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Economic diplomacy: The “one–China policy” effect on trade<sup>☆</sup>

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## ABSTRACT

Chinese foreign policy is mainly characterized by the Beijing consensus and the one-China principle in international relations. More precisely, the situation faced by Taiwan is a “core interest” in China’s economic diplomacy strategy. We investigate whether the “one-China policy” (OCP) has had visible effects on bilateral trade flows. In other words, does the compliance of diplomatic commitments with China undermine Taiwanese trade and enhance China’s trade position? Using a structural gravity model based on worldwide panel data for the period 1948–2012, we approximate the OCP through two dummy variables: the vote by countries of the UN resolution about China’s recognition in 1971 and the existence of diplomatic ties with China. The first component of the OCP drastically increased on average in trade flows with China regardless of the vote of trading partners concerning this UN resolution as well as that for Taiwan. On average, results suggest that diplomatic relations with China improve bilateral trade flows for China, but a trade-deteriorating effect appears for Taiwan with certain ex-colonies. We also find that the effects of these economic diplomacy components confirm previous results reported for the period studied.

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## 1. Introduction

The Chinese government frequently lobbies its trading partners when the partners undermine Beijing’s foreign policy. In 2007, a United Nations (hereafter UN) resolution was rejected when Taiwan wanted to become a member of this international organization<sup>1</sup>. South-Africa was criticized for refusing to grant the Dalai Lama a visa. More recently, the Gambia has severed diplomatic ties with Taiwan for reasons of “national strategic interest” by now counting 22 countries<sup>2</sup> in the world that recognize Taiwan. Since 1949, the Popular Republic of China (PRC) has applied the “one-China policy” (hereafter OCP) under the principle of “one China, two systems” in international relations with Taiwan. More precisely, PRC is the sole government representing the Chinese territory and population around the world whereas Taiwan must be a part of China with relative autonomy. Taiwan is another core interest of the Chinese authorities in foreign affairs, particularly in trade relationships with outside countries to isolate and compel Taiwan to apply this doctrine. According to *Bergeijk, de Groot, and Yakop (2011)*, “economic diplomacy can be defined as the use of international political tools - diplomacy - to achieve economic objectives”. Following this definition,

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<sup>1</sup> [http://www.nytimes.com/2007/07/24/world/asia/24iht-taiwan.1.6799766.html?\\_r=0](http://www.nytimes.com/2007/07/24/world/asia/24iht-taiwan.1.6799766.html?_r=0).

<sup>2</sup> Burkina Faso, Sao Tome and Principe, Swaziland, Kiribati, Marshall Islands, Nauru, Palau, Solomon Islands, Tuvalu, Paraguay, Belize, Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines and the Holy See.

we study the use of specific diplomatic tools by China to improve the country's position in international trade relations at the expense of Taiwan. This paper's contribution is the assessment of the effects of the OCP on Chinese and Taiwanese bilateral trade flows, of which no empirical studies have been conducted to date.

The links between trade and foreign policy have been increasingly studied, although without directly addressing this issue. Indeed, [Nitsch \(2007\)](#) investigated the impact of official state visits on bilateral trade and showed that this tool of foreign policy significantly improves trade for hosting countries. [Rose \(2007\)](#) shows that diplomatic representations have a positive effect on trade due to trade facilitation mechanisms that allow for a reduction in trade transactions. [Yakop and van Bergeijk \(2011\)](#) extend this analysis for developing countries confirming the trade-promoting effect of embassies and consulates on trade. As suggested by [Fuchs and Klann \(2013\)](#), is political compliance a precondition for healthy trade relations with China? The authors find that visits by the Dalai Lama lead to a trade-deteriorating effect on exports to China for host countries only over a recent period. In other words, they empirically demonstrate the effectiveness of Chinese lobbying on their trading partners when these latter countries do not respect the doctrine of Chinese foreign policy.

