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The Determinants of Trade on Conflict – Some Evidence from Emerging Market Economies

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Abstract

Recent empirical studies have reached mixed results on the effects of international trade and the likelihood of conflict. We argue that this relationship is likely to depend both on economic factors as well as political considerations including power capability of the government and the degree of democracy. Using the disaggregated data for a sample of 42 emerging market countries from 1995-2015, we discover some interesting patterns on international trade, democracy and power capability. We also find strong support for the liberal proposition that a more trade-oriented and democratic political system is more likely to reduce conflict particularly for emerging market economies.

Keywords

Trade, Democracy, Power capability, Conflicts

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Introduction

The interaction between international trade (economic interdependence)[1] and political variables has been a major topic for classical economists (Ricardo, 1817), Marxists (Lenin, 1916), Keynesians (Keynes, 1919), and political economists (Hirschman). Recently, the link between bilateral trade and political conflict has become central in the international political economy literature. Current debates over the question of whether economic interdependence promotes peace or contributes to international conflict are often framed in terms of the "paradigm wars" between liberal and realist theory. Liberals argue that economic interdependence lowers the likelihood of war by increasing the value of trading over the alternative of aggression. Realists dismiss the liberal argument, instead arguing that high interdependence increases rather than decreases the probability of war. Earlier studies such as Polachek (1980) modeled how trade can enhance cooperation between countries. The logic behind his argument is simple. If conflict leads to a cessation or at least a diminution of trade, then countries with the greatest gains from trade face the highest costs for potentially lost trade and hence engage in the least conflict and the most cooperation. However[2], Polachek does not take political variables into account. Factors such as joint power capability, and joint democracy are the traditional main concerns of political scientists when analyzing conflict. Therefore, the primary focus of this study is to reexamine the conflict-trade model presented by Polachek, while incorporating a number of these variables in order to make predictions regarding how political factors affect conflict.

In this paper we examine the relationship between trade and conflict by adopting Polachek's suggestions while including political factors: power capability, and democracy into our model. Unlike Polachek's work, which measured trade-conflict relations by linear regression, we argue that there is an inverse non-linear relationship of trade on conflict. Non-linearity has a better fit for estimating all the components in our study. In general, we are looking at whether trade still leads to a decline in conflict after controlling these variables. The estimation period in this cross-sectional time series analysis is from 1995-2015 and is based on the conflict among emerging market economies.[3]

[1] We use both trade and economic interdependence interchangeably in this paper.

[2] Solomon W., Polachek, "Conflict and Trade," *Journal of Conflict of Resolution* 24 (1980): 55-78.

[3] It is common in the literature in this area to focus on middle/low income countries. Most countries with middle incomes share common traits where the economic fundamentals are often unstable, the financial systems are less developed and both political and institutional qualities are not as strong as compared to industrialized economies. These will in turn make emerging countries more prone to potential currency crises and create potential conflict. Please see the Appendix A for the list of countries included in this study.

The paper is organized as follows. Section 2 reviews the theoretical undergrounds for conflict-trade arguments based on two different approaches: liberalism and realism and provides the rationale for the variables included in the regression equation. Section 3 outlines the research design and examines the conflict-trade relations empirically by applying a logit model. Empirical findings are presented in section 4, and section 5 concludes and provides some insights for future research.

Literature Review

Realists approach

Realists argue that trade brings conflict. The earliest empirical studies that considered the impact of trade on international relations identified a positive relationship between trade and war. Bruce Russett (1967) found that pairs of states united in high trade were more likely to engage in war than those not so linked. In general, trade may increase political tension by enhancing outward expansion and competition for limited product markets and production inputs (Sayrs, 1990). If a country assists domestic industries in the competition, bilateral hostility increases. Park et al. (1976) investigated Middle Eastern oil exporters from 1947-1974 by constructing an events dataset focusing on oil. Moreover, Tyson (1992) connected controlling shares of world trade in leading sectors to sustained economic growth. Competition over world markets for basic manufactures, minerals, and fuels leads to disputes because most of these industries are also of strategic significance for the production of military goods. He then concluded that competition over trade shares in leading sectors intensifies bilateral conflict. Barbieri (1995, 1997, 1998) also found a positive relationship between trade and conflict by refining measures and expanding her database to incorporate more states as well as relying on new statistical techniques. Even among the so-called “politically relevant” dyads (Maoz & Russet, 1993)- contiguous states and pairs containing at least one major power- Barbieri finds that economically important trade is positively associated with conflict, though the relationship for this important group of countries is not statistically significant.

