

State Control and the Effects of Foreign Relations on Bilateral Trade*

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Abstract

A growing literature addresses the question of whether powerful states use trade to reward and punish partners. WTO rules and pressures of globalization restrict states' capacity to manipulate trade, but we argue that governments can map their political preferences onto economic outcomes using less direct avenues of influence. More specifically, where governments control the operations of firms through state ownership, they can manipulate bilateral trade at the firm level. Taking China and India as examples, we collect sector-level data on firm ownership and bilateral trade, as well as measures of bilateral political relations based on UN voting and political events to estimate the effect of political relations on import and export flows. Our results support the hypothesis that trade controlled by state-owned enterprises (SOEs) exhibits stronger responsiveness to political relations than trade controlled by non-SOEs. This research holds broader implications for how we should think about the relationship between political and economic relations going forward, especially as a number of countries with partially state-controlled economies—and the BRIC countries in particular—continue to gain strength in the global economy.

Powerful states have a long tradition of using economic statecraft to reward or punish trade partners. Global trade rules, however, restrict the ability of governments to use trade policy as a tool of influence. Transnational production further complicates efforts to link trade to foreign policy (Brooks, 2007; Davis and Meunier, 2011). A growing consensus has emerged that states have less leeway for using trade as carrot and stick in foreign policy.

Nevertheless, the news is full of stories about governments manipulating trade in response to political disputes. Furthermore, the phenomenon appears to have extended beyond great powers to a wide range of states engaging in the practice. Earlier this year, for example, *Telam*, Argentina's official news outlet, reported that Ministry officials had asked some 20 companies to cease importing materials from the U.K. in response to diplomatic tensions over the Falkland (Malvinas) Islands.¹ India asked firms to cut oil imports from Iran, the country's largest oil supplier, in response to U.S. pressure to support Iranian sanctions. China made waves in 2010 when it cut off exports of rare earths minerals to Japan supposedly over a territorial dispute in the East China Sea and again when it halted fresh salmon imports from Norway after the Nobel Committee awarded its Peace Prize to Chinese human rights activist Liu Xiaobo. Russia's decisions to cut off natural gas exports in 2006 and again in 2009, amidst long-standing disputes with Ukraine over gas contracts and the operation of its gas pipeline, sparked energy crises in a number of European countries. This year Ukraine cut its natural gas imports from Russia in an attempt to push Moscow towards conciliation on those same issues.²

These examples illustrate that while systemic changes may have reduced the *capacity* of some governments to direct trade in pursuit of foreign policy goals, they have not eliminated the *motive*. Political disputes still result in trade retaliation, at least some of the time. The methods of manipulation, however,

¹"Falklands dispute: Argentina 'urges UK import ban,'" *BBC News*, February 28, 2012.

²These disputes have raised tensions in other areas as well, with Russia threatening to cut imports of Ukrainian cheese and Ukraine imports of Russian meat, for example. See Sawomir Matuszak, "The Growing Russian-Ukrainian Gas Dispute," *Eastweek*, Center for Eastern Studies, January 18, 2012.

have been more subtle than the public economic sanctions that are a large focus in the literature on economic statecraft. In many cases, officials approach firms directly to request that they cut trade or change suppliers rather than adopting formal policy changes. Consequently, a government's capacity for trade manipulation hinges not only on its ability to legislate but also on its ability to influence decision-making at the firm level.

We argue in this paper that where governments exercise influence over the trading decisions of firms, we should observe a relationship between foreign relations and trade flows. More specifically, we examine the impact of bilateral political relations on bilateral trade in the state-controlled sector of the economy versus trade through firms not under state control. Our study extends the literature on two fronts. First, we depart from the traditional emphasis in the literature on major powers to examine emerging countries. We focus our analysis on two important cases: China and India. Both are global players with active foreign policy agendas and whose economies rank among the largest in the world.³ Secondly, within countries, some firms operate under heavy state influence, while others enjoy more autonomy, a distinction that is often masked by the focus on aggregate trade flows in existing studies. To remedy this shortcoming, we compare patterns of trade flows through state-owned enterprises (SOEs) and firms in the private sector of the economy. Our selection of China and India also facilitates this analysis because they retain high levels of state ownership in some sectors of the economy alongside other sectors with little state involvement.

The distinction between SOEs and non-SOEs is increasingly significant to the study of trade politics. How does state control impact firms? A prominent concern is whether closeness to the state leads these firms to favor state interests. SOEs figure prominently in the examples above, with the "gas wars"

³China is now the second largest economy in the world and India the tenth, as determined by GDP. Together, these countries accounted for 12 percent of world exports and almost 15 percent of world imports in 2011. See (World Trade Organization, N.d.). We also considered Russia as a potential case, but detailed data on state ownership are unavailable. See (Gaidar Institute for Public Policy, 2012).

between Russia and Ukraine conducted entirely through dictates handed down to state-owned gas firms Gazprom and Naftogaz, the domination of China's rare earths and fisheries sectors by large SOEs, and India's strong state presence in the oil sector. State-owned firms are intimately connected to government, often managed by current or former government officials, and financed from public coffers. Governments exert more influence over the operations of state-owned firms than private firms and are often accused of using their influence to satisfy political rather than economic goals. But the distinction between SOEs and non-SOEs is also critical for the strong and growing role of state-owned and partially state-owned firms in the economies of many emerging countries. Indeed, after the widespread privatizations of the 1980s and 1990s, recent trends suggest movement back towards state-directed capitalism in the emerging world, as the governments of a number of these countries—China, Brazil, Argentina, South Africa, and Russia among them—have taken steps to expand the number and size of state-owned enterprises in key sectors and develop corporate “champions.” SOEs now account for 80 percent of China's stock market, 62 percent of Russia's, and 38 percent of Brazil's, for example, and increasingly occupy the ranks of the world's largest firms.⁴

We hypothesize a stronger relationship between bilateral political relations and bilateral trade flows in sectors with higher levels of state ownership. While most of the recent literature has focused on military conflict to connote poor relations, we adopt a broader interpretation that encompasses lower-level frictions, such as threats, complaints, and diplomatic spats, that fall well short of war but combine to form the foundation of interstate relations. We quantify the bilateral political relationship using various measures of political events and voting alignment in the United Nations General Assembly (UNGA) and measure state ownership as the share of sector assets held by SOEs. In addition, we explore the distinction between consumer goods and non-consumer goods as another sector-level characteristic. Across

⁴“The Visible Hand,” *The Economist*, January 21, 2012. Figures as of June, 2011.

these different measures of relations and sector characteristics, we expect negative relations to correspond with lower trade volume. We examine the effects of political relations on imports and exports separately, as we expect a stronger relationship for the effect of relations on imports than on exports. Countries may punish trade partners who engage in hostile actions by seeking other sources of imports, but they would be less likely to hurt themselves by restricting exports. Russia's manipulation of gas exports and China's restrictions on rare earth exports represent two high-profile cases where dominant market position over natural resources allowed use of export restrictions as a tool to hurt other countries. Beyond that, reduced activities of economic diplomacy as a consequence of political tensions may also lead to reductions in overall exports.⁵ Therefore, although less obvious, there might be also some impact on exports.

Statistical analysis provides support for the hypothesis. Negative political events correspond with a reduction in imports, and the relationship is significantly greater for trade in sectors controlled by state-owned enterprises. Importantly, these results hold for both China and India. It does not appear that the influence of state control in the economy is contingent on regime type. As expected, the results are more mixed for exports. Interestingly, while we find some support that relations affect exports in both China and India, our hypothesis that this relationship will be stronger at high levels of state ownership holds only for India. The analysis of consumer goods trade is also mixed; Chinese consumer goods trade is especially subject to negative influence from a downturn in relations, while the India analysis reveals both consumer and non-consumer goods are equally likely to have negative response.

Our research indicates that economic statecraft remains relevant in the current era of globalization. Trade patterns respond to political relations in areas where governments maintain the capacity to manipulate trade. Moreover, our analysis demonstrates the need for more nuanced studies of the relationship

⁵For example, China has canceled state visits and trade missions as a response to foreign leader's receptions of the Dalai Lama (Fuchs and Klann, 2010). Empirical evidence has shown that state visits have a trade-promoting effect (Nitsch, 2007).

between political and economic relations, taking into account the relationships between governments and firms. Research focused on aggregate trade flows may obscure important sector-level effects, while cross-national panels may obscure distinctions at the country-level, particularly as future studies expand to encompass countries outside of the major powers.

The paper proceeds as follows: the second section presents a brief overview of the current literature and introduces some motivating examples of cases in which China and India limited trade in response to political conflicts; the third section discusses the argument and hypothesis; the fourth section presents the data, while the fifth section presents the empirical strategy and our results; the final section concludes.

1 Economic Statecraft in Theory and Practice

We are interested in how governments shape economic policy to meet foreign policy goals. Indeed, states employ any number of tools, from economic statecraft to military and diplomatic measures to influence the behavior of other states (Baldwin, 1985). In this regard, extensive evidence has shown that states use both punishments, such as economic sanctions, and rewards, such as foreign aid, to influence other states' behavior (e.g. Drezner, 2003; Kuziemko and Werker, 2006; Dreher, Sturm and Vreeland, 2009). Is such intervention observed in trade? Patterns of trade flows and trade agreements have been shown to follow alliance relations (Gowa, 1994; Mansfield and Bronson, 1997), but evidence has been mixed on the responsiveness to smaller shifts in relations (Pollins, 1989; Keshk, Reuveny and Pollins, 2004; Davis and Meunier, 2011; Fuchs and Klann, 2010).

1.1 Theoretical Perspectives on Economic Interdependence

Economic interdependence has long played a contested role in theories of international relations. As a component of state power, economic wealth is central to realist theories. Major powers seek to avoid trade with adversaries who could use the wealth generated by trade to purchase security advantages (Gowa, 1994). Interdependence introduces vulnerability, which may be used as means of control (Hirschman, [1945] 1980; Lake, 2009). This supports the expectation for states to structure their economic relations on the basis of political relations and to manipulate such dependency as part of coercive strategies.

Liberal theories place more emphasis on the constraining dynamic of economic ties. States act on the interests of social actors within the state, and the economic gains from interdependence may encourage cooperative relations under commercial liberalism. (Polachek, 1980; Russett and Oneal, 2001). While most attention is paid to the claim that trade promotes peace, there is a prior assumption that a break in political relations would interfere with economic exchange. Trade follows the flag because firms expect a lower likelihood of disruptive conflict when trading with states that share good relations (Pollins, 1989).

Thus from both perspectives, one would expect to observe a correlation between political relations and economic relations. The end of the Cold War reduced the expectation of realist theories for strong differentiation among partners, however, and the high levels of intra-industry trade and global production networks in the current era of globalization raise sunk costs in specialized production and relationships, slowing the response of economic actors to political shifts (Gowa, 1989; Davis and Meunier, 2011). Do states still engage in economic statecraft in a unipolar world? Are patterns of economic exchange swayed by politics in a global economy?

1.2 Examples of Punishment

China offers a test of these theories given its status both as a major power and a country deeply embedded in global trade. Significant attention has been given to China's use of investment and aid policies to win influence (e.g. Brautigam, 2010; Dreher and Fuchs, 2011; Cheung et al., 2012). Recent disputes suggest that the Chinese government is also willing and able to use its economic weight to punish states through trade reductions. Two such cases motivate our research into the conditions that support the use of economic statecraft by China. The first highlights import restrictions and the second focuses on export restrictions. Finally, we look into India-Pakistan relations as an Indian example of trade affected by political tensions.

