaction term for U.S.-France trade during the year 2003 of peak tensions is not significant except for the positive coefficients for wine and leather handbags, for which France experienced robust sales in the US. Even in these high salience industries that would be the most likely to be targeted, we are unable to find economic harm from political tensions.

*Table 4 here*

Yet trade is just the tip of the iceberg of the Franco-American economic relationship. Franco-American economic interdependence is even stronger when measured through foreign

direct investment. American companies are major sources of jobs for French workers, providing about 580,000 direct jobs.<sup>47</sup> Conversely, there are at least 2,400 French subsidiaries in the U.S. providing more than 500,000 direct jobs.

Foreign Direct Investment figures show similar absence of pattern linking politics and economics. Within Europe, the largest percentage increase of U.S. FDI between 2003 and 2004 was in France (22%), followed by Ireland (17%), Germany (16%), Italy (13%) and Spain (12%).<sup>48</sup> In 2005, the U.S. ranked first among foreign investors in France, with an 18% share, concentrated in real estate, business services, manufacturing sector and financial sector.<sup>49</sup> Similarly, European investment in the United States during the same period does not reflect political alignments on foreign policy. In 2004, the largest investment positions in the U.S. were held, respectively, by the UK (16.5%), Japan (11.6%), the Netherlands (11%), Germany (10.7%) and France (9.7%). Between 2003 and 2004, U.S. affiliates with parents in Europe accounted for the largest dollar increase in foreign direct investment in the U.S.: the UK had the largest increase, followed by the Netherlands, France and Germany.<sup>50</sup> Figures 3 and 4 show that U.S.-French FDI has fluctuated less than British investment over the past five years, with no visible long-lasting impact from the 2003 tensions.

*Figures 3 and 4 here*

We also conduct regression analysis of U.S. inward and outward FDI flows using the same base gravity model with quarterly data for the period 1994 to 2006 (data limitations prevent starting in 1990). We look for any evidence that the period of political tensions from fourth quarter 2002 through the end of 2003 depressed FDI levels. We find none. Table 5 shows a negative significant coefficient for outward investment to France in Model 1, but it is half the size of the negative coefficient for the period interaction term with investment in the UK. A similar pattern is seen for FDI inflows in models 3 and 4.

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<sup>47</sup> “France and the United States: A Strong Economic Relationship”, Embassy of France in the United States, March 7, 2007; Hamilton and Quinlan, 2004, p. 164.

<sup>48</sup> Source: Jennifer L. Koncz and Daniel R. Yorgason, “Direct Investment Positions for 2004: Country and Industry Detail,” Bureau of Economic Analysis, July 2005.

<sup>49</sup> “France and the United States: A Strong Economic Relationship”, Embassy of France in the United States, March 7, 2007.

<sup>50</sup> Jennifer L. Koncz and Daniel R. Yorgason, “Direct Investment Positions for 2004: Country and Industry Detail,” Bureau of Economic Analysis, July 2005.

*Table 5 here*

Finally, as Hamilton and Quinlan emphasize in their study of transatlantic economic relations, it is crucial to note that a large portion of the trade between France and the US is actually made up of “related party trade,” which approximates intra-firm cross-border trade.<sup>51</sup> Figure 5 presents data of US merchandise trade with France that reveals the interconnectedness of the French and the American economies: over the years from 2003 to 2007, 42.5% of all US imports and exports to France was related party trade.

*Figure 5 here*

Yet even when we look at the sales of high profile American firms, the impact of boycotts can hardly be felt. In their recent study of the consequences of anti-Americanism, Peter Katzenstein and Robert Keohane compared revenues of major U.S.-based and Europe-based consumer products firms in Europe between 2000 and 2004.<sup>52</sup> These firms include four American firms often mentioned as potential targets of anti-American boycotts (Coca-Cola, Pepsi, McDonald's, and Nike) and three European competitors (Adidas-Salomon, Cadbury-Schweppes, and Nestle). If anti-Americanism had a significant impact on sales, one should find U.S.-based firms' sales falling in 2003-04, when anti-American views rose sharply in Europe, compared to 2000-2001, when the United States was still very popular there. This fall in the sales of American firms should occur both in absolute terms and relative to the performance of European firms. Yet Katzenstein and Keohane find that all four American firms increased the *share* of their revenues in Europe between 2000-01 and 2003-04. Indeed, the average sales gain for the four American firms was about 44 percent, compared to 24 percent for the three European firms.

In France, ironically, McDonald's has been performing particularly well over the past five years, so much so that the former president of McDonald's France was promoted president of McDonald's for all of Europe.<sup>53</sup> Today, France is the world's second most profitable market

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<sup>51</sup> Defined as trade with an entity outside the US in which the importer holds at least a 6% equity interest and the exporter holds at least 10% (US Census Bureau).

<sup>52</sup> Peter Katzenstein and Robert Keohane, “Consequences of Anti-Americanism,” in Katzenstein and Keohane eds., *Anti-Americanisms in World Politics*, Cornell University Press, 2006.

<sup>53</sup> See Sophie Meunier, “The Distinctiveness of French Anti-Americanism,” in Katzenstein and Keohane, 2006.

for McDonald's, after the U.S.<sup>54</sup> Neither the anti-globalization actions calling for destroying McDonald's outlets in the late 1990s, nor the anger against the U.S. over the invasion of Iraq in early 2003 seem to have destroyed the French appetite for U.S.-style fast food. McDonald's opened 30 new outlets in France in 2005 and 35 in 2006. Whether in aggregate terms or even at the level of individual firms, it is thus "business as usual" in the Franco-American economic relationship.

### **Sino-Japanese Rift Over Yasukuni Shrine Visits**

Observing political tensions. In July 2006 Prime Minister Ryutaro Hashimoto caused outrage in China when he visited Yasukuni shrine, which is dedicated to the spirits of Japan's war dead including those executed as war criminals. He announced he would not make another visit during his term as Prime Minister in order to avoid harming diplomatic relations. During his five years in office from August 2001 until August 2006, Japanese Prime Minister Junichiro Koizumi made it his stated policy to visit Yasukuni shrine every year. Each visit sparked tensions in Sino-Japanese relations. Citing his insensitivity to China's experience as a victim of Japan's wartime aggression, Chinese leaders refused to meet with Prime Minister Koizumi. Disagreements over territorial claims to islands near major energy resources and broader concerns about changing power positions in East Asia also underlie tensions between the countries. In 2005, China threatened to veto Japan's long sought goal to gain a permanent seat on the UN Security Council. This five year period of the Koizumi administration was marked by worsening public opinion about the bilateral relationship on both sides and repeated calls in China for boycotts of Japanese products.

Figure 6 shows the trend of negative events between Japan and China from 1990 to 2004. The quarterly time periods with visits to Yasukuni shrine by a prime minister have an average negative score of 43, which is more than double the average score of 19 for the entire period. The visit by Hashimoto in 1996 corresponds with the highest recorded negative events with a score of 74, and the Koizumi administration was marked by higher negative scores than other periods (mean score of 26 relative to mean score of 17 for prior decade).

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<sup>54</sup> "McDonald's in France", PlanetRetail, February 2007.

*Figure 6 here*

Public opinion surveys show a marked increase of political tensions. In China, the percent of urban Chinese residents who disliked Japan rose from 46 percent in the year 2000 to 59 percent in 2005.<sup>55</sup> Data measuring Chinese feelings of amity on a scale of 1-100 (higher values indicate more positive feelings) show that Chinese amity toward Japan dropped from neutral levels of 50 in 1998 during the first year of the survey to a low of 30 in 2004.<sup>56</sup> Similar deterioration of public opinion is found on the Japanese side where the percent of Japanese who did not feel close to China rose from 47 percent in the year 2000 to 58 percent in 2004.<sup>57</sup> Japanese evaluations of the direction of Japan-China relations turned negative for the first time in 2004 with a jump from 43 percent believing relations were going in a negative direction in 2003 to 61 percent holding such pessimistic views in 2004. Spikes in political tension could be observed following each visit to Yasukuni shrine. Tension at the level of the government was evident from strong public statements by Chinese officials criticizing Prime Minister Koizumi for visiting the shrine and the refusal to meet with him for a formal summit meeting during the five years of his administration after the single summit held in October 2001 of his first year in office.

Expected economic effects of political tensions. After years of repeating the slogan that Sino-Japanese relations were “cold in politics” and “hot in economics,” the media began warning that spillover from political problems had begun to cool economic relations. Under the title “Political Chilliness Begins to Affect Economic Ties” the People’s Daily Online cited a warning from Chinese Minister of Commerce Bo Xilai that prolonged “disharmony in political relations” between Japan and China would damage bilateral trade and economic cooperation.<sup>58</sup> Indeed, fear that political relations would harm economic relations led officials in China to issue statements trying to discourage boycotts and pointing out the mutual benefits from the economic

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<sup>55</sup>Public Survey on Chinese Views Toward Japan, 2000 and 2005, available at [www.comrc.cn](http://www.comrc.cn)

<sup>56</sup> The authors thank Alastair Iain Johnston for sharing the survey data from the Beijing Area Study, an annual randomly sampled survey of Beijing residents. See Alastair Iain Johnston and Daniela Stockmann, “Chinese Attitudes toward the United States and Americans” in Peter Katzenstein and Robert Keohane, editors, *Anti-Americanisms and World Politics* (Ithaca: Cornell University Press, 2007)

<sup>57</sup> *Zenkoku yoron chosa no genjo* (The state of current national public opinion), Tokyo: Cabinet Office, 2004, p. 16-17.

<sup>58</sup> Xinhua, “Political chilliness begins to affect economic ties: Bo Xilai” 24 April 2005, People’s Daily Online available at <http://english.people.com.cn>.

relationship.<sup>59</sup> The Japanese media readily picked up on the reported warnings of potential economic harm.<sup>60</sup>

Anecdotes about actual incidents causing economic costs were widely reported. During April 2005, protesters rallying against Japan's bid to gain a permanent seat on the UN Security Council destroyed a Japanese retail store Ito-Yokado in Sichuan Province.<sup>61</sup> Some Chinese retail stores were said to have stopped selling Asahi beer after boycotts targeted Asahi Breweries and several other Japanese companies that were alleged to have provided funding for a controversial textbook reform council in Japan.<sup>62</sup> Negative sentiment toward Japan in China was said to obstruct economic relations in even more subtle ways as Japanese firms were unpopular among Chinese job-seekers and Chinese consumers reacted with more extreme responses to product defects by Japanese firms.<sup>63</sup> As foreign banks acquired Chinese financial institutions, analysts reported that Japanese banks were lagging behind because political problems made Chinese banks prefer other partners over Japanese banks.<sup>64</sup>

Business leaders in Japan and China expressed fears of economic harm. In a survey sent to 100 executives of leading Japanese companies (95 responded), 51 expressed concerns that Sino-Japanese tensions would harm their business interests in China.<sup>65</sup> Some Japanese business leaders urged the prime minister against visiting Yasukuni shrine. Kakutaro Kitashiro, the Chairman of the Japan Association of Corporate Executives (*Keizai Doyukai*) said at a news conference "Prime Minister Koizumi's visits to Yasukuni Shrine could spread negative views about Japan (in China) and cause adverse effects on Japanese companies activities there," and the organization passed a resolution in May 2006 urging the prime minister to reconsider his policy of visiting the shrine.<sup>66</sup> As Japanese business leaders watched European and American leaders actively engaging with China and encouraging business deals for their industries, many

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<sup>59</sup> "Trading Blows," *South China Morning Post*, 3 May 2005.