Another important argument of realism is that it emphasized on the “relative gain” rather than “absolute gain” in assessing the possibility of cooperation between trading partners in international politics. According to this argument, envy is the major impediment in the attempt to create lasting institutions. In sum, realists seek to highlight one main point: political concerns driven by anarchy must be injected into the liberal calculus. Since states must be primarily concerned with security and therefore with control over resources and markets, one must discount the liberal optimism that great trading partners will always continue to be greater trading partners simply because both states benefit absolutely.

Accordingly, a state vulnerable to another's policies because of dependency will tend to use force to overcome that vulnerability.

Liberal approach

The second strand of the literature-liberalism argues trade brings peace. Polachek (1980) consistently revealed an inverse relationship between trade and conflict by moving to the dyadic level of analysis. He assessed the impact of trade on the overall dyadic relationship, where conflictual and cooperative events are evaluated in a combined measure of net conflict (the frequency of conflictual events minus cooperative events).[4] Polachek concluded that trade promotes peace, based on the inverse relationship between trade and his net conflict indicators. Gasiorowski and Polachek (1982) hypothesized that 'the economic structures of different countries will affect their benefits from trade in certain types of goods and hence also the strength of incentives associated with these goods to reduce conflict'. When an economic sector is strong, indicative of comparative advantage, trade will induce cooperation. Countries will have less incentive to reduce hostility when trade is in goods that exhibit low demand or have few domestic substitutes. Empirically, Domke (1988) uncovered that nations heavily involved in foreign trade are less likely to make decisions for war. Similarly, Mansfield (1994) examined the effect of trade on the likelihood of war at the system level of analysis between 1850-1965. He showed that a high level of trade in year t-1, measured as the ratio of global exports to total world output, reduces the average number of wars initiated in the five years after year t.

The standard liberal argument is quite straightforward. Unlike realists, liberalists tend to agree with the notion that trade are mutually beneficial to all nations. This so called "gains from trade" in other words suggest an independent state should therefore seek to improve trading relations with other states and avoid potential conflicts since peaceful trading maximizes mutual benefits. Clearly, leaders are deterred from initiating conflict against important trading partners for fear of losing welfare gains associated with trade. An extended liberal argument suggests that it is not merely the volume of trade, but the type of trade that exists between partners that affects utility calculations for conflict.[5] Moreover, while liberals recognize that gains from trade and the potential costs accompanying interdependence are

[4] Katherine Barbieri and Gerald Schneider, "Globalization and Peace: Assessing New Directions in the Study of Trade and Conflict," *Journal of Peace Research* 36, No.4 (1999): 387-404.

[5] Solomon W. Polachek & Judith McDonald, "Strategic Trade and the Incentive for Cooperation", in Manas Chatterji & Linda Rennie Forcey eds, *Disarmament, Economic Conversion, and Management of Peace.* (New York: Praeger, 1992), p273-84.

not always equal, they claim that trade ties imply net positive benefits for both states. Thus, a clear link is established between expanded trade and peace within the liberal tradition. In my view, the link is tenuous for those who maintain that trade might entail net costs or for those who view states' concerns about absolute gains as subordinate to concerns about the relative gains.

While the liberal and the realist arguments display critical differences, however, they appear to agree on the effects of conflict on trade. Both imply that trade and other forms of economic interchange between states will cease or be drastically reduced once states are engaged in serious conflicts with each other. The liberal hypothesis that trade deters conflict is based on the premise that conflict will substantially reduce trade or adversely affect the terms of trade. Realist theories imply that trade, particularly in strategic goods, will terminate between opponents due to relative gains concerns. As least one state will have an incentive to cease trade because of fearing that its adversaries will reap relative gains from the continuation of tra My argument, again, is that even both liberal and realist theories generate a strong hypothesis that the outbreak of conflict/war will substantially reduce levels of trade, the effects of trade on conflict still remains controversial. This deviation has to do with their emphasis on the benefits versus the costs of economic interdependence. The realist approach highlights an aspect that is severely downplayed by the liberal theory, namely, consideration of the potential costs from the severing of a trading relationship. While liberal theory certainly neglects the realist concern to some extent for the potential costs of severed trade. Based on the discussions above, several testable hypotheses can be derived as follows:de and exploit those gains to increase its military power.