Chinese Boycott of Norwegian Salmon

The announcement on October 8, 2010 that the Norwegian Nobel Committee had awarded the Nobel Peace Prize to Chinese human rights activist Liu Xiaobo set off a controversy in Norwegian-Chinese relations. With a former Norwegian prime minister on the committee, it was difficult for the Norwegian government to distance itself from the award. The Chinese government immediately protested the decision with public statements charging that Liu was a criminal and that selecting him for the award could harm China-Norway ties.⁶ Three days later, the Chinese government canceled a scheduled meeting with the Norwegian fisheries minister after her arrival in China, which Norwegian officials attributed to "reaction to the Nobel Peace Prize."⁷ These would not be the only repercussions. A new set of veterinary controls imposed at ports in China on fresh salmon had immediate effects. Norwegian salmon was re-

⁶Zheng Xinyi, "Beijing blasts Nobel Peace Prize Meddling," *People's Daily Online*, October 9, 2010, <http://english.peopledaily.com.cn/90001/90776/90882/7160366.html>.

⁷Sharon LaFraniere, "Chinese Cancel Meeting with Norwegian Minister," *New York Times*, October 11, 2010.

ported to be left rotting in the ports, while Scottish salmon encountered no obstacles.⁸ The data in figure 1 reveal the sharp drop of fresh salmon exports from Norway to China compared with those to the world after the announcement of the Peace Prize. Yet the target was quite narrow; no visible change is observed in either exports of total fish nor total exports from Norway to China. There may be further consequences for Sino-Norwegian trade that are more difficult to observe in the data, however. Specifically, China put on hold plans to sign a free trade agreement with Norway.⁹

Also important to this story is the relationship of the government to the fishing sector. State ownership in fishing is about 10 percent and 30 percent in the distance water fishing, the sub-sector most likely to compete with foreign suppliers. Despite the relatively low share of state ownership, the government maintains strong influence over the sector, with the stated goal of modernizing, expanding, and restructuring it under the direction of the state. Moreover, only a handful of companies comprise the state-owned share of the sector, while the private share is comprised largely of medium- and small-sized (often household-run) enterprises, encompassing over 4,000 fisheries villages and over 3 million individual fishermen, affording state-owned enterprises a more unified voice in the policy process. Though the average enterprise size is larger in distance fishing than in inland or coastal fishing, given the nature and expense of the equipment and labor involved, one SOE, China National Fisheries Corporation, and its subsidiaries account for about a third of total sector production.¹⁰ But even short of ownership, the state maintains strong control over the sector by providing large subsidies to private fishing enterprises, without which most would not survive, and integrating the entire fishing fleet into a large maritime militia on which the government calls to shore up maritime security.¹¹ Even private fishermen are thus routinely

⁸“Norway’s salmon rot as China takes revenge for dissident’s Nobel Prize,” *The Independent*, October 6, 2011.

⁹See website of China’s Ministry of Commerce available at <http://fta.mofcom.gov.cn/topic/ennorway.shtml>.

¹⁰The discussion in this paragraph draws largely on (Blomeyer et al., 2012)

¹¹Lyle Goldstein, “China’s fishing fleet sets challenge to US,” *Asia Times*, August 7, 2009.

mobilized in the service of political goals.

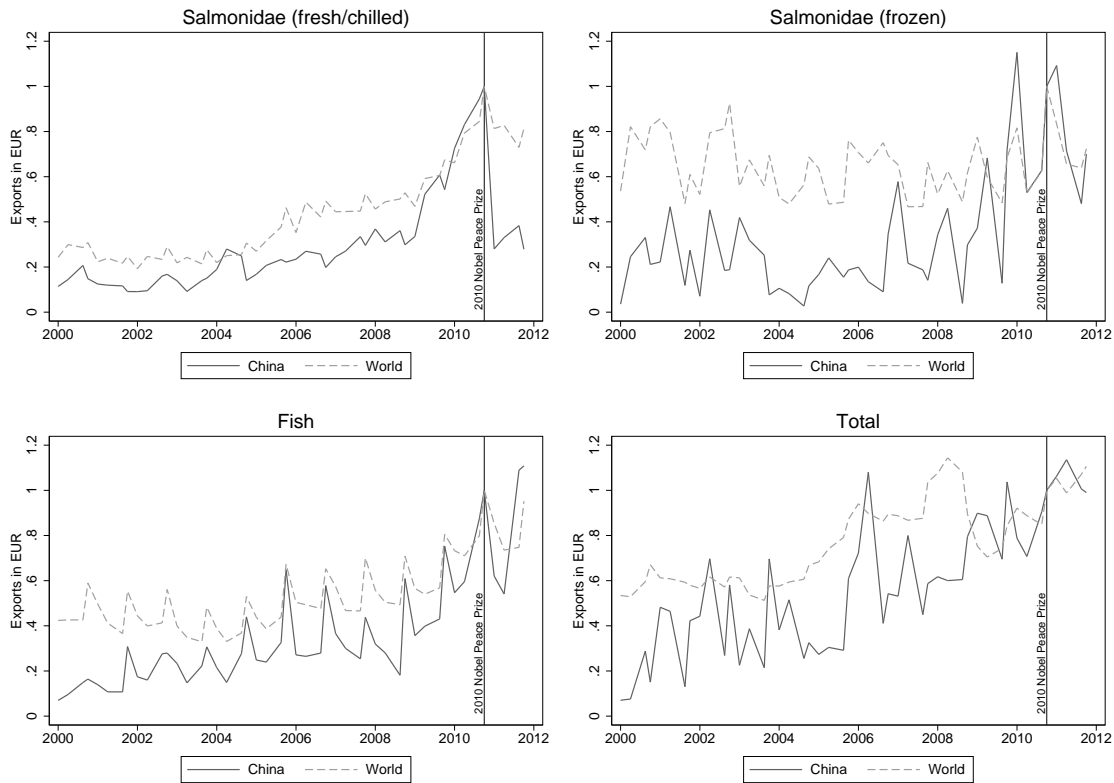


Figure 1: *Salmon Boycott*: Norwegian exports before/after the 2010 Nobel Peace Prize. Using disaggregated monthly trade data for Norway, we first compute quarterly values for Norwegian exports to China and to the world. As a second step, we normalize all values so that they take a value of 1 in the last quarter of 2010 when the Nobel Peace Prize was conferred. Data source: Eurostat.

Chinese Rare Earth Embargo on Japan

During this same period, Japan also experienced problems with China after the Japanese Coast Guard arrested the crew of a Chinese fishing boat on September 7, 2010 during a hostile encounter in the waters surrounding the disputed territory of the Senkaku/Diaoyu islands. Amidst anti-Japanese demonstrations in Beijing and a halt to cabinet-level exchanges, relations worsened as Japan extended its detention of the fishing boat captain. Evidence of targeted economic retaliation began to appear. Chinese travel firms canceled trips to Japan for 10,000 tourists, and the media reported that Beijing tourism authorities had

told travel agencies to abstain from encouraging tours to Japan.¹² Most significantly, Japan reported stoppage of rare earth exports from China, which threatened to cut off a vital resource used as an input for everything from engines for electric and hybrid autos to industrial batteries and flat screen LCD displays. Given that China supplied over ninety percent of the global supply of rare earth elements, the prospect of an embargo was quite serious. A survey by the Ministry of Economy, Trade and Industry of Japanese firms found that those directly engaged in trading rare earths reported that barriers to exports from China had increased starting September 21st and included problems gaining export licenses and demands for translation of documents.¹³

Possibly fearful of WTO violation, the Chinese government denied that there was any boycott against Japan specifically and widened the restrictions on exports, which it then justified as serving environmental concerns regarding the sustainable development of natural resources.¹⁴ The release of the Chinese captain on September 25th took away the most direct source of tensions, and rare earth exports from China to Japan began to increase in November.¹⁵

Importantly, the Chinese government maintains tight control over the rare earths industry. The industry is comprised of about 90 companies, the largest of which are centrally state-owned. Inner Mongolia Baotou Steel Rare-Earth Hi-Tech, a subsidiary of major SOE Batou Iron and Steel Group, dominates mining in the north. SOE China Minmetals controls the south. Other major players include SOE China Nonferrous Metal Mining (Group) Co., Ltd and Aluminum Corporation of China, Ltd (Chalco), a state-backed holding company. Since 2006 the government has controlled the total-amount exploitation of

¹²“Chugoku kakuryo koryu wo teishi (China stops cabinet level exchanges),” *Asahi Shimbun* 21 September 2010. “Hounichi ryokou jishyuku (self-restraint on travel to Japan)” *Asahi Shimbun* 23 September 2010.

¹³“Chugoku ni okeru yushutsunyu jyoukyo ni kan suru chyosa kekka (Results of a survey regarding exports and imports from China),” October 5, 2010. Summary of survey provided to author.

¹⁴“China is said to widen its embargo of rare earth minerals to Western countries,” *New York Times*, October 20. 2010.

¹⁵While a short-term embargo can slip by WTO rules as a ‘hit-and-run’ by eliminating the policy before another can file a complaint, in this case China continued to impose some restrictions, and Japan joined with the U.S. and EU to file a WTO complaint against the export restrictions in March 2012.

rare earths and has exercised management over rare earths production by mandatory planning since 2007. Presently, the government is working to consolidate the entire industry into three large state-run conglomerates through a process of mandated mergers and acquisitions.¹⁶

These two examples highlight several dimensions that we focus on in this paper. First, China has shown it can use economic channels to punish states that displease the central government. Second, the restrictions are quickly imposed and implemented selectively on narrowly targeted sectors. Yet the mechanism is more subtle than public sanctions. Instead, a range of new standards, informal guidance, and customs procedures appear as culprit. Even while lamenting the practice, one must admire the effectiveness with which the government marshals the resources of economic statecraft. Does the large role of the central government in the economy facilitate China's behavior in these and other such cases?

The Case of Ongoing Tensions: India and Pakistan

The enduring rivalry between Pakistan and India offers an example where negative relations have suppressed trade generally more than in response to specific events. Figure 2 displays India's imports from and exports to Pakistan against the backdrop of negative events. The two highest peaks of tensions represent respectively the Indian Parliament attack and escalation of the Kargil conflict. These were severe crises in bilateral relations. Even as the two countries agreed to confidence building measures in the face of their rival nuclear tests in 1998, conflict in Kashmir worsened. In May 1999 India engaged in airstrikes against militants supported by Pakistan in Kashmir's Kargil sector. Pressure on both sides from the major powers led to negotiations. The December 2001 suicide squad attacks on the Indian Parliament prompted both countries to mobilize troops and missiles such that they were reported to be on "war footing" (New

¹⁶According to a June 2012 government White Paper, the government launched its plan to "exercise planned regulation and control, restrictive exploitation, tightened access and comprehensive utilization for rare earths...." in 2008 under the National Plan for Mineral Resources (2008-2015), re-assuming the authority for "registering, examining and approving the prospecting and mining of specified minerals" in 2009. See State Council (2012)

India–Pakistan: Trade and Negative Events 1990–2004

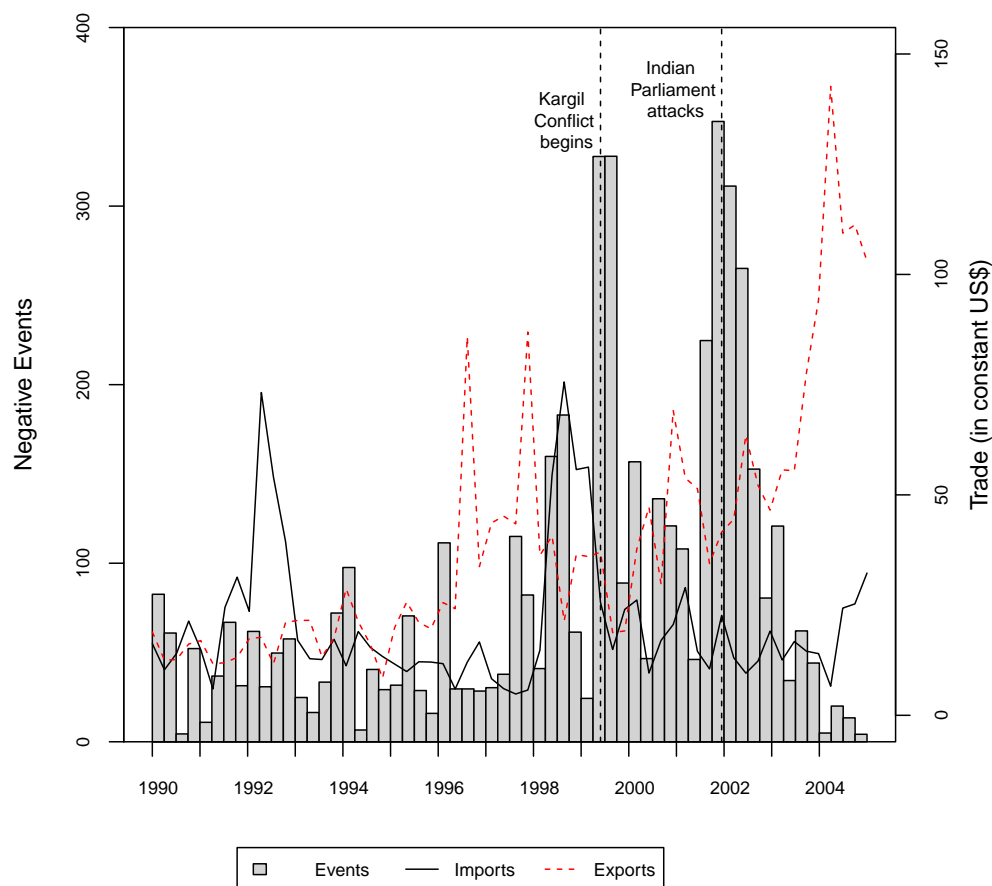


Figure 2: *Erratic Trade Between Enduring Rivals*: Quarterly imports and exports of India with Pakistan plotted against quarterly negative events data. Data source: King-Lowe events dataset.

