

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

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## Abstract

Can governments still use trade to reward and punish partner countries? While World Trade Organization (WTO) rules and the pressures of globalization restrict states' capacity to manipulate trade policies, politicization of trade is likely to occur where governments intervene in markets. We examine state ownership of firms as one tool of government control. Taking China and India as examples, we use new data on bilateral trade disaggregated by firm ownership type as well as measures of political relations based on bilateral events and United Nations voting data to estimate the effect of political relations on import flows since the early 1990s. Our results support the hypothesis that imports controlled by state-owned enterprises are more responsive to political relations than imports controlled by private enterprises. This finding suggests that politicized import decisions will increase as countries with partially state-controlled economies gain strength in the global economy. Extending our analysis to exports for comparison, we find a similar pattern for Indian but not for Chinese exports and offer potential explanations for these differential findings.

## Keywords

state-owned enterprises, trade interdependence, China, India, foreign economic policy

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Powerful states have a long tradition of economic statecraft. Trade relations form a means of influence (Hirschman [1945] 1980; Baldwin 1985; Lake 2009; Flores-Macías and Kreps 2013), and alliances support favorable economic agreements (Mansfield and Bronson 1997; Long and Leeds 2006). During the Cold War, trade patterns closely reflected political relations (e.g., Pollins 1989; Gowa 1994; Mansfield and Bronson 1997; Keshk, Reuveny, and Pollins 2004; Kastner 2007; Berger et al. 2013). Governments today, however, have less leeway for using trade as carrot and stick in foreign policy. Global trade rules restrict the ability of governments to discriminate among trading partners, and transnational production further complicates efforts to link trade to foreign policy (Gowa and Mansfield 2004; Brooks 2007; Davis and Meunier 2011; Carnegie 2014). What are the channels by which governments induce trade patterns to follow foreign policy interests in today's global economy? This article revisits the question of whether trade follows the flag and highlights state ownership of firms as a key means for politicization of trade. Where previous studies examine aggregate trade at the cross-national level, we bring new data on trade flows based on firm ownership.

Anecdotal evidence suggests that governments continue to manipulate trade in response to political disputes. In 2014, for example, the United States and the European Union announced a range of economic penalties to punish Russian intervention in Ukraine, and Russia retaliated with its own boycotts of agricultural products from Europe (Crozet and Hinz 2016). Politically motivated trade disruptions, however, are not limited to formal sanctions. In 2012, *Telam*, Argentina's official news outlet, reported that ministry officials had asked some twenty companies to cease importing materials from the UK in response to diplomatic tensions over the Falkland (Malvinas) Islands.<sup>1</sup> In Vietnam, the government encouraged manufacturing firms to diversify their imports away from China partly in response to tensions in the South China Sea.<sup>2</sup>

We argue that government influence over firms makes trade flows more responsive to foreign relations. State-owned firms align their behavior with state interests because of dependence at the level of personnel and finances. Where private firms trade on the basis of business interests, state-owned firms also pursue government interests. As a result, we expect the impact of political relations on trade to be a function of state control. To test this argument, we compare the responsiveness to political tensions of bilateral import flows through state-owned enterprises (SOEs) and private firms. By examining how imports between the same pair of countries are impacted by political tensions conditional on ownership type of the importing firms, our research design allows a direct test of state control as the mechanism by which governments influence trade patterns. At the cross-national level, governments with high levels of state ownership in the economy will have the tools to engage in politicized trade, while states with low levels of state ownership lack these tools and are less likely to exhibit evidence of politicized trade patterns. This is the first study to analyze the impact of state ownership on bilateral patterns of trade.

Our article challenges the view that market expectations and business lobbying alone shape commercial relations. Liberal theories emphasize the constraints that arise from the economic interests of social actors within the state. A large body of research has argued that interdependence encourages cooperative relations between states under commercial liberalism because governments respond to private economic interests (Polachek 1980; Russett and Oneal 2001; Li and Sacko 2002; Gartzke 2007; Lee and Mitchell 2012). Instead, we demonstrate the ongoing role of the state in trade discrimination. Economic patriotism has been shown to motivate selective liberalization as well as protection (Levy 2006; Clift and Woll 2012; Rickard and Kono 2014). Berger et al. (2013) find that the positive impact of Central Intelligence Agency (CIA) interventions on US imports by a country is conditional on the government's share of the economy. These studies have begun to highlight the role of the state in politicizing trade but do not specify the channel through which governments generate this effect. We identify SOEs as a key factor that allows governments to manipulate imports as a tool of foreign policy. State ownership of firms explains how some states escape the constraints of trade rules and global markets to remain users of economic statecraft, while others have stopped engaging in this behavior.

The distinction between SOEs and non-SOEs is increasingly significant to the study of trade politics. SOEs occupy an expanding role in key sectors for a large number of emerging markets (World Bank 2014). SOEs now occupy the ranks of the largest firms. The world's thirteen largest oil companies, largest bank, and largest natural gas company are all state owned or state supported.<sup>3</sup> Over 10 percent of the Forbes Global 2000 list of the largest publicly traded companies are majority-owned SOEs, the combined sales of which, at US\$3.6 trillion, amount to more than the gross national income of Germany and total almost 6 percent of world gross domestic product (GDP; Kowalski et al. 2013, 20).<sup>4</sup> As governments in a number of emerging countries have actively supported the expansion of SOEs abroad in recent years and taken steps to foster national "champions," concerns about financial and political advantages to state-owned and state-supported firms have featured prominently in trade and investment dialogues—recently as a major obstacle in negotiations over the Trans-Pacific Partnership (TPP) Agreement.

We focus our analysis on two important cases: China and India. Both are global players with active foreign policy agendas whose economies rank among the largest in the world.<sup>5</sup> The potential for China to wield its growing economic power as tool of foreign policy is readily apparent (Flores-Macías and Kreps 2013; Kastner 2016). China made waves in 2010 when it cut off exports of rare earths minerals to Japan in response to a territorial dispute over the Diaoyu/Senkaku Islands<sup>6</sup> 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.<sup>7</sup> Fuchs and Klann (2013) find that countries whose leadership receives the Dalai Lama suffer a temporary reduction in exports to China. India offers a useful comparison with China to test the argument within a different context of domestic institutions and geopolitical

relations. Critical for our study is the fact that both retain high levels of state ownership in some sectors alongside other sectors with little state involvement. Chinese and Indian firms comprised the largest numbers of SOEs on the Forbes Global 2000 list in 2013, and both countries also have vibrant private-sector economies and leading private firms.<sup>8</sup> We leverage this variation within each country to conduct parallel analysis for China and India that compares the responsiveness of imports to political relations between SOEs and privately owned firms. After demonstrating support for the SOE mechanism of control within India and China, we offer a placebo test of the argument through examination of the United States and South Africa, which have very low levels of state ownership in the economy.

Whereas much of the literature on conflict and interdependence focuses on militarized disputes (Pollins 1989; Morrow et al. 1998; Morrow 1999; Long 2008; Gowa and Hicks 2017), we also examine lower-level frictions such as threats, complaints, and diplomatic spats. Issues that fall well short of war and even appear minor in isolation may have a larger cumulative effect on interstate relations. We measure political relations by negative bilateral political events and voting alignment in the United Nations General Assembly (UNGA). Across these different measures of relations, we expect more negative political relations to correspond with lower imports, with the most pronounced effect in import flows through SOEs.

Our statistical analysis of annual imports by China and India from the early 1990s through 2012 demonstrates that negative bilateral events correspond with a reduction in imports. The relationship is stronger for imports by firms in the state-owned sector of the economy relative to privately owned firms. The strength and statistical significance of the findings varies across the different measures of political relations but is generally robust to alternative specifications. We also confirm the absence of politicization in the aggregate import patterns of the United States and South Africa; given their low levels of state ownership, imports and political relations are largely uncorrelated.

Extending our analysis to exports for comparison, we find a similar pattern for Indian but not for Chinese exports. While in India there is evidence of greater trade politicization in the state-controlled sector in line with our import findings, in China, it would appear that—if anything—the private sector shows a larger trade responsiveness to negative political relations than the state-owned sector of the economy. The Chinese state may be unwilling or unable to push the costs of politicized trade onto its state-owned export champions, which are powerful actors in China's domestic political economy and are reluctant to lose sales through export restrictions.

Our analysis of economic statecraft in emerging markets and our use of new trade data disaggregated by firm ownership make an original contribution to the literature. Our research indicates that economic statecraft remains relevant in the current era of globalization and examines state ownership as a mechanism that has not been previously studied in the literature on economic interdependence. We highlight that state control in the economy represents an important condition underlying the exercise of economic statecraft. Trade patterns respond to political relations in areas where governments maintain the capacity to manipulate trade.

## State Control and Noncommercial Interests in Trade

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. Denying key resources or market opportunities harms the target state, while preferential access offers benefits. Using economic policy to achieve foreign policy goals, however, can produce negative externalities for the domestic market, as firms are forced to move away from the market equilibrium. Indeed, the domestic costs of intervention in trade enhance the credibility of economic sanctions and underlie theories that portray economic interdependence as a tool for states to signal resolve in conflict bargaining (Martin 1992; Gartzke, Li, and Boehmer 2001; Reed 2003). Despite possible foreign policy gains, economic decisions dictated by geopolitical interests may not coincide with the best economic outcomes.