<sup>60</sup> "Disputing the argument about separation of politics and economics," *Asahi Shimbun* 6 September 2006.

<sup>61</sup> "China boycott threatens firms" *The Daily Yomiuri*, 4 April 2005.

<sup>62</sup> Xinhua Net, 25 April 2005 available at <http://news.263.net/20050425/00476199.html>

<sup>63</sup> Kanshi Yu, "Cold Political Relations harm hot economic relations," *Chuo Koron* 119: 11 (November 2004): 68-71.

<sup>64</sup> David Ivison, "Clamour to boost China stakes reveals Japan anomaly," *Financial Times*, 21 October 2005.

<sup>65</sup> "Over half of top firms fret Japan-China ties," *The Japan Times*, 3 August 2005.

<sup>66</sup> "National interests should dictate Tokyo's posture," *The International Herald Tribune/Asahi Shimbun*, 14 December 2004. "Keizai Doyukai urges Prime Minister to reconsider shrine visits (translated from Japanese)" *Asahi Shimbun*, 10 May 2006.

feared that the freeze on top leadership meetings between Japan and China would leave them excluded from new opportunities and slow down prospects for strengthened economic partnership agreements. Others began to express concerns about the risk of investment in China.<sup>67</sup> At the same time, Chinese businessmen warned that contracts for business projects with Japanese companies in China might be delayed.<sup>68</sup> Others expressed fears that reluctance by Japanese firms to invest in China would reduce much needed jobs and capital.

Assessing the economic consequences of political tensions. Yet the economic relationship between Japan and China has become increasingly interdependent over the same period that political relations worsened. For years the asymmetrical economic relationship was seen as largely to the benefit of China which received large flows of development assistance and investment from Japan. Indeed, some in Japan voiced concerns about a hollowing out of Japanese industry as firms moved factories to China in order to take advantage of lower labor costs. When the Japanese economy finally returned to positive growth in 2003, many admitted that demand from China's surging economic growth had helped to pull Japan out of recession.<sup>69</sup>

As shown in figure 7, a steadily increasing share of Japanese trade has been with China. Many factors contribute to this trend --in particular, China's accession to the WTO in December 2001, which was accompanied by liberalization that created new market access opportunities. In 2004, China replaced the United States as Japan's biggest trading partner as total trade with China (including Hong Kong) reached \$213 billion dollars relative to \$197 billion in trade with the United States.<sup>70</sup> Given that political tensions were most intense on the Chinese side with anger directed against Prime Minister Koizumi's yearly visits to Yasukuni shrine, it is useful to look more closely at whether Chinese imports from Japan on a quarterly basis show any decline as a possible sign of negative impact on the willingness of Chinese consumers and firms to purchase Japanese goods. Figure 8 shows that imports from Japan followed a steady upward

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<sup>67</sup> David Pilling, "Japanese companies in China rethink" *Financial Times*, 10 June 2005.

<sup>68</sup> Cheung, Gary and Dennis Eng, "Hong Kong won't be spared if business ties are damaged," *South China Morning Post*, 19 April 2005.

<sup>69</sup> Kanshi Yu, "Cold Political Relations harm hot economic relations," *Chuo Koron* 119: 11 (November 2004): p. 70.

<sup>70</sup> David Pilling, "China replaces US as Japan's biggest commerce partner with \$213 billion trade," *Financial Times*, 27 January 2005. One has to note, however, that in an era of globalization the national origins of trade flows are as complicated to define as the national origins of products. Bilateral trade flows also include intra-firm trade as Japanese firms export parts to factories in China, where value is added and products are then exported elsewhere. As much as a third of Japan's exports to China reach the US as their final destination.

trend. There is not any break following Prime Minister Koizumi's visits to Yasukuni shrine. The slowdown in growth at the end of 2004 was attributed to a temporary decline in Chinese demand for industrial equipment and cars from Japan.<sup>71</sup>

*Figures 7 and 8 here*

Statistical analysis shows that Japanese exports to China are more than would be predicted by the standard variables that influence trade. Parallel to the analysis of U.S. trade discussed above, we conducted regression analysis of Japanese exports using variables from the gravity model specification and quarterly data from 1990 to 2006. We focus on Japan's exports because the boycott calls were one-sided in nature arising from Chinese public and private condemnation of Japanese government actions, in contrast to the two-sided condemnation that occurred in the U.S.-France dispute. In table 6, Models 1 and 4 examine the time series of Japan-China trade, while other models include the cross-national sample.<sup>72</sup> Two variables measure political tensions. First we include a variable to measure the effect of the Koizumi administration, October 2001 to August 2005, on Japan's exports to China. Although Koizumi's successor as prime minister, Shinzo Abe, was known as a hawk in his ideology, the change of administration signaled a normalization of Sino-Japanese relations as Abe refrained from making public visits to the shrine and top level summits resumed. Second we include a variable to measure whether there is any effect on trade between Japan and China during the quarter after a prime minister visits Yasukuni shrine. The fixed effect of Japan-China trade is captured in the China coefficient, while the interaction term measures the effect on Japan's trade with China from the period of political tensions. We find no statistically significant difference in Japan-China trade patterns during either the Koizumi Administration or during the quarters after Yasukuni visits when controlling for country, time, and standard variables used to explain trade flows. High salience Japanese exports such as cars, cameras, and beer also did not suffer any

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<sup>71</sup> Ibid.

<sup>72</sup> Models 1 and 4 for the Japan-China time series estimate Newey-West standard errors to take into account autocorrelation up to 4 periods lag. Models 2 and 5 for the cross-national sample estimate robust standard errors clustered on trade partner and include quarter fixed effects. Models 3 and 5 estimate country fixed effects and drop time invariant variables.

negative impact from the Koizumi administration – quite to the contrary the result a positive and significant coefficient for Japanese auto exports (Table 7).

*Tables 6 and 7 here*

Direct foreign investment represents a substantial component of the Japan-China economic relationship. After the United States, China is the largest destination for Japanese FDI. Figure 9 shows that during the period of the Koizumi administration when political relations were at their worst, China was taking a growing share of Japan's FDI. For China, Japan has for many years been the largest source of FDI inflows.

*Figure 9 here*

We also conducted regression analysis of Japanese outward FDI flows. We estimate period effects of political tensions on Japanese quarterly FDI outflows using the same model from the analysis of trade with the addition of an indicator measuring the presence of a bilateral investment treaty.<sup>73</sup> Model 1 of Table 8 shows a significant positive coefficient for FDI from Japan to China during the Koizumi administration. In order to focus on a discrete event of high publicity, we also examine the period in 2005 of major anti-Japanese sentiment in China centered around Japan's bid to gain a permanent seat on the UN Security Council. This period began with street protests and vandalism of Japanese stores in April and continued through September, and could be considered a high point of political tensions that would concern Japanese investors in China. Given the expectation that investment decisions would precede their appearance as a shift in FDI flows, we look at the lagged effect of political tensions measured by the period July to December 2005. The significant positive coefficient in Model 2 indicates that if anything, Japan's FDI to China increased during and after the violent anti-Japan protests. We are not suggesting that political tensions perversely increase investment, but rather that tensions did not act as a restraint on other factors that contributed to the booming bilateral investment relationship during this particular period.

*Table 8 here*

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<sup>73</sup> As for the U.S. analysis, the FDI model does not conform to the standard gravity model specification because the dependent variable FDI takes both positive and negative values and is not calculated in log form.

Clearly the trend in trade and investment indicates that Sino-Japanese economic relations were deepening even as their political relations worsened. Yet one could expect that such aggregate level data conceals areas where there is more direct impact. Therefore it is useful to look at specific firms that are closely identified with Japan and sell directly to consumers, since these are the most likely to be subjected to consumer animosity, especially those selling products with substitutes provided by domestic or alternative foreign producers. Two Japanese firms stand out for this test: Sony and Toyota. Both represent flagship companies for Japan's export industry, and sell products readily substituted with other major multinationals deeply engaged in trade and investment with China.

*Figure 9 here*

There is some evidence from consumer surveys that Japanese firms suffer a penalty. When asked about their confidence in specific companies, Chinese respondents ranked Sony 13<sup>th</sup> and Toyota 17<sup>th</sup> after companies such as IBM, Motorola, Volkswagen, GM, and Samsung.<sup>74</sup> Sony reported a 25 percent drop in sales of items such as digital cameras and personal computers during the second quarter of 2005 when anti-Japanese riots took place in China.<sup>75</sup> Nevertheless, when those who planned to purchase a digital camera were asked what brand they would purchase, 26 percent chose Sony, which was the highest among all options given. While Toyota has a small market share in China relative to other foreign auto companies such as GM and Volkswagen, it has seen a rapid increase in sales over the past five years. Toyota's vehicle sales to China rose from a mere 13,400 in 2001 to 183,500 in 2005, which represents a higher growth rate than its sales in the United States or other large developing country markets like Brazil and India. In the Chinese market, Toyota's sales outpaced the two leading major foreign automakers GM and Volkswagen as well as the average growth in total vehicle consumption in the Chinese market.<sup>76</sup> Such figures do not rule out the possibility that Sony and Toyota would have done even better given a more positive political environment, but they do cast doubt on hypotheses that leading Japanese exporters would suffer a downturn from worsening relations.

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<sup>74</sup> "Chugoku shyohishya no brando ishiki (Chinese consumers brand awareness)" Tokyo: Searchina Research Center, 2005.

<sup>75</sup> *Yomiuri Shimbun*, 28 April 2005.

<sup>76</sup> Stephen Cooney, "China's Impact on the U.S. Automotive Industry," Congressional Research Service Report for Congress, 4 April 2006; data available at [http://www.toyota.co.jp/en/about\\_toyota/pdf2006/index.html](http://www.toyota.co.jp/en/about_toyota/pdf2006/index.html).

Interviews and surveys about business plans also do not show evidence of a strong reaction to worsening relations. A representative from the Japanese business organization, *Keidanren*, noted that while shrine visits may be followed by sudden cancellation of business meetings or an increase in the price on the table for a contract negotiation, in the long term contracts were not cancelled.<sup>77</sup> An official of a Japanese financial investment firm heavily involved in business with China said China's boycott calls were famous for having no effect.<sup>78</sup> While a survey of companies indicated lessening enthusiasm for expansion of investment in China, the number of firms said to consider downsizing or withdrawal of business remained at a low 4 percent one month after the April 2005 anti-Japanese riots in China.<sup>79</sup>

The overall evidence points to an absence of direct economic damage. Trade and investment between Japan and China has been growing at such a rapid pace that spillover from politics has at most manifested itself as a cautious wind cooling optimism about the prospects for interdependence.

## **Why a Firewall Between Political Tensions and Economic Exchange**

The central finding that there has been no substantial economic fallout from political tensions challenges the realist hypothesis about the primacy of politics and the liberal hypothesis about the mobilization of economic actors. In this section, we revisit the hypotheses and explain why high levels of mutual economic interdependence discourage both governments and business actors from letting politics interfere with economics. We highlight the importance of transnationality to reduce politics-to-economics spillover in the cases, while noting that regulatory decisions, multilateral governance, and sectors with high substitutability would be where one would most expect to find negative effects from political tensions. Finally, we discuss the possibility of a temporal threshold beyond which spillover would occur.