York Times December 28, 2001). Imports and exports move in response to these crises, but quickly return to trade levels comparable with earlier periods in the 1990s. Even as imports fell by more than half from 66.5 million (constant 2000 U.S.\$) in 2001 to 32.4 million in 2002 exports remained steady and imports returned to 60.6 million in 2003. Furthermore, the May 1998 nuclear tests in India and Pakistan actually correspond with a surge of trade. Sanctions by other states enacted to oppose the nuclear tests may have increased their trade with each other. Another possibility is these numbers reflect the ‘sugar wars’ in which Pakistan was accused of flooding India’s market with subsidized sugar—hostility that perversely manifests as an increase in trade.

Beyond the responses to specific events, however, most striking are the overall low levels of trade between the two neighbors, as India trades substantially less with Pakistan over the full period than it does with other developing countries of similar characteristics.¹⁷ Where there is trade, it is largely conducted on the black market, outside of the realm of state control and not reported in official trade statistics. Both governments impose lengthy lists of sensitive goods restricted from bilateral trade, and Pakistan has long denied most favored nation status to India. The start of a strategic dialogue between the two countries in 2004 under pressure from the United States began a process of improving trade relations that led to a 2011 decision by Pakistan to offer India MFN status and even sparked rumors of future negotiations on a preferential trade agreement. While these are signs of possible improvement, the overall pattern shows two governments that have taken every step possible over the years to reduce the level of trade within the context of ongoing tensions.

2 State Control

The exercise of economic statecraft has distributional consequences both at home and abroad. The objective is to punish or reward another state for its policy position and attempt to influence its behavior. Denying key resources or market opportunities harms the target state, while preferential access to resources and markets benefits the recipient. When using economic policy as carrot and stick to achieve foreign policy goals, however, there is a negative externality for the domestic market. To the extent that the state encourages a move away from the market equilibrium, firms will suffer costs for moving away from the economically optimal solution.

Some argue that sanctions gain credibility through imposing domestic costs (Martin, 1992; Hufbauer,

¹⁷This is confirmed through simple regressions of a gravity model with controls as outlined in the empirical part of this paper. The exception is 1998, where imports from Pakistan were larger than predicted.

Schott and Elliott, 1990). Gartzke, Li and Boehmer (2001) model the signaling value of economic harm as the mechanism behind the commercial peace. The logic underlying these arguments is that the willingness to bear such costs reflects high resolve.

The negative externality for domestic actors, however, raises the challenge for using economic statecraft in the first place. Several studies find that harm to economic actors at home limits the use of economic statecraft (Skalnes, 2000; Davis, 2008/9). During the Cold War, the sanctions regime by the West to restrict exports to Soviet bloc countries (CoCoM) faced ongoing resistance from firms eager to trade more freely. Even when retaliation occurs in the context of WTO-authorized enforcement against a violation by a trade partner, the decision to raise tariffs encounters opposition from home industries that would suffer from the actions.¹⁸ Sanctions become much easier when they serve the interests of domestic actors by leveling the playing field or offering protection favored by a declining industry (e.g. DeSombre, 2000; Hiscox, forthcoming).

State control over economic activities in a sector addresses this problem by lowering domestic opposition to letting foreign policy influence business decisions. Firstly and most fundamentally, the very purpose behind state-owned enterprises is to advance the goals of the state. SOEs serve primarily as conduits through which the government may intervene in the economy to serve particular social, economic, or political objectives deemed necessary for national security or for the healthy functioning of the country.¹⁹ In China, for example, many SOEs are required to maintain burdensome employment levels and forced to manage resource-depleting social ventures under their corporate umbrellas, like schools

¹⁸Andersen and Blanchet (2010, p. 237) describes how such petitions from business prevented use of the carousel retaliation plan devised by Congress to increase the pain of retaliation against Europe in two well known disputes (hormones and bananas). Europe encountered similar difficulties when trying to draft a list for retaliation against the United States in the steel safeguard dispute (Nordstrom, 2010, p. 268).

¹⁹For example, the Indian government describes the role of state-owned enterprises (known as “public sector undertakings” (PSUs)) on its official portal as the following: “PSUs provide leverage to the Government (their controlling shareholder) to intervene in the economy directly or indirectly to achieve the desired socio-economic objectives and maximize long-term goals.” See http://www.india.gov.in/spotlight/spotlight_archive.php?id=78; accessed August 20, 2012.

and hospitals, to serve the government's goals of mitigating social unrest. In India, the original purpose behind the formation of Hindustan Latex in 1969 (now HLL Lifecare), one of the country's largest condom producers, was to promote the government's population control policies. Even today, the company is tasked with distributing prophylactics to populations at high risk for disease, again serving an explicit policy objective.²⁰ While state-owned companies sometimes compete for revenues and market share, they are not solely focused on the pursuit of profits. Top managers at SOEs ultimately face evaluation not by public shareholders or corporate trustees but by political officials who assess them not only on the basis of the firm's economic performance but also on how successfully they have implemented "government strategic and commercial directives" and government policy initiatives.²¹ Given that fulfilling political imperatives is a one of the primary *raison d'être* of these firms, we should expect them to pose less resistance to political demands than private firms.

The close relationship between the leadership of the state and state-owned firms is also likely to reduce opposition to political maneuvering. Not only is the firm's management directly accountable to the government, but the individual players themselves overlap. The top managers of major SOEs are often determined by political appointment, blurring the lines between business and politics, and introducing personal incentives for business leaders to appease the demands of the state. Indeed, the appointees themselves are often political insiders. A recent study by Minxin Pei shows that the three top leadership positions—CEO, Chairman and Party Secretary—in almost all centrally-managed Chinese SOEs are occupied by senior members of the Chinese Communist Party (CCP). In a number of cases, the CEO and Party Secretary are one and the same person (Pei, 2006). Thus business managers in state-owned enterprises often view their responsibilities as two-fold: to advance the interests of both the firm

²⁰"Stakes and Mistakes: India Is Privatising Companies for the Wrong Reasons," *The Economist*, November 12, 2009.

²¹John Lee, "China's Corporate Leninism," *The American Standard*, May/June 2012. Even in cases where shares of SOEs are publicly traded, the government retains a controlling stake in the company and strong influence over management staffing decisions.

and the state. It has been observed at the meetings of the World Economic Forum in Davos, for example, that contrary to Western delegations, “Chinese delegates from both [government and business] tend to have the same point of view, and even the same patriotic talking-points.”²²

But even where principal and agent do not necessarily overlap in the firm/state relationship, the government still maintains considerable leverage over SOEs. In the first place, these firms do not, and in many cases could not, operate without the financial sponsorship of the state. Much scholarly and policy research has documented the inefficiencies of state-backed firms, especially relative to private firms (e.g. Alchian, 1965; Boardman and Vining, 1989, 1992; World Bank, 1995). In India, the government recently approved an expensive bailout plan for 46 centrally-owned SOEs it deems “sick” (severely underperforming), which account for about 20 percent of all centrally-owned SOEs.²³ Even where state-owned firms are competitive and make money, their success often depends on continued government support. In China, over 75 percent the country’s capital, provided largely by state-owned banks, flows to SOEs.²⁴ For these firms, refusing to comply with political demands could mean a reduction in financial benefits. At the same time, the bureaucratic channels linking these firms directly to the state provide ample opportunity not only for government oversight but also for managers to communicate the effects of state policy on the health of the firm and request compensation for damages. In China, the paring down of SOEs to only the most important and strategic for the government under the policy of “grasp the big, let go the small” (zhuada fangxiao) has led to greater centralization of SOE oversight.²⁵ In

²²“The Rise of State Capitalism,” *The Economist*, January 21, 2012. Even in systems where SOE leaders and political leaders do not directly equate, the government retains formal or even informal influence over leadership appointments. The former head of state-owned mining giant Vale, Roger Agnelli, was ousted by the President last year, for example, for being too “independent-minded” and failing to follow the government’s development agenda. (See “The Visible Hand,” *The Economist*, January 21, 2012.)

²³Purba Das, “Rs 40,650 cr for sick PSUs,” *The Sunday Guardian*, August 19, 2012.

²⁴John Lee, “China’s Corporate Leninism,” *The American Standard*, May/June 2012.

²⁵In 2003, the government established the State-owned Assets Supervision and Administration Commission (SASAC) under which the monitoring and management of SOEs, previously separated across several ministries and agencies, was consolidated. The SASAC falls directly under the authority of the State Council of the National People’s Congress, the

India, the responsibility for managing SOEs falls with the relevant ministries, determined by industry, and the Department of Public Undertakings. The ministers responsible for these agencies report directly to parliament.²⁶ Thus SOEs are probably more likely than private firms to be recompensed by the state for losses suffered as a result of political maneuvering. Given their subsidized operations, SOEs are therefore less sensitive than private firms to the distributional costs borne from the manipulation of economic policies. Instead, dependence on the state requires responsiveness to government requests.

The close relationship between firm and state increases the likelihood of discriminatory policies within the state-controlled sector. Indeed, the WTO already recognizes this distinction in its Article XVII of the General Agreement, which explicitly notes that state-trading enterprises must make purchases “solely in accordance with commercial considerations.”²⁷ While the manipulation of economic policies to serve political interests clearly challenges the market economy and non-discrimination rules of the WTO, the admonition itself highlights that state-controlled enterprises are most likely to exhibit interference and noncommercial considerations and are thus most in need of monitoring.²⁸

country’s chief administrative authority. Locally-owned SOEs report to local SASACs, which in turn report to the central SASAC. SASAC also maintains the power to appoint the leadership of the 100 smaller central SOEs with the approval of the Central Organization Department (COD). For the fifty largest SOEs, that authority lies directly with the COD, the head of which is a member of the Politburo, the executive committee of the CCP. Local SASACs control appointments for local SOEs under the direction of the central SASAC. By consolidating the management of SOEs under central government authority and controlling directly the appointment of leadership positions, the government exercises a great amount of control over the decisions and operations of state-owned firms.

²⁶Within parliament the 22-member Committee on Public Undertakings is tasked with reviewing the reports of the relevant administrative bodies and is also responsible for monitoring and evaluating the management of SOEs more directly. Decisions regarding how SOEs will be utilized in the service of economic policy fall to the legislature and executive, affording the government a great deal of influence over their direction and operation. In January 2012, for example, in an attempt to stimulate the economy, the Prime Minister’s office ordered seventeen public utilities companies to invest over 35 billion US\$ of their cash reserves in infrastructure projects and overseas expansions. (See James Lamont, “India to launch 35bn of public investments,” *The Financial Times*, January 18, 2012.) Recently, the government has taken steps to allow SOEs more independence in corporate decision-making. Importantly, however, the process of gaining autonomy and the level that will be granted are still heavily controlled by the state. More specifically, firms may apply for one of three special classes of status—Maharatna, Navratna, or Miniratna—that allow them some independence in corporate decision-making, such as the freedom to make investments under a certain amount without express government approval or set up joint ventures or overseas offices, depending on indicators such as their annual turnover, net worth, and general health.