Several studies find that harm to economic actors at home limits the use of economic statecraft (Skalnes 2000; Davis 2008/2009). 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. As the United States and European governments debated sanctions against Russia for its actions in Ukraine in 2014, the harm to business interests loomed as a major concern.<sup>9</sup> State ownership of enterprises addresses this problem by lowering domestic opposition to letting foreign policy influence business decisions. Close integration with the state in terms of personnel, funding, and goals hardwires business actors to follow government interests. Market competition pushes for decisions on a commercial basis, but state intervention introduces additional decision criteria that call on economic actors to incorporate noncommercial goals. WTO rules reflect this tendency, admonishing that state-trading enterprises must make purchases “solely in accordance with commercial considerations.”<sup>10</sup> While the manipulation of economic policies to serve political interests clearly challenges the non-discrimination rules of the WTO, the explicit statement highlights that state-controlled enterprises are most subject to interference and in need of monitoring.

### *State Ownership as Mechanism for Politicization of Trade*

How does state ownership facilitate the politicization of trade? We highlight three pathways by which state ownership influences firm behavior: firm mission, personnel, and financing. First and most fundamentally, the purpose of SOEs is to advance the goals of the state. While SOEs can and increasingly do operate with commercial considerations, they serve primarily as conduits through which the government may intervene in the economy to serve particular social, industrial, or political objectives in the national (or narrow government) interest. SOEs were historically established to fulfill socioeconomic policy objectives, such as infrastructure building, energy and food provision, and health care, and they remain tasked today with providing public services. SOEs may also serve as tools to promote industrial policies when

governments support SOEs in sectors the government deems “strategic” for infant industry development. Given that fulfilling political imperatives is one of the primary *raison d’être* of these firms, we should expect them to pose less resistance to political demands than private firms.

Second, close ties between the state and SOEs are clearly visible in corporate governance structures. Unlike in private firms, where managers generally report to an independent board of directors, in the case of SOEs, directors are regularly determined by political appointment (Vagliasindi 2008). Blurring the lines between business and politics further, top SOE managers are often themselves political insiders; their performance as corporate leaders impacts not only their position with the firm but also their position in the political hierarchy. Business managers in SOEs thus often view their responsibilities as twofold—to advance the interests of the firm and the state—and may suffer consequences for failing to do so.

Third, financial support also provides leverage over SOEs. These firms do not, and in many cases could not, operate without the financial sponsorship of the state. In some cases, the subsidies are staggering. For example, subsidy payments to just three SOEs in Malaysia averaged 4 percent of GDP between 2003 and 2006 (World Bank 2014, 11). Much scholarly and policy research has documented the inefficiencies of state-backed firms, especially relative to private firms (e.g., Boardman and Vining 1989; World Bank 1995) but also the range of advantages they enjoy over private firms including favorable taxation, subsidies, and preferential access to financing (DeWenter and Malatesta 2001; Capobianco and Christiansen 2011). Government bailouts of financially underperforming SOEs are commonplace in many countries. Even where state-owned firms achieve competitiveness, they owe much of their success to privileged access to capital and other regulatory benefits.

The interactions between SOEs and policy makers represent mutual dependence. Just as the bureaucratic channels linking SOEs directly to the state enhance government oversight, they also provide avenues for managers to bargain for compensation when state policy adversely impacts firm profits or operations. Indeed, SOEs enjoy higher levels of policy influence than private firms (Aisbett and McAusland 2013; Baccini, Impullitti, and Malesky 2017). But the political influence of SOEs that may win them special deals is unlikely to be used in opposition to government directives. Given their subsidized operations and ability to negotiate for compensation, SOEs are less sensitive than non-SOEs to distributional costs arising from the manipulation of economic policies. They have less need to object to state influence that injects noncommercial criteria for business. Instead, dependence on the state requires responsiveness to government requests.

The cooperation of firms is important for politicizing trade. Most directly, the firms can act as the agent of the state to shift import sourcing or cancel export contracts in response to bilateral tensions. Indirect support is also important—often governments may intervene through the actions of customs agents to delay or block import and export shipments. Such actions would normally provoke opposition from

domestic trading firms that suffer costs waiting for shipments. To the extent that SOEs tolerate such inconveniences, they support the politicization of trade policy.

### *SOEs in China and India*

Turning to our countries of focus—China and India—we see ample evidence of the three primary mechanisms posited to link state ownership of firms with the politicization of trade: service to policy objectives, government influence over personnel decisions, and access to state-sponsored subsidies.

In both China and India, most SOEs derive their origins from state-sponsored efforts to manage the economy and enhance social welfare. In China, SOEs were tasked with rebuilding the country's infrastructure following the civil war and served to a large extent as the sole providers of goods, services, and jobs for the next three decades. In support of the government's effort to mitigate social unrest, SOEs were forced to maintain burdensome employment levels and offer social welfare services like schools and hospitals—requirements that persist to a more limited degree even today (Steinfeld 2000). In India, the state-owned Food Corporation of India, for example, was established in 1965 to ensure price supports for farmers and implement the distribution and stockpiling of grains for national food security. The Indian government describes the role of SOEs (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.”<sup>11</sup>

SOE management is subject to close government oversight. In China, the State-owned Assets Supervision and Administration Commission (SASAC) is charged with the appointment of the leadership of the 121 central SOEs, but the actual power to appoint managers at the largest 53 SOEs lies with the Central Organization Department (COD), the head of which is a member of the Politburo (Brødsgaard 2012). In almost all centrally managed Chinese SOEs, senior members of the Chinese Communist Party occupy the three top leadership positions—CEO, chairman, and party secretary (Pei 2006). In a number of cases, the CEO and party secretary are the same person. Such close ties have led observers at the meetings of the World Economic Forum in Davos to note that “Chinese delegates from both [government and business] tend to have the same point of view, and even the same patriotic talking-points.”<sup>12</sup> Below the central level, local equivalents of the COD and SASAC have similar influence over leadership appointments of locally owned SOEs. Since local leaders care about promotions, they face incentives to abide by the political demands of the central government and influence the decision-making of local SOEs accordingly.<sup>13</sup> In India, the responsibility for managing SOEs falls with the relevant ministries, determined by industry, and the Department of Public Undertakings (DPU). The government has recently taken steps to allow some SOEs more independence in corporate decision-making, but ministries continue to control major

decisions such as the appointment and removal of the CEO. Even where boards of directors are empowered to make strategic decisions, board members are beholden to strict guidelines set by the DPU and are frequently political insiders themselves (World Bank 2014, 183-84).

In both countries, SOEs are heavily subsidized by the state and receive favorable access to credit. In China, the government spent an estimated US\$300 billion (in nominal dollars) on the biggest SOEs between 1985 and 2005 in the form of direct payments, cheap financing, and subsidized inputs. Between 2001 and 2011, US\$28 billion flowed to the auto parts industry alone, with another US\$10.9 billion promised by 2020 (Haley and Haley 2013, 124). Over 75 percent of the country's capital, largely provided by state-owned banks, flows to SOEs (Lee 2012). Previous research provides direct and indirect empirical support for a bias in bank lending behavior in favor of SOEs (e.g., Wei and Wang 1997; Lu, Zhu, and Zhang 2012; Jarreau and Poncet 2014). In India, the government approved in 2012 an expensive bailout plan for forty-six SOEs it deems "sick" (severely underperforming), which account for about 20 percent of all centrally owned SOEs.<sup>14</sup> For these firms, refusing to comply with political demands could mean a reduction in financial benefits.

We hypothesize that economic statecraft is contingent on government capacity to control economic actors. Completely free markets are unlikely to show much correlation between political relations and import decisions. In free-market economies, states must adopt explicit policies to constrain markets such as imposing legal restrictions on trade to force compliance by private actors. In contrast, where the state maintains more control over firms, politicizing imports can be a quick and informal process. For the reasons outlined above, firms owned by the state are the most likely to be responsive to government preferences. Looking within China and India, we expect to observe a stronger correlation between political relations and imports in the state-owned sector of the economy compared to the private sector.

Firm preferences over trade may reinforce rather than simply respond to government directives. We do not exclude this possibility, which would act in conjunction with state control. Import-competing firms that seek protection may opportunistically act on political tensions to achieve additional restrictions (e.g., Kaempfer and Lowenberg 1992). The close ties between SOEs and the government enhance their lobbying power relative to private firms.<sup>15</sup> In that case, a negative relationship between tensions and trade would reflect a cooperative outcome between firm and government demands. When firms benefit from trade restrictions, state control will be more mutual than coercive.

One potential concern is which side of the trading relationship exerts influence. For our primary analysis of imports, we assume that the partners do not restrict their exports, and more importantly, that any export restrictions do not differentiate by the firm ownership of recipients. With most governments holding mercantilist views of trade, export restrictions are less likely than import restrictions.