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<sup>77</sup> Interview, 21 December 2005, Tokyo Japan.

<sup>78</sup> Interview, 22 August 2006, Tokyo Japan.

<sup>79</sup> JETRO, "Special Survey of Japanese Businesses in China: Impact of the April Anti-Japan Demonstrations," June 2005. available at [http://www.jetro.go.jp/en/stats/survey/surveys/20050620\\_special.pdf](http://www.jetro.go.jp/en/stats/survey/surveys/20050620_special.pdf).

## Revisiting the hypotheses about politics and economics

The “politics first” hypothesis suggests that states should direct economic flows towards states with whom they share closer political relations, and businesses should shift their exchanges to “safer” countries. The evidence from our case studies shows quite the opposite, however, with economic interdependence increasing parallel to worsening political relations. One explanation would be that an intensity threshold with implications for security cooperation must be reached before political conflict would motivate a state to intervene in economic policy or raise the risk perception of investors. The studies predicting “politics first” emphasize long term structural changes such as alliance shifts and conflict escalation. Here in our cases, expectations that there would not be a disruption of political relations may have moderated the response of economic actors. In other words, tensions between France and the US and between Japan and China were not high enough to trigger a shift in expectations. As shown by Copeland, expectations of future trends condition how actors view interdependence.<sup>80</sup> Indeed, the United States and France remained committed partners in NATO as well as partners on the ground in Afghanistan throughout their fight over Iraq. Japan and China were not contemplating imminent war. When governments chose not to intervene in economic activities, this in itself signaled to private actors that political tensions might be resolved without further escalation.

However, one should not dismiss the seriousness of both episodes of tension. Some perceived the Franco-American split over Iraq as shaking the foundations of the Atlantic alliance, revealing how far Europe and the U.S. had drifted apart after the end of the Cold War, and fueling anti-Americanism in the world. Certainly relations between Japan and China were tense over both symbolic issues related to history and actual security concerns over Taiwan and territorial disputes.<sup>81</sup> At a news conference in December 2005, Japanese foreign minister Taro Aso (currently serving as Prime Minister) said China was “a neighboring country with one billion people, nuclear arms, military spending that has shown double-digit growth for the last 17 years, with extremely little transparency. It’s becoming a considerable threat.”<sup>82</sup> The intensity of tensions and animosity in both cases should therefore not be minimized. Our findings suggest

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<sup>80</sup> Copeland 1996.

<sup>81</sup> Kent Calder, “Japan and China’s Simmering Rivalry,” *Foreign Affairs*, March/April 2006.

<sup>82</sup> *New York Times*, 23 December 2005.

that it requires a very high threshold of political conflict before the “politics first” dynamic operates.

The “economics first” hypothesis points to the role of lobbying to restrain political squabbles before they cause serious damage to economic relations. Yet when we examine the level of business lobbying, it appears to have been neither substantial nor effective. In the U.S., the group Business for Diplomatic Action (BDA) was formed with fanfare to combat the perceived deleterious effects of anti-Americanism on business. But their mandate was never to lobby the administration in order to shift the course of American foreign policy, and they never tried to do so. In France, some business groups (mostly in the wine and luxury goods industry) complained in early 2003 about the potential economic fallout of President Chirac’s hard stance against the U.S., but this did not seem to change the course of French foreign policy either.<sup>83</sup> In Japan, some businessmen voiced concerns, but the major business organization, *Keidanren* was notably circumspect about directly approaching the issue.<sup>84</sup> Since economic flows were largely unimpeded by negative sentiment, the business lobbying that would operate as the mechanism for a commercial peace restraint did not take place.<sup>85</sup> Neither does it appear that those who lobbied wielded any influence. Defiant to the end, in his last month as Prime Minister, Koizumi chose to visit the shrine on August 15<sup>th</sup> 2006 on the anniversary of the end of WWII, which was perceived as the most controversial timing for a visit. Those concerned about worsening relations with China could not change the course of foreign policy decisions made for political reasons.

In both the Franco-American and the Sino-Japanese cases, governments were unwilling to intervene because they valued ongoing economic ties and trade rules that prohibit arbitrary discrimination against the imports or investment of one country. Boycotts remained unofficial and government-led sanctions were not imposed. For example, after three weeks of anti-Japan protests and boycott calls in April 2005, the Chinese Commerce Minister warned citizens not to harm economic development and stated “We don’t expect the economic and trade relations

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<sup>83</sup> Based on interviews with staff members from the French Embassy in the U.S., November 2006.

<sup>84</sup> Chairman Fujio Mitarai said that the issue of Yasukuni visits was a matter for politicians. *Yomiuri Shimbun* 29 July 2006. An official noted that Keidanren would not take a common position on the issue and said the business of the organizations’ China committee focused mostly on issues related to China’s compliance with WTO agreements. Interview by author, Tokyo 21 December 2005.

<sup>85</sup> Yinan He, “Hot Economy and Cold Politics? Commerce and History in Sino-Japanese Relations,” Paper presented at the ISA annual meeting, San Diego, 2005, p. 31.

between the two countries to be infringed upon.”<sup>86</sup> Yet at the same time his government continued on its collision course over political issues ranging from opposition to Japan’s UN bid, repeated incursions in the disputed territorial waters, and strong criticism of Koizumi for his visits to Yasukuni. When some U.S. Congressmen threatened to deny U.S. government procurement contracts to the French firm Sodexho in 2003, noting with outrage that it had been awarded contracts to feed the U.S. Marines, Sodexho only needed to point to its 110,000 U.S. employees for the threats to dissipate.

The cases also show that businesses on both sides saw the market opportunities as too great to sacrifice. In Japan, Sony officials expect that in a few years sales in China will be greater than Japan, and Toyota officials say they expect China to become the biggest auto market.<sup>87</sup> The head of a major Japanese private equity firm operating in China said in December 2005 that “We are not necessarily optimistic about our China investments, but we would never exclude China from our portfolio.”<sup>88</sup> On the Chinese side, only a small number of retailers took actions to support the boycott, citing that with complex distribution channels they were importing through mainland suppliers rather than directly from Japan.<sup>89</sup>

Transnationality of commercial and financial flows creates such mixed interests and identities that calls for national boycotts have little impact. The importance of intra-firm trade in today’s economy severely constrains the possibility of a spillover happening from the political to the economic realm. Firms are not expected to discriminate against their own parent/subsidiary firm unless if the situation becomes really physically dangerous. Consumers may also be unable to differentiate foreign origin products as local production reduces the “foreignness” of global companies. Transnationality explains in large part the relative firewall between politics and economics in the Franco-American case, where foreign affiliate sales are the backbone of the transatlantic economy – trade represents a mere 2 percent of commercial exchange.<sup>90</sup> The complex regional production networks of Japanese firms in East Asia are characterized by mutual supply of intermediate goods to the point where the national identity in final production

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<sup>86</sup> *New York Times*, 23 April 2005, p. 3.

<sup>87</sup> *South China Morning Post*, 11 May 2005, p. 16.

<sup>88</sup> Rawi Abdelal and David Lane (2006) “Chrysanthemum and Dragon: JAFCO Asia in China,” Harvard Business School Case Study 9-706-012, p. 15.

<sup>89</sup> *South China Morning Post*, 21 April 2005.

<sup>90</sup> Hamilton and Quinlan, 2004, p. xi.

is lost and nearly one fourth of trade flows represent sales to foreign affiliates.<sup>91</sup> Japanese FDI in China has been largely focused on serving the Japanese domestic market and global markets, with exports from Japanese multinationals boosting China's overall exports.<sup>92</sup>

### Conditions for spillover

Whether political tensions will spill over into economic interactions or not depends on the following conditions: the involvement of governments in the bilateral economic relationship; the extent to which bilateral economic interactions are institutionalized and subject to multilateral governance; the substitutability of the goods and services traded; and the time horizon considered.

### Government involvement

Where governments have more discretion and direct involvement in the bilateral economic relationship --such as through public procurement, aid, and regulatory decisions— spillover from politics to economics is more likely to occur. The defense industry, energy sector, infrastructure projects, and financial institutions are examples of economic sectors with heavy government involvement. Therefore, the higher the percentage of the bilateral economic relationship made up of goods and services from these sectors, the more likely it is for spillover to occur. Both case studies provide such examples of the consequences of government involvement. American awards of contracts for the reconstruction of Iraq in December 2003 explicitly excluded France from the list of countries eligible to compete for these \$18.6 billion worth of contracts in retribution for the French position in the weeks leading up to the war.<sup>93</sup> In the case of China and Japan, the most frequently cited business casualty of political tensions was an infrastructure project to build a high-speed railway linking Beijing and Shanghai.<sup>94</sup> Delays in the expected Chinese purchase of Japanese high-speed technology and the eventual granting of

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<sup>91</sup> An analysis of trade statistics for the year 2000 shows that 29 percent of imports from East Asia to Japan were from foreign-based operations of Japanese firms and 24 percent of exports from Japan to East Asia were contracted with foreign affiliates. Motohashi Kazuyuki, "Spotlight on Japan's Competitiveness," *Journal of Japanese Trade and Industry*, 1 November 2002.

<sup>92</sup> Yuqing Xing, "Japanese FDI in China: Trend, Structure, and the Role of Exchange Rates," in *China as a World Factory*, pp. 110-125, K.H. Zhang (ed.), Routledge, Taylor, & Francis, 2006.

<sup>93</sup> See for instance Sue Fleming, "U.S. Shuts Out France, Germany for Iraq Work," *Reuters*, 9 December 2003.

<sup>94</sup> *The Financial Times*, 30 March 2004, p. 19.

the contract to Germany were attributed to repeated visits by Koizumi to Yasukuni shrine.<sup>95</sup> On a smaller scale, local government purchase plans in China frequently opted against Japanese products to avoid criticism.<sup>96</sup> Japanese banks are also reported to have greater difficulty getting permission from government to open branches than the banks of other countries.<sup>97</sup>

Procurement decisions are often subject to “buy national” considerations even during periods of good relations, and therefore would be the most likely area to be affected by a downturn in bilateral relations. In February 2008, when relations between France and the US were back to normal according to analysts and diplomats, the US Air Force awarded a \$35 billion contract to a partnership between US company Northrop Grumman and EADS, the European parent company of Airbus, for a new fleet of air-refueling tankers. As French president Sarkozy commented then, ““Isn't it a welcome change when we are reconciled with the Americans? Could you imagine for a minute that the contract which EADS has won in such a magnificent way to build aerial tankers could have been signed in the spirit of tension which used to exist between the Americans and French?”<sup>98</sup> American political opposition to the deal was very public, however, and commercials were run to criticize the deal using French-bashing arguments.<sup>99</sup> The award was later overturned and the contract, estimated to be worth \$100 billion over the next thirty years, cancelled in September 2008.

### Multilateral Governance

Another important determinant of whether the politics-to-economics spillover occurs is how much of the bilateral economic relationship is subject to multilateral governance. The more an economic relationship is governed by multilateral agreements, the less subject it will be to political volatility. International economic institutions act as a buffer for political tensions.