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H1: There exists a non-linear correlation (U-shape) between trade and conflict.

H2: Asymmetric power capability among nations reduces conflict

H3: Democracy reduces the likelihood of conflict via promoting trade

Research Design

In this section, we begin with exploring the validation of liberal and realist theory using logit regression analysis of pooled cross-sectional time-series data. As before, the unit of analysis is dyad-year. We limit our study to major power states dyads by the Correlates of War (COW) projects from 1995-2015. Moreover, we focus below on defining the dependent and independent variables briefly and forming a hypothesis. Also, we address the measurement of the variables and present a model by applying a statistical technique.

Dependent Variable

In our analysis, we test the effect of trade on conflict using a set of militarized interstate disputes assembled by COW. This is the most widely used data set on international conflict. Unlike the event data implemented by Polachek (1980), we define the dependent variable based on the overall level of hostility (scale 0-5) in the dyads, andtreat conflict as a dichotomous variable where one represents the hostility level above 4 and zero, otherwise.[6]

Independent Variable

Trade (Proposition 1: There exists a non-linear correlation (U-shape) between trade and conflict)

We use the data from the Direction of Trade (International Monetary Fund) as the basis for our bilateral measure of trade. Several trade measures are used in the trade and conflict literature. Oneal et al. (1996) uses the ratio of bilateral trade to national income. Polachek (1980) and Pollins (1989) use the value of bilateral trade. Since national income is not disaggregated into the same commodity groups of trade, we cannot create such a ratio measure for disaggregated trade. However, we define the degree of dependence in terms of the ratio of import on total volume of trade as frequently used in the standard economic literatures Specifically, country i's dependence on trade with j in year t-1 is

$$TRAij,t-1 = Mij,t-1/ (Xij,t-1 + Mij,t-1)$$

we incorporate one-year lag to ensure that trade has not been affected by a dispute to be explained. Also, the log of trade is used in the logit regression to account for the large variation of trade with the system. Additionally, the non-linearity characteristic of trade is measured by its square term in this analysis.

[6] *Daniel M. Jones, Stuart A. Bremer and J. David Singer,* "Militarized Interstate Disputes, 1816-1992: Rationale, Coding Rules, and Empirical Patterns." *Conflict Management and Peace Science* 15 no 2 (1996): 163:213.

Power capability (Proposition 2: Asymmetric power capability reduces conflict)

We include a measure of the dyadic balance of power. Recent evidence suggests that a preponderance of power inhibits overt conflict (Kugler & Lemke, 1996). Empirical studies at the dyadic level support the power preponderance proposition (Bremer, 1993; Geller, 1993). To measure the national capabilities, we used the COW Composite Index of National Capabilities (CINC) composed of a country's share of the system's total population, urban population, energy consumption, military manpower, and military expenditures (Singer & Small, 1995). Relative power is operationalized as the relative capabilities available to each state in a given dyad. A ratio of the larger to the smaller state's capabilities is used to measure relative power. Also, the log of the relative capabilities is used in the logit regression analysis below to control for the large variations in CINC scores among states within the system.

Democracy (Proposition 3: Democracy reduces the likelihood of conflict)

Whether democracies are more peaceful than other states is still disputed, but powerful evidence indicates that democracies rarely fight one another (Maoz and Abdolali, 1989; Bueno de Mesquita and Lalman, 1992, Rummel, 1996). Theoretical explanations of these results typically imply that the more democratic a pair of states, the less likely they are involved in conflict. Moreover, democracy tends to encourage trade and interdependence. In democracies, economically powerful groups are likely to be politically powerful as well (Papayoanou, 1996). Trade agreements among democracies may also last longer. Because executives in democratic countries must persuade and accommodate other influential groups such as their legislature, and interest groups, they are more likely to abide by their international commitments than are nondemocratic leaders. In my view, consequently, democracy will reduce the probability of conflict indirectly through increasing bilateral trade.