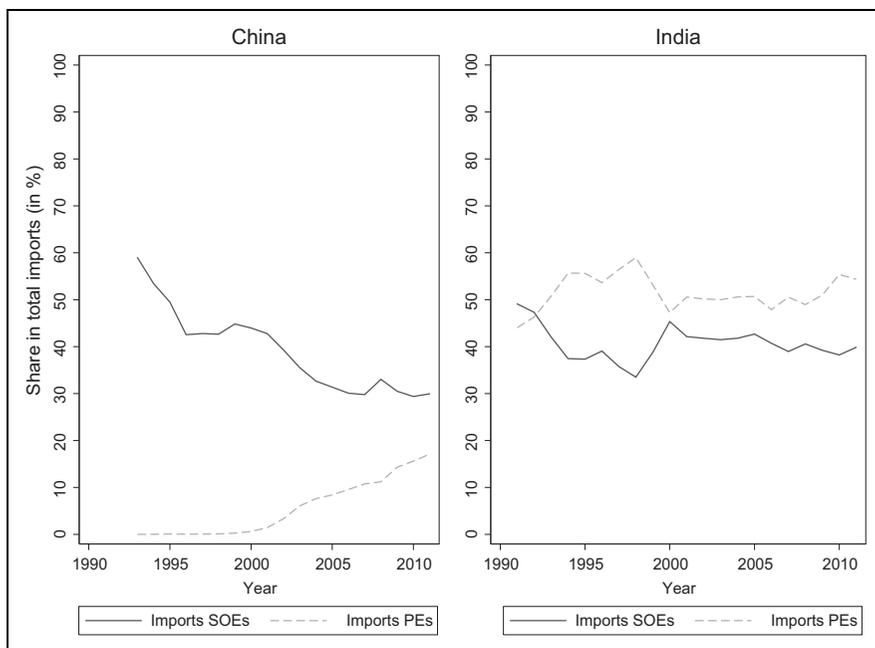
## Measuring State Control and Political Relations

The two-way relationship between economics and politics has long challenged research on economic interdependence (e.g., Reuveny and Kang 1996; Mansfield and Pollins 2001; Keshk, Reuveny, and Pollins 2004). By relying on the observational data of state behavior, we are limited to describe patterns of association that arise through complex interaction across multiple dimensions. We are unable to provide exogenous variation in political relations or state ownership for strong causal identification of the underlying effects. But our analysis of bilateral trade flow patterns with microlevel attention to variation in firm ownership allows us to hold constant many other factors that would otherwise be confounders in studies of interdependence. For example, unobserved factors that shape the political interaction between two countries could also impact aggregate bilateral trade, but it is less likely that they would give rise to variation in trade across ownership ties of firms. Similarly, the structural incentives to favor state ownership for certain sectors would impact distribution of protection within the economy but would not imply variation across trade partners within sectors over time. We also employ standard approaches to include country-fixed effects and lagged explanatory variables as steps to mitigate the concern about endogeneity.

### *Imports by Ownership Type: SOEs versus Private Enterprises*

To analyze the effect of political relations on import flows as a function of state control over economic activity, we need separate data on the trading activities of the state-controlled and private sectors of the economy. For our analysis of Chinese imports, we obtained data on trade by enterprise ownership type from the General Administration of Customs through Customs Info, a government-owned company licensed to distribute official customs data.<sup>16</sup> The data include the annual value of bilateral imports by ownership category.<sup>17</sup> For our purposes, the relevant categories are private enterprises and SOEs. SOEs are defined as enterprises in which the government holds the majority equity share and include both centrally and locally owned enterprises. We are thus able to directly measure the annual value of China's imports from a partner country through state-owned firms versus private firms.

For India, we combine Prowess firm-level data from the Centre for Monitoring the Indian Economy, an Indian think tank, and import data from United Nations (UN) Comtrade.<sup>18</sup> The Prowess database includes data on total assets, sector, and ownership type for 27,000 companies, which together comprise 75 percent of all corporate tax revenue. We define as SOEs those enterprises categorized as "central government," "state government," or "central and state government" in Prowess.<sup>19</sup> Unfortunately, statistics on bilateral trade by firm ownership type are not available in Prowess. We therefore construct variables that proxy for imports through SOEs and private enterprises using the following procedure: we first calculate the share of assets held by SOEs in each sector; we



**Figure 1.** Trade by enterprise ownership type: imports of state-owned enterprises and private enterprises as a share of total imports (1991–2012; data for China begin in 1993; data for India are estimates).

then multiply the sector share by the value of imports for the sector (from UN Comtrade) for a particular bilateral trade relationship; finally, we sum the resulting values across sectors to get an estimate of the annual value of imports flowing through SOEs for the dyad. We repeat the procedure for each partner country. Private-enterprise import flows are calculated by the same method.<sup>20</sup>

Our procedure for the India data assumes that SOE shares in total assets are equivalent to SOE shares in trade, which is unlikely to be true in reality. The potential for overestimating or underestimating trade will not affect our estimation results, however, as long as there are not systematic differences across trade partners. Moreover, we do not face this concern for the China analysis where we were able to obtain official data on bilateral trade flows disaggregated by firm ownership.

Figure 1 demonstrates the contribution of SOEs and private enterprises to Chinese and Indian imports over the sample period. The share of China's imports comprised by SOEs has fallen over the last decade with privatization, while the private-sector share of trade has risen correspondingly. The decline in SOE shares has leveled off recently, and they remain substantial at about 30 percent of imports. The pattern for India has been more stable over time, and about 40 percent of imports are estimated to have been through SOEs.<sup>21</sup>

One challenge to making inferences about state ownership is the strategic nature of government decisions that determine state ownership; SOE intensity is not randomly allocated across sectors. Energy and resource sectors experience the highest levels of state ownership because of their importance to both economic growth and security. The decisions about ownership reflect state priorities toward the sector in general. This mitigates the endogeneity problem for our research question because we leverage the variation in political relations with specific trading partners, which is largely independent of ownership decisions for different sectors.

### *Political Relations*

While bilateral trade is objectively quantifiable, political relations between countries are difficult to measure. We build on indicators common in the literature—negative political events and voting alignment in the UNGA—for both China and India.

Our first two measures quantify the tensions between China, India, and their trading partners using bilateral events data. We use the Global Data on Events, Location and Tone data from Leetaru and Schrodtr (2013). The data set, considered the most comprehensive of its kind, uses a machine coding system to classify daily reports of events from eleven global news outlets into categories of the actors involved in the event.<sup>22</sup> Each event is weighted by the corresponding “Goldstein score,” a value between  $-10$  and  $10$  that measures the expected severity based on its type (Goldstein 1992). For example, a use of military force would be weighted more heavily than an expulsion of another country’s diplomats, but expelling diplomats would be weighted more heavily than a verbal condemnation of another country’s actions. We sum the severity-weighted number of negative events to create a single annual observation and take the log to smooth the distribution.

In contrast to previous research using negative event counts (e.g., Davis and Meunier 2011; Li and Liang 2012), we do not simply use the total number of events. We restrict our negative event counts to actions performed by a partner country upon China and India, respectively. This approach allows us to mitigate endogeneity concerns, as these events are arguably more exogenous than actions where China (or India) itself is the sender. Specifically, our first indicator captures events involving a government (nonmilitary) actor of a country that trades with China (or India), while the second captures events involving a military actor to determine whether militarized disputes provoke a stronger reaction than diplomatic events. By only using negative events that involve a government (or military) actor, we discard pure business events, which are not exogenous to our import measure. This approach also discards negative events with a country’s opposition or nonstate actors that should lead to substantially smaller (or no) reaction from governments. The correlation between our two measures is 71.5 percent.<sup>23</sup>