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<sup>95</sup> “The Frontline of Politics: Koizumi Foreign Policy (translated from Japanese),” *Yomiuri Shimbun* 31 May 2005; Jin Xide, “High Speed Train in Sino-Japanese Relations (translated from Chinese),” *People’s Daily*, 16 September 2003 available at <http://www.people.com.cn>.

<sup>96</sup> Interview, Representative of Japanese firm involved in assisting Japanese firms to invest in China. 22 August 2006, Tokyo Japan.

<sup>97</sup> Interview, Japanese Ministry of Foreign Affairs Official, 24 August 2006, Tokyo Japan.

<sup>98</sup> “France says EADS deal reflects better US ties,” Reuters, March 5, 2008.

<sup>99</sup> See <http://www.miquelon.org/2008/03/22/french-bashing-no-longer-a-conservative-monopoly/>.

It is possible for political tensions to indirectly influence economic outcomes if they reduce cooperation in multilateral venues for international economic governance. Governments may use a public forum to display their opposition to another country. Such grandstanding would reduce opportunities for cooperation that might have been possible without negative linkages among issues.

Overall, however, the rule-guided framework of multilateral venues is intended to prevent such negative linkages and focus on areas where common interests in cooperation bring states together. Decisions made in this setting may be sheltered from political tensions by the shared commitment to upholding the rules and mission of the particular institution. Indeed, some analysts have noted that economic policy-makers often try to overcompensate for the bad state of political relations. For instance, despite several instances of WTO inconsistent policies by China that harm major Japanese export industries, Japanese business and government officials acknowledge reluctance to initiate a WTO complaint against China due to the tense political relations.<sup>100</sup> As for France and the U.S., during the 2003 Cancun meeting of the World Trade Organization, European and American trade negotiators went out of their way to smooth out the bad transatlantic relations over Iraq. So far, the growing transatlantic political rift does not seem to have affected cooperation in multilateral economic governance. Transatlantic trade disputes are not bigger or more acrimonious today than they were several years ago.

Moreover, if one of the countries (or both) belongs to institutional arrangements with third countries, such as a customs union or a single market, this further limits the spillover of tensions from the political to the economic realm. The fact that France is a member of the European Union (EU) limits the retaliatory trade actions that the US could take against French goods and services without incurring, in turn, retaliation by the entire EU. Such thick institutional arrangements have the effect of mitigating and insulating political tensions.

### Substitutability

The third determinant of a politics-to-economics spillover is the substitutability of the goods and services making up the bulk of the bilateral economic relationship. Not all industries

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<sup>100</sup> Interview of METI official, 17 August 2006, Tokyo Japan.

are created equal with respect to consumer boycotts. Those with high substitutability, such as tourism and luxury goods, will be the most readily targeted. Although our analysis of high salience products such as French wine or Japanese autos did not show a negative impact on trade from political tensions, further analysis is necessary. A detailed study of the impact of the Iraq war on French wine sales in the U.S. found that the public boycott of French wines in the U.S. led to a 13% decrease in sales over six months and a peak in the boycott nine weeks after the first news report of the boycott, with an estimated 26% lower volume of French wine sold.<sup>101</sup> But eight months after the Iraq war started, there was no more trace of the boycott on French wine sales. Tourism also shows some evidence of harm. During the period following anti-Japanese protests in April 2005, one of Japan's major airline companies reported that 1,000 Japanese were cancelling flights to China daily.<sup>102</sup> Travel since then has recovered to previous levels. Although French wine and China as a travel destination had sufficient appeal to outlast the negative image from political tensions, other brands or countries without such well established attraction could be subject to more enduring harm.

### A temporal threshold

An important qualification to our findings is the possibility of a temporal threshold beyond which political tensions start seeping into the economic realm. Sunk costs in existing markets are sufficient to slow any impulsive reaction based on short term political trends. But in the long term, the harm to brand image and residual consumer animosity are two mechanisms for such effects.

Marketing scholars have developed the “animosity model of foreign product purchase” to analyze whether political animosity between two countries has a significant impact on consumers' buying decisions.<sup>103</sup> These studies include models that measure cross-national hostility and predict how animosity towards a foreign nation will affect the purchase of goods produced by that country. Overall, they find that a product's origin (signaled by place of

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<sup>101</sup> Larry Chavis and Phillip Leslie, “Consumer Boycotts: The Impact of the Iraq war on French Wine Sales in the U.S.”, NBER Working Paper 11981, January 2006.

<sup>102</sup> *Financial Times*, 19 April 2005, p. 6.

<sup>103</sup> Jill G. Klein, Richard Ettenson, and Marlene D. Morris, “The Animosity Model of Foreign Product Purchase: An Empirical Test in the People's Republic of China,” *Journal of Marketing*, Vol. 62, January 1998, pp. 89-100. For a literature review, see Petra Riefler and Adamantios Diamantopoulos, “Consumer Animosity: A Literature Review and a Reconsideration of its Measurement” *International Marketing Review*, forthcoming 2007.

manufacture and/or brand name) can affect consumers' purchase behavior independent of product quality. Moreover, these marketing studies argue that the consumer preferences shaped by political tensions between two countries have effects that extend beyond company-specific boycotts, which are typically short-lived. By contrast, these "societal boycotts" have the potential for greater long-term harm.<sup>104</sup> Consumer animosity towards a country and its effects on sales of products from this country may persist long after the initial source of political tension, in part because such animosity is often rooted in deeply held beliefs.

Prolonged political animosity between two countries may exert long-term economic consequences as predicted by the marketing literature consumer animosity model. Residual animosity means that the economic effects of political tensions accumulate through a ripple effect on the desirability of certain brands and certain products. The possibility of "unconscious brand association" between American products and American foreign policy concerns the American business community. As the *Financial Times* analyzes, "warnings from the marketing industry suggest the risk stems not so much from overt boycotts, but from a loss of cachet among younger consumers. Where once Marlboro cigarettes, Big Macs and a can of coke appeared cool even among French teenagers, a significant percentage may now think twice about the cultural message that U.S. brands project."<sup>105</sup> According to marketing professor John Quelch, "we have reached the tipping point where Pax Americana now threatens Brand America."<sup>106</sup> There may be a generational component as younger people become less attracted to the image of American lifestyle promoted by some American products. Keith Reinhardt, founder of the group Business for Diplomatic Action, explains, "research across much of the globe shows that consumers are cooling toward American culture and American brands, but there is still no hard evidence showing direct impact on bottom lines. In marketing, we know that attitude precedes behavior, and the warning signs are there."<sup>107</sup>

Similar concerns are seen in Japan. In a survey of Japanese companies conducted in May 2005 after anti-Japan protests and boycott calls in China, "tarnished image of products" was the

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<sup>104</sup> Richard Ettenson, N. Craig Smith, Jill Klein and Andrew John, "Rethinking Consumer Boycotts," *MIT Sloan Management Review*, Vol. 47, No. 4, pp. 6-7.

<sup>105</sup> Dan Roberts, "US icons lose their cool in Europe," *The Financial Times*, October 24, 2004.

<sup>106</sup> "Will American brands be a casualty of war?", Interview with John Quelch, Working Knowledge, Harvard Business School, <http://hbswk.hbs.edu/item.jhtml?id=3429&t=marketing>.

<sup>107</sup> *Corporate Citizen*, 2004. See also <http://www.businessfordiplomaticaction.org/index.php>.

second most frequently cited concern about harmful impact from demonstrations after decreased sales.<sup>108</sup> Research institutes have conducted detailed surveys of corporate brand image in China to begin tracking the status of Japanese corporate image in terms of consumer confidence and trust.<sup>109</sup> Leading Japanese firms such as Sony and Toyota lag behind their American and Korean competitors in the perceptions of Chinese consumers.

While our findings show little effect from the political tensions for now, the lingering effects could yet to be felt in the future. Rather than a sharp economic response to particular incidents, there may appear diffuse effects following multiple episodes of sustained political tension. The Japan-China relationship represents the most likely case to observe such effects given that they experienced both severe hostility at war and sustained aggravation through a series of politicized history problems. Nonetheless their economic relations continue to deepen both in absolute and relative terms. Thus while there may be long term effects not fully captured in our analysis, it also appears that economic relations at the aggregate level over time do not suffer from political grievances.

## **Conclusion**

This paper asked whether economic ties are insulated from political discord and analyzed under which conditions political tensions spill over into the economic realm. We found the threshold for such spillover to be very high. Overall, economic relations seem to be quite insulated from political relations. In both the Franco-American and the Sino-Japanese cases, we found little short-term economic impact of political tensions. In spite of serious political disagreements for both pairs of countries, it is business as usual. Even when examining trade for high salience industries such as French wine or Japanese autos, we found no evidence of serious harm. Yet it does not mean that the firewall between politics and economics is impenetrable. At the micro level, collateral damage from political tensions may harm some firms in economic sectors that are more vulnerable to animosity from consumers or regulatory intervention by

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<sup>108</sup> JETRO, “Special Survey of Japanese Businesses in China: Impact of the April Anti-Japan Demonstrations,” June 2005. available at [http://www.jetro.go.jp/en/stats/survey/surveys/20050620\\_special.pdf](http://www.jetro.go.jp/en/stats/survey/surveys/20050620_special.pdf).

<sup>109</sup> Nomura Research Institute and Searchina Research Institute jointly published a survey “Corporate Brand in China” in 2005 and again in 2006.

governments. Future effects may also appear through erosion of brand image, as shown by the evidence in studies of consumer animosity.

Our findings have implications for the debate on economic interdependence and cooperation. While studies have pointed to evidence that trade follows the flag and that interdependence may constrain conflict, more research is necessary to specify the causal mechanisms and conditions under which the relationship holds. How much latitude do states have to direct economic flows in the present era of globalization? While we saw some evidence of interference at the margin on procurement and regulatory decisions, none of the governments involved in the political feuds we examine exerted a concerted effort to interfere with economic exchange. In a period of liberalized economies and multinational companies, governments may find it more difficult to dictate economic outcomes according to political interests and face greater penalties for doing so. Market actors appeared unfazed by political tensions at either the firm or consumer level. High levels of transnationality in trade between the United States and France and between Japan and China and the sunk costs in existing economic relationships made it impractical and undesirable for firms to switch purchase and investment plans. Given the evidence from our cases that political tensions short of war do not produce economic harm, the business lobbying for improved political relations necessary for a commercial peace may not take place. If severe crisis is the necessary trigger for such lobbying, one must question whether at such a late stage economic interests would be able to pull countries back from the brink of war. Yet even if unable to prevent conflict as hypothesized by the commercial peace, the resilience of economic interdependence to political crises creates a buffer zone of normal business interactions that dilute the harm from political tensions.

**Data Sources:**

Quarterly aggregate trade data are from IMF's *Direction of Trade*. GDP and population are from the IMF's *International Financial Statistics*. When quarterly GDP data was unavailable for the trade partner, it has been imputed from annual GDP data.

Events data, "10 Million International Dyadic Events" are available at <http://dvn.iq.harvard.edu/dvn/dv/king> (see King and Lowe, 2003).

Annual industry level trade data are from the United Nations Comtrade database.

GATT/WTO Data from Rose has been updated from 2002-2005 using information from the WTO website. PTA data are from Goldstein, Rivers, and Tomz (2007), and the WTO website.

U.S. FDI data are from the Bureau of Economic Analysis.

