Business as Usual? Economic Responses to Political Tensions

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Do political tensions harm economic relations? Theories claim that trade prevents war and political relations motivate trade, but less is known about whether smaller shifts in political relations impact economic exchange. Looking at two major economies, we show that negative events have not hurt U.S. or Japanese trade or investment flows. We then examine specific incidents of tensions in U.S.-French and Sino-Japanese relations over the past decade—two case pairs that allow us to compare varying levels of political tension given high existing economic interdependence and different alliance relations. Aggregate economic flows and high salience sectors like wine and autos are unaffected by the deterioration of political relations. In an era of globalization, actors lack incentives to link political and economic relations. We argue that sunk costs in existing trade and investment make governments, firms, and consumers unlikely to change their behavior in response to political disputes.

Do political tensions have economic consequences? The relationship between economic interdependence and conflict has been a central debate in international relations. Leading scholars contend that "states with good relations should have more trade than states with poor relations" and import decisions of firms will respond to "the climate of friendliness or hostility that exists between the importer and exporter" (Morrow, Siverson, and Tabares 1998, 650; Pollins 1989b, 739). Analysis of trade and conflict in a simultaneous equations model concludes that "political relations are driving commerce, not the other way around" (Keshk, Pollins, and Reuveny 2004, 1175). We reexamine these arguments in the current globalization era to show that sunk costs reduce incentives for state and private actors to link political and economic relations.[1]

Political relations vary along a continuum from cooperative normal relations, to political tensions, to threats of force, and to war. While most analysis of the interdependence debate focuses on militarized disputes, we analyze the shift at the lower level from normal relations to political tensions. As noted by Pevehouse, "much of the nuance of interdependence theory has been discarded" in recent empirical studies that use dichotomous measures for conflict, and new insights may be gained by returning to the earlier approach in the literature that measured conflict and cooperation with events data (2004, 247). A large range of interactions determines the status of political relations between states. By political tensions, we mean disagreement over policy issues, hostility between leaders, and negative public sentiment. In the contemporary world, occasions when states threaten force are rare, but tensions are frequent.

To the extent that political tensions are an element of a state's calculation about the likelihood of future conflict, it represents a variable underlying realist theory. At the

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[1]Supporting Information files and replication data are available at http://www.princeton.edu/~cldavis/research/.

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same time, to the extent that political tensions act as a catalyst for business lobbying to improve relations, it represents a variable underlying liberal theory. The focus in the existing empirical analysis on explaining direct conflict neglects the need to test the threshold at which causal mechanisms connecting political and economic outcomes come into operation. This article takes a first cut at this task by evaluating linkages between politics and economics at the level of conflict escalation when bilateral relations move into a period of political tensions.

Whereas most research on trade and conflict has been based on the two world wars and Cold War period, we assess whether claims that trade follows the flag or leads to commercial peace still apply in the current era of globalization. Not only is major power war unlikely, but interdependence has become a background condition for most states and strengthened international rules govern trade and investment. Theories about linkages between economics and politics need to be updated to reflect the current reality of a fully globalized economy.

We examine the economic relations of the United States and Japan as two major economies. We first analyze the response of aggregate trade and investment patterns to negative events. Here we follow the approach of previous literature to model conflict as a continuous event count variable while taking advantage of a new events dataset and quarterly economic data for a more precise analysis. Then we closely examine specific incidents of political tensions in the bilateral relationships between the United States and France and between Japan and China from 1990 to 2006. This choice of cases allows us to evaluate the effect of political tensions during the post–Cold War period in two different security contexts: between allies and between regional rivals. The cases also include variation in the regime that could affect freedom of civil society to engage in boycott activities and capacity of governments to intervene. We closely examine the timing of shifts in political relations to observe any impact on aggregate trends in trade and foreign direct investment (FDI), as well as on iconic industries such as French wine and Japanese autos, and we compare them with the political and economic relationship with third countries. We find no observable evidence that political tensions harmed economic relations (after controlling for material factors unrelated to the political tensions, such as GDP and the exchange rate between the two currencies). Analysis of the years from 1990 to 2004 shows that the number of negative events reported in the media does not reduce the trade or investment flows for either the United States or Japan in their economic relations with other countries. Neither have they suffered economic harm from high-profile political tensions with leading economic partners. Franco-American political tensions peaked during the rift over Iraq in 2003. Nevertheless, in 2004, trade and investment between the United States and France, its nemesis in the United Nations over Iraq, grew as rapidly as U.S. trade and investment with Britain, its loyal partner in Iraq. Japan and China have confronted a hostile political atmosphere created by controversies over history and territorial disputes. During the five years of the Koizumi Administration (2001–2006), tensions led to anti-Japanese riots and boycotts in China and the suspension of high-level diplomatic meetings. At the same time, bilateral trade and investment flows grew at a rapid pace and in 2004 China surpassed the United States, the unwavering ally, as Japan's top trade partner.