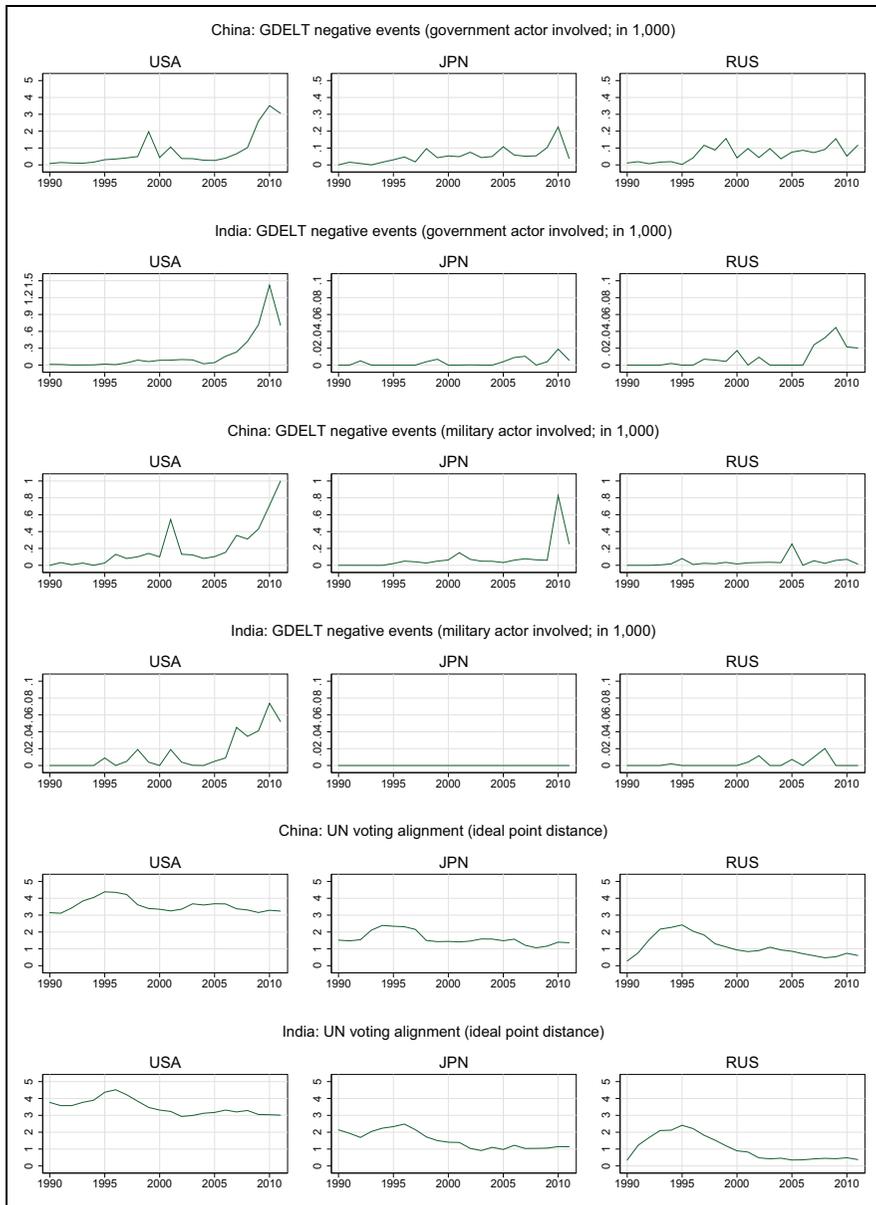
Figure 2 plots the weighted number of negative events that occurred after 1990 between China (first and third panel) and India (second and fourth panel) with three major partners—the United States (left), Japan (center), and Russia (right). The

events measure here is shown in its unlogged form in units of 1,000 events, and the range of the plots has been adjusted to match the observed variance by country. Prominent events that have caused bilateral tensions are visible in the data. For example, the US bombing of the Chinese embassy in Belgrade and the Hainan Island incident, during which the Chinese government detained the crew of a US Navy Intelligence plane, are reflected in the spikes in negative events in 1999 and 2001, respectively. Similarly, the Japanese government's 2010 detention of a Chinese fishing vessel and its captain near the disputed Diaoyu/Senkaku Islands mentioned in the introduction is reflected in the data. Turning to India, the spikes in both government and military tensions with the United States in 1998, for example, correspond to the events surrounding India's nuclear weapon tests in Pokhran.

Our third relations variable measures the distance in foreign policy orientation between China or India and each partner country.<sup>24</sup> Bailey, Strezhnev, and Voeten (2017) use UNGA voting data to construct an annual measure of each country's ideal point along a single dimension that captures its position *vis-à-vis* a "US-led liberal order." The resulting values are differenced to obtain dyadic measures of the distance between a pair of states in terms of their foreign policy preferences. The measure uses resolutions that were identical over time to "bridge observations," allowing researchers to separate out shifts in state preferences from changes in the UN agenda and make more meaningful comparisons of state preferences over time.<sup>25</sup> Our analysis applies the ideal point distance measure to proxy for states' bilateral political relations based on their relative orientation toward the US-led liberal order.

Both the Chinese and Indian government take very seriously the voting records of other countries in the UN (e.g., Flores-Macías and Kreps 2013; Ferdinand 2014; Strüver 2016). For example, Fuchs and Vadlamannati (2013) find India's aid allocation pattern to be even more responsive to its recipients' voting behavior in the UNGA than is the case for Western donor countries. India's Ministry of External Affairs considers a recipient's voting record in the UN before it approves a loan of the country's Export-Import Bank.<sup>26</sup> Since these loans are an important tool for export promotion, this highlights one of the mechanisms through which political tensions can affect trade. Similarly, China's aid allocation has been found to follow political alignment as measured by UN voting (e.g., Dreher and Fuchs 2015; Dreher et al. Forthcoming).

Figure 2 also plots the ideal point distances between China (fifth panel) and India (sixth panel) and the United States, Japan, and Russia. Mirroring divisions between the United States and its allies on one hand, and the rising powers on the other (see Voeten 2000), China's and India's distance to the three partner countries looks similar at first sight. Still, there are some striking differences. For example, while the distances between China and the United States and China and Japan remained relatively stable from the mid-1990s through 2010, India bridged some of its distance with these countries between the mid-1990s and early 2000s. The plots also reflect the increasing proximity of both China and India with Russia. By 2010, both countries were closer to Russia than to either the United States or Japan.



**Figure 2.** Diplomatic tensions: measures of political relations (1990–2011).

Table 1 compares the measures of political relations by ranking the states with the most negative relationships. China’s relations are worst with the United States according to all three measures. Taiwan occupies the second spot for China in terms

**Table 1.** Bad Relations: List of Countries with the Worst Relations with China and India by Measure of Political Relations (1990–2012).

| China: negative events (government) | China: negative events (military) | China: UNGA voting (ideal point distance) |
|-------------------------------------|-----------------------------------|---|
| 1. The United States                | 1. The United States              | 1. The United States                      |
| 2. Taiwan (China)                   | 2. Taiwan (China)                 | 2. Israel                                 |
| 3. Papua New Guinea                 | 3. Japan                          | 3. United Kingdom                         |
| 4. United Kingdom                   | 4. South Korea                    | 4. Palau                                  |
| 5. Australia                        | 5. Russia                         | 5. Micronesia Fed States                  |
| 6. South Korea                      | 6. Philippines                    | 6. France                                 |
| 7. Russia                           | 7. Vietnam                        | 7. Canada                                 |
| 8. France                           | 8. Pakistan                       | 8. Marshall Islands                       |
| 9. India                            | 9. Myanmar                        | 9. Belgium                                |
| 10. Philippines                     | 10. United Kingdom                | 10. the Netherlands                       |
| India: negative events (government) | India: negative events (military) | India: UNGA voting (ideal point distance) |
| 1. Pakistan                         | 1. Pakistan                       | 1. The United States                      |
| 2. The United States                | 2. Sri Lanka                      | 2. Israel                                 |
| 3. China                            | 3. The United States              | 3. United Kingdom                         |
| 4. Venezuela                        | 4. China                          | 4. France                                 |
| 5. Sri Lanka                        | 5. Myanmar                        | 5. Micronesia Fed States                  |
| 6. Afghanistan                      | 6. American Samoa                 | 6. Palau                                  |
| 7. United Kingdom                   | 7. Bangladesh                     | 7. Canada                                 |
| 8. Bangladesh                       | 8. Russia                         | 8. Marshall Islands                       |
| 9. Nepal                            | 9. Israel                         | 9. Belgium                                |
| 10. Saudi Arabia                    | 10. United Arab Emirates          | 10. the Netherlands                       |

Note: We do not observe United Nations (UN) voting alignment with Taiwan (China) because it is not a member of the UN. UNGA = United Nations General Assembly.

of both negative government events and military events but fails to appear in UNGA voting because it is not recognized as a sovereign country by the UN. South Korea and Russia feature prominently on both events lists for China, while Pakistan, the United States, Sri Lanka, and China are among the countries that experienced the most negative events with India. Thirty-nine countries were engaged in no government or military events with China over the sample period, and ninety-seven did not experience any events with India. Moving to UNGA voting, the patterns for China and India are quite similar; the same ten countries comprise the list for both countries with slight differences in order. After the United States, the countries with which both China and India are most distant are Israel (average score of 3.1 for China and 3.0 for India) and the UK (2.6 for China and 2.5 for India). On the flip side, China is most closely aligned with Pakistan (.20) and Nigeria (.22), while India is closest to East Timor (.19), Uganda (.19), and Ghana (.19). We recognize that underlying conditions related to size, geography, and historical interactions such as colonial

ties will shape the overall relations between countries and their trade, and so our analysis will focus on variation within country pairs over time rather than this broader range of difference across partners. The events measure and voting alignment capture different dimensions of foreign policy, and so we treat them as alternative measures.

## Empirical Analysis

To test our hypothesis, we build on the gravity model of trade, the “workhorse” of the empirical trade literature (e.g., Tinbergen 1962; Anderson and van Wincoop 2003). Trade flows are expected to increase with both the exporter’s supply and the importer’s demand of goods, proxied by exporter and importer GDP, respectively, and to decrease with trade costs. Geographic distance is used as a proxy for trade costs, and additional variables, such as common language, measure friction. We model import flows controlled by SOEs and those controlled by private enterprises using seemingly unrelated estimations.<sup>27</sup> This approach facilitates our comparison of the relationship between political relations and imports across the two categories of firm ownership.