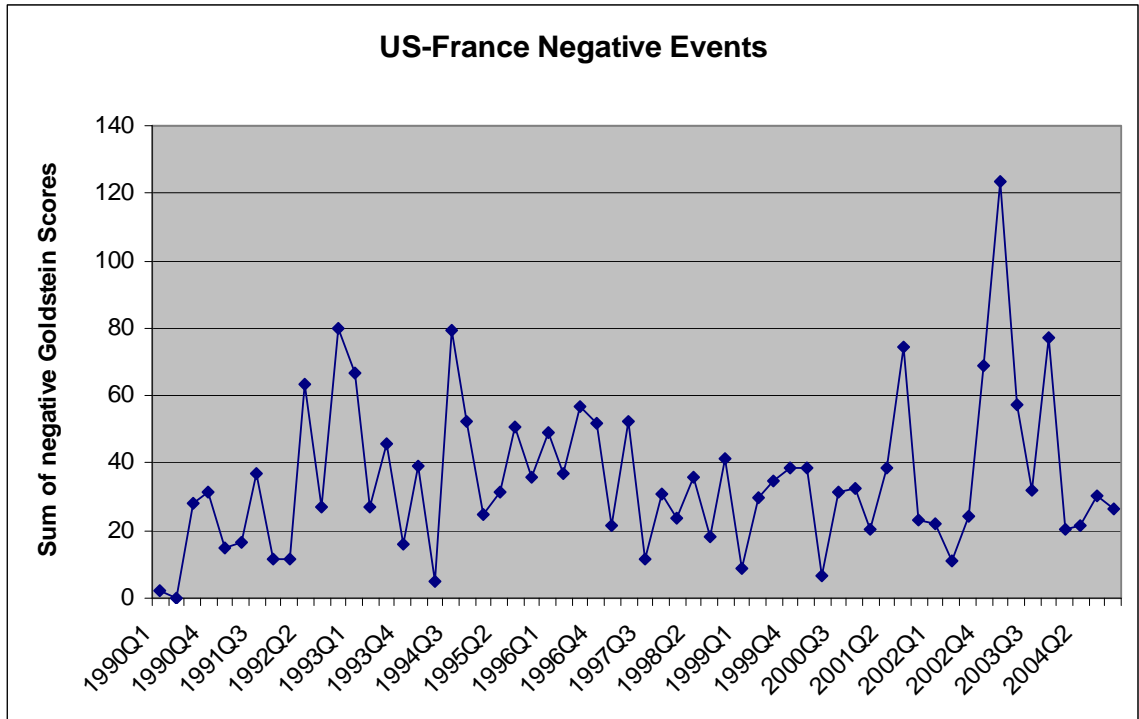
Japanese FDI data are from the Bank of Japan.

BIT data is from UNCTAD.

Distance, language, and island/landlocked variables are based on the CIA Factbook.

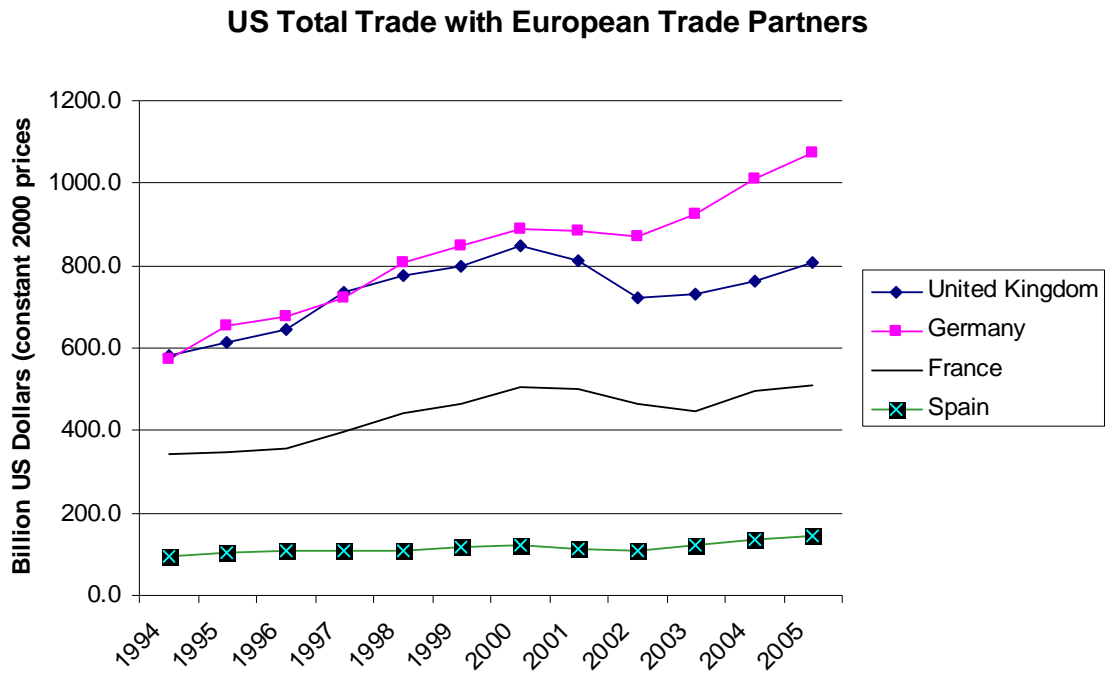
Alliance data are from Correlates of War (COW alliance data 3.03), with all values extended unchanged from the last year of data availability in 1990.

Figure 1



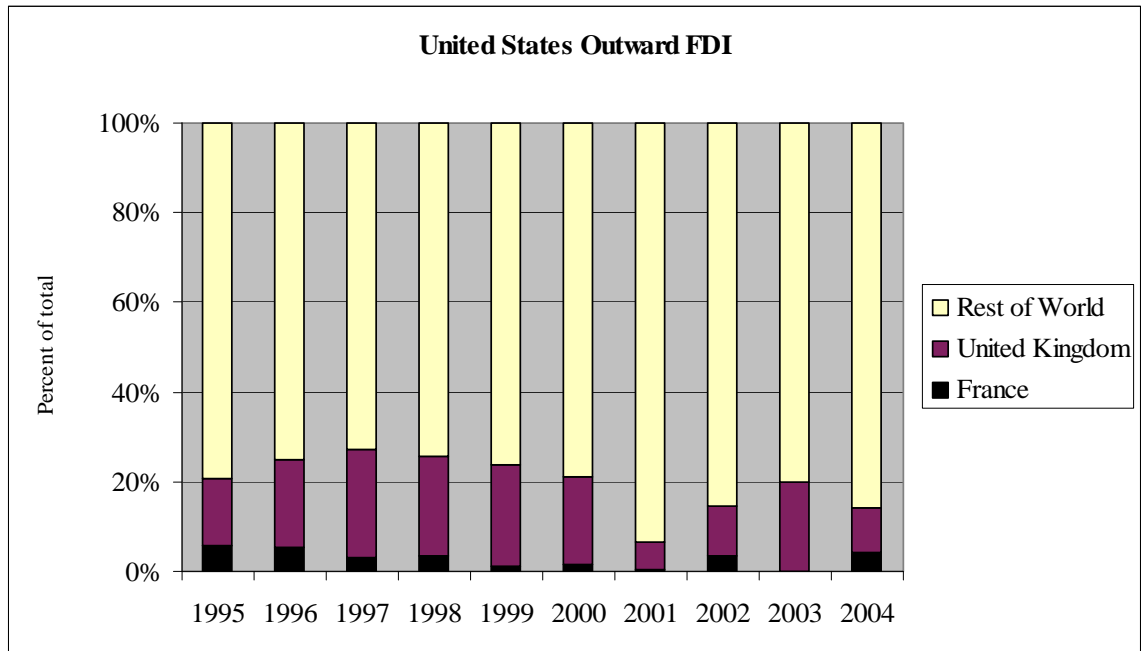
Quarterly time-series plot of Goldstein-Scaled negative events between the US and France from 1990 to 2004.

Figure 2



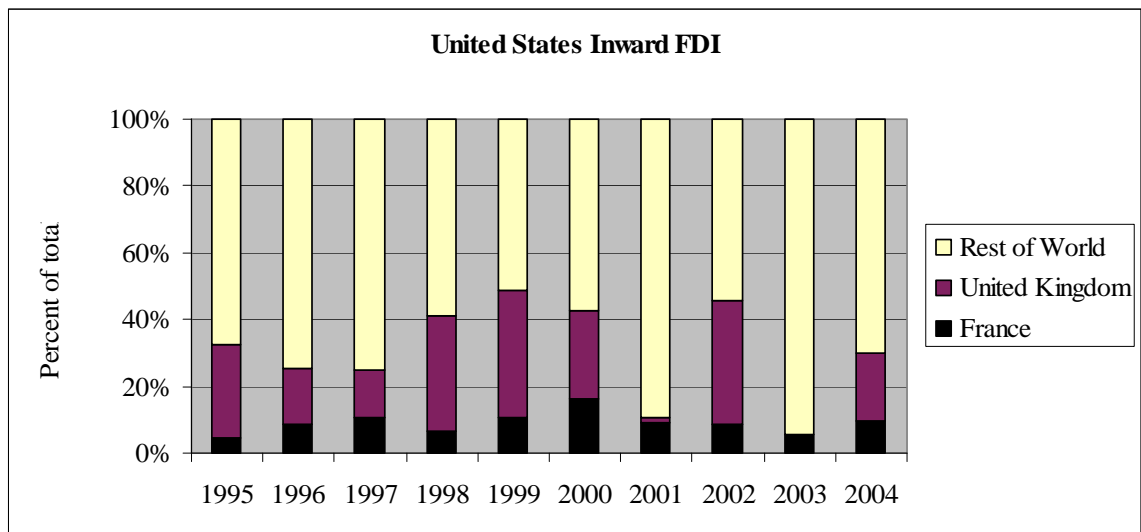
Source: IMF Direction of Trade.

