



Trade, conflict, and political integration: Explaining the heterogeneity of regional trade agreements

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ABSTRACT

Many historians argue that the main goal of European trade integration was the preservation of peace. This paper investigates whether this reasoning is relevant for the EU and other regional trade agreements (RTAs). I provide empirical evidence that customs unions and common markets (deep RTAs) do reduce the probability of war between members. Partial scope and free trade agreements (shallow RTAs) however have no effect on war probabilities. Accordingly, international insecurity has a differential impact on incentives to create RTAs. Deep RTAs are signed between countries that are involved in many interstate disputes and that have low trade costs with the rest of the world, whereas the opposite is true for shallow RTAs.

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1. Introduction

The European Union (EU) is unquestionably the most integrated regional trade agreement (RTA) in the world, and a yardstick for other regions of the world. Many historians argue that the main goal of the European integration process was the preservation of peace after three increasingly destructive wars in Europe in less than a century. This view is illustrated by Robert Schuman's proposal for the creation of the European Coal and Steel Community, the forerunner to EU: "by pooling basic production and by instituting a new High Authority, whose decisions will bind France, Germany and other member countries, this proposal will lead to the realization of the first concrete foundation of a European federation indispensable to the preservation of peace".¹ This paper investigates whether the reasoning linking security and regional trade integration is relevant for Europe and other regions of the world by asking two questions: do RTAs prevent the outbreak of war and is international security a motive for RTA creation?

The literature in international relations identifies two channels through which regional trade integration is likely to affect international insecurity (Bearce, 2003).² First, since war disrupts bilateral trade (Martin et al., 2008; Glick and Taylor, 2010), an RTA increases the opportunity cost of war by increasing intra-regional trade (Martin et al., 2008; Polachek, 1980; Oneal and Russett, 1999). Second, supranational institutions created in relation to regional integration promote the exchange of information on military capabilities and resolve and patience in conflicts, through formal security/military substructures, joint military exercises and forums of defence ministers. Moreover, regular meetings of head of states and high level officials or the

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¹ Declaration of 9 May 1950, http://europa.eu/abc/symbols/9-may/decl_en.htm.

² Schiff and Winter (2003) identify a third channel related to access to raw materials.

existence of an executive secretariat create habits of negotiation and build trust between political leaders.³ International institutions are thus likely to reduce asymmetries of information in conflicts and to mitigate problems of credible commitment in interstate negotiations, which reduces the probability that a dispute escalates into war (Fearon, 1995; Grossman, 2004).⁴

Supranational institutional frameworks however differ greatly depending on the form of regional trade integration. Creating a customs union requires agreement on a common external tariff and revenue distribution between member states. A common market requires more comprehensive political institutions to agree on a broader set of issues (harmonization of regulation and standards, free movement of goods and factors...),⁵ whereas a free trade agreement or partial scope arrangement involves little or no political or institutional integration.⁶ According to the political integration criterion, two categories of RTAs can be distinguished: deep (customs unions and common markets) and shallow (partial scope and free trade agreements) RTAs. Only deep RTAs require a significant common institutional framework likely to promote the negotiated settlement of conflicts and support peace between members.

If countries can design regional trade agreements to pacify interstate relations, international security should affect decisions on trade policy. In a purely economic framework in which RTAs have no effect on war probabilities, two partners that have more issues of dispute would have fewer incentives to create an RTA since disputes may escalate into war and disrupt bilateral trade.⁷ Conversely, if an RTA reduces the probability of war between members, then having more disputes may increase the likelihood of an RTA being set up. To the extent that only deep RTAs pacify relations between members, international insecurity should have a differential effect on incentives to create RTAs (and should affect both the choice of form of trade integration and the choice of partner). In a nutshell, a history of conflicts should enhance the creation of deep RTAs, but not shallow ones.