Specifically, we estimate the following system of equations:

$$\text{imports}_{\text{SOE},ijt} = \beta_0 + \beta_1 \text{relations}_{ijt-1} + \beta_2 \text{GDP}_{ijt-1} + \beta_3' \mathbf{X}_{ijt-1} + v_j + \tau_t + \varepsilon_{ijt}, \quad (1)$$

$$\text{imports}_{\text{private},ijt} = \tilde{\beta}_0 + \tilde{\beta}_1 \text{relations}_{ijt-1} + \tilde{\beta}_2 \text{GDP}_{ijt-1} + \tilde{\beta}_3' \mathbf{X}_{ijt-1} + \tilde{v}_j + \tilde{\tau}_t + \tilde{\varepsilon}_{ijt}, \quad (2)$$

where  $\text{imports}_{\text{SOE}}$  and  $\text{imports}_{\text{private}}$  represent (logged) import flows between country  $i$  (China or India) and its trading partner  $j$  that are under the control of SOEs or private enterprises,  $\text{relations}$  represents each of our three measures of political relations,  $\text{GDP}$  denotes the (logged) product of exporter and importer GDP in constant 2005 US\$,  $\mathbf{X}$  represents a vector of control variables,  $v$  represents a set of partner-country fixed effects,  $\tau$  represents a set of year-fixed effects, and  $\varepsilon$  is the error term. Standard errors are clustered on partner country. To test our hypothesis, we include each measure of relations separately. All measures are logged with the exception of binary control variables.

Note that our specification is identical to an estimation of ordinary least square equation by equation since both equations use the same set of regressors. Seemingly unrelated estimations enable us to test whether the coefficients on our political relations variables differ between SOE and private-enterprise trade. We expect that political relations play a larger role in trade controlled by SOEs than in trade controlled by private enterprises. Since larger values correspond with more negative relations, our formal expectation is  $\beta_1 < \tilde{\beta}_1$ .

We include the partner country’s GDP from the standard gravity model with data from World Development Indicators (WDI). Because we employ partner-country fixed effects, we exclude geographic distance and other time-invariant determinants of bilateral trade

flows. Within our set of control variables  $X$ , we first include market potential, which we proxy as the (logged) value of the trading partner's population size, with data from WDI.<sup>28</sup> We also add a binary variable that takes a value of 1 if the partner country is a member of the WTO for the majority of a given year (data from the WTO website). Because trade relations have been found to depend on regime type (e.g., Mansfield, Milner, and Rosendorff 2000; Manger and Pickup 2016), we include the polity2 variable from the Polity IV Project (Marshall, Gurr, and Jaggers 2013). Polity is a twenty-one-point index, where the largest value refers to a fully institutionalized democracy.

Finally, to mitigate endogeneity concerns, we lag all covariates by one year. Our analysis begins in 1993 for China, the first year for which Customs Info provides data by ownership type and 1991 for India when the country entered its period of economic liberalization. All estimations extend through 2012, which is the limit of our data on trade flows by firm ownership. Table S1 in Online Appendix A lists all variables, their definitions, and their sources. Descriptive statistics appear in Table S2.

### *Results for Chinese Imports*

Table 2 presents our results for imports to China. Each column shows the results for one of our three measures of political relations. The upper half of the table displays the results for SOE trade; the lower half shows the corresponding results for private-enterprise trade.

Beginning with column 1, the coefficient for negative government events between China and its trade partner has a significant negative effect on SOE imports. There is no significant effect on private-enterprise trade, and a Wald test (final row of Table 2) shows that the observed difference in the political relations coefficients for SOE, and private trade is statistically significant at the 1 percent level. Moreover, the substantive effects are large; a 1 percent increase in our government events index decreases SOE imports by 0.12 percent. To give an example, Japan's retention of a Chinese fishing vessel near the Diaoyu/Senkaku Islands in 2010 registered an increase in negative events of 218 percent; our model would predict a corresponding 26.2-percent drop in SOE imports from Japan between 2010 and 2011.

In column 2, we see that negative military events produce similar adverse impact on SOE imports. A 1-percent increase in military events decreases SOE imports by 0.16 percent. The coefficient on negative events is again insignificant for private enterprises. However, the corresponding Wald test does not show a statistically significant difference between SOEs and private enterprises for military events. Turning to UN voting (column 3), we again find the effect of political relations on imports to be limited to SOEs and a statistically significant difference between state and private enterprises, as shown by the Wald test. A 1-percent increase in the ideal point distance between China and a given trade partner reduces SOE imports by 0.43 percent. Summing up, we find statistically significant effects of political tensions only on SOE imports. Our findings support the hypothesis that diplomatic tensions have a larger impact on imports in the state-owned sector of the economy than on private enterprises.

**Table 2.** Imports to China (1993–2012): Results of a Gravity Model Estimating the (Logged) Import Value between China and Its Trading Partners with Partner-country and Year-fixed Effects.

|                                 | (1)                             | (2)                           | (3)                                   |
|---------------------------------|---------------------------------|-------------------------------|---------------------------------------|
|                                 | Imports                         | Imports                       | Imports                               |
|                                 | Negative events<br>(government) | Negative events<br>(military) | UNGA voting<br>(ideal point distance) |
| <b>SOE trade</b>                |                                 |                               |                                       |
| (log) Political relations       | −0.1223***<br>(0.0399)          | −0.1558***<br>(0.0359)        | −0.4271***<br>(0.1098)                |
| (log) GDP                       | 1.3986*<br>(0.7603)             | 1.4042*<br>(0.7659)           | 1.0098<br>(0.7886)                    |
| (log) Population                | 5.0901**<br>(2.0038)            | 4.9864**<br>(1.9963)          | 4.7263**<br>(1.9070)                  |
| WTO member                      | 0.0846<br>(0.5003)              | 0.1094<br>(0.5011)            | 0.1332<br>(0.5053)                    |
| Polity                          | 0.0294<br>(0.0544)              | 0.0312<br>(0.0544)            | 0.0493<br>(0.0555)                    |
| <b>Private-enterprise trade</b> |                                 |                               |                                       |
| (log) Political relations       | 0.0607<br>(0.0558)              | −0.1348<br>(0.0925)           | −0.0972<br>(0.1354)                   |
| (log) GDP                       | 1.8650*<br>(0.9531)             | 1.8390*<br>(0.9576)           | 1.9037*<br>(1.0728)                   |
| (log) Population                | 4.0989**<br>(1.7659)            | 4.0868**<br>(1.7517)          | 3.7731**<br>(1.7163)                  |
| WTO member                      | 2.0431***<br>(0.6342)           | 2.0483***<br>(0.6349)         | 2.0681***<br>(0.6522)                 |
| Polity                          | −0.0707<br>(0.0565)             | −0.0742<br>(0.0564)           | −0.0777<br>(0.0570)                   |
| Number of observations          | 3,003                           | 3,003                         | 2,973                                 |
| Wald test ( <i>p</i> value)     | .003                            | .811                          | .027                                  |

Note. Standard errors are clustered on partner country. Regressions for SOE and private-sector trade are run as seemingly unrelated estimations. UNGA = United Nations General Assembly; GDP = gross domestic product; WTO = World Trade Organization; SOE = state-owned enterprise.

\*Significant at 10 percent.

\*\*Significant at 5 percent.

\*\*\*Significant at 1 percent.

Turning to the control variables, a partner's population size is positive and significant at conventional levels in all equations. Partner-country GDP is a robust predictor of trade through private enterprises. WTO membership of the partner is highly significant for private trade while not exercising any impact on SOE trade. Polity does not achieve statistical significance at conventional levels in any of the models.

**Table 3.** Imports to India (1991–2012): Results of a Gravity Model Estimating the (Logged) Value of Imports into India from Its Trading Partners with Partner-country and Year-fixed Effects.

|                                 | (1)                             | (2)                           | (3)                                   |
|---------------------------------|---------------------------------|-------------------------------|---------------------------------------|
|                                 | Imports                         | Imports                       | Imports                               |
|                                 | Negative events<br>(government) | Negative events<br>(military) | UNGA voting<br>(ideal point distance) |
| <b>SOE trade</b>                |                                 |                               |                                       |
| (log) Political relations       | -0.4058***<br>(0.0645)          | -0.5383***<br>(0.0859)        | -0.2529**<br>(0.1245)                 |
| (log) GDP                       | 2.7808**<br>(1.1265)            | 3.0373***<br>(1.1289)         | 2.8118**<br>(1.3232)                  |
| (log) Population                | 4.5555*<br>(2.6542)             | 4.3917<br>(2.6919)            | 4.2704<br>(2.6816)                    |
| WTO member                      | 0.4088<br>(0.5797)              | 0.5317<br>(0.5843)            | 0.6146<br>(0.5786)                    |
| Polity                          | 0.0302<br>(0.0746)              | 0.0293<br>(0.0761)            | 0.0293<br>(0.0780)                    |
| <b>Private-enterprise trade</b> |                                 |                               |                                       |
| (log) Political relations       | -0.3906***<br>(0.0556)          | -0.4657***<br>(0.0865)        | -0.1520<br>(0.1241)                   |
| (log) GDP                       | 2.8516**<br>(1.1743)            | 3.0897***<br>(1.1707)         | 2.7590**<br>(1.3468)                  |
| (log) Population                | 2.4070<br>(2.1974)              | 2.2528<br>(2.2433)            | 2.1433<br>(2.2379)                    |
| WTO member                      | 0.6177<br>(0.5695)              | 0.7318<br>(0.5720)            | 0.8827<br>(0.5552)                    |
| Polity                          | 0.0243<br>(0.0718)              | 0.0245<br>(0.0732)            | 0.0386<br>(0.0754)                    |
| Number of observations          | 3,179                           | 3,179                         | 3,144                                 |
| Wald test ( <i>p</i> value)     | .623                            | .014                          | .046                                  |

Note. Standard errors are clustered on partner country. Regressions for SOE and private-sector trade are run as seemingly unrelated estimations. UNGA = United Nations General Assembly; GDP = gross domestic product; WTO = World Trade Organization; SOE = state-owned enterprise.