Figure 3



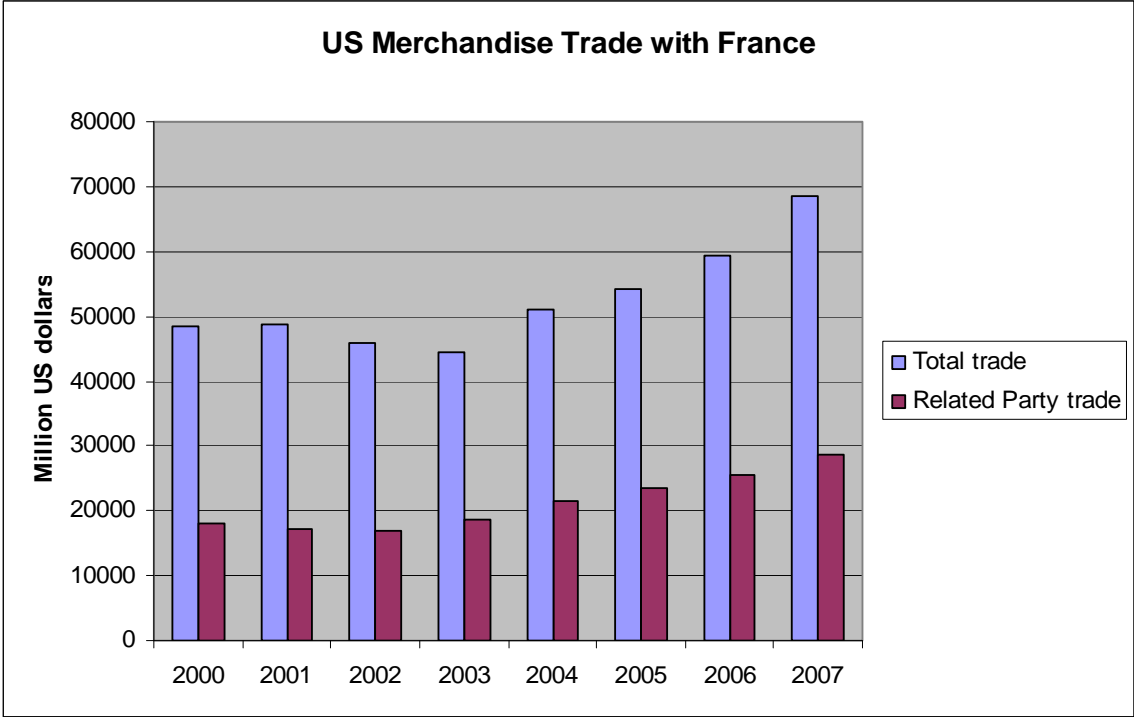
Source: OECD International Direct Investment by Country, [www.sourceoecd.org](http://www.sourceoecd.org)

Figure 4



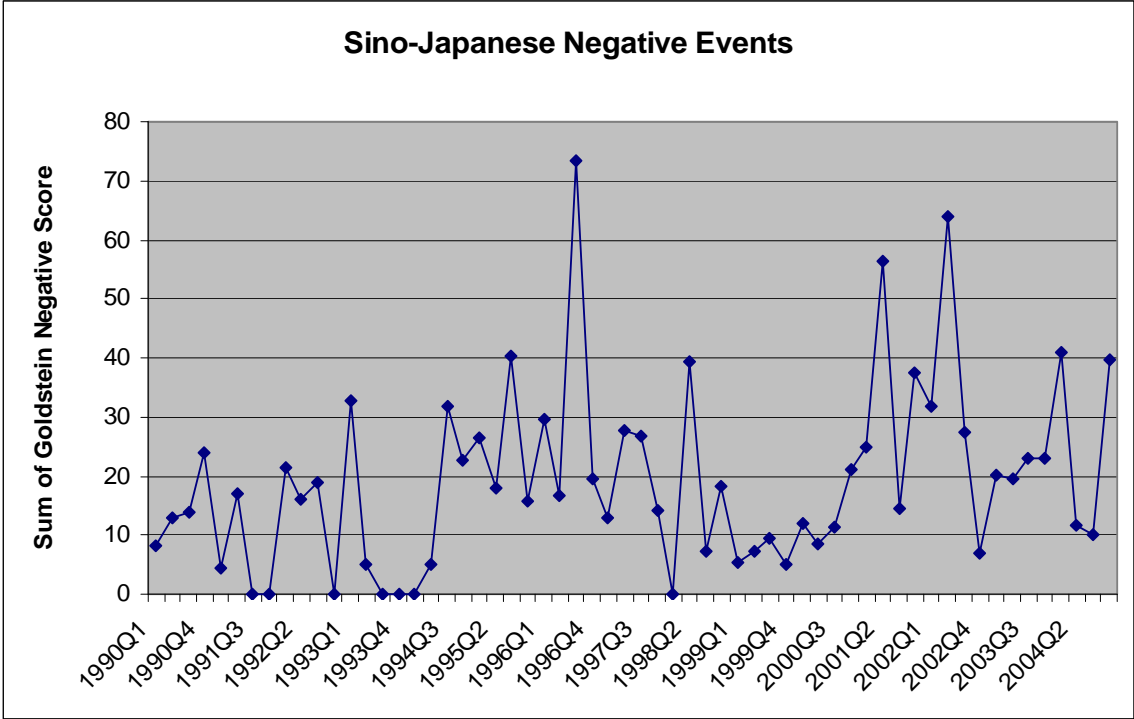
Source: OECD International Direct Investment by Country, [www.sourceoecd.org](http://www.sourceoecd.org)

Figure 5



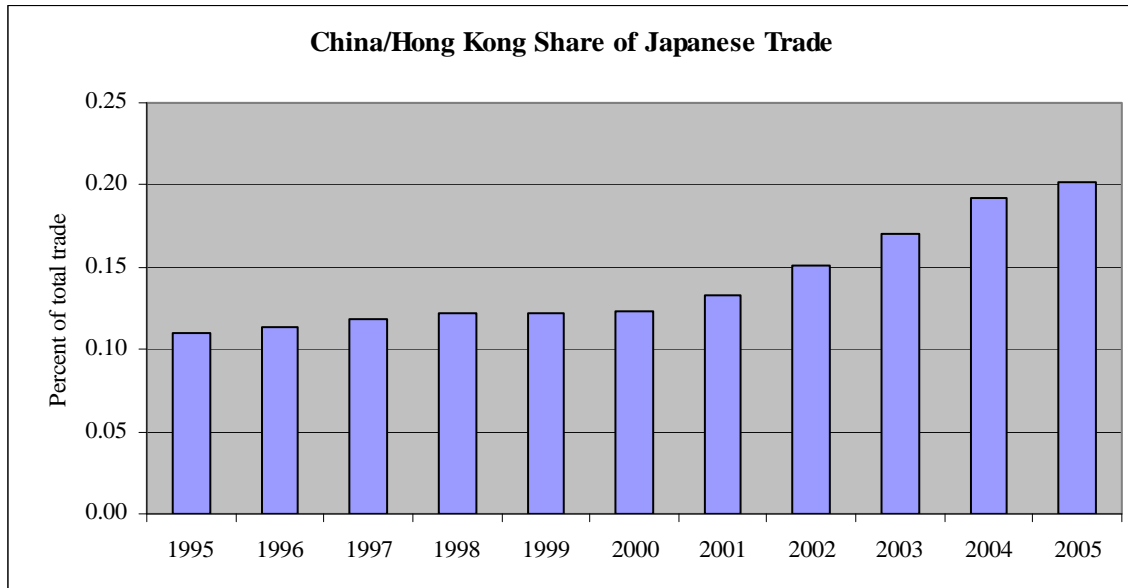
Source: U.S. Census Bureau. Related Party Trade refers to the sum of U.S. imports and exports with France in which the U.S. importer (exporter) holds at least a 6% (10%) equity interest in the French firm.

Figure 6.



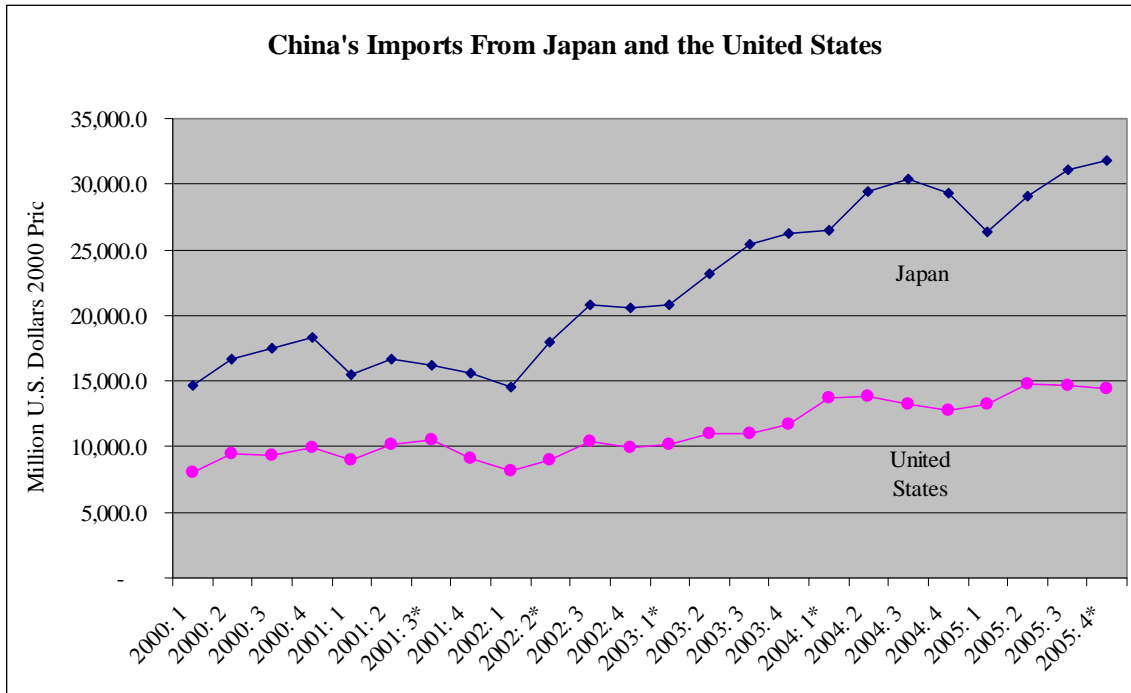
Quarterly time-series plot of Goldstein-Scaled negative events between Japan and China from 1990 to 2004.

Figure 7



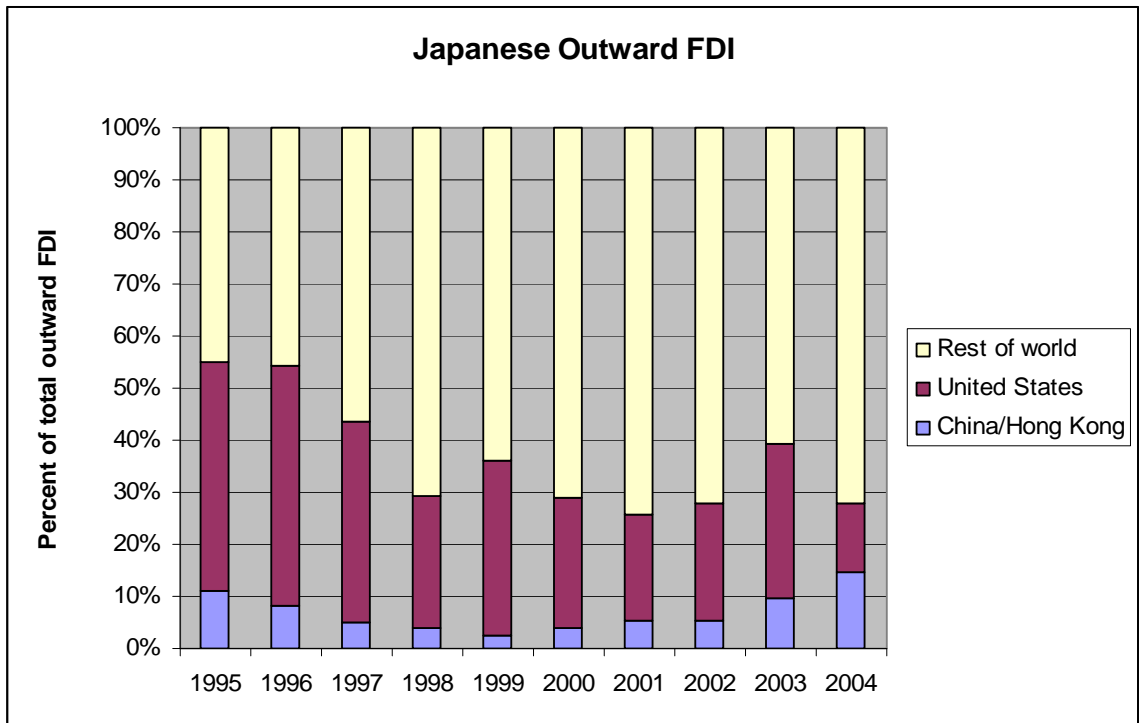
Source: Ministry of Finance, "Trade Statistics of Japan" <http://www.customs.go.jp>

Figure 8



The Figure shows the quarterly imports of China from Japan and the United States. The dates marked with an asterisk indicate the periods that Prime Minister Koizumi visited Yasukuni shrine. Source: IMF Direction of Trade (Global Insight, November 2, 2006).

