



Impact of foreign political instability on Chinese exports

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ARTICLE INFO

Article history:

Accepted 4 June 2013

Keywords:

International trade
Political instability
Exchange rate
Chinese exports
Dynamic panel model

ABSTRACT

International trade promotes economic development and growth to people and stability in a country. Political instability affects trade through its direct effect on income and investment and indirectly through its influence on investment in physical capital. This study attempts to examine the impact of foreign political instability on Chinese exports. A panel data set of 120 import countries, covering time period from 1988 to 2011 is used to investigate the potential impact of foreign political instability on Chinese exports. The data was analyzed using the alternative dynamic panel and dynamic system generalized method of moments (SGMM). Three measures of political instability including political safety, revolutionary wars and adverse regime change have been used to analyze the impact of foreign political instability on Chinese exports. Results suggest that foreign political instability (adverse regime change) has negative and statistically significant impact on Chinese export. The results further show that income and real exchange rate have a positive and significant impact on Chinese exports.

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1. Introduction

In past three decades, Chinese economy has witnessed a marvelous growth that not only raised the living standards of Chinese people but also make China a key player in world affairs. Since 1978, China has chased the export promotion as the key economic strategy (Atlin, 2011) which makes China as one of the economic giants along with the United States and the European Union in 21st century (Bertin, 2012). According to *The Economist* (2012), the contribution of China GDP in world GDP grew up from 4% in 1996 to 15% in 2012. China not only became larger exporter but also the second big economy after the United States in 2012. At present China's economy is facing diversified internal and external problems. Internal problems include reducing its high domestic savings rate and domestic demand, lesser new jobs for increasing young labor force, rising corruption, environmental damage, rapidly aging population, loss of arable land because of erosion and economic development and increasing of alternative sources other than coal and oil. External problems include territorial disputes with neighboring countries, terrorism movements in Arab and some African countries, Persian Gulf sea conditions and the world economic slowdown. These internal and external problems can have serious consequences on the Chinese economic incentives through

diminishing the external demand for Chinese products in the foreign markets in the recent years.

Economists always favor export promotion over import substitution as the appropriate strategy for economic development particularly from developing countries to developed countries (Balassa, 1985; Feder, 1983; Ghura, 1995; Lussier, 1993; Michaely, 1977; Ram, 1985; Tyler, 1981). A widespread literature explains the role of economic variables such as price level, level of income and exchange rate in bilateral trade but there are few studies that explore the relationship of political instability and trade. Although relation between political instability and trade is as important as trade with other macroeconomic and financial variables (Awokuse and Gempesaw, 2005) thus, it is important to investigate the role of political instability in the performance of the export sector.

Awokuse and Gempesaw (2005) define “political instability as the propensity for a change in the governance of a country, which may include any type of insurgency, revolution, regime change, and military-led coups or the frequency of events that increase the likelihood of social and political unrests. Which include politically motivated assassinations, number of people killed as a result of domestic mass violence, number of successful coups, number of anti-government demonstrations and general strikes among others.” Oh and Reuveny (2010) define “the political risk level of a country broadly and include factors such as interstate and/or intrastate militarized conflict, religious and/or ethnic tension, political instability, weak rule of law, civic disorder, low level of democracy, public and private sector corruption, socioeconomic conditions that promote public discontent, inhospitable investment climate, and incapable bureaucracy.”

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In trade literature very few studies tried to explore the relationship between political instability and bilateral trade. [Srivastava and Green \(1986\)](#) show that stable nations export more while instability of importing country does not affect significantly the bilateral trade. Similarly, [Siverson and Emmons \(1991\)](#) find that democratic governments and political alliances stimulate bilateral trade. [Summary \(1989\)](#) explains that international political factors play an important role in U.S. industrial products trade. According to [Awokuse and Gempesaw \(2005\)](#), political instability abroad can increase the demand of U.S. agricultural products only if we assume that political instability disrupts agricultural production, but does not cut off communication and transportation routes necessary for imports of food and other agricultural products. [Oh and Reuveny \(2010\)](#) explain that increase in climatic disasters or political risk reduces bilateral trade. Countries hit by more disasters see an increasingly larger decline in their trade when their political risk increases.

Generally, poor functioning of domestic institutions and insecurity increase transaction costs between exporters and importers and thus reduce the incentives to create and maintain trading relationships. [Anderson and Marcouiller \(2002\)](#) argue that insecurity can serve as a hidden tax on trade which raises the price of traded goods and makes certain countries at a comparative disadvantage. [Nunn \(2007\)](#) argues that imperfect contract enforcement can be a larger barrier than resource endowments. Similarly, [Easterly and Levine \(1997\)](#) argue that ethnic & linguistic differences are major hurdle in implementation of appropriate policies for economic growth in sub-Saharan Africa (SSA). Furthermore, [Davies \(2008\)](#) shows that the economic costs of war continue after the war is over because war leads to high inflation and high inflation leads towards capital flight in those countries that have just experienced civil wars. [Martin et al. \(1998\)](#) find that severe civil wars reduce trade. [Sambanis \(2004\)](#) shows unrest and instability reduces the confidence of traders and investors. Domestic policy uncertainty reduces private investment in developing countries ([Blomberg and Hess, 2006; Roubini, 1991](#)). [Anderson and Marcouiller \(2002\)](#) examine the impact of various forms of violence on international trade and find that terrorism, internal conflicts, and external conflicts have economically and statistically significant impacts on bilateral trade.