We estimate the peacefulness of democracies using the most recent Polity IV data (Jaggers & Gurr, 1995, 1996, 2010). Following Oneal and Russett (1999), the measure of joint democracy is created using the regime score of the two members of each dyad.

$$JDEMij,t-1 = ((Demi,t-1 + 10)*(Demj,t-1 + 10))$$

where DEMi,t = DEMOCi,t – AUTOCi,t. This measure takes into account the coexistence of democracy and autocracy in many governments.

Control variables

The explanatory variables and their sources are categorized according to the three groups of factors hypothesized as affecting (positively or negatively) a country's peacefulness. The economic factors include: the rate of economic growth; per capita GDP; income distribution; inflation rate; unemployment rate; and openness of the economy. The political factors include: effective democratic governance; level of public-sector corruption; press freedom; and civil liberties. The socio-demographic factors include: education levels of the population; literacy levels of the population; health status of the population; importance of religion in political or social life; and population growth rate.

The Model

We apply logit regression analysis to test the propositions. Certain statistical techniques will also be used in modeling cross-sectional time-series analysis. The basic model specification is:

$$\mathbf{CONF}_{ij,t} = \alpha + \beta 1\,(\mathbf{TRA})^2_{ij,t-1} + \beta 2\,\log \mathbf{JDEM}_{ij,t-1} + \beta 3\,\log \mathbf{CAP}_{ij,t-1} + \beta 4\,\mathbf{X}_{i,\,t-1} + \varepsilon t$$

where **CONF** = the overall level of hostility between each dyad.

TRA = trade dependency of country i on country j.

JDEM = joint democracy between each dyad.

CAP = power capability ratio of the stronger state to the weaker member.

Xi = economic and social economic control variables

ε = A random error term normally distributed with mean zero.

Empirical Analyses

Table 1 presents the summary of descriptive statistics. Results on logit regressions are presented in Table 2, which shows the effect of trade on conflict in a basis of major-power dyads from 1995-2015.

Table 1 Statistical Summary

Variable	Mean	Median	St.dev.	Min.	Max.
CONFLICT	0.46	0.76	0.25	0.25	1
GROWTH	0.15	0.26	0.48	-0.32	0.46
DEMOC	2.62	6.88	2.55	-8.21	9.69
POWER	3.68	4.71	2.67	0.23	10
INCOME	46.26	27.9	8.78	2.9	64.3
INFL	5.21	7.34	6.26	-4.56	25.12
UNEMP	7.17	6.56	4.78	0.83	34.22
TRADE	-0.14	-0.67	0.86	-4.66	1.98

The estimation coefficient of TRASQ ((**TRA**)^2), and **JDEM** are negatively significant at 95 percent (p<. 005) in equation (1) and equation (2). These results indicate that the increase of trade alone is associated with lower probability of conflict, while adding democracy will tend to increase the effect even larger, indicating that democracy tends to promote international trade and therefore reduces the likelihood of conflict. The other variable **POW** comes into the equation (3) which is negatively significant at 95 percent (p<. 01). This result provides strong support for liberal theory. The overall model in equation (3) is significant at 5 percent since the difference between unrestricted log likelihood (-42.7483) and restricted log likelihood (-53.5889) is greater than referred chi-square distribution (10.8406>0.3518). Furthermore, the coefficient of TRA is -6.221 indicating that by an increase in one percent in the trade dependence ratio, the probability of conflict will be 9.5 times more likely to be reduced which implies that more trade leads to less conflict as suggested by liberal theory. Similarly, the coefficient of JDEM is -0.557 showing that an increase in the level of joint democracy between two dyads will decrease the likelihood of conflict by 0.17 percent. In other words, this result supports the argument that democracy reduces the probability of involving in armed war. Moreover, the power capability has a negative impact on conflict. The coefficient is -0.909, which implies that a one percent increase in the capability ratio will result in a 0.248 percent decrease on the likelihood of conflict. Power preponderance holds in this scenario.

Furthermore, I also examine the impact of trade on conflict in both the pre-and post-war era using different measure of democracy and power capability. Questions have been raised about many of the quantitative proxies for political variables. Clearly they cannot capture all of the relevant nuances, and in some cases different proxies for the same concept differ substantially. Thus, in addition to democracy measure in POLITY IV, I use measures from Bueno de Mesquita et. al. (2003), who argued proxies using the ratio of the size of the winning coalition to the selectorate will better capture the essence of democracy in nature. The results on these robustness checks are displayed in Table 2 equation (4), (5), and (6). As we can see from these results, TRASQ, JDEM, and POW are negative and significantly associated with the probability of conflict, which are consistent with our main findings.