\*Significant at 10 percent.

\*\*Significant at 5 percent.

\*\*\*Significant at 1 percent.

### Results for Indian Imports

Columns 1 to 3 of Table 3 present our results for Indian imports. We find that negative events reduce imports for both SOE- and private-enterprise trade, which is significant at the 1-percent level for events initiated by government and those initiated by military actors. In contrast to the Chinese case, the commercial penalty

from political tensions is thus apparent in both the SOE and private sector in India. In line with our hypothesis, the coefficients on negative events are more pronounced for SOE imports. A 1-percent increase in negative government events produces a 0.41-percent decrease in imports for SOEs, while the comparable effect for negative military events is 0.54 percent. The Wald tests indicate a significant difference between SOE and private-enterprise imports for military events but not for government events. Turning to UN voting, we observe a significantly negative effect of the ideal point distance measure for SOEs but not for private enterprises. In support of our hypothesis, the Wald test shows the difference in the coefficients to be statistically significant at the 5-percent level. Overall, the state-owned sector of the economy appears to be more responsive to bad political relations than private companies.

Turning to the control variables, the effect of GDP is positive and significant for both SOEs and private trade in all models. Population is also positive in all models but only achieves statistical significance in one SOE specification. The coefficients on WTO and polity are positive across all models for both SOEs and private enterprises but never achieve significance at conventional levels.

### *Robustness Tests and Extensions*

In this subsection, we study the robustness of our findings and discuss extensions of our analysis. Specifically, we examine the sensitivity of our results to the set of countries covered, analyze differences between oil states and nonoil states, and run a random-effects rather than a fixed-effects model. Finally, we test whether imports are less dependent on political relations in two economies that lack significant state ownership of firms: the United States and South Africa.

First, we test whether our findings are driven by single countries. Removing the United States, Japan, and Pakistan—countries with which China and/or India experience a large number of negative events—as trade partners does not qualitatively change the results on Chinese and Indian imports, nor does removing any other single trade partner.<sup>29</sup> Second, we explore whether political relations have differential effects on imports for oil states and nonoil states. We define oil states as those countries that show gross revenues from net oil exports that exceed 10 percent of GDP in 2000 (Colgan 2010). Including a separate coefficient for political relations with oil states allows the model to estimate distinct effects of political relations on imports conditional on whether the partner is an oil state. For China, we find some evidence that SOE imports from nonoil states are more responsive to bad political relations than imports from oil states (see Table S3 in the Online Appendix for details). This conforms to the expectation that oil-dependent economies have little choice but to continue importing from an oil-exporting country regardless of any bilateral conflicts that may arise with the state (e.g., Polachek 1980). For India, the picture is mixed, and we do not observe a clear pattern for whether oil interests shape whether India is more responsive to bad political relations (Table S4 in the Online Appendix). In both cases, our findings are not systematically driven by oil resources.

Third, we estimate models with random effects rather than fixed effects to analyze both the within and between variation across observations. In these specifications, we add standard time-invariant variables usually included in gravity trade models: (logged) bilateral distance, contiguity, common language, and landlocked (data from Mayer and Zignago [2011]). We address the argument that structural patterns of trade follow alliance blocs (Gowa 1994), with an indicator for trading partners that share an alliance with the United States; given that India does not have any formal alliances of its own, and China has few, US allies proxy for where one could expect a negative security externality to suppress bilateral trade.<sup>30</sup> Tables S5 and S6 in the Online Appendix show that the results of the random-effects model are similar to those obtained using the partner-country fixed effects specification. In all models, we find the effect of bad political relations on Chinese or Indian imports to be more negative in the state-controlled sector of the economy compared to the private sector.

Finally, we conduct a placebo test analysis for the United States and South Africa. An additional implication of our argument is that states without significant state ownership should show less (or no) evidence that trade flows are politicized since virtually all of their trade is conducted by private traders where economic statecraft is harder to implement. We select the United States because of its status as the world's largest economy and its minimal interference by the state in economic activities. We select South Africa as it is the emerging economy with the lowest SOE share of assets (Kowalski et al. 2013, 22). We rerun our regressions with logged total imports as dependent variable. Table 4 shows the results for the United States and South Africa together with those for China and India rerun at the aggregate level over the 1993 to 2012 period for the sake of an equivalent comparison. Only one of the three political relations measures, negative military events, reaches weak statistical significance in the South African case. In line with expectations, the effect size is very small compared to the corresponding coefficients for China and India. What is more, political relations do not appear to matter at all for trade with the United States, which fits our expectation given the low level of SOEs in the economy.

## **Export Response to Political Relations**

Next, we examine the effects of political relations on Chinese and Indian exports. In the mercantilist framework of most governments, limiting or diversifying imports will be preferred to restricting exports.<sup>31</sup> Krugman (1992, 429) describes the objectives of countries toward trade negotiations as following three principles: "Imports are bad. Exports are good. Other things equal, an equal increase of exports and imports is good." Firms are also reluctant to restrict exports given the possibility that such actions allow foreign competitors to expand their market share as alternative suppliers. Nevertheless, there may be some circumstances under which states would focus on exports as a tool of statecraft. For example, Russia's manipulation of gas exports in 2006 and 2009 amid long-standing disputes with Ukraine, and the sanctions imposed by Western countries since 2014 to block

**Table 4.** Imports to China, India, South Africa, and the United States (1993–2012): Results of a Gravity Model Estimating the (Logged) Import Value between Each Country Specified in Column (China, India, South Africa, and the United States) and Its Trading Partners with Partner-country and Year-fixed Effects.

|  | (1)                    | (2)                    | (3)                  | (4)                 |
|--|------------------------|------------------------|----------------------|---------------------|
|  | CHN                    | IND                    | ZAF                  | USA                 |
|  | Imports                | Imports                | Imports              | Imports             |
| (log) Negative events (government)       | -0.1011***<br>(0.0313) | -0.2659***<br>(0.0505) | -0.0075<br>(0.0249)  | -0.0105<br>(0.0134) |
| Number of observations                   | 3,003                  | 2,942                  | 2,853                | 2,927               |
| (log) Negative events (military)         | -0.1366***<br>(0.0297) | -0.4140***<br>(0.0810) | -0.0726*<br>(0.0429) | -0.0001<br>(0.0111) |
| Number of observations                   | 3,003                  | 2,942                  | 2,853                | 2,927               |
| (log) UNGA voting (ideal point distance) | -0.3147***<br>(0.1053) | -0.1728<br>(0.1284)    | -0.0626<br>(0.0514)  | 0.4107<br>(0.2825)  |
| Number of observations                   | 2,973                  | 2,912                  | 2,827                | 2,898               |

Note. The model estimates a single-equation ordinary least square specification with the same control variables in Tables 2 and 3 using total import values without separation into private and SOE trade. Standard errors are clustered on partner country. UNGA = United Nations General Assembly; SOE = state-owned enterprise; CHN = China; IND = India; ZAF = South Africa; USA = United States.

\*Significant at 10 percent.

\*\*Significant at 5 percent.

\*\*\*Significant at 1 percent.