These are puzzling findings, which counter both public commentary and many theoretical studies that link political and economic relations. This article addresses the paradox of solid, and even stronger, economic ties in the face of weakened political ties. The first section lays out the existing arguments in the literature about the spillover from the political to the economic realms and introduces our revised liberal hypothesis about why, in an era of globalization, actors lack incentives to link political and economic relations. We draw on theories in economics and marketing about sunk costs that prevent economic actors from updating behavior in response to new conditions. Not only intrafirm contracting relationships, but also consumer purchase decisions exhibit strong path dependence. The second section probes evidence from U.S. and Japanese trade and investment patterns, where we find no significant spillover. The final section revisits the hypotheses and concludes that sunk costs in existing trade and investment relations make governments, firms, and consumers unlikely to change behavior in response to political disputes.

Theoretical Perspectives on Economic Interdependence and Conflict

The business community shows genuine concern about the economic impact of political tensions, and the media give sensational coverage to boycotts. But from a theoretical standpoint, why is it puzzling that political tensions between two countries would have limited impact on their economic relations? In this section, we discuss how both realist and liberal theories generate expectations for feedback and then present our theory about how economic relations in an era of globalization involve sunk costs that act as a buffer to absorb political shocks.

Politics First

From the realist perspective, political factors that influence the likelihood of future conflict will affect economic relations. States concerned about survival must be cautious about economic activities that could create vulnerability or strengthen a future rival (Kirshner 1999, 71, 75). Gowa and Mansfield (1993) argue that interstate alliances affect the pattern of international trade because states will have less concern about the security externalities gains from trade produce if they strengthen an ally rather than an adversary. Shifts in alliance stability and the level of security threat motivate use of economic statecraft to serve political purposes (Mastanduno 1998; Skalnes 2000).

A related argument is that "trade follows the flag" because private actors closely observe political relations and update their expectations about future conflict. Pollins (1989b) argues that importers trade with friendly countries in order to manage risk and minimize potential economic disruption. Consumers "express goodwill or solidarity toward those whom they identify as friends, while shunning or punishing those they perceive as foes" (Pollins 1989a, 739–40). As a result, bilateral trade levels should be correlated with shifts in political relations even without explicit government policies to sanction a state. Referencing events such as Willy Brandt's Ostpolitik and the growth of U.S.-Egyptian trade after the Camp David Accords, Pollins notes, "it is not only alignment and open conflict that can affect trade but the broad orientation of states' foreign policies toward each other" (Pollins 1989a, 739). Hostile foreign policy events and rhetoric by leaders framing the events have been shown to generate ripple effects in the U.S. economy triggered by shifts of consumer expectations (Wood 2009).

Moreover, states holding similar policy positions on most global issues are more likely to trade (Dixon and Moon 1993). Shared democratic institutions also affect trade flows positively because economic actors are more knowledgeable about consumer tastes, business trends, and government regulatory constraints (Bliss and Russett 1998; Morrow, Siverson, and Tabares 1998). Trust also matters. Even when controlling for standard predictors of trade levels in a sample of European states with common political orientation, states with higher trust measured by Eurobarometer surveys have statistically significant higher levels of trade, portfolio investment, and direct investment (Guiso, Sapienza, and Zingales 2009).

We can derive from these arguments the *hypothesis of politics first:* rising political tensions lead governments to adopt policies that reduce economic interdependence and encourage business actors to shift trade and investment to other partners. This hypothesis suggests that political tensions would lead to a downward trend of economic exchange with that country relative to stable or increasing economic ties with other countries.

Economics First

By contrast, liberal theories of international relations have long emphasized the commercial peace argument that economic interdependence creates vested interests opposed to conflict. From Montesquieu to Adam Smith to contemporary liberals, scholars have argued that free trade encourages peace. Zeev Maoz conducts an extensive battery of statistical tests and finds strong support for the liberal paradigm that economic interdependence reduces conflict (Maoz 2009). In other words, economics prevails over politics. These arguments are based on the premise that political conflict harms economic interaction.

The "commercial peace" literature offers two mechanisms to explain why economic relations inhibit interstate hostilities (Barbieri 2002; Mansfield and Pollins 2003). First, the traditional view has been an economic interest model (Oneal and Russett 1997; Polachek 1980). Private actors who expect to benefit from continued commerce lobby to restrain the state from engaging in conflict (Copeland 1996; Kastner 2007; Mansfield 1994; Papoyouanou 1997). Business pressure is expected to encourage positive relations with economic partners and not just rally against war. Second, in information models economic interdependence promotes peace by deepening transnational ties. Gartzke, Li, and Boehmer (2001) argue that states with interaction through trade and capital markets have policy tools short of war by which to signal their dissatisfaction with another state and demonstrate their own resolve.