We use two variables to approximate the OCP based on the works of [Xin \(2001\)](#) and [Chiang \(2004\)](#): first, the vote by countries of the UN resolution regarding China's recognition in 1971 when the PRC replaced Taiwan in the UN bodies by formally representing China in the international community; second, the existence of bilateral diplomatic ties with China by which foreign countries recognize "the government of PRC as the sole legal government of China and the sole legal government representing the entire Chinese people". There are various examples of the tools used by the Chinese government to isolate Taiwan in international diplomatic and economic relations. Through the OCP, China tries to undermine Taiwanese bilateral trade by putting political pressure on trading partners, for example, by the temporary closure of embassies, or by putting economic pressure by granting trade preferences<sup>3</sup>. Furthermore, since the creation of the PRC in 1949, official diplomatic ties with Taiwan have drastically decreased, to the benefit of China. This paper analyses whether the vote on China's recognition by the UN in 1971 and the existence of diplomatic ties with China enhance the two-way trade flows of China with its trading partners. We suppose that a reverse effect occurs for Taiwanese bilateral trade flows due to China's willingness to isolate Taiwan by applying its doctrine.

We perform a theory-consistent structural gravity model ([Anderson & van Wincoop, 2003](#); [Head & Mayer, 2014](#)) with a worldwide database over the period 1948–2012. Indeed, we improve our regressions with country-year and country-pair fixed effects to account for multilateral resistance and endogeneity of political factors. We also implement a Poisson pseudo-maximum likelihood (PPML) model to avoid an omission bias due to zero trade flows in the sample ([Santos Silva & Tenreyro, 2006, 2011](#); [Gomez Herrera, 2013](#); [Fally, 2015](#)). To determine whether the possible effects of these components of the OCP on bilateral trade flows vary over time, we decide to break down our variables of interest over a specific time period, i.e. all 5 years during the first 15 years after China's recognition in 1971 and after the implementation of these diplomatic agreements.

The paper is organized as follows. [Section 2](#) presents a review of the literature on economic diplomacy. [Section 3](#) describes the OCP. [Section 4](#) details hypotheses, data and the empirical approach used. [Section 5](#) discusses results and [Section 6](#) concludes.

## 2. Related literature: economic diplomacy matters

"Economists and diplomats are different specimen. For long they could neglect each other's existence" ([Bergeijk, 2009](#)). The interaction between economists and diplomats has become an increasingly popular topic in the economic and international relations literature. According to [Bergeijk \(2009\)](#), "economic diplomacy is at the interface between these subject fields as its aim is to influence decisions about cross-border economic activities pursued by governments and non-state actors". To better grasp this dimension in international trade relations several papers have empirically demonstrated the strong links between diplomacy and trade.

Indeed, [Rose \(2007\)](#) analysed the effects of foreign services (embassies, consulates, foreign missions<sup>4</sup>) on the trade of exporting countries. These diplomatic representations sustain the interests of the represented States, but they also tend to improve market access through the fall of transactions costs. Rose considers the example of the US Commercial Service, which allows for business partners to be found, the identification of trade opportunities, advice on market potential and help in launching a company. Rose finds that the presence of foreign embassies in countries improves their exports. [Yakop and van Bergeijk \(2011\)](#) focus on the impact of embassies and consulates within the OECD and in South-South trade. They confirm that these diplomatic tools decrease the risk of future (trade) distortions, and they further knowledge about foreign markets. They use a larger dataset than that used by [Rose \(2007\)](#), and they obtain two sets of results. On the one hand, these diplomatic representations enhance trade between developing countries to a greater extent than that between OECD countries because of the trade cost gap. On the other hand, these tools of economic diplomacy could be used to set government failures in motion to diminish insecurity and the high transaction costs in less-developed countries. [Bergeijk et al. \(2011\)](#) confirm these findings, suggesting that compared with other forms of representation, embassies are important tools for facilitating trade.

[Nitsch \(2007\)](#) studied the impact of political factors on trade through official visits of Heads of State in exporting countries. He found that the official travels of France, Germany and the US lead to the promotion of exports for host countries. Nitsch justifies these results by indicating that they improve the conditions of doing business in exporting economies. [Fuchs and Klann \(2013\)](#)

<sup>3</sup> <http://esango.un.org/ldcportal/trade/news/-/blogs/china-announces-97-per-cent-dfqf-treatment-for-ldc-imports>.

<sup>4</sup> [Head and Ries \(2010\)](#) provide an empirical examination of how Canadian trade missions are associated with trade creation. In this case study, the author finds that trade missions do not increase bilateral trade between beneficiary and donor countries when country-pairs are included in gravity regressions.

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