²⁷Full text available at the WTO website: http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf.

²⁸Exactly because of the close relationship between firm and state, however, formal regulations are unnecessary and there

We hypothesize that economic statecraft is contingent on government capacity to control economic actors. Completely free markets are the least likely to show any correlation between political relations and trade. In free-market economies, states must adopt explicit policies to constrain markets, such as imposing legal restrictions on trade to enforce private actor compliance with strategies of economic statecraft. The centralized economies of communist states, government procurement markets, and sectors with high shares of state ownership will exhibit stronger correlation between political relations and trade. The use of economic statecraft will not require the high threshold for action and formal restrictions, as state influence facilitates quick and informal action.

3 Data

3.1 Trade with the State-controlled Sector of the Economy

To analyze the differential effect of political relations on import and export flows as a function of state control over economic activity, we need data on the trading activities of both the state-controlled sector and the private sector of the economy. Unfortunately, separate statistics on bilateral trade for SOEs on the one hand, and non-SOEs on the other, are not available. In order to test our hypothesis, we construct variables that proxy for trade “under state control” and trade processed through the non-state-owned sector. Specifically, we match disaggregated bilateral trade data with industry-level data on the share of total assets held by SOEs. First, we download trade data from UN Comtrade using the World Bank’s World Integrated Trade Solution (WITS) software.²⁹ An advantage of WITS is that one can directly access data classified according to the third revision of the International Standard Industrial

may exist no paper trail of discriminatory policies that could be challenged in the WTO.

²⁹Data are available at <http://wits.worldbank.org>; accessed May 2012.

Classification of All Economic Activities (ISIC). This simplifies the process of matching trade data with state ownership data in the next step. All trade values are converted to constant US\$ using US consumer price indices obtained from the World Bank's World Development Indicators database.³⁰ Second, we split trade flows into two components: trade with the SOE sector and trade with the private sector. Using data on enterprise ownership, we proxy for the share of each sector that is under state control. Specifically, to obtain a measure of imports and exports under SOE control, we multiply the sectoral trade values with the respective SOE share of total assets by sector and sum the resulting values. Analogously, we take the sum of the product of non-SOE trade values by sector and the non-SOE share of assets by sector (equal to 1 minus the respective SOE share) to get a measure of imports and exports not under control of SOEs.

For China, ownership data at the sector level are obtained from the *China Statistical Yearbook* (various years). The data, aggregated to the sector level in the *Yearbook*, are based on firm-level data from the Industrial Enterprises Survey released by the National Statistics Bureau since 1999. The data cover all enterprises with annual sales larger than RMB 5 million and splits out enterprises in which the state is the largest stakeholder from those in which it is not.³¹ In all, about 150 centrally managed and 120,000 provincially or locally managed SOEs remain today, which together account for around 40 percent of GDP and hold 30 percent of all assets in the secondary and tertiary sectors (Szamosszegi and Kyle, 2011; Gao, 2010, p. 21).³² With these data, we are able to determine the share of assets held by SOEs in a given sector in each year over the 1999-2009 period.³³ Unfortunately, we lack information on SOE shares of total assets before 1999. We therefore proxy for SOE shares in previous years. Since privatization offi-

³⁰Data are available at <http://data.worldbank.org/indicator>; accessed May 2012.

³¹The data include ownership by both the central government and local governments.

³²The share of assets is based on data from the Second National Economic Census conducted in 2008.

³³We use total assets rather than other indicators (e.g. sales, production, etc.) due to better data availability.

cially began in China in 1995, we assume that all sectors had a SOE share of 1 in all years prior to 1995. We then linearly interpolate the missing values between 1994 and 1999 to obtain a full time series.³⁴

Table 1 lists all ISIC divisions (2-digit level ISIC code) covered in trade data, sorted by SOEs' share of total assets. To demonstrate the importance of each particular sector for trade with China, we add information on the respective shares of each sector in total imports and total exports. There is huge variation in state ownership across sectors. In China, between 1995 and 2009, forestry, tobacco, and oil and gas extraction were almost completely state-dominated, with shares of state ownership averaging near 100 percent over the period. Textiles, leather, and other "soft goods," on the other hand, averaged only around 20 percent.³⁵ Though masked by period averages, additional variation exists over time. Not only have "non-strategic" firms been let go, particularly by the central government, over time, but sectors and firms have been added to these lists as well. For example, in its 2006 *Guiding Opinion on Promoting the Adjustment of State-Owned Capital and Reorganization of State-Owned Enterprises*, SASAC expanded the list of China's priority sectors to include autos, shipping, and civil aviation, requiring the state to maintain a majority share in all major firms in those and other critical sectors (SASAC, 2006).

For India, we use firm-level data provided by the Centre for Monitoring Indian Economy, an Indian think-tank. Specifically, we employ the PROWESS database, which includes information on 27,000 companies that cover 75 percent of all corporate tax revenue.³⁶ Most relevant to our analysis, the database includes each company's value of total assets and indicates whether a company is majority owned by the central government. In India, there are currently about 250 central public sector enterprises (CPSEs) and about 850 state-level public enterprises (SLPEs) still in operation; CPSEs alone accounted for 6.45 percent of GDP in 2010/11 (Government of India, 2011, p. 14). We first convert all national industry

³⁴Restricting our estimation sample to the 1999-2009 period does not significantly change the results.

³⁵Due to data limitations, figures for China are for industrial sectors only and do not include agricultural activities.

³⁶See <http://prowess.cmie.com/>; accessed April/May 2012.

codes to the ISIC standard. As for China, we calculate the share of total assets held by SOEs for each sector. Though overall shares of state ownership are smaller than for China, similar variation is found in the Indian data (see table 2). Mining of uranium and thorium ores tops the list of state-controlled sectors (SOE share of 100 percent). While the top five sectors relate to trade in natural resources, machinery and equipment, in sixth position and comprising 8.1 percent of India's imports, shows significant state control (SOE share of 44.9 percent). Four sectors are entirely in private hands, of which manufacture of wearing apparel is the most important in terms of trade (9.7 percent of India's exports).

The following example illustrates how we split trade into exports and imports under state control on the one hand and trading activities through the non-SOE sector on the other. Consider exports from India to Poland. In 2000, India exported 806,000 US\$ worth of electrical machinery and apparatus to Poland (SITC division 31). In this sector, SOEs hold 13.9 percent of total assets in this particular year. Combining these values, an estimated 112,470 US\$ worth of exports went out through SOEs ($= 806,000 \cdot 0.139$), and 693,876 US\$ through non-SOEs ($= 806,000 \cdot (1 - 0.139)$). We repeat this procedure for all ISIC divisions covered in trade data and sum for SOE and non-SOE trade. Our estimates show that SOE exports from India to Poland amounted to 6.5 million US\$, compared to 74.5 million US\$ outside the SOE sector.

ISIC code (Rev. 3)	Description	Average SOE share	Share in total imports	Share in total exports
02	Forestry, logging and related service activities	99.4%	0.6%	0.0%
16	Manufacture of tobacco products	98.8%	0.0%	0.1%
11	Extraction of crude petroleum and natural gas; related service activities	98.0%	8.1%	0.6%
10	Mining of coal and lignite; extraction of peat	88.9%	0.3%	0.5%
40	Electricity, gas, steam and hot water supply	87.4%	0.0%	0.1%
23	Manufacture of coke, refined petroleum products and nuclear fuel	81.4%	2.5%	1.2%
34	Manufacture of motor vehicles, trailers and semi-trailers	72.7%	3.1%	2.1%
35	Manufacture of other transport equipment	72.7%	2.0%	2.2%
27	Manufacture of basic metals	71.4%	7.9%	4.5%
13	Mining of metal ores	66.1%	4.8%	0.1%
14	Other mining and quarrying	64.9%	0.6%	0.3%
12	Mining of uranium and thorium ores	63.9%	0.0%	0.0%
24	Manufacture of chemicals and chemical products	57.6%	13.8%	5.5%
29	Manufacture of machinery and equipment n.e.c.	55.9%	12.0%	8.0%
22	Publishing, printing and reproduction of recorded media	46.6%	0.3%	0.3%
26	Manufacture of other non-metallic mineral products	44.4%	0.6%	1.9%
15	Manufacture of food products and beverages	44.3%	2.6%	2.9%
32	Manufacture of radio, television and communication equipment and apparatus	43.0%	17.9%	14.7%
30	Manufacture of office, accounting and computing machinery	42.9%	3.7%	11.6%
33	Manufacture of medical, precision and optical instruments, watches and clocks	42.9%	6.4%	3.2%
21	Manufacture of paper and paper products	42.3%	1.8%	0.5%
17	Manufacture of textiles	37.6%	3.5%	8.8%
20	Manufacture of wood, of products of wood and cork and of articles of straw and plaiting materials	36.5%	0.6%	1.0%
31	Manufacture of electrical machinery and apparatus n.e.c.	36.1%	4.7%	6.1%
25	Manufacture of rubber and plastics products	35.4%	1.7%	2.8%
28	Manufacture of fabricated metal products, except machinery and equipment	28.8%	1.4%	3.7%
36	Manufacture of furniture; manufacturing n.e.c.	28.1%	0.6%	6.7%
18	Manufacture of wearing apparel; dressing and dyeing of fur	20.0%	0.3%	9.2%
19	Tanning and dressing of leather; manufacture of luggage, handbags, saddlery, harness and footwear	19.4%	0.9%	4.5%
01	Agriculture, hunting and related service activities	N/A	3.3%	1.3%
05	Fishing, operation of fish hatcheries and fish farms; service activities incidental to fishing	N/A	0.0%	0.2%

Table 1: *Trade with China and State Control*: List of ISIC sectors (Rev. 3) covered in trade data, sorted by the share of state-owned enterprises in total assets (1995-2009).

ISIC code (Rev. 3)	Description	Average SOE share	Share in total imports	Share in total exports
12	Mining of uranium and thorium ores	100.0%	0.0%	0.0%
11	Extraction of crude petroleum and natural gas; related service activities	89.9%	26.7%	0.1%
10	Mining of coal and lignite; extraction of peat	68.1%	2.6%	0.1%
13	Mining of metal ores	65.5%	1.4%	3.3%
40	Electricity, gas, steam and hot water supply	60.2%	0.0%	0.0%
29	Manufacture of machinery and equipment n.e.c.	44.9%	8.1%	3.6%
23	Manufacture of coke, refined petroleum products and nuclear fuel	43.6%	6.7%	10.5%
27	Manufacture of basic metals	40.3%	13.7%	7.1%
32	Manufacture of radio, television and communication equipment and apparatus	39.6%	4.5%	1.1%
33	Manufacture of medical, precision and optical instruments, watches and clocks	38.8%	2.1%	0.7%
36	Manufacture of furniture; manufacturing n.e.c.	25.6%	2.1%	18.3%
35	Manufacture of other transport equipment	14.6%	3.7%	1.8%
21	Manufacture of paper and paper products	14.5%	1.1%	0.3%
31	Manufacture of electrical machinery and apparatus n.e.c.	13.7%	2.4%	1.9%
24	Manufacture of chemicals and chemical products	13.1%	13.4%	12.3%
17	Manufacture of textiles	11.6%	1.2%	12.2%
28	Manufacture of fabricated metal products, except machinery and equipment	7.2%	1.1%	2.9%
22	Publishing, printing and reproduction of recorded media	3.9%	0.8%	0.5%
26	Manufacture of other non-metallic mineral products	3.8%	0.5%	1.3%
01	Agriculture, hunting and related service activities	3.0%	2.1%	5.4%
19	Tanning and dressing of leather; manufacture of luggage, handbags, saddlery, harness and footwear	2.3%	0.3%	3.3%
14	Other mining and quarrying	2.1%	6.8%	1.1%
30	Manufacture of office, accounting and computing machinery	1.5%	2.1%	0.5%
15	Manufacture of food products and beverages	1.1%	2.8%	8.7%
25	Manufacture of rubber and plastics products	0.8%	0.8%	1.9%
20	Manufacture of wood, of products of wood and cork and of articles of straw and plaiting materials	0.6%	0.1%	0.1%
02	Forestry, logging and related service activities	0.0%	0.8%	0.5%
16	Manufacture of tobacco products	0.0%	0.0%	0.1%
18	Manufacture of wearing apparel; dressing and dyeing of fur	0.0%	0.0%	9.7%
34	Manufacture of motor vehicles, trailers and semi-trailers	0.0%	0.0%	2.7%
05	Fishing, operation of fish hatcheries and fish farms; service activities incidental to fishing	N/A	0.0%	0.2%

Table 2: *Trade with India and State Control*: List of ISIC sectors (Rev. 3) covered in trade data, sorted by the share of state-owned enterprises in total assets (1995-2009).