Table 2 Models of Trade, Democracy, and Capability on Conflict, 1995-2015.

	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
$TRASQ_{t-1}$	-6.858***	-5.187*	-6.221**	-6.945**	-3.124***	-6.292*
	(2.81)	(-1.69)	(-2.05)	(2.12)	(-2.97)	(-1.78)
$JDEM_{t-1}$		-2.147***	-0.557**		-2.542**	-0.608**
		(-2.96)	(1.65)		(-2.31)	(1.95)
POW_{t-1}			-0.909**			-0.972***
			(-2.05)			(-3.16)
$INCOME_{t-1}$	0.218**	0.344	0.817**	0.925**	0.872*	0.421**
	(2.51)	(0.12)	(2.88)	(2.51)	(1.74)	(2.48)
$INFL_{t-1}$	0.273*	0.985**	0.652	0.763*	0.547**	0.925
	(1.86)	(2.31)	(1.59)	(1.86)	(2.64)	(1.27)
$GROWTH_{t-1}$	-2.019*	-5.013**	-4.335**	-5.099**	-3.216**	-4.012**
	(-1.76)	(2.63)	(2.71)	(2.76)	(2.65)	(2.47)
$UNEMP_{t-1}$	0.225***	0.292***	0.541**	0.872***	0.316**	0.981***
	(3.23)	(3.01)	(2.62)	(3.23)	(2.04)	(3.21)
_cons	-2.644***	-4.792***	-3.965**	-1.459**	-2.731**	-2.087*
	(-5.10)	(-3.04)	(-2.85)	(-2.85)	(-2.47)	(-2.07)
N	687	724	838	653	767	866

Note: *t* statistics in parentheses. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Conclusion

This paper provides empirical support for the liberal proposition that trade creates a path to interstate peace. After controlling for the influence of joint democracy and relative power capabilities, the evidence suggests that economic interdependence on trade decreases the likelihood that major-power dyads engage in conflict. Moreover, both joint democracy and relative power capabilities are generally associated with a reduction in interstate violence. Despite the evidence favored by liberal theory, one main challenge to the liberal view that has to be pointed out here is that economic ties not only offer the prospect of mutual gain but also may transmit economic ills and create rivalry over the division of benefits. When relations are asymmetrical, trade can be a source of influence, which may lead to exploitation and conflict.

Another important finding in this paper is that trade inclines to decrease before the conflict while increasing after the conflict among hostile dyadic as analyzed previously. Countries can evaluate their relationships with adversaries by the change of trade on the one hand. Less trade indicates a higher likelihood of conflict, which is consistent with liberal theory. On the other hand, the overall increasing pattern over time points out that countries will have an incentive to maintain a trading relationship even with their enemies in peacetime simply because trade creates mutual benefits for both sides, which is also coherent with liberal theory. In this sense, trade tends to reduce the probability of conflict. These findings also provide policy implications to certain degrees. For emerging market economies, trade might tent to create tensions in the early stage but in the long run, it prevails and outruns the cost by creating mutual benefits.

Future research should clarify the functional form that expresses the link between interdependence and peaceful interstate relations. Moreover, research should consider further the proper technique for estimating logistic regression analysis with pooled time-series data. And, especially, we need to address the complex causal relations linking democracy, economic interdependence, and other international organizations, and conflict. But for now, it seems clear that economically important trade does have important pacific benefits.

Appendix A: List of Sample Countries in the Estimation

Sample for 42 emerging market countries:

Angola	Dominican Republic	Kazakhstan	Oman	Sri Lanka
Argentina	Ecuador	Latvia	Panama	Thailand
Bolivia	Egypt	Lebanon	Paraguay	Tunisia
Brazil	El Salvador	Malaysia	Peru	Turkey
Bulgaria	Georgia	Mauritius	Philippines	Uruguay
Chile	Guatemala	Mexico	Romania	Venezuela, Bolivarian Republic of Venezuela
China,P.R	Hungary	Moldova	Russia	
Costa Rica	Indonesia	Morocco	South Africa	
Czech Republic	Jamaica	Nicaragua	Swaziland	

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