In this paper, I set out an empirical analysis of the relevance of international security in the creation of shallow and deep RTAs. The motives for choosing different strategies of integration are based on the premise that a deep RTA reduces the probability of war between members while a shallow RTA does not. I first test this proposition using data on militarized interstate disputes from the Correlates of War (COW) project covering the 1950–1991 period. I address the selection issue due to the heterogeneity of dispute occurrence across country pairs using a bivariate probit model accounting for selection and event data from Kinsella and Russett (2002) to measure interstate dispute occurrence. I find a sizeable impact of membership in a deep RTA: it reduces the probability of a dispute escalating into war by two-thirds. Membership of a partial scope or free trade agreement has no significant effect on war probabilities.

Second, I test the determinants of the likelihood of deep and shallow RTAs on a cross-section of 2814 unique country pairs in 2005. The endogeneity bias related to past membership of RTAs and omitted variables is addressed by controlling for several co-determinants of regionalism and conflict and by implementing an instrumental variable strategy. I find that deep RTAs are signed between countries that have many interstate disputes and that have low trade costs with the rest of the world, whereas the opposite is true with respect to shallow RTAs. These empirical results provide strong support for the differential effect of international insecurity on incentives to create deep and shallow RTAs. Besides the reduction of tariffs, this paper explicitly emphasizes the role of RTAs as a regulating mechanism for interstate relations. By offering empirical evidence on the choice of RTA partners as well as the form of regional integration, this paper complements Baier and Bergstrand's (2004) analysis of the economic determinants of RTAs.

This paper is related to the theoretical literature on the endogenous formation of RTAs that emphasizes non-traditional gains from regional integration.⁸ This strand of the literature explicitly recognizes various motives for regional integration and identifies distinct problems that a trade agreement may solve (Maggi and Rodriguez-Clare, 1998; Mitra, 2002; Limao, 2007). Regional trade integration may indeed provide non-traditional gains and help solving problems of time inconsistency, signaling, insurance, cooperation and security (Fernandez and Portes, 1998; Whalley, 1998; Schiff and Winters, 1998). In such a framework, RTAs are not only regarded as engines of preferential liberalization but also as international institutions providing public goods to their members (Limao, 2007; Alesina et al., 2005). These papers however only consider the case of free trade agreements or customs unions, or do not distinguish between RTAs according to the form they take.⁹ The usual classification of RTAs, derived from Balassa (1961), considers regional trade integration as a step-by-step process leading to economic union, through free trade area, customs union and common market. The underlying assumption is that more integrated arrangements provide deeper trade integration.¹⁰ Vicard (2009) however

³ For instance, Manzetti (1993/94) reports that discussions of sensitive policy issues such as nuclear proliferation concerns have taken place within the MERCOSUR institutions.

⁴ Jackson and Massimo (2007) also show, in a setting where countries are at war because of the political biases of their leaders that when state leaders lack the ability to credibly commit to a negotiated deal, the scope for negotiated settlement of disputes is reduced.

⁵ See, for instance, Alesina and Wacziarg (1999) for a detailed mapping of policy areas carried out at the EU level, and Bouzas and Soltz (2001) concerning the institutional framework of MERCOSUR.

⁶ The ASEAN free trade agreement is an illustrative example, with weak regional institutions in order to limit any supranationalism (Best, 2005). Pomfret (1997) also emphasizes how the will to limit political integration has been fundamental to the creation of NAFTA.

⁷ This reasoning assumes either that negotiating or implementing an RTA involves costs or that increasing trade integration increases the number of disputes and thus the probability of trade disruption in the future.

⁸ The optimal tariff strand of the literature focuses on traditional trade gains (Riezman, 1985; Yi, 1996; Ornelas, 2005).

⁹ From an empirical point of view, Mansfield and Pevehouse (2000) and Martin et al. (2010) also investigate the impact of RTAs on security without differentiating between RTAs.

¹⁰ In his seminal paper, Balassa (1961) also mentions social integration, but he dismisses this second criterion.

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