3.2 Measuring Political Relations

While bilateral trade is objectively quantifiable in values and volumes, political relations between countries are hard to measure. Our analysis relies on several variables that capture different aspects of relations. We include indicators now common in the literature—negative political events and voting alignment in the United Nations General Assembly (UNGA)—for both China and India, as well as unique “China-specific” measures. We explain each measure in turn.

Our first measure quantifies the tensions that occur between China, India, and their trading partners. More precisely, we use the King and Lowe (2003) events data to construct a yearly continuous event variable. The coding program Virtual Research Associates Reader classifies daily Reuters news reports into event categories and has been shown to be as accurate as human coders. The dataset includes negative events between nations at both the government- and citizen-level. Each event is weighted by the corresponding Goldstein score (i.e. use of force is weighted more heavily than a reference to “expel”, but expel would be weighted more heavily than a reference to “demand”). The weighted scores are summed to produce a single annual observation. Unfortunately, no data are available after 2004.

Figure 3 plots the number of negative events that occurred after the Cold War between China (first panel) and India (second panel) on the one hand and the United States (left), Japan (center) and Russia (right) on the other. Several events that have caused bilateral tensions with China are visible in the data. For example, the Taiwan Strait Crisis, the U.S. bombing of the Chinese embassy in Belgrade and the Hainan Island incident³⁷ are all reflected in the high number of negative events in 1995/96, 1999 and 2001, respectively. Similarly, India’s nuclear tests in 1998 appear to have affected India’s relations with all three countries as the number of negative events peaks in this year in all three cases. The United States, Taiwan and the United Kingdom top the list of the countries that experienced the most negative events

³⁷On April 1, 2001, a U.S. navy aircraft collided with a Chinese military aircraft near the Chinese province of Hainan.

with China (see table 3). While the first six countries on the list are not surprising, it is interesting to find North Korea, China's communist southern neighbor, in seventh position, which may be attributable to bilateral disagreements on North Korea's nuclear program.

We take as our second measure of relations dyad-specific voting alignment in the UNGA. The underlying idea is that countries with good relations are more likely to share similar policy positions, which should be reflected in the voting patterns in the Assembly. Previous research has shown a positive relationship between voting alignment and bilateral trade (Dixon and Moon, 1993). In contrast to the above-mentioned events data, the advantage of UNGA voting alignment is that it is a direct measure of government behavior. Moreover, the data cover all member countries of the United Nations and are available for the entire period of our analysis. Our measure builds on the dataset constructed by Voeten and Merdzanovic (2009) and updated by Kilby (2009). We calculate the number of times a country votes in line with China (or India) as a share of total votes in a particular year. An observation is coded as "in line" if both countries voted yes, both voted no, both abstained from voting, or both were absent. The resulting value provides the bilateral voting coincidence and is bounded between zero and one.

An obvious weakness of the alignment measure is that it attributes equal weight to each vote. Therefore, we also compute the voting alignment based only on key votes as defined by the U.S. Department of State (see Thacker, 1999; Kilby, 2009). This measure will outperform a measure of voting alignment based on all votes if key areas of interest of the United States largely overlap with issues that are salient for China and India respectively.³⁸ Unfortunately, the Chinese and Indian governments do not provide a list that names all votes that are key for their respective countries.

The third and fourth panel of figure 3 plot China's and India's voting alignment on key votes with the United States, Japan, and Russia respectively. Mirroring divisions between the United States and its allies

³⁸This assumption is contestable. For example, votes relating to the Palestinian conflict may be of larger importance for the United States than for China and India.

on one hand, and the rising powers on the other (see Voeten, 2000), we find the expected co-movement of China's and India's voting alignment with respect to all three partner countries.³⁹ Interesting differences arise between China's and India's partner countries. While both countries' voting alignment with the United States shows a decreasing trend, the voting coincidence with Russia is mostly increasing since the early 1990s. No clear trend is observable for both countries' voting alignment with Japan. The United States tops the list of the countries with the lowest voting alignment with China and India, followed by Israel and three small island states in the Pacific Ocean (see table 3).

For the analysis of China, we employ two additional measures based on how Chinese media and scholars view political relations with China. We first build on a dataset constructed by Fang (2010), who counted all the events reported to have "hurt the feelings of the Chinese people" according to the *People's Daily*, China's largest government-owned newspaper. By replicating his method, we updated his dataset through 2009. According to this updated dataset, 104 events "hurt the feelings of the Chinese people" after the end of the Cold War (1990-2009). The first event listed is the reception of the Dalai Lama by Germany's President Richard von Weizsäcker in October 1990.⁴⁰ The list ends in October 2009 with U.S. arms sales to Taiwan. Most events that "hurt the feelings of the Chinese people" relate to Sino-Japanese war history, the One-China policy with respect to Taiwan and Tibet, and border disputes. As can be seen in Figure 3, feelings were most "hurt" by the United States in 1995 (Taiwan Strait Crisis) and 1999 (NATO bombing of the Chinese embassy in Belgrade). According to the count of "hurt feelings," Sino-Japanese relations reached a low in 2005, when the bilateral dispute regarding Sino-Japanese war history was most intense (see also Davis and Meunier, 2011). As seen in the graph on the right, Fang (2010) does not list any event in which Russia "hurt the feelings of the Chinese people." According

³⁹While the correlation of China's and India's UN voting alignment on key votes was only 10.6% in the 1980s (data available for 1983-1989), it increased to 57.9% in the 1990s and reached 94.7% in the 2000s.

⁴⁰See Fuchs and Klann (2010) for a detailed discussion of diplomatic tensions caused by foreign leaders' meetings with the Dalai Lama.

to this measure, Japan, the Vatican, and the United States were the countries that experienced the most severe tensions with China in the 1994-2008 period (see again table 3).

Our final measure is a numeric score that captures the overall level of relations between China and eleven trade partners from a Chinese perspective. Developed by Chinese scholar Yan Xuetong and colleagues, this conflict-cooperation index is based on reports of bilateral political events from Chinese newspapers (Yan, 2010).⁴¹ Events—both positive and negative—are amassed on a monthly basis and weighted by severity in similar fashion to the Goldstein scores explained above. The resulting values are then summed to form positive and negative index scores, which are weighted by the overall level of relations from the previous month and summed again to obtain the change in relations from the previous month. The rationale behind this weighting scheme is that the effect of events should be conditional on the existing level of relations. To give an example, a verbal criticism probably affects the overall level of relations less between two countries already at war than between two countries with cooperative relations. The change from the previous month is added to the previous month's overall relations score to form the new overall relations score. The final relations score is bounded between -9 and 9.

The relations score covers only 11 countries. According to the average score on Yan's scale, Russia was the country with the best relations in the 1994-2008 period (average score of 7.0), followed by Pakistan (6.4) and Germany (4.6). The United States had the worst relations of all the 11 countries (0.6, see table 3). Figure 3 demonstrates that the relations score also captures Sino-Japanese tensions that arose from disputes over war history in the middle of the 2000s. In line with the evolution of Sino-Russian voting alignment in the UNGA, the score on relations with Russia shows a steady increase after the end of the Cold War.

⁴¹We are grateful to Professor Yan for generously sharing an updated version of the dataset and to Professor Qi Haixia for so patiently fielding our many questions about the data.

China: Negative events		China: UN voting alignment (key votes)		China: Hurt feelings	
1	United States of America	1	United States of America	1	Japan
2	Taiwan (China)	2	Israel	2	Holy See
3	United Kingdom	3	Palau	3	United States of America
4	Japan	4	Marshall Is	4	India
5	Philippines	5	Micronesia Fed States	5	France
6	Korea Rep	6	Montenegro	6	Guatemala
7	Korea Dem P Rep	7	Canada	7	Germany
8	Australia	8	Australia	8	Denmark
9	India	9	Nauru	9	Nicaragua
10	France	10	Latvia	10	Iceland

India: Negative events		India: UN voting alignment (key votes)		China: Yan index	
1	Pakistan	1	United States of America	1	United States of America
2	United States of America	2	Israel	2	Japan
3	Bangladesh	3	Palau	3	Indonesia
4	Saudi Arabia	4	Marshall Is	4	India
5	United Kingdom	5	Micronesia Fed States	5	United Kingdom
6	China	6	Montenegro	6	Korea Rep
7	Sri Lanka	7	Australia	7	Australia
8	Australia	8	Canada	8	France
9	Afghanistan	9	Nauru	9	Germany
10	Bhutan	10	Latvia	10	Pakistan

Table 3: *Bad Relations*: List of countries with worst relations by measure of political relations (1994-2008). Note that the Yan index covers 11 countries only. With the highest average score on Yan's scale, Russia is the eleventh country. Please note also that we could not compute UN voting alignment with Taiwan (China) as the entity is not a member of the United Nations.

4 Empirical Analysis

4.1 Empirical Strategy

To test our hypothesis, we employ the gravity model of trade, which has become the “workhorse” of the empirical trade literature (e.g., Tinbergen, 1962; Anderson and van Wincoop, 2003). According to this model, trade flows are expected to increase with both the exporter’s supply and the importer’s demand of goods and to decrease with trade costs. While supply and demand are usually proxied by exporter and importer GDP, respectively, geographic distance is commonly used as a proxy for trade costs along with a set of additional variables to measure friction such as language. We estimate bilateral trade flows controlled by state-owned enterprises (SOEs) separately from those controlled by non-SOEs as seemingly unrelated estimations.⁴² Specifically, we estimate the following system of equations:

$$trade_{SOE,ij} = \beta_0 + \beta_1 relations_{ijt} + \beta_2 distance_{ijt} + \beta_3 gdp_{ijt} + \beta_4 X_{ijt} + \tau_t + \varepsilon_{ijt} \quad (1)$$

$$trade_{nonSOE,ij} = \tilde{\beta}_0 + \beta_1 relations_{ijt} + \tilde{\beta}_2 distance_{ijt} + \tilde{\beta}_3 gdp_{ijt} + \tilde{\beta}_4 X_{ijt} + \tau_t + \tilde{\varepsilon}_{ijt} \quad (2)$$

where $trade_{SOE}$ represents our proxy for the (logged) import or export flows between country i (China or India) and its trading partner j that are under state control. Analogously, $trade_{nonSOE}$ represents the corresponding (logged) import or export flows between country i (China or India) and its trading partner j that are not under state control. We run each system of equations separately for import and export flows to allow for differential effects of political relations on a country’s shipments into and out of its economy. To test our hypothesis, we include each measure of *relations*, our variable of interest, separately. Note

⁴²We use the STATA command “suest” to combine estimation results.

that our results are identical to an estimation of OLS equation by equation since both equations use the same set of regressors. Nevertheless, seemingly unrelated estimations enable us to test hypotheses involving parameters in both equations. Specifically, we will test whether the coefficient on our political relations variables differs between SOE and non-SOE trade. We expect to find that political relations play a larger role in trade controlled by SOEs than in trade by privately owned enterprises, i.e. $\beta_1 > \tilde{\beta}_1$.