**Table 5.** Exports from China (1993–2012): Results of a Gravity Model Estimating the (Logged) Export Value between China and Its Trading Partners with Partner-country and Year-fixed Effects.

|                                 | (1)                             | (2)                           | (3)                                   |
|---------------------------------|---------------------------------|-------------------------------|---------------------------------------|
|                                 | Exports                         | Exports                       | Exports                               |
|                                 | Negative events<br>(government) | Negative events<br>(military) | UNGA voting<br>(ideal point distance) |
| <b>SOE trade</b>                |                                 |                               |                                       |
| (log) Political relations       | -0.0089<br>(0.0074)             | -0.0357***<br>(0.0107)        | -0.0446*<br>(0.0243)                  |
| (log) GDP                       | 1.1437***<br>(0.2162)           | 1.1414***<br>(0.2143)         | 1.1783***<br>(0.2336)                 |
| (log) Population                | 0.2078<br>(0.4429)              | 0.1930<br>(0.4391)            | 0.0954<br>(0.4318)                    |
| WTO member                      | 0.0699<br>(0.1100)              | 0.0737<br>(0.1090)            | 0.0852<br>(0.1127)                    |
| Polity                          | 0.0093<br>(0.0108)              | 0.0091<br>(0.0106)            | 0.0083<br>(0.0107)                    |
| <b>Private-enterprise trade</b> |                                 |                               |                                       |
| (log) Political relations       | -0.0317<br>(0.0497)             | -0.1853**<br>(0.0822)         | -0.2496**<br>(0.1189)                 |
| (log) GDP                       | 2.8871***<br>(0.7104)           | 2.8727***<br>(0.7062)         | 3.4749***<br>(0.7147)                 |
| (log) Population                | 1.2767<br>(2.1145)              | 1.2065<br>(2.0860)            | 0.6266<br>(1.9968)                    |
| WTO member                      | 0.2080<br>(0.6511)              | 0.2264<br>(0.6523)            | 0.0592<br>(0.6371)                    |
| Polity                          | 0.0919*<br>(0.0552)             | 0.0905*<br>(0.0542)           | 0.0936*<br>(0.0522)                   |
| Number of observations          | 3,003                           | 3,003                         | 2,973                                 |
| Wald test ( <i>p</i> value)     | .639                            | .055                          | .065                                  |

Note. Standard errors are clustered on partner country. Regressions for SOE and private-sector trade are run as seemingly unrelated estimations. UNGA = United Nations General Assembly; GDP = gross domestic product; WTO = World Trade Organization; SOE = state-owned enterprise.

\*Significant at 10 percent.

\*\*Significant at 5 percent.

\*\*\*Significant at 1 percent.

certain technology exports from the Russian energy sector, represent high-profile cases where dominant market position over strategic goods supported manipulation of exports.<sup>32</sup>

The analysis of Chinese and Indian export response to political relations sheds light on whether SOEs are pushing for restrictions or just responding to government initiatives. While the foreign policy goals of the government and economic interests

**Table 6.** Exports from India (1991–2012): Results of a gravity model estimating the (logged) value of exports from India to its trading partners with partner-country and year-fixed effects.

|                                 | (1)                             | (2)                           | (3)                                   |
|---------------------------------|---------------------------------|-------------------------------|---------------------------------------|
|                                 | Exports                         | Exports                       | Exports                               |
|                                 | Negative events<br>(government) | Negative events<br>(military) | UNGA voting<br>(ideal point distance) |
| <b>SOE trade</b>                |                                 |                               |                                       |
| (log) Political relations       | -0.1194***<br>(0.0174)          | -0.1420***<br>(0.0309)        | -0.0098<br>(0.0247)                   |
| (log) GDP                       | 0.8716***<br>(0.2179)           | 0.9443***<br>(0.2191)         | 1.0125***<br>(0.2632)                 |
| (log) Population                | -0.1993<br>(0.4723)             | -0.2464<br>(0.4806)           | -0.3271<br>(0.4878)                   |
| WTO member                      | 0.0632<br>(0.1143)              | 0.0980<br>(0.1188)            | 0.0712<br>(0.1182)                    |
| Polity                          | -0.0058<br>(0.0122)             | -0.0058<br>(0.0126)           | -0.0019<br>(0.0130)                   |
| <b>Private-enterprise trade</b> |                                 |                               |                                       |
| (log) Political relations       | -0.1163***<br>(0.0172)          | -0.1105***<br>(0.0315)        | -0.0000<br>(0.0222)                   |
| (log) GDP                       | 0.9498***<br>(0.2275)           | 1.0160***<br>(0.2287)         | 1.0713***<br>(0.2743)                 |
| (log) Population                | -0.2182<br>(0.4692)             | -0.2623<br>(0.4838)           | -0.3292<br>(0.4868)                   |
| WTO member                      | 0.0024<br>(0.1104)              | 0.0341<br>(0.1150)            | 0.0078<br>(0.1165)                    |
| Polity                          | 0.0008<br>(0.0122)              | 0.0014<br>(0.0128)            | 0.0042<br>(0.0130)                    |
| Number of observations          | 3,179                           | 3,179                         | 3,144                                 |
| Wald test ( <i>p</i> value)     | .709                            | .051                          | .472                                  |

Note. Standard errors are clustered on partner country. Regressions for SOE and private-sector trade are run as seemingly unrelated estimations. UNGA = United Nations General Assembly; GDP = gross domestic product; WTO = World Trade Organization; SOE = state-owned enterprise.

\*Significant at 10 percent.

\*\*Significant at 5 percent.

\*\*\*Significant at 1 percent.

of an uncompetitive SOE could align to favor reducing imports from countries with bad political relations, this is not true for exports. The highly competitive SOE champions that lead in exports have no commercial reason to restrict their exports. We would thus only expect to see a negative effect of political relations on exports from SOEs as a result of government pressure. Where SOEs are politically influential, they may be able to resist the government demands such that we would observe no or minimal reduction in exports from the SOEs.

The relationship between government and business will mediate which firms bear the cost of reducing exports. Kastner (2007) argues that political tensions do not harm trade if domestic actors that gain from trade are strong politically because they use their influence to support open trade. Policy makers seek to reduce the economic costs of trade sanctions for special interest groups (McLean and Whang 2014). There are many reasons to believe that SOEs use their political influence to gain advantages. Chari and Gupta (2008), for example, find that Indian SOEs were more successful at preventing foreign entry than private companies during India's period of economic reforms. The influence of Chinese SOEs on decision-making was readily apparent during China's WTO accession as the government significantly favored their interests over consumers when allocating tariff reductions (Branstetter and Feenstra 2002). We assess whether SOEs are also able to resist state efforts to restrict trade by comparing the effect of negative political relations in the SOE sector with that in the private sector.

Table 5 presents our results for estimating Chinese exports with each of our three measures of political relations. We do not observe a significant effect of government events on either SOE- or private-enterprise exports (column 1). Military events (column 2) and distance in foreign policy preferences measured by UN voting (column 3) produce a negative and significant effect on both SOE and private exports. However, the impact of military events and distance in foreign policy preferences is larger for private enterprises. These coefficients are generally smaller in size, and the results are less robust than our import findings for China, but they suggest that private enterprises rather than SOEs are the main channel for export restrictions. Whether through favoritism by the government or their own recalcitrance to resist demands, Chinese SOE exporters do not appear to be a major actor in economic statecraft.

Turning to India in Table 6, we find support for the hypothesis that negative political events harm exports; the coefficients on both measures of events are negative for both SOEs and private enterprises and statistically significant at the 1-percent level (columns 4 and 5). The Wald test indicates a significantly larger trade response to military tensions in the state-owned sector. This effect does not extend to ideal point distance, however (column 6). The coefficient on ideal point distance is negative, as expected, but never achieves significance for either SOEs or private enterprises. Overall, political relations have an impact on India's export patterns that is more pronounced for SOEs than for private enterprises but much smaller than the effect observed for imports.

The results for exports suggest that Indian SOEs are responsive to government demands. Even where exporting firms would have no prospect to commercially benefit from trade restrictions on their exports, we observe a shift in trade patterns suggestive of cooperation with the demands of economic statecraft from the government. In the Chinese case, however, SOEs appear to be relatively stronger in their power relation with the government. On the one hand, SOE importers willingly go along to restrict imports where they may both support government demands of statecraft and seek any opportunity to reduce competition from foreign

imports. But SOEs, the strong export champions among them, largely refrain from efforts to politicize export flows. Their private-sector counterparts are more likely to play this role.

Our conclusions from analyzing exports help us to address the question of government and firm initiative because export restrictions are strictly negative from the perspective of the implementing firms. Yet we have to be cautious in our interpretation and acknowledge the shift of export flows may reflect import restrictions by the trade partner. The export analysis assumes that partners do not restrict imports from Chinese and Indian SOEs more than those from non-SOE firms.

## Conclusion

Does globalization render economic statecraft obsolete? Our research 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. We trace the politicization of trade directly to the role of government in the economy. The literature on interdependence, which aggregates the incentives of private actors and state intervention, has been unable to explain how the linkage between trade and foreign policy arises. We identify state control as a mechanism that explains why import decisions correlate with political relations and bring original data to test the relationship.

Where governments maintain control over the economy, trade continues to follow the flag. We argue that this is most likely to occur when the government holds an ownership stake in firms sufficient to influence their operations. We show that negative political events with a trade partner reduce imports by China and India, respectively, and that the magnitude of the change is greater in the state-controlled sector of the economy compared to the private sector. Political distance between states, as measured by their UNGA voting behavior, reveals a similar pattern. By showing that the relationship between foreign policy and imports is conditional on state ownership of firms, our study offers a new perspective on the debate about economic interdependence and cooperation. Export flows generate a more nuanced set of results with evidence that politically motivated export restrictions are more prevalent in the SOE sector for India and less so in China; Chinese SOEs appear to resist demands from the government to incur the costs from restricting exports. Furthermore, countries without SOEs cannot avail themselves of this tool—we confirm that both the United States and South Africa have low politicization of trade that corresponds to their low levels of state ownership.