Previous studies' results suggest that the rise in political risk or political instability adversely affects the bilateral trade. It is also observed that none of these studies examined the impact of political instability on Chinese trade. Therefore, to explore that how political and social unrest in foreign countries can affect Chinese trade, we have chosen Japan, for example, political and institutions instability in Euro-zone, and Japan, the one of the largest importer of Chinese products have a significant upshot on Chinese export. It can also be guessed that war and other forms of political instability in the Arab countries and Africa would affect Chinese export, even though China is not a larger exporter to the Arab countries and African market. However, any kind of regime change or revolution in Arab or African countries can affect the Chinese future interest in these regions. Socio-political unrest and instability in the Persian Gulf can affect Chinese trade, because political turmoil in the Gulf region will lead to reduced transportation access to the region, which consequently links foreign markets access for China.

These hypothetical but realistic scenarios emphasize the need for empirical investigation of the role of political instability in determining the direction and magnitude of Chinese trade. The current study explores the extent to which political instability in foreign countries can influence Chinese trade. The purpose of this paper is to analyze the impact of political instability in trading partner country on Chinese trade over the period 1988 to 2011. We use alternative estimation techniques including static and dynamic pool OLS, dynamic panel FE, instrumental variable FE and dynamic system GMM to get most suitable and economically and econometrically appropriate results. We use three proxy variables including Political Safety index, Revolutionary War and Adverse Regime Change. Political Safety index measures the overall instability of the country and its impact on Chinese export. Revolutionary War explores the effect of war abroad on Chinese exports. While Adverse

Regime Change analyzes the role of change in government system abroad on Chinese export. The results from the current analysis provide evidence in support of the view that some forms of political instability are significant determinants of trade. Our results reveal that political risk abroad has a positive while revolutionary wars and adverse regime change abroad have a negative effect on Chinese export but only regime change has statistically significant effect. Domestic and foreign incomes have positive and statistically significant impact on Chinese exports. Whereas, domestic population has a negative while foreign population has positive and statistically significant effect on Chinese export. The results provide evidence in support of the view that some forms of political instability abroad can have significant influence on Chinese exports.

The reminder of this study is organized as follows. Section 2 consists of a brief discussion of previous studies. Section 3 discusses the data and methodology of the study. Section 4 presents the results of the empirical models and the last section concludes the study.

2. Literature review

Trade promotes economic development which leads to peace and stability in countries ([Fujita et al., 1997](#)). Trade can also lessen internal conflict by strengthening government to discourage rebellions ([De Soysa, 2000; Fearon and Laitin, 2003](#)) because trade provides an alternative source of earning to rebel ([Collier and Hoeffler, 1998; Fearon and Laitin, 2003; Ross, 2004](#)). Only a few studies analyze the relationship between trade and political instability. [Srivastava and Green \(1986\)](#) showed that politically stable nations export more. Similarly, [Morrow et al. \(1998\)](#) state that democratic governments and political alliances stimulate bilateral trade. [Summary \(1989\)](#) explains that international political factors play a significant role in U.S. industrial products trade. [Awokuse and Gempesaw \(2005\)](#) argue that political instability abroad can increase the demand of U.S. agricultural products only if we assume that political instability disrupts agricultural production in foreign countries. According to [Oh and Reuveny \(2010\)](#) increase in political risk or the incidence of disasters substantially reduces bilateral trade. We can analyze the role of political instability with trade into two ways. First, impact of political instability on exporting country, secondly, impact of political instability on importing country. Both impacts have been discussed with separate sub-section of this study.

2.1. Impact of political instability on exporting country

In the words of [Awokuse and Gempesaw \(2003\)](#), political instability can affect international trade directly through its impact on income and prices or indirectly through its impact on other economic variables such as investment in physical capital. Political instability can directly affect the level of exports by influencing domestic production and increasing level of political and economic uncertainty. [Alesina and Tabellini \(1989\)](#) also have a view that political instability increases production inefficiency. [Gyimah-Brempong and Traynor \(1999\)](#) and [Fosu \(2003\)](#) view that in addition to the production inefficiency, political instability leads to brain drain that depletes a given country's stock of high skilled labor. [Fosu \(2003\)](#) argues that loss of such labor should reduce human capital which affects country's overall development generally and exports particularly. He further stated that political instability is a reason behind capital flight due to the diminishing expected return risk linked with political instability. Such kind of capital flight has devastating effect on export of the country.

Political instability creates political risk for economic agents involved in international trade ([Awokuse and Gempesaw, 2003](#)). Also, the potential threat of future government action to restrict trade can lead to reduction in the current volume of international trade ([Awokuse and Gempesaw, 2003; Dixon and Moon, 1993; Pollins, 1989; Siverson and Emmons \(1991\)](#)). Many authors examined the

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