Both versions of the commercial peace argument depend on the assumption that political conflict harms economic interaction. In the economic interest models, fear of economic harm from deteriorating political relations creates the incentives to support good political relations. In the information models, observable economic harm from political conflict is necessary to provide the costly signal of resolve. Thus, even lower-threshold political tensions are relevant, since signaling through changes of economic behavior often occurs below the threshold of militarized conflict (Gartzke, Li, and Boehmer 2001, 405). Indeed, Morrow argues that militarized conflict has little impact on trade because economic actors adjust their trading activities before a dispute occurs in response to

lower-level changes of political relations (Li and Sacko 2002; Morrow 1999, 488).

We can derive from these liberal arguments the *hypothesis of economics first:* rising political tensions will have a negative impact on economic relations that motivates business actors to lobby their governments and signals high resolve to the opponent. Improvement of political relations would be expected to follow.

Economic Ties Absorb Political Shocks

Both of these simplified versions of realist and liberal views on economic and security linkages are based on an image of state-society relations that no longer fits the current era of globalization. The "politics first" argument portrays the state having substantial control over economic actors, while "economics first" portrays economic actors with substantial influence over political leaders. Yet debates on comparative political economy point to the need for a more nuanced approach to the balance between states and markets (Berger 2000; Kahler and Lake 2003; Keohane and Milner 1996). On the one hand, governments retain some autonomy to select how they respond to market pressures and interest group demands. On the other hand, the development of a global economy with low trade barriers, capital mobility, and multinational firms has constrained the ability of states to direct trade or investment flows to meet national goals. World trade rules (GATT Article XXI) allow for economic sanctions in the case of national security or international emergency, but raising tariffs over smaller political differences could lead to potential challenges and retaliation in WTO dispute settlement. Governments that are competing to attract investment may be unwilling to intervene in economic affairs for fear of losing confidence of investors. As liberalization has broadened across a wide range of countries, few are now free to engage in politicized economic policies, such as impeding trade in response to political conflict.[2] Trade rules and capital mobility increase the cost of unilateral government actions to restrict commerce. We offer a revised version of a liberal hypothesis.

Instead of responsive linkages between economic and political trends, we may observe path dependence of economic relations as businesses consider sunk costs in existing trade and investment flows. Economists have developed theoretical models to show significant hysteresis exists in bilateral trade flows, and empirical evidence indicates that firms' export decisions are influenced substantially by consideration of these costs (Baldwin 1988; Dixit 1989; Roberts and Tybout 1997). Sunk costs for export firms include information about market conditions for successful product selection and development of distribution, sales, and servicing networks. Once firms have established exports to a particular market, they do not quickly change their trading patterns. FDI presents even greater sunk costs since there is duplication of production facilities (Helpman, Melitz, and Yeaple 2004).

Intra-industry trade and FDI often require firms to sink costs in assets dedicated for specific markets. The existence of economies of scale underlies intra-industry trade with specialization in differentiated products. In addition to the constant labor component, the firm bears a fixed cost for skilled labor necessary to produce the differentiated product independent of the quantity produced (Helpman and Krugman 1994, 141). Production techniques and branding of products also support increasing returns from the initial investment. Differentiated product markets are less likely to be perfectly competitive. A firm trading commodities on a market exchange can more easily switch to alternative suppliers than a firm that relies on relational contracts in a market with imperfect substitutes. Costs of movement are substantial for the firm engaged in intra-industry trade, irrespective of industry adjustment at the national level (Gilligan 1997, 462). This shift in trade structure is especially relevant to the period of this study. Between 1970 and 1997, intra-industry trade as a share of national trade grew from 50% to 77% in the United States, 66% to 76% in France, 23% to 39% in Japan, and 10% to 44% in China (Kono 2009).[3] New research also shows that much of FDI occurs among industrialized countries on the basis of intra-industry vertical FDI that involves high-skill intermediate inputs near final production stage rather than raw materials (Alfaro and Charlton 2009).

Relationship-specific sunk costs discourage fluid adjustment by economic actors to changing political circumstances. The estimate of political stability in the relationship occurs at the time of initial investment based on observable characteristics such as alliance relations. Gowa and Mansfield (2004) argue that alliances promote intra-industry trade by reducing the fear of holdup that could otherwise suppress such trade that involves irreversible investments. Subsequent events affecting expectations of hostile political climate are discounted given the sunk cost in existing economic relations. Hence, weakening alliance ties or animosity between rivals would not produce a parallel shift in economic ties.

[2]Kastner (2007) argues protectionist governments are prone to react to political tensions with more trade barriers.