Turning to the standard gravity variables, *distance* is the (logged) geographic distance between exporter and importer; *gdp* denotes the product of exporter and importer GDP in constant 2000 US\$. GDP data have been obtained from the World Bank's World Development Indicators. We make use of the distance dataset provided by the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) (Mayer and Zignago, 2011).⁴³

The gravity model is usually augmented by a set of additional control variables X that are expected to impact on bilateral trade flows in addition to the standard gravity variables. We include market potential, which we proxy with the (logged) product of exporter and importer population size. Data are obtained from the WDI. In addition to the effect of geographic distance, sharing a common border and common language are also expected to facilitate trade. We therefore include a dummy for continuity and a variable that takes a value of 1 if at least nine percent of the population in both countries shares a common language. Being landlocked, however, should reduce bilateral trade, as these countries face higher trade costs. Consequently, we include a dummy variable that takes a value of 1 if a trading partner has no access to the sea. All three dummy variables are obtained from the CEPII's GeoDist dataset (Mayer and Zignago, 2011).

A strand of the empirical literature analyzes the effect of formal trade agreements on trade (e.g., Rose, 2004). In line with this research, we add two dummy variables to our model. Based on information

⁴³Bilateral distance is defined as the great-circle distance between the 25 major cities of each country, weighted by the share of each city in the overall country's population.

provided on the website of the WTO, we first construct a dummy that takes a value of 1 if both countries are members of the WTO for the majority of a given year. The other variable takes a value of 1 if both countries have concluded a preferential trade agreement with one another.

Trading relations are found to depend on regime type (see, for example, Mansfield, Milner and Rosendorff, 2000; Aidt and Gassebner, 2010). To control for differences in trade policies between democratic and authoritarian regimes, we include a dummy variable that takes a value of 1 if the regime of the partner country trading with China/India is democratic (Cheibub, Gandhi and Vreeland, 2010). Finally, to address the argument that structural patterns of trade follow alliance blocs (Gowa, 1994), we add a dummy variable that takes a value of 1 if a trading partner is an ally of the United States in a particular year. Given that India does not have any formal alliances of its own and China has few, the measure of U.S. alignment offers a better indicator of states that might generate security externalities and therefore reductions in trade. Data are obtained from the Alliance Treaty Obligations and Provisions (ATOP) project (Leeds et al., 2002). Because these data end in 2003, we carry forward the 2003 value to the end of our dataset under the assumption that a country's alliance portfolio does not vary much over time.⁴⁴

Finally, note that τ represents a set of year dummies; and ε is the error term. To mitigate endogeneity concerns, we lag all time-varying covariates by one year. Standard errors are clustered at the trading partner country level. Our analysis on China starts in 1995, when the Chinese government started its privatization program, and the analysis on India begins in 1991, when the country entered into the period of economic liberalization. While the regressions that use the number of negative events as measure of political relations end in 2005, all other estimations cover the period until 2009. Table 8 in the appendix lists all variables employed, their definitions and sources. Table 9 provides descriptive statistics.

⁴⁴Removal of the democracy and alliance variables that could be seen as confounding political relations does not shift our key findings.

4.2 Results

4.2.1 Trade with China

Table 4 presents our results for imports to China. Each column shows the results for one of the four measures of political relations. While the upper half of the table displays the coefficient of each explanatory variable for SOE trade, the lower half shows the corresponding results for the non-SOE equation. As can be seen, the coefficient on the number of negative events between China and its trading partner has the expected negative sign and is statistically significant at conventional levels in both equations (column 1). While we consistently find China's bilateral imports to decrease with an increasing number of negative events, the effect is more pronounced with respect to imports under the control of SOEs. More precisely, an additional negative event reduces Chinese imports under state control by 0.4 percent, compared to only 0.3 percent in the non-SOE sector. A Wald test confirms that the observed differences in the coefficients are statistically significant at the one-percent level (see p-value of the Wald test in the last row of table 4). The results of this first equation support our hypothesis that the trade-relationship is stronger in the state-controlled sector of the economy.

Turning to column 3, we see that China also imports less from countries that have "hurt the feelings of the Chinese people." The respective coefficients are both negative and statistically significant at the one-percent level. The estimated effects are huge and imply import reductions of 35.3 and 26.0 percent, respectively. According to the Wald test reported at the bottom of table 4, the coefficient on political relations is significantly larger in absolute terms in the SOE trade equation compared with the non-SOE trade equation. This finding provides additional support for the hypothesis that the role of diplomatic tensions for trade depends on state control over firms. With respect to UNGA voting alignment on key votes (column 2) and Yan's relations score (column 4), we do not find any significant effect in either

the SOE or the non-SOE trade equation, at conventional levels of significance. While voting may be less suited to capture political tensions than events-based measures, Yan's index has the drawback that it covers only eleven countries.⁴⁵

The results for the control variables are largely in line with our expectations. Looking at columns 1-3, the coefficient on (logged) distance is negative, statistically significant at least at the five-percent level and close to 1 in all equations. Proxying for market size, the (logged) product of both countries' GDP shows the expected positive relationship with import flows. The coefficient is statistically significant at the one-percent level in both equations. The population variable does not reach statistical significance at conventional levels. All else being equal, we find import flows of both SOEs and other firms to be significantly larger from neighboring and Chinese-speaking countries, in line with our expectations. The coefficient on the dummy for landlocked countries is negative as expected, but it gains statistical significance in only one equation (SOE trade in column 1). Interestingly, the WTO dummy shows the expected positive coefficient in non-SOE trade only. This is to be expected given that fewer commitments were made in the SOE sectors. However, our results do not show the expected positive effect of PTAs on Chinese imports. In none of the four specifications is the respective coefficient positive and significant at conventional levels. While Chinese imports do not significantly differ between U.S. allies and countries not allied with the United States, autocratic China imports significantly more from authoritarian regimes than from democratic trading partners. The bias against democracies is stronger for imports under state

⁴⁵To test for the robustness of our results, we do not only run all regressions with the voting alignment index calculated based on all votes, but also use an alternative definition of what constitutes a key vote from the Chinese and Indian perspectives. To try to account for the one-dimensional voting pattern that exists in the General Assembly, with the United States and other Western countries on one pole and a "counterhegemonic voting bloc," most notably the rising powers, on the other (see Voeten, 2000), we construct a measure of voting coincidence for the set of polarized votes where Brazil, Russia, India and China vote 'yes' and the United States votes 'no' or vice versa (see Fuchs and Vadlamannati, 2012). Note that our conclusions are the same if we replace UNGA voting on key votes by all votes or by this set of polarized votes. The same holds if we replace key votes as defined by the US Department of State by votes that the United States votes 'No' on (see Carter and Stone, 2011).

control than for imports not under state control.⁴⁶ When introducing Yan's relations score as a measure of political relations, the sample size decreases from more than 2,400 to 165 observations, covering only eleven trading partners over fifteen years (column 4). None of these countries belongs to the group of Chinese-speaking countries or is landlocked, so these two variables are dropped from our estimation. Of the remaining variables, distance and GDP are statistically significant at the one-percent level with expected signs. Import flows are significantly lower with increasing population size of trading partners, at the ten-percent level of significance, mirroring economies of scale in production. Moreover, U.S. allies among the eleven countries have significantly lower imports from both SOEs and other firms, while the WTO dummy shows a surprising negative sign for imports under state control.

Next, we turn to China's export decisions. Table 5 presents our results. We again show the results for each of the four measures of political relations. The coefficients on negative events (column 1), UNGA voting (column 2) and "hurt feelings" (column 3) all fail to reach statistical significance at conventional levels in both the respective SOE and non-SOE equations. Fearing high losses due to unrealized sales, China's exports decisions seem to be more independent from political relations than imports, which may be due to China's status as an export-led economy. Officials may be less willing to restrict exports to serve foreign policy goals.⁴⁷ Yan's relations score is the only measure that seems to be related with Chinese exports (column 4). The corresponding coefficient is positive and statistically significant at the one-percent level in both equations, suggesting that China exports more to countries with which it has *good* relations. The coefficient on political relations is larger for non-SOE trade than for SOE trade, which seems to contradict our hypothesis, but the difference in coefficients is not statistically significant at conventional levels according to the Wald test of equal coefficients. In line with our hypothesis, we

⁴⁶The difference in coefficients on democracy between SOE and non-SOE trade is statistically significant at the one-percent level in columns 1-3.

⁴⁷The example of China restricting rare earths exports given earlier may be an anomaly in this respect because China holds a near-monopoly on rare earths exports and so did not need to fear other countries would offer alternative supplies.

	(1) Imports Negative events	(2) Imports UN voting (key votes)	(3) Imports Hurt feelings	(4) Imports Yan index
SOE trade				
Political relations	-0.004 *** (0.001)	0.124 (0.842)	-0.436 *** (0.098)	0.178 (0.122)
(log) Distance	-1.070 *** (0.343)	-0.907 ** (0.383)	-0.954 *** (0.364)	-1.171 *** (0.216)
(log) GDP	1.585 *** (0.117)	1.631 *** (0.116)	1.650 *** (0.113)	0.964 *** (0.202)
(log) Population	-0.117 (0.149)	-0.106 (0.146)	-0.108 (0.143)	-0.822* (0.437)
Neighbor	1.581 ** (0.758)	1.398* (0.791)	1.366* (0.778)	-0.120 (0.804)
Common language	1.507 *** (0.458)	1.361 *** (0.447)	1.296 *** (0.429)	
Landlocked	-0.704* (0.390)	-0.468 (0.389)	-0.454 (0.379)	
Both in WTO	0.497 (0.519)	0.696 (0.515)	0.692 (0.514)	-1.472* (0.889)
PTA	-1.696 ** (0.766)	-0.551 (0.642)	-0.604 (0.627)	0.063 (0.306)
Democracy	-0.992 ** (0.423)	-1.418 *** (0.429)	-1.408 *** (0.409)	-0.404 (0.585)
U.S. ally	-0.189 (0.401)	-0.048 (0.403)	-0.075 (0.396)	-1.940 ** (0.925)
Non-SOE trade				
Political relations	-0.003 ** (0.001)	-0.441 (0.637)	-0.301 *** (0.076)	0.146 (0.094)
(log) Distance	-1.109 *** (0.334)	-1.000 *** (0.340)	-1.051 *** (0.327)	-1.184 *** (0.189)
(log) GDP	1.554 *** (0.105)	1.521 *** (0.096)	1.547 *** (0.093)	0.909 *** (0.115)
(log) Population	-0.112 (0.127)	-0.075 (0.122)	-0.091 (0.118)	-0.570* (0.309)
Neighbor	1.858 *** (0.646)	1.569 ** (0.631)	1.510 ** (0.624)	-0.306 (0.571)
Common language	2.696 *** (0.410)	2.561 *** (0.389)	2.467 *** (0.376)	
Landlocked	-0.279 (0.342)	-0.171 (0.324)	-0.133 (0.317)	
Both in WTO	0.753* (0.392)	0.984 *** (0.375)	0.975 *** (0.377)	-0.228 (0.446)
PTA	-1.149 ** (0.525)	-0.203 (0.454)	-0.314 (0.457)	0.077 (0.241)
Democracy	-0.373 (0.339)	-0.716 ** (0.332)	-0.652 ** (0.322)	-0.456 (0.386)
U.S. ally	0.175 (0.348)	0.238 (0.338)	0.235 (0.333)	-1.343 ** (0.648)
Number of observations	1654	2400	2407	165
Wald test (p-value)	0.007	0.222	0.030	0.334

Table 4: *Imports to China (1995-2009)*: Results of a gravity model estimating the (logged) import value between China and its trading partners. Regressions for SOE and non-SOE trade are run as seemingly unrelated estimations. *** significant at 1%; ** significant at 5%; * significant at 10%.

find that the coefficient on UNGA voting for exports through SOEs is significantly larger than the corresponding coefficient for exports in the market sector. Taken together, while we find empirical evidence in favor of our hypothesis of a stronger relationship between politics and Chinese import decisions with increasing state control, we lack robust empirical support of our hypothesis with respect to exports from China.