Figure 9



Source: OECD International Direct Investment by Country, [www.sourceoecd.org](http://www.sourceoecd.org)

Table 1: Gravity Model estimation of U.S. Trade and Investment

Variable	EXPORTS				IMPORTS				FDI_outflow			
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
Political tension	0.084	0.049	-0.009	0.007	0.015	0.063	-0.010	0.0119	0.281	0.444	-0.219	0.224
Hostility	-0.470	0.255	-0.110	0.068	-0.056	0.287	-0.062	0.1025	1.927	2.777	1.127	1.737
Distance	<b>-1.201</b>	<b>0.183</b>			<b>-0.740</b>	<b>0.245</b>			<b>-7.573</b>	<b>2.455</b>		
GDP	<b>0.866</b>	<b>0.043</b>	<b>0.135</b>	<b>0.028</b>	<b>1.023</b>	<b>0.055</b>	<b>0.248</b>	<b>0.0367</b>	<b>4.571</b>	<b>1.251</b>	<b>4.398</b>	<b>1.109</b>
Landlocked	<b>-0.484</b>	<b>0.181</b>			<b>-0.532</b>	<b>0.302</b>			3.262	2.150		
Island	<b>0.104</b>	<b>0.157</b>			0.213	0.240			5.664	3.315		
Exchange rate	-0.057	0.033	<b>-0.046</b>	<b>0.010</b>	-0.007	0.045	<b>-0.027</b>	<b>0.0130</b>	<b>-1.465</b>	<b>0.517</b>	-0.196	0.193
GATT/WTO	0.152	0.212	<b>0.102</b>	<b>0.034</b>	0.458	0.300	<b>0.189</b>	<b>0.0508</b>	-0.358	2.395	-1.641	1.097
PTA	0.582	0.304	0.079	0.048	<b>0.844</b>	<b>0.282</b>	<b>0.823</b>	<b>0.1556</b>	-0.354	5.244	-2.045	3.504
BIT									-2.078	1.797	-0.711	1.098
Alliance	0.381	0.203	<b>0.313</b>	<b>0.064</b>	0.018	0.249	<b>0.468</b>	<b>0.0545</b>	0.944	1.715		
Common language	<b>0.780</b>	<b>0.165</b>			<b>0.744</b>	<b>0.224</b>			5.854	3.125		
Constant	<b>-7.585</b>	<b>1.763</b>	0.901	0.717	<b>-15.950</b>	<b>2.272</b>	<b>-114.396</b>	<b>30.756</b>	<b>-56.730</b>	<b>24.233</b>	<b>-115.036</b>	<b>30.999</b>
Fixed effects	quarter		quarter and country		quarter		quarter and country		quarter		quarter and country	
Adj. R-squared	0.829		0.955		0.753		0.939		0.245		0.425	
N	8522		8522		8358		8358		2176		2176	

Note: Data cover 1990-2004 for exports and imports, and 1994-2004 for FDI. The unit of analysis is a directed dyad with the United States and its partner for a quarter time period, and the dependent variable is the natural log of U.S. exports/imports/FDI outflows to the partner (measured in 2000 U.S. dollars). Political tension is the sum of negative events (Goldstein-scaled weights) reported between the two countries during the quarter period. All variables except dummies are expressed in natural logarithms; estimation is by ordinary least squares. Fixed effects coefficients are not shown. Coefficients shown in bold type are significant at 5 percent level.

Table 2: Gravity Model estimation of Japanese Trade and Investment

Variable	EXPORTS				FDI_outflow			
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
Political tension	<b>0.154</b>	<b>0.068</b>	0.014	0.015	0.007	0.004	0.003	0.004
Hostility	<b>0.597</b>	<b>0.261</b>	0.148	0.087	0.004	0.010	-0.001	0.012
Distance	<b>-0.848</b>	<b>0.247</b>			0.000	0.004		
GDP	<b>0.914</b>	<b>0.042</b>	<b>0.241</b>	<b>0.035</b>	0.007	0.004	0.000	0.006
Landlocked	<b>-0.737</b>	<b>0.238</b>			<b>-0.014</b>	<b>0.004</b>		
Island	<b>0.746</b>	<b>0.200</b>			0.017	0.011		
Exchange rate	-0.019	0.085	<b>-0.200</b>	<b>0.025</b>	-0.004	0.002	-0.003	0.002
GATT/WTO	<b>0.623</b>	<b>0.224</b>	<b>0.335</b>	<b>0.046</b>	0.005	0.006	<b>0.046</b>	<b>0.013</b>
PTA	<b>2.832</b>	<b>0.260</b>	<b>-0.165</b>	<b>0.047</b>	-0.003	0.018	-0.005	0.016
BIT					0.014	0.012	0.000	0.007
US	0.408	0.287			<b>0.155</b>	<b>0.023</b>		
Constant	<b>-12.887</b>	<b>2.879</b>	<b>-2.551</b>	<b>0.879</b>	-0.215	0.117		
Fixed effects	quarter		quarter and country		quarter		quarter and country	
Adj. R-squared	0.777		0.950		0.318		0.356	
N	8344		8344		926		926	

Table 3. Gravity Model of U.S. Bilateral Trade, 1990-2006

Variable	EXPORTS						IMPORTS					
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
France			-0.169	0.235					-0.342	0.213		
Iraqpt*France	<b>-0.153</b>	<b>0.0460</b>	-0.054	0.059	-0.085	0.067	-0.065	0.033	0.049	0.073	-0.042	0.047
Spain			<b>-0.420</b>	<b>0.205</b>					<b>-0.953</b>	<b>0.200</b>		
Iraqpt*Spain			<b>-0.271</b>	<b>0.107</b>	<b>-0.150</b>	<b>0.062</b>			-0.043	0.121	-0.051	0.052
UK			<b>-0.596</b>	<b>0.237</b>					<b>-0.918</b>	<b>0.335</b>		
Iraqpt*UK			<b>-0.118</b>	<b>0.048</b>	-0.087	0.048			-0.069	0.064	-0.061	0.041
Distance			<b>-1.069</b>	<b>0.214</b>					<b>-0.727</b>	<b>0.211</b>		
GDP	0.007	0.1011	<b>0.895</b>	<b>0.042</b>	<b>0.163</b>	<b>0.028</b>	0.333	0.179	<b>1.044</b>	<b>0.052</b>	<b>0.262</b>	<b>0.035</b>
Landlocked			<b>-0.455</b>	<b>0.177</b>					-0.503	0.281		
Island			0.230	0.171					0.263	0.236		
Exchange rate	<b>-0.144</b>	<b>0.0430</b>	<b>-0.070</b>	<b>0.034</b>	<b>-0.034</b>	<b>0.009</b>	<b>-0.268</b>	<b>0.080</b>	-0.012	0.040	-0.019	0.012
GATT/WTO			0.253	0.208	<b>0.094</b>	<b>0.032</b>			0.487	0.290	<b>0.236</b>	<b>0.049</b>
PTA			0.597	0.346	0.048	0.036			<b>0.769</b>	<b>0.237</b>	<b>0.499</b>	<b>0.110</b>
Alliance			0.354	0.189	<b>0.218</b>	<b>0.031</b>			0.014	0.173	<b>0.076</b>	<b>0.034</b>
Common language			<b>0.757</b>	<b>0.167</b>					<b>0.721</b>	<b>0.219</b>		
Constant	<b>8.392</b>	<b>3.1008</b>	<b>-9.512</b>	<b>1.875</b>	0.389	0.724	-1.048	5.496	<b>-16.583</b>	<b>2.064</b>	<b>-2.122</b>	<b>0.914</b>
Fixed effects			quarter		quarter and country				quarter		quarter and country	
Adj. R-squared	0.398		0.825		0.954		0.786		0.766		0.940	
N	67		9487		9487		67		9295		9295	

Note: The unit of analysis is a directed dyad with the United States and its trade partner for a quarter time period, and the dependent variable is the natural log of U.S. exports to the trade partner (measured in 2000 U.S. dollars). Models 1 and 4 present the time series for U.S.-France trade with Newey-West standard errors to adjust for autocorrelation up to a 4 period lag. Other models include the full sample of U.S. trade partners. Models 2 and 5 include quarter fixed effects and show robust standard errors clustered by trade partner. Models 3 and 6 include both quarter and country fixed effects (not shown). Coefficients in bold type are significant at 5 percent level.

Table 4. Gravity Model of U.S. Bilateral Imports of High Salience Products, 1990-06

	Blue Cheese		Wine		Champagne		Leather handbags		Perfume	
Variable	Model 1		Model 2		Model 3		Model 4		Model 5	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
France	<b>1.104</b>	<b>0.302</b>	<b>5.423</b>	<b>0.876</b>	<b>6.393</b>	<b>0.961</b>	<b>3.542</b>	<b>0.810</b>	<b>6.144</b>	<b>0.701</b>
Iraqpt*France	-0.167	0.540	<b>0.572</b>	<b>0.274</b>	0.209	0.303	<b>0.657</b>	<b>0.184</b>	-0.250	0.223
Spain	<b>-0.723</b>	<b>0.233</b>	<b>3.828</b>	<b>0.885</b>	<b>4.774</b>	<b>1.005</b>	<b>2.196</b>	<b>0.727</b>	<b>4.241</b>	<b>0.676</b>
Iraqpt*Spain	0.960	0.483	0.569	0.474	0.007	0.475	<b>1.097</b>	<b>0.303</b>	<b>-0.661</b>	<b>0.303</b>
UK	0.202	1.307	0.505	1.121	0.316	0.956	-0.700	0.824	<b>3.564</b>	<b>0.563</b>
Iraqpt*UK	0.072	0.558	<b>0.572</b>	<b>0.251</b>	<b>-0.952</b>	<b>0.258</b>	<b>1.158</b>	<b>0.164</b>	<b>0.529</b>	<b>0.207</b>
Distance	-0.094	1.500	<b>2.383</b>	<b>0.668</b>	0.817	0.446	-0.219	0.490	-0.654	0.432
GDP	<b>2.438</b>	<b>0.336</b>	0.345	0.175	<b>0.503</b>	<b>0.222</b>	<b>1.023</b>	<b>0.178</b>	<b>0.621</b>	<b>0.113</b>
Landlocked	<b>-7.379</b>	<b>1.496</b>	-0.140	0.773	-0.711	0.539	0.553	0.563	0.854	1.137
Island	<b>-5.017</b>	<b>1.560</b>	0.232	1.076	0.698	1.067	-0.287	0.687	-0.166	0.414
Exchange rate	0.045	0.072	-0.057	0.174	0.046	0.152	<b>0.249</b>	<b>0.103</b>	<b>-0.234</b>	<b>0.078</b>
GATT/WTO	(dropped)		0.762	0.557	-0.004	0.584	0.077	1.158	-0.076	0.565
PTA	-1.604	2.003	<b>1.578</b>	<b>0.754</b>	-0.160	0.466	-0.704	0.758	1.054	0.641
Alliance	-1.686	1.076	<b>1.251</b>	<b>0.562</b>	0.395	0.307	0.652	0.441	0.069	0.405
Common language	<b>6.157</b>	<b>1.228</b>	-0.138	0.777	-0.915	0.731	0.830	0.552	0.113	0.602
Constant	<b>-61.718</b>	<b>14.658</b>	<b>-23.842</b>	<b>7.779</b>	<b>-14.491</b>	<b>7.172</b>	<b>-20.890</b>	<b>5.366</b>	-3.268	4.004
Adj. R-squared	0.739		0.345		0.574		0.418		0.491	
N	147		793		425		1113		906	

Note: Data for imports from all trade partners. The unit of analysis is an annual directed dyad with the United States and its trade partner, and the dependent variable is the natural log of U.S. imports from the trade partner (measured in 2000 U.S. dollars). The models estimate U.S. imports of the following five goods: blue cheese (SITC 0243), wine (SITC 11217), champagne (SITC11215), leather handbags (SITC 83111), and perfume (SITC5531). Year fixed effect coefficients are not shown. Robust standard errors are clustered by trade partner. Coefficients shown in bold type are significant at 5 percent level.

Table 5. Gravity Model of U.S. Bilateral FDI, 1994-2006

Variable	FDI OUTFLOWS				FDI INFLOWS			
	Model 1		Model 2		Model 3		Model 4	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
France	-1.615	1.953			<b>15.998</b>	<b>6.195</b>		
Iraqpt*France	<b>-3.726</b>	<b>0.866</b>	-3.439	5.462	<b>-27.231</b>	<b>1.649</b>	<b>-26.654</b>	<b>9.400</b>
Spain	-2.754	1.675			<b>-11.444</b>	<b>4.382</b>		
Iraqpt*Spain	<b>-2.103</b>	<b>1.046</b>	-1.017	4.719	<b>-3.768</b>	<b>1.379</b>	0.054	4.139
UK	<b>38.422</b>	<b>1.979</b>			<b>27.174</b>	<b>5.187</b>		
Iraqpt*UK	<b>-10.836</b>	<b>0.819</b>	-10.914	20.063	<b>-24.739</b>	<b>1.913</b>	-24.714	44.265
Distance	<b>-2.721</b>	<b>1.214</b>			1.310	2.664		
GDP	<b>2.514</b>	<b>0.344</b>	<b>2.747</b>	<b>0.932</b>	<b>3.806</b>	<b>1.728</b>	-1.928	2.310
Landlocked	3.372	1.956			9.011	6.424		
Island	2.075	1.172			2.171	2.697		
Exchange rate	<b>-0.885</b>	<b>0.229</b>	-0.241	0.195	<b>-2.074</b>	<b>0.846</b>	-0.265	0.646
BIT	-2.161	1.320	1.329	1.193	3.365	3.953	1.570	2.932
GATT/WTO	-0.358	1.697	-0.398	1.191	0.912	3.955	-4.110	2.328
PTA	4.795	2.775	0.002	4.540	0.377	4.271	0.998	2.739
Alliance	<b>3.525</b>	<b>1.587</b>			<b>7.932</b>	<b>2.232</b>		
Common language	2.284	1.578			-2.912	3.980		
Constant	<b>-43.471</b>	<b>10.170</b>	<b>-66.657</b>	<b>26.181</b>	<b>113.975</b>	<b>49.727</b>	65.001	66.552
Fixed effects	quarter		quarter and country		quarter		quarter and country	
Adj. R-squared	0.282		0.320		0.118		0.154	
N	2568		2568		1596		1596	

Note: The unit of analysis is a quarter directed dyad with the United States and its partner, and the dependent variable is the total value of U.S. FDI (measured in 2000 U.S. dollars). Models 1 and 3 include quarter fixed effects and estimate robust standard errors clustered by partner. Models 2 and 4 include both quarter and country fixed effects. Coefficients shown in bold type are significant at 5 percent level.

Table 6. Gravity Model of Japanese Bilateral Exports, 1990-2006.

Variable	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
China			0.624	0.322					<b>0.692</b>	<b>0.313</b>		
Koizumi	<b>0.396</b>	<b>0.103</b>	0.219	0.201	<b>0.571</b>	<b>0.083</b>						
Yasukuni							<b>0.171</b>	<b>0.064</b>	0.130	0.116	<b>0.367</b>	<b>0.097</b>
Distance			<b>-0.889</b>	<b>0.228</b>					<b>-0.887</b>	<b>0.229</b>		
GDP	<b>1.180</b>	<b>0.181</b>	<b>0.943</b>	<b>0.040</b>	<b>0.268</b>	<b>0.035</b>	<b>1.561</b>	<b>0.140</b>	<b>0.944</b>	<b>0.040</b>	<b>0.264</b>	<b>0.035</b>
Landlocked			<b>-0.739</b>	<b>0.230</b>					<b>-0.745</b>	<b>0.231</b>		
Island			<b>0.840</b>	<b>0.202</b>					<b>0.844</b>	<b>0.202</b>		
Exchange rate	0.239	3.462	0.065	0.101	<b>-0.157</b>	<b>0.025</b>	-5.836	3.588	0.067	0.100	<b>-0.160</b>	<b>0.024</b>
GATT/WTO			<b>0.544</b>	<b>0.226</b>	<b>0.348</b>	<b>0.044</b>			<b>0.553</b>	<b>0.225</b>	<b>0.374</b>	<b>0.044</b>
PTA			<b>2.218</b>	<b>0.624</b>	<b>-0.144</b>	<b>0.053</b>			<b>2.215</b>	<b>0.625</b>	<b>-0.152</b>	<b>0.053</b>
Alliance (US)			<b>0.889</b>	<b>0.231</b>					<b>0.883</b>	<b>0.233</b>		
Constant	<b>-25.704</b>	<b>5.041</b>	<b>-13.286</b>	<b>2.751</b>	<b>-2.844</b>	<b>0.867</b>	<b>-36.291</b>	<b>3.879</b>	<b>-13.349</b>	<b>2.766</b>	<b>-2.767</b>	<b>0.867</b>
Fixed effects			quarter		quarter and country				quarter		quarter and country	
Adj. R-squared	0.924		0.788		0.951		0.879		0.787		0.952	
N	67		9419		9419		66		9286		9286	

Note: The unit of analysis is a directed dyad with Japan and its trade partner for a quarter time period, and the dependent variable is the natural log of Japanese exports to the trade partner (measured in 2000 U.S. dollars). The first three models measure political tensions for the period of the Koizumi administration (2001 3<sup>rd</sup> quarter to 2006 2<sup>nd</sup> quarter), and the second three models measure political tensions as an indicator for the quarter after a prime minister visited Yasukuni shrine. Both Koizumi and Yasukuni variables are an interaction term with the China indicator to measure the effect on exports to China. Models 1 and 4 are the time series for Japan-China trade and estimate Newey-West standard errors to adjust for autocorrelation up to a 4 period lag. Other models include the full sample of all Japanese trade partners in cross-section time series analysis. Models 2 and 5 including quarter period effects and estimate robust standard errors clustered by trade partner. Models 3 and 6 add country fixed effects. Coefficients shown in bold type are significant at 5 percent level.

Table 7. Gravity Model of Japanese Exports of High Salience Products, 1990-06.

Variable	Autos		Beer		Cameras	
	Model 1 Coef.	Std. Err.	Model 2 Coef.	Std. Err.	Model 3 Coef.	Std. Err.
China	0.067	0.436	<b>-1.699</b>	<b>0.641</b>	<b>-1.096</b>	<b>0.538</b>
Koizumi	<b>0.497</b>	<b>0.230</b>	0.011	0.523	0.690	0.376
Distance	0.445	0.343	<b>-0.940</b>	<b>0.237</b>	<b>-1.127</b>	<b>0.307</b>
GDP	<b>0.900</b>	<b>0.051</b>	<b>0.458</b>	<b>0.088</b>	<b>1.122</b>	<b>0.074</b>
Landlocked	-0.293	0.299	-0.401	0.485	0.177	0.408
Island	<b>1.232</b>	<b>0.238</b>	0.437	0.510	<b>0.947</b>	<b>0.333</b>
Exchange rate	-0.110	0.109	-0.274	0.148	-0.058	0.123
GATT/WTO	0.465	0.254	-0.769	0.555	0.181	0.398
PTA	<b>1.685</b>	<b>0.499</b>	1.695	1.065	1.716	1.140
Alliance (US)	<b>1.665</b>	<b>0.326</b>	<b>3.834</b>	<b>0.417</b>	<b>1.405</b>	<b>0.403</b>
Constant	<b>-16.169</b>	<b>3.935</b>	2.476	3.594	<b>-12.773</b>	<b>3.858</b>
Fixed effects	quarter		quarter		quarter	
Adj. R-squared	0.662		0.447		0.647	
N	2359		427		1344	

Note: The unit of analysis is a directed dyad with Japan and its trade partner for one year, and the dependent variable is the natural log of Japanese exports to the trade partner (measured in 2000 U.S. dollars). Each model measures political tensions for the period of the Koizumi administration. Model 1 shows estimates for exports of autos (SITC 7812), Model 2 shows estimates for exports of beer (SITC 1123), and Model 3 shows estimates for exports of cameras (SITC 88111). Year fixed effect coefficients are not shown. Robust standard errors are clustered by trade partner. Coefficients shown in bold type are significant at 5 percent level.

Table 8. Gravity Model of Japanese Bilateral FDI outflows, 1996-2006.

Variable	Model 1		Model 2	
	Coef.	Std. Err.	Coef.	Std. Err.
China	<b>0.027</b>	<b>0.010</b>	<b>0.056</b>	<b>0.010</b>
Koizumi	<b>0.059</b>	<b>0.005</b>		
Anti-Japan protests			<b>0.065</b>	<b>0.007</b>
Distance	-0.005	0.004	-0.004	0.004
GDP	0.007	0.004	0.007	0.004
Landlocked	-0.006	0.009	-0.007	0.009
Island	0.017	0.014	0.017	0.014
Exchange rate	-0.003	0.002	-0.002	0.002
BIT	-0.008	0.011	-0.008	0.010
GATT/WTO	0.004	0.006	0.012	0.010
PTA	0.003	0.019	0.002	0.019
Alliance (US)	<b>0.185</b>	<b>0.015</b>	<b>0.185</b>	<b>0.015</b>
Constant	-0.154	0.133	-0.159	0.135
Fixed effects	quarter		quarter	
Adj. R-squared	0.343		0.339	
N	1236		1236	

Note: The unit of analysis is a directed dyad with Japan and its FDI partner for a quarter time period, and the dependent variable is total Japanese FDI outflow to the partner (measured in billion 2000 U.S. dollars). Quarter time period fixed effect coefficients are not shown. Robust standard errors are clustered by trade partner. Coefficients shown in bold type are significant at 5 percent level.