[3]We thank Daniel Kono for sharing his data on intra-industry trade.

Consumers also face sunk costs in purchasing decisions and are therefore reluctant to change their behavior in the face of political tensions. For one, as marketing researchers have long documented, consumers invest information seeking, knowledge, and emotional costs in brands and products—a concept referred to as "brand loyalty" and "product attachment" (Kotler 2002). They are not likely to participate in a boycott when forgoing a preferred good is costly for them. Klein, Smith, and John (2004) refer to this as "constrained consumption" and show few consumers are willing to make the sacrifice inherent in boycotting. Moreover, consumers may reject a national boycott, even if they agree with the political message, because of collective action problems. Either they perceive that their individual contribution will be too small to make any difference on foreign policy, or they believe that they can free-ride on the boycott decisions of others (Klein, Smith, and John 2004; Sankar, Gurhan-Canli, and Morwitz 2001).

The growth of transnational business also reduces incentives for private actors to respond to political trends. Firms engaged in regional production networks that subcontract components may not easily find replacement suppliers. Those that sell to foreign affiliates have little reason to punish their own subsidiary. Consumers may be unable to express political preferences in ways that would connect with national origin of goods because leading American, European, and Japanese brands increasingly are attached to goods made elsewhere. Indeed, firms manipulate consumer perceptions through marketing strategies. Advertisements using a national image to sell the product can be replaced with more localized appeals that disguise national identification.

Such stickiness in economic transactions works against any reversal prompted by realist concerns, but also undermines the credibility of the commercial peace mechanism—if everything goes forward with business as usual regardless of politics, there is no pressure applied for improving political relations. Businesses will fail to lobby, and no costly signal communicates preferences. Politics and economics are separate.

We can derive from these arguments the *hypothesis of separation of politics and economics:* governments will not directly intervene in the economy for political reasons, and private actors will be slow to change trade and investment patterns in response to worsening political relations. This hypothesis suggests that political tensions will have little effect on market interactions. This argument points to a different mechanism for liberal interdependence in which economic ties promote peace as a shock absorber of tensions rather than as a trigger for lobbying by vested interests or as a costly signal of preferences.

First Test: Measuring Political Tensions with Event Count Data

Previous literature has analyzed events data to measure levels of conflict and cooperation in dyadic relations among states, and we use this as our starting point. The Conflict and Peace Data Bank (COPDAB) was used by Pollins in his classic article showing the effect of political relations on bilateral trade relations (Polachek 1980; Pollins 1989b). This data series coded diplomatic events reported in newspapers and has been modified to weight events according to significance (Goldstein 1992). King and Lowe (2003) provide the most recent and comprehensive events dataset, which extends on the approach of these earlier surveys using computer coding of media reports. The coding program (Virtual Research Associates Reader) reads daily Reuters news reports to extract a list of events that identify the actors, date, and type of event according to cue words (i.e., complain, demonstrate, seize). The program filters out routine updates such as stock reports and has been shown to be as accurate as human coders. The King-Lowe events data are available for 1990 to 2004, in contrast to the earlier events datasets that end in 1985.

In regression analysis we examine the effect of negative events (defined below) between the United States and its partners on their level of economic exchange measured as exports, imports, and FDI outflows. A parallel analysis is conducted for negative events between Japan and its partners. We include all partners (152 countries) over the period 1990 to 2004. We implement a gravity model of trade to estimate bilateral export and import flows when controlling for the variables that provide a baseline expectation for trade levels between two countries. This specification explains the log value of trade as a function of the log of the joint income of two countries and the log of the distance between them (Anderson and Wincoop 2003). We estimate the models with ordinary least squares and include the standard set of "resistance" factors such as geography (islands trade more, landlocked states trade less), trade agreements (GATT/WTO and PTA), alliance ties, and common language. We also add a control for the exchange rate, since shifts in currency values change the relative prices of imports and exports and therefore affect their demand and supply. A similar model is used to examine FDI outflows, with the addition of a control for the presence of a bilateral investment treaty between the two countries.[4]

[4]The specification for FDI differs from the gravity model because the dependent variable takes both positive and negative values and

We add to the standard specification an independent variable for *political tensions*, which measures negative events with either government- or citizen-level origin between two countries.[5] Each event has been coded with a "Goldstein score" weighting its significance, i.e., a military attack would receive the score −10, cutting off aid would receive −5.6, and issuing a formal complaint or protest would receive −2.4. Our political tension variable sums negative Goldstein scores for the dyad in each quarter (reported as positive values in log form). We also include a *hostility* variable for the proportion of all events between the two countries in a dyad that involve high hostility levels, which uses the cutoff of events coded as more serious than a threat or warning, i.e., those involving demonstrations, formal reduