



Regionalism and conflict: Peace creation and peace diversion[☆]



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ABSTRACT

We investigate the implications of preferential trade agreements (PTAs) for interstate conflict. We set up a two-stage game with three competing importers, where first, two of the countries decide on whether to initiate war against each other, and subsequently, all three countries select their import tariffs. We show that PTAs produce both a “peace-creation” effect and a “peace-diversion” effect, whereby they reduce the likelihood of conflict between member countries (peace creation), but render the eruption of war between member and non-member countries more likely (peace diversion). This paper is the first to identify and explicitly model the peace-diversion effect of PTAs, and is also the only one in this literature to endogenize countries’ terms of trade. We use data from the Correlates of War project to empirically test these predictions, and after controlling for endogeneity, we find robust evidence of both peace creation and peace diversion in relation to PTA establishment.

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1. Introduction

It is widely believed among historians and political scientists that the most important reason for establishing the European Coal and Steel Community (ECSC) in 1951—the original predecessor of the European Union (EU)—was the desire to avoid another devastating major war in Europe. In the words of the Schuman Declaration, which was presented by French foreign minister Robert Schuman on 9 May 1950 and proposed the creation of the ECSC, the pooling of coal and steel production would make any war between age-old rivals France

and Germany “not merely unthinkable, but materially impossible.”¹ The pacifying role of the EU and its forerunners was recognized by the Norwegian Nobel Committee in 2012, which awarded to the EU the Nobel Peace Prize. In its official announcement, the committee stated, “The stabilizing part played by the EU has helped to transform most of Europe from a continent of war to a continent of peace.”²

In this paper, we investigate both theoretically and empirically the implications of preferential trade agreements (PTAs) for interstate conflict. In particular, we explore whether, in line with the EU case, PTAs reduce the likelihood of conflict between member countries. At the same time, since PTAs have important ramifications for the bilateral trade relationship between member and non-member countries, we also analyze the impact of PTAs on the likelihood of war between PTA members and non-member states. We should emphasize from the beginning that our focus lies in highlighting a novel terms-of-trade channel through which PTAs can affect countries’

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¹ See http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/index_en.htm.

² See http://nobelpeaceprize.org/en_GB/laureates/laureates-2012/announce-2012/.

incentives to initiate war and thereby, their *likelihood* of engaging in interstate conflict. To this end, we abstract from mechanisms involving incomplete information or commitment problems which are common in the political science literature, although we do acknowledge that these mechanisms are pivotal in explaining why wars actually take place despite being so costly, even in the presence of rational leaders (see Fearon, 1995).

On the theoretical side, we develop a three-country competing-importers model, where two of the countries are “enemies”, as they contest part of each other’s resources. The countries engage in a two-stage game, in the first stage of which, the two enemies decide on whether to wage war against each other. In the second stage, all three countries select their import tariffs. Countries at war do not trade with each other and, additionally, bear a fixed cost of destruction. Moreover, in the event of war, the victor seizes its adversary’s contested resources, with the probability of prevailing in an armed conflict being a function of the relative military expenditures of the enemy countries. We solve this dynamic game under the scenario of no regionalism, which is our benchmark scenario, and under four different PTA scenarios, involving a free-trade-area (FTA) or a customs-union (CU) agreement either between the two enemies or between one of the enemies and the third country.

In the absence of regionalism, we find that conflict can only arise for sufficiently asymmetric military expenditures of the enemy countries. Furthermore, a PTA between the enemy countries, in the form of either an FTA or a CU agreement, renders the eruption of war less likely, in the sense that an even larger asymmetry in military spending between the two enemies is then required for war to break out in equilibrium. This stems from the fact that a PTA between the enemies increases their welfare under peace (and thus, the opportunity cost of war) via (i) eliminating the inefficient Nash trade barriers between them; and (ii) improving their terms of trade vis-à-vis the third country—due to the PTA’s tariff-complementarity effect in the case of an FTA agreement, or as a result of both its market-power and tariff-complementarity effects in the case of a CU agreement. Hence, at a more general level, our results establish that PTAs exert a “peace-creation” effect on their member countries, which is in line with the EU experience.

However, our analysis illustrates that PTAs can also be detrimental to peace. More specifically, in the case of an FTA or a CU agreement between one of the adversaries and the third country, the former is more likely to start a war in comparison with our benchmark scenario, since such a PTA raises the country’s expected welfare under war relative to its welfare under peace. The reason is that under war, the country in question trades only with its non-enemy country (that is, the third country in our model); thereby, it stands to enjoy a significantly larger welfare gain from the trade liberalization entailed by the PTA under war than under peace. At the same time, the adversary that is not part of the PTA is also more likely to initiate war against its enemy than in the no-regionalism case, since that country faces, as a result of the agreement’s terms-of-trade ramifications, a decrease in its welfare under peace relative to its expected welfare under war. Therefore, a PTA between one of the adversaries and the third country renders, unambiguously, the eruption of war between the enemy countries more likely. More generally, our results show that PTAs produce a “peace-diversion” effect on member as well as on non-member countries. At a broad level, the peace-creation and peace-diversion effects of PTAs that emerge from our analysis are somewhat reminiscent of their trade-creation and trade-diversion effects originally identified by Viner (1950).

We use data on militarized interstate disputes (MIDs) from the Correlates of War (COW) project to empirically test these predictions. Our sample consists of 260,781 annual country-pair (“dyadic”) observations over the period 1958–2000. We address the possible endogeneity bias with respect to membership of FTAs and CUs mainly by (i) controlling for a large number of potential common

determinants of both regionalism and interstate conflict; (ii) taking advantage of the panel dimension of our data set by estimating an unobserved-effects dynamic probit model using the Chamberlain (1980, 1982)–Mundlak (1978) device; and finally, (iii) implementing a recursive bivariate probit strategy. Our empirical results provide robust evidence of both peace creation and peace diversion in relation to PTA establishment.

Few papers look at the interplay between regionalism and interstate conflict. In particular, Mansfield et al. (1999) and Mansfield and Pevehouse (2000), using data on MIDs over the period 1950–1985, find that PTAs produce a peace-creation effect on their member countries. In another, more recent, empirical study, Vicard (2012) provides evidence that deep PTAs, such as CUs and common markets, reduce the probability of conflict between member countries, but shallow PTAs, such as FTAs and partial scope agreements, have no such effect. On the other hand, Martin et al. (2012) look at the reverse question, and find that country pairs with a higher frequency of old wars are more likely to sign PTAs, whereas a higher frequency of recent wars has the exact opposite effect. Finally, Schiff and Winters (1998) develop a theoretical model in which they assume that trade reduces frictions between hostile neighboring countries, and explore whether a PTA can generate welfare gains for its members under those conditions and how such a PTA would evolve over time. We differ from these papers in two important ways. First, this is the first paper to identify and explicitly model the peace-diversion effect of PTAs. Second, this is the only paper in this literature to endogenize countries’ terms of trade, proposing a novel mechanism through which regionalism can affect interstate conflict.

Our paper is also naturally related to the literature on the impact of international trade on interstate conflict. More particularly, a voluminous body of research has empirically investigated the long-standing “liberal peace hypothesis” that trade promotes peace. Many studies find a negative relationship between bilateral trade and bilateral conflict, lending support to the liberal peace hypothesis (see, for example, Polachek, 1980; Oneal and Russett, 1999). A number of papers, though, either find no evidence of the pacifying effect of economic interdependence (see, for instance, Kim and Rousseau, 2005) or even find that trade increases conflict (see, for example, Barbieri, 1996), which are in line with the theories of the neo-Marxist and realist/neo-realist schools of thought in political science. On the theory side, Skaperdas and Syropoulos (2001) and Garfinkel et al. (2009, 2012) develop models of trade with an insecure resource, and compare the effects of autarky and free trade on the intensity of competition between countries (through arming) over the contested resource as well as on their welfare. In their analyses, the world relative price of the contested resource emerges as the pivotal factor. Last, Martin et al. (2008) investigate both theoretically and empirically the ramifications of trade for war, and find that bilateral trade openness deters bilateral war, while multilateral trade openness increases the probability of war between any given pair of countries. None of these papers, however, shares our focus on regionalism and its implications for interstate conflict via its terms-of-trade effects.

The remainder of the paper is organized as follows. The next section sets out the basics. Section 3 solves our dynamic game under our benchmark scenario of no regionalism. Sections 4 and 5 explore, theoretically, the impact of FTA and CU agreements on interstate conflict. Section 6 provides empirical evidence in support of our theoretical predictions. Finally, Section 7 concludes. Appendix A discusses the robustness of our results to adopting a competing-exporters framework instead.

2. The model

We assume that the world consists of three countries, *A*, *B*, and *C*, that trade three goods, *a*, *b*, and *c*, with trade being subject to the

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