4.2.2 Trade with India

Next, we turn to India. Columns 1 and 2 of Table 6 present our results for import flows. As for China, we find a negative relationship between the number of negative events and imports for the SOE and non-SOE trade equations (column 1). Imports under state control decrease on average by 0.7 percent for each negative event, and the coefficient is statistically significant at the one-percent level. This effect is larger in absolute size than the effect obtained for non-SOE trade (0.5 percent) and the difference between both coefficients is statistically significant at the one-percent level. While this supports our hypothesis, we again do not find a statistically significant relationship between political relations and imports if we replace our negative events variable with bilateral voting alignment in the UNGA.

Turning to the control variables, imports to India decrease with geographic distance between India and its trading partner and increase with the product of both countries' GDP, in line with the standard gravity model. Few additional control variables are found to be significant determinants of imports to India. According to our results, U.S. allies have weaker commercial relations with India. The respective coefficient is negative and statistically significant in both equations. Mirroring our results for China, WTO membership seems to have a trade-promoting effect only on imports not controlled by SOEs. All other covariates do not reach statistical significance at conventional levels.

Finally, we analyze the role of political relations for Indian exports. Starting again with the number of

	(1) Exports Negative events	(2) Exports UN voting (key votes)	(3) Exports Hurt feelings	(4) Exports Yan index
SOE trade				
Political relations	0.001 (0.001)	0.492 (0.555)	-0.000 (0.056)	0.107 * ** (0.029)
(log) Distance	-0.414 * ** (0.177)	-0.417 * ** (0.167)	-0.397 * ** (0.174)	-0.818 * ** (0.104)
(log) GDP	0.762 * ** (0.077)	0.769 * ** (0.074)	0.760 * ** (0.070)	0.883 * ** (0.086)
(log) Population	0.245 * ** (0.075)	0.214 * ** (0.079)	0.225 * ** (0.074)	-0.473 * ** (0.189)
Neighbor	0.789* (0.464)	0.763* (0.437)	0.794* (0.444)	0.047 (0.378)
Common language	2.039 * ** (0.491)	1.958 * ** (0.484)	2.004 * ** (0.473)	
Landlocked	-0.848 * ** (0.228)	-0.786 * ** (0.215)	-0.793 * ** (0.205)	
Both in WTO	0.199 (0.207)	-0.039 (0.244)	-0.032 (0.249)	-0.045 (0.197)
PTA	-0.110 (0.378)	-0.215 (0.218)	-0.140 (0.213)	0.021 (0.140)
Democracy	0.139 (0.204)	0.207 (0.195)	0.165 (0.181)	-0.226 (0.245)
U.S. ally	-0.127 (0.265)	-0.079 (0.241)	-0.097 (0.241)	-1.411 * ** (0.382)
Non-SOE trade				
Political relations	0.001 (0.001)	0.196 (0.472)	-0.000 (0.055)	0.126 * ** (0.033)
(log) Distance	-0.315* (0.172)	-0.343 * ** (0.160)	-0.337 * ** (0.165)	-0.655 * ** (0.094)
(log) GDP	0.804 * ** (0.072)	0.798 * ** (0.067)	0.796 * ** (0.065)	1.124 * ** (0.090)
(log) Population	0.228 * ** (0.071)	0.214 * ** (0.072)	0.217 * ** (0.068)	-0.691 * ** (0.172)
Neighbor	0.722 (0.548)	0.750 (0.494)	0.759 (0.501)	0.416 (0.371)
Common language	1.815 * ** (0.475)	1.795 * ** (0.440)	1.812 * ** (0.434)	
Landlocked	-0.758 * ** (0.235)	-0.695 * ** (0.215)	-0.691 * ** (0.208)	
Both in WTO	0.273 (0.189)	0.105 (0.207)	0.106 (0.210)	-0.227 (0.191)
PTA	-0.247 (0.394)	-0.290 (0.220)	-0.259 (0.217)	0.116 (0.175)
Democracy	0.122 (0.205)	0.155 (0.192)	0.143 (0.178)	-0.553* (0.321)
U.S. ally	-0.150 (0.249)	-0.110 (0.221)	-0.119 (0.222)	-1.394 * ** (0.321)
Number of observations	1863	2617	2638	165
Wald test (p-value)	0.527	0.051	0.994	0.425

Table 5: *Exports from China (1995-2009)*: Results of a gravity model estimating the (logged) export value between China and its trading partners. Regressions for SOE and non-SOE trade are run as seemingly unrelated estimations. *** significant at 1%; ** significant at 5%; * significant at 10%.

negative events (column 3), we find evidence that political tensions harm export flows and that the effect of political relations is more pronounced for trading decisions under state control than in the market sector. While the coefficient on negative events is -0.006 for SOE trade, the corresponding coefficient for non-SOE trade is only -0.005. Both coefficients are statistically significant at the one-percent level. The Wald test rejects the hypothesis that both coefficients are of equal size and thus supports the idea of a larger role of bilateral political relations in trade controlled by SOEs compared to market activities. As can be seen from column 4, the coefficient on India's voting coincidence with its trading partners is statistically significant at conventional levels in both the SOE trade and the non-SOE trade equation. If a trading partner increases its voting alignment with India by ten percentage points, Indian exports under state control increase by 13.6 percent on average. The coefficient on voting is larger in size for SOE trade than in the non-SOE equation. An increase in bilateral voting alignment by ten percentage points leads to an increase of exports by privately-owned enterprises by 11.8 percent on average. Note, however, that this finding should not be overemphasized as the difference between both coefficients is not statistically significant at conventional levels.

The results for the control variables are again largely in line with our expectations. The coefficients on distance, GDP and population as well as on the dummies for common language, landlocked and joint WTO membership all exhibit the expected signs and reach statistical significance at conventional levels. In contrast to our findings for China, we do not find that India entertains more intense commercial relations with its neighbors. Moreover, PTAs and regime type do not seem to matter for Indian exports.

In summary, political relations, as measured by the number of negative events between India and its partner, affect both imports to and exports from India. The effect is more pronounced in trade relations controlled by SOEs compared to non-SOEs. There is little support for our hypothesis when we replace negative events by bilateral voting coincidence in the UNGA.

	(1) Imports Negative events	(2) Imports UN voting (key votes)	(3) Exports Negative events	(4) Exports UN voting (key votes)
SOE trade				
Political relations	-0.007 * * (0.003)	0.736 (0.895)	-0.006 * ** (0.001)	1.275 * * (0.539)
(log) Distance	-1.317 * ** (0.274)	-1.266 * ** (0.271)	-1.225 * ** (0.185)	-1.198 * ** (0.177)
(log) GDP	1.448 * ** (0.139)	1.476 * ** (0.137)	0.706 * ** (0.077)	0.722 * ** (0.076)
(log) Population	-0.054 (0.170)	-0.111 (0.157)	0.335 * ** (0.087)	0.296 * ** (0.087)
Neighbor	0.909 (1.218)	0.583 (1.255)	0.316 (0.701)	-0.191 (0.803)
Common language	0.245 (0.426)	0.113 (0.395)	0.711 * ** (0.202)	0.630 * ** (0.202)
Landlocked	-0.240 (0.454)	-0.425 (0.406)	-0.612 * * (0.249)	-0.668 * ** (0.222)
Both in WTO	0.644 (0.428)	0.397 (0.395)	0.980 * ** (0.190)	0.898 * ** (0.193)
PTA	-0.457 (0.835)	-0.843 (0.832)	0.119 (0.527)	0.049 (0.448)
Democracy	-0.551 (0.354)	-0.405 (0.296)	-0.267 (0.216)	-0.070 (0.213)
US ally	-0.787* (0.413)	-0.911 * * (0.403)	-0.578 * * (0.250)	-0.634 * * (0.260)
Non-SOE trade				
Political relations	-0.005* (0.002)	0.219 (0.809)	-0.005 * ** (0.001)	1.118 * * (0.494)
(log) Distance	-0.932 * ** (0.257)	-0.945 * ** (0.248)	-1.260 * ** (0.183)	-1.213 * ** (0.175)
(log) GDP	1.071 * ** (0.127)	1.073 * ** (0.126)	0.734 * ** (0.072)	0.724 * ** (0.071)
(log) Population	0.123 (0.138)	0.123 (0.129)	0.251 * ** (0.081)	0.246 * ** (0.081)
Neighbor	1.204 (1.165)	0.909 (1.150)	-0.064 (0.827)	-0.414 (0.834)
Common language	0.102 (0.371)	0.040 (0.343)	0.643 * ** (0.192)	0.541 * ** (0.188)
Landlocked	-0.530 (0.400)	-0.576 (0.357)	-0.621 * ** (0.235)	-0.693 * ** (0.212)
Both in WTO	0.952 * * (0.371)	0.868 * * (0.339)	0.865 * ** (0.178)	0.813 * ** (0.178)
PTA	-0.375 (0.778)	-0.573 (0.752)	0.030 (0.591)	-0.045 (0.497)
Democracy	-0.183 (0.344)	-0.157 (0.314)	-0.210 (0.212)	-0.048 (0.207)
US ally	-1.073 * ** (0.389)	-1.054 * ** (0.379)	-0.433* (0.241)	-0.462* (0.242)
Number of observations	2006	2748	2412	3150
Wald test (p-value)	0.005	0.288	0.004	0.342

Table 6: *Trade with India (1991-2009)*: Results of a gravity model estimating the (logged) import or export value between India and its trading partners. Regressions for SOE and non-SOE trade are run as seemingly unrelated estimations. *** significant at 1%; ** significant at 5%; * significant at 10%.

4.2.3 Consumer Behavior

Next, we test whether the effect of political relations on trade works through consumer behavior. With respect to industrialized countries, there is mixed evidence as to whether consumer reactions to political tensions matter for bilateral trade (see, for example, Disdier and Mayer, 2007; Pandya and Venkatesan, 2012). If driven by the public response, then the consumer effect could appear in both India and China. However, high levels of state control of the media suggest that consumer responses could be subject to manipulation by the state. This could especially be the case for China. In its 2012 edition of the Freedom of the Press index, Freedom House classifies the Chinese media as “not free,” and the country ranks only 187th in the world. India’s press is only ranked as “partially free” (80th position).⁴⁸ Similarly, Reporters Without Borders ranks China 174th and India 131st in the 2011-2012 World Press Freedom Index.⁴⁹ Given the substantial state influence over media coverage, the government can manipulate which particular events “hurt the feelings” of the people and which do not. Since China and India are both members of the WTO, the number of trade policy levers available is limited and thus trade manipulations through consumer behavior may constitute a welcome alternative. Moreover, state control of enterprises and state control of the media may both impact trade relationships simultaneously and in the same direction. Specifically, the government has incentives to discourage consumption of products that compete with SOEs, and SOEs have incentives to lobby for this type of protectionism. This is especially likely in China, where SOEs dominate important consumer sectors. For example, Chinese sales at major Japanese automakers Toyota, Honda, and Nissan were down 49, 41, and 35 percent respectively in September of this year, after a reoccurring territorial dispute between the two countries over the Diaoyu/Senkaku islands erupted into a spate of popular protests across China aimed at Japan. Similarly, plunging Chinese

⁴⁸See <http://www.freedomhouse.org/report/freedom-press/freedom-press-2012>.