The article also addresses the political economy of state ownership. It is not surprising that state control over economic actors would shift their behavior. Yet 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 (or even expand) control over selected sectors. 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 findings also extend to India, suggesting that the phenomenon is neither "China-specific" nor driven by regime type. Other major economies such as Brazil and Russia with large SOEs are likely to exhibit similar behavior and more may choose to follow. Furthermore, the role of SOEs is not limited to energy and raw materials sectors; analysis of SOE shares among the world's largest companies reveal that even for sectors such as motor vehicles, there is a 20percent SOE share (Kowalski et al. 2013, 6). It is critical for international political economy scholarship to examine the cross-border effects of SOEs.

Trade negotiators have devoted more attention to this question given the concern that state ownership introduces more latitude for discriminatory policies. WTO rules include the provision that state-trading enterprises act on a commercial basis, and the accession protocol for countries often includes additional provisions in which states declare that state-trading goods will be nondiscriminatory.<sup>33</sup> The TPP added a chapter in the agreement on SOEs with the US Trade Representative's description declaring that the "TPP's State-Owned Enterprise (SOE) chapter ensures that businesses, regardless of ownership, compete fairly through enforceable rules to ensure that foreign-owned SOEs compete on the basis of quality and price, not on the basis of discriminatory regulation, subsidies, or favoritism."<sup>34</sup> Trade remedies imposed as barriers to trade from SOEs differentiate among market and nonmarket economies and firms, so that higher duties are applied to nonmarket actors. It is thus not surprising that China put pressure on countries to obtain market economy status (Kastner 2016). Yet rules cannot change the fact that SOEs may act upon state interests across both commercial and noncommercial dimensions without requiring formal evidence of intervention. Legal enforcement tools are unable to challenge such informal sources of discrimination.

Future research should address the effectiveness of these strategies. From both theoretical and policy perspectives, it is important to know whether states modify their behavior to avoid negative effects on trade flows. New studies highlight evidence that China's commercial relations enhance its foreign policy influence (Flores-Macías and Kreps 2013; Kastner 2016). At the same time, scholars have been unable to draw strong inferences about the causal effect between political relations and trade given the challenge to identify exogenous sources of variation in political relations. We circumvent this problem by comparing import flows across sectors within the same country. Outside of our proposed mechanism, improved relations would have a similar effect across sectors. In addition, since China and India have only emerged in the past decade as economic powers with markets large enough to sway other countries, there is less concern about entrenched patterns of endogenous sanctioning and cooperation. Over time, partners who trade heavily in the sectors with large shares of state ownership may experience trade punishment sufficiently often that they will begin to modify their behavior.

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## Supplemental Material

Supplemental material for this article is available online.

## Notes

1. "Falklands Dispute: Argentina 'Urges UK Import Ban,'" *BBC News*, February 28, 2012.
2. See "Southeast Asia's Dance with China," *New York Times*, May 26, 2016. China has also been reported to ban state-owned enterprises (SOEs) from bidding on new contracts in Vietnam during periods of tensions. See "Rigged: Comradely Relations Go from Bad to Worse," *The Economist*, June 14, 2014.
3. See "The Visible Hand," *The Economist*, January 21, 2012.
4. Figures are from 2010/2011 and count only majority government-owned enterprises as SOEs.
5. In 2015, China was the world's second largest economy and India the seventh, as determined by gross domestic product (GDP). Together, these countries accounted for 15.4 percent of world exports and 12.4 percent of world imports in 2015, see <http://stat.wto.org>.

6. In line with our argument, Fisman, Hamao, and Wang (2014) find that at the time of the incident, Chinese sectors with high SOE intensity reduced their trade with Japanese firms more than sectors dominated by private firms.
7. As the Chinese government avoids formal legislation to implement sanctions, Chen and Garcia (2016, 34) argue that it “can only effectively command official bureaus and state-owned firms, but not private firms or actors that are involved in China’s salmon trade.”
8. SOEs comprise the majority of firms on the list for both China (90 of the 136 firms) and India (31 of the 56 firms). Included in the SOE count for China are subsidiaries with SOE parents. See <http://www.forbes.com/global2000/list/> and Naazneen Karmali, “India Faces Reality Check in Latest Global 2000,” *Forbes Business*, April 27, 2013. Figure for China by authors’ calculation.
9. Alison Smale and Danny Hakim, “European Firms Seek to Minimize Russia Sanctions,” *New York Times*, April 26, 2014.
10. Article XVII of the General Agreement, available at [http://www.wto.org/english/docs\\_e/legal\\_e/gatt47\\_e.pdf](http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf), accessed October 30, 2017.
11. (see [http://www.india.gov.in/spotlight/spotlight\\_archive.php?id=78](http://www.india.gov.in/spotlight/spotlight_archive.php?id=78), accessed August 20, 2012)
12. “The Rise of State Capitalism,” *The Economist*, January 21, 2012.
13. Shih, Adolph, and Liu (2012) have shown that promotion systems are dominated by the immediate needs of the regime and its leaders rather than regional economic growth.
14. Purba Das, “Rs 40,650 cr for Sick PSUs,” *The Sunday Guardian*, August 19, 2012.
15. Analyzing the decision to open certain industries for foreign direct investment, Chari and Gupta (2008), for example, find that the Indian government was more receptive to the interests of SOEs than to those of private firms.
16. (see <http://www.customs-info.com/>, last accessed May 24, 2017)
17. The nine ownership categories are as follows: SOE, sino-foreign contractual joint venture, sino-foreign equity joint venture, foreign-owned enterprise, collective enterprise, private enterprise, privately or individually owned business, enterprise with customs declaration authority but without permission to trade, and “other.” Importantly in the context of our study, an enterprise categorized as “private” may have the government as a minority shareholder.
18. Trade data are accessed using the World Bank’s World Integrated Trade Solution software (<http://wits.worldbank.org>, accessed October 28, 2013; International Standard Industrial Classification (ISIC) Rev. 3). For details on the Prowess database, see <http://prowess.cmie.com/>, accessed April/May 2012 and November 2013.
19. We also include in this category enterprises classified as “state and private sector” and “joint enterprises,” a class of enterprises in which the state is typically the majority shareholder.
20. To understand how we construct our proxies, consider imports to India from Poland. In 2000, India imported US\$ 16.5 million worth of electrical machinery and apparatus from Poland (ISIC Rev. 3, division 31). In this sector and year, SOEs held 12.1 percent and

private enterprises held 77.4 percent of total assets. Multiplying the trade values by the asset shares, we estimate that US\$2.0 million worth of imports from Poland entered India through SOEs and US\$12.7 million through private enterprises. We repeat this procedure for all ISIC divisions covered and sum across sectors to obtain values for SOE and private enterprise imports.

21. SOE and private-sector shares do not sum to 100 given presence of other enterprise types.
22. The data are produced from Textual Analysis by Augmented Replacement Instructions system for machine coding based on pattern recognition. It has been found to be as accurate as human coders. See, for example, Best, Carpino, and Crescenzi (2013). The data base has been criticized for listing events without naming actors and for its reliance on English-language media sources (Weller and McCubbins 2014). To address the former, we exclude events with missing actors. The latter concern is mitigated by the use of country-fixed effects in our empirical analysis.
23. The correlation of these measures with the total event count that includes all actors is 90.8 and 81.7 percent, respectively. The correlation of this total event count based on Global Data on Events, Location and Tone (GDELT) with a total event count based on the widely used King and Lowe (2003) data is 75.1 percent. We do not use the King and Lowe (2003) data set because it ends in 2004, whereas GDELT extends to 2012 and is continuously updated.
24. Since foreign policy preferences of states are not directly observable, United Nations General Assembly voting data have been widely used as a basis for measurement (e.g., Gartzke 2000; Bearce and Bondanella 2007; Strüver 2016).
25. This is the major innovation of ideal point distances compared to simple affinity or *S* scores (e.g., Gartzke 1998; Signorino and Ritter 1999). As Bailey, Strezhnev, and Voeten (2017, 433) emphasize, these similarity indices “weight all votes identically and will ebb and flow as these votes influenced by idiosyncratic factors come and go from the agenda.”
26. Authors’ interview with a manager of the Export–Import Bank of India in New Delhi, September 8–9, 2014.
27. We use the STATA (version 14) command “suest” to combine estimation results.
28. We only include the partner country’s GDP and population size as the respective values for China or India are captured by the time-fixed effects in our models.
29. Full regression results are available upon request.
30. Alliance data are from the Alliance Treaty Obligations and Provisions project (Leeds et al. 2002). The data end in 2003; we carry forward the 2003 value to the end of our data set under the assumption that a country’s alliance portfolio does not vary much over time.
31. See Kaempfer and Lowenberg (1992) for a discussion of the effects of trade sanctions on both the sender and target economy.
32. See Crozet and Hinz (2016) for estimates of the costs of the Russia sanctions and counter-sanctions on both sender and receiver.
33. See *Handbook on Accession to the WTO*, accessed December 16, 2016, [https://www.wto.org/english/thewto\\_e/acc\\_e/cbt\\_course\\_e/c5s2p9\\_e.htm](https://www.wto.org/english/thewto_e/acc_e/cbt_course_e/c5s2p9_e.htm).
34. See report, accessed December 16, 2016, <https://ustr.gov/sites/default/files/TPP-Chapter-Summary-State-Owned-Enterprises.pdf>.

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