⁴⁹See http://en.rsfs.org/IMG/CLASSEMENT_2012/CLASSEMENT_ANG.pdf.

sales caused Panasonic to post the second largest loss in the company's history, surpassing 30 times that predicted by analysts.⁵⁰ State ownership of the auto and electronics sectors averages 72.7 percent and 43.0 percent respectively (see again Table 1).⁵¹

To test whether political relations influence consumer behavior, we separately estimate imports and exports of consumer goods and non-consumer goods as seemingly unrelated estimations. Non-consumer goods are raw materials, intermediate goods and capital goods, i.e., products not intended for final consumption. Data are again obtained from the World Bank's WITS. Table 7 displays our results. We again compute a Wald test that tests the null hypothesis that the effect of political relations is the same in both product groups. As can be seen, we find a statistically significant difference in the coefficients on negative events for imports to China, as indicated by the p-value of the Wald test. Poor political relations have a negative impact concentrated in the import of consumer goods. This finding suggests that consumer behavior indeed plays a role. In addition to state control of enterprises, state control of the media complements the tool box of economic statecraft of emerging powers. This distinction is less relevant in India, where the negative effect on trade from poor relations occurs equally in consumer and non-consumer goods sectors. With weaker control of media and less SOE influence in the consumer goods sectors, India does not appear to target its use of economic statecraft specifically at consumer goods market. At the same time, levels of state ownership in consumer-goods sectors are generally low. For example, state ownership in two major consumer sectors—autos and food and beverage manufacturing—averages 0.0 percent and 1.1 percent respectively (Table 2). These are preliminary efforts to explore how sector characteristics interact with state intervention. The mechanisms that enable governments to form political consumers seems to be an important topic for future research.

⁵⁰Bruce Einhorn, "Panasonic Feels Pain of Chinese Backlash," *Bloomberg Businessweek*, October 31, 2012.

⁵¹Manufacture of radio, television and communication equipment and apparatus is used as the measure of electronics.

	(1) Imports China	(2) Exports China	(3) Imports India	(4) Exports India
Consumer goods				
Negative events	-0.005 *** (0.002)	0.001 (0.001)	-0.004* (0.002)	-0.004 ** (0.002)
(log) Distance	-2.226 *** (0.330)	-0.079 (0.194)	-1.671 *** (0.274)	-1.282 *** (0.210)
(log) GDP	1.883 *** (0.125)	0.882 *** (0.073)	1.538 *** (0.114)	0.728 *** (0.078)
(log) Population	-0.366 ** (0.149)	0.131* (0.074)	-0.316 ** (0.147)	0.202 ** (0.089)
Neighbor	1.235* (0.691)	0.809 (0.620)	1.039 (0.993)	-0.437 (1.116)
Common language	3.688 *** (0.505)	1.537 *** (0.491)	0.137 (0.361)	0.742 *** (0.205)
Landlocked	0.175 (0.422)	-0.754 *** (0.246)	0.277 (0.386)	-0.496 ** (0.247)
Both in WTO	0.045 (0.565)	0.241 (0.206)	0.536 (0.440)	0.778 *** (0.204)
PTA	-1.203 ** (0.561)	-0.721 (0.456)	0.276 (0.623)	-0.071 (0.712)
Democracy	0.635 (0.388)	0.042 (0.215)	0.497 (0.370)	-0.275 (0.229)
US ally	-0.281 (0.395)	-0.129 (0.260)	-0.967 ** (0.390)	-0.182 (0.253)
Non-consumer goods				
Negative events	-0.000 (0.001)	0.002 ** (0.001)	-0.004 ** (0.002)	-0.004 *** (0.001)
(log) Distance	-0.854 *** (0.297)	-0.610 *** (0.166)	-0.767 *** (0.235)	-1.115 *** (0.144)
(log) GDP	1.226 *** (0.093)	0.688 *** (0.065)	1.056 *** (0.098)	0.716 *** (0.071)
(log) Population	-0.107 (0.120)	0.240 *** (0.066)	-0.047 (0.106)	0.173 ** (0.076)
Neighbor	1.317 ** (0.601)	0.771 ** (0.385)	0.198 (0.711)	-0.004 (0.463)
Common language	1.667 *** (0.392)	2.311 *** (0.418)	0.515* (0.286)	0.523 *** (0.186)
Landlocked	-0.072 (0.302)	-0.672 *** (0.217)	-0.101 (0.381)	-0.591 *** (0.217)
Both in WTO	0.341 (0.388)	0.365* (0.211)	0.534 (0.379)	0.827 *** (0.167)
PTA	-1.168 ** (0.588)	-0.042 (0.311)	0.102 (0.429)	0.431 (0.335)
Democracy	-0.743 ** (0.353)	0.175 (0.198)	-0.591* (0.302)	0.029 (0.208)
US ally	-0.157 (0.346)	-0.087 (0.222)	-0.782 ** (0.334)	-0.858 *** (0.251)
Number of observations	1378	1860	1559	2389
Wald test (p-value)	0.020	0.336	0.991	0.572

Table 7: *Trade in Consumer Goods (1991/95-2005)*: Results of a gravity model estimating the (logged) import or export value between China or India and its trading partners. Regressions for consumer and non-consumer goods are run as seemingly unrelated estimations. *** significant at 1%; ** significant at 5%; * significant at 10%.

4.2.4 Robustness Checks

To test whether the observed effect mainly stems from differences between trading partners or whether trade reacts to changes within countries, we add partner country fixed effects to our regression equations. In our setting, this is similar to two-way fixed effects in a usual gravity framework as we estimate trade values for China and India separately. Focusing on the number of negative events and starting with India, our results are similar to the ones presented in Table 6. The effects of negative events are again stronger in the state-controlled sector of the economy for both imports and exports, but the Wald test shows that the difference is only statistically significant at conventional levels in the export regression (detailed regression tables available upon request). For China, however, the coefficient on negative events does not show the expected negative and statistically significant coefficient. It seems that specific events do not impact trade enough to show a significant effect with respect to the average value of bilateral trade of a particular pair. This suggests that it is only the relative level of political relations compared with other countries that matters for trade with China—as suggested by the results presented in Tables 4 and 5.

Finally, we test how our results change if we add trade via Hong Kong to our measures of exports and imports. Hong Kong is a Chinese special administrative zone and reports separate trade statistics. This is of particular importance as much of China's exports may be falsely counted as exports to Hong Kong although they are re-exported to third countries. Our results using “total Chinese trade” as dependent variable are very similar to those reported in Tables 4 and 5 for trade with mainland China (detailed results available upon request).

5 Conclusion

Does globalization render economic statecraft obsolete? Our paper suggests that the answer is no. Governments still aspire to use economic tools to influence international politics. Deregulation of markets, transnational production, and international trade rules have simply narrowed their capacity for action.

Where governments maintain control over trade flows, however, we should still observe trade following the flag. We argue that this is most likely to occur when the government holds an ownership stake in firms and thus exercises influence over their operations. We show that negative events with a trade partner reduce imports by China/India respectively, and that the magnitude of change is greatest the state-controlled sector of the economy. More general trends toward political “closeness” between states, as measured by similarities in their UN voting records, do not show a clear pattern. Our study is the first of its kind to consider the relationship between foreign policy and trade in the state-controlled sector of emerging economies, and our results point to a new area for attention in the debate about economic interdependence and cooperation. States can still find room to exercise economic statecraft, but their capacity to do so is limited in scope and varies by sector.

The paper also addresses the political economy of state ownership. It is not surprising that state control over economic actors would shift their behavior. Despite this obvious point, the literature has paid insufficient attention to how state interests shape trade patterns as a function of state control. Even as market-based economic policies are the norm, many states continue to exercise control over selected sectors, a trend that appears to be rising rather than declining. With China’s emergence as the world’s second largest economy, state influence over economic actors becomes an even more important avenue of inquiry. Our research highlights one important dimension of this influence for international relations research: the incentives for state-owned firms to make decisions based on political rather than commercial interests allows states to influence trade patterns in the service of foreign policy goals.

Importantly, our research indicates that these patterns are not “China-specific.” India displays a similar tendency to fuse trade with foreign policy, particularly in the state-controlled sector of the economy. Our results predict that political relations may become a more, not less, important driver of trade patterns as more emerging countries, many with partially state-controlled economies, rise in the global trading system.



Figure 3: *Diplomatic Tensions: Measures of political relations (1990-2010).*

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A Appendix

Variable	Description	Source
<i>Trade data</i>		
(log) Imports (SOE trade)	(log) Imports under control of SOEs (in constant 2000 US\$)	Own construction (see text)
(log) Imports (Non-SOE trade)	(log) Imports not under control of SOEs (in constant 2000 US\$)	Own construction (see text)
(log) Exports (SOE trade)	(log) Exports under control of SOEs (in constant 2000 US\$)	Own construction (see text)
(log) Exports (Non-SOE trade)	(log) Exports not under control of SOEs (in constant 2000 US\$)	Own construction (see text)
(log) Imports (Consumer goods)	(log) Imports of consumer goods (in constant 2000 US\$)	UN Comtrade via WITS
(log) Imports (Non-consumer goods)	(log) Imports of non-consumer goods (in constant 2000 US\$)	UN Comtrade via WITS
(log) Exports (Consumer goods)	(log) Exports of consumer goods (in constant 2000 US\$)	UN Comtrade via WITS
(log) Exports (Non-consumer goods)	(log) Exports of non-consumer goods (in constant 2000 US\$)	UN Comtrade via WITS
<i>Variables of interest</i>		
Negative events	Sum of the negative Goldstein scores	King and Lowe (2003)
UN voting (key votes)	UNGA voting alignment on key votes	Voeten and Merdzanovic (2009)
Hurt feelings	Number of events that hurt the feelings of the Chinese people	Fang (2010) (own update)
Yan index	Diplomatic relations score (9: best relations, -9: worst relations)	Yan (2010)
<i>Control variables</i>		
(log) Distance	(log) Distance (between major cities, population-weighted, in km)	CEPII (Mayer and Zignago, 2011)
(log) GDP	(log product) GDP (constant 2000 US\$)	WDI 2012 (data.worldbank.org)
(log) Population	(log product) Population, total	WDI 2012 (data.worldbank.org)
Neighbor	1 if both countries share a common border	CEPII (Mayer and Zignago, 2011)
Common language	1 if both countries share a language (>9% of the population)	CEPII (Mayer and Zignago, 2011)
Landlocked	1 if partner country is landlocked	CEPII (Mayer and Zignago, 2011)
Both in WTO	1 if both countries are WTO members in most of the year	WTO (www.wto.org)
PTA	1 if PTA between both countries is in force	WTO (www.wto.org)
Democracy	1 if the regime qualifies as democratic	Cheibub, Gandhi and Vreeland (2010)
U.S. ally	1 if the partner country and the United States share an alliance	ATOP (atop.rice.edu)

Table 8: *Variables and Sources*: The table lists all variables employed in the empirical analysis, their definitions and sources.

Variable	Obs.	Mean	Std.Dev.	Min.	Max.
<i>Trade data</i>					
(log) Imports (SOE trade)	6418	14.94	4.55	-2.11	24.22
(log) Imports (Non-SOE trade)	6017	15.65	4.10	-3.71	25.07
(log) Exports (SOE trade)	7779	15.45	3.57	-0.50	24.45
(log) Exports (Non-SOE trade)	7222	16.63	3.32	3.13	25.78
<i>Variables of interest</i>					
Negative events	5446	4.07	31.70	0.00	809.50
UN voting (key votes)	7181	0.65	0.15	0.04	1.00
Hurt feelings	7666	0.01	0.24	0.00	11.00
Yan index	217	3.14	2.64	-6.30	8.00
<i>Control variables</i>					
(log) Distance	8467	8.94	0.57	6.93	9.86
(log) GDP	7309	50.32	2.58	42.47	59.96
(log) Population	7971	36.04	2.32	29.67	43.64
Neighbor	8623	0.05	0.22	0.00	1.00
Common language	8623	0.19	0.39	0.00	1.00
Landlocked	8643	0.16	0.37	0.00	1.00
Both in WTO	9229	0.31	0.46	0.00	1.00
PTA	9229	0.03	0.16	0.00	1.00
Democracy	7242	0.55	0.50	0.00	1.00
U.S. ally	8668	0.37	0.48	0.00	1.00

Table 9: *Descriptive Statistics*: The table presents the number of observations (Obs.), the average value (Mean), the standard deviation (Std.Dev.), the minimum (Min.) and maximum (Max.) of all variables employed in the empirical analysis for the entire dataset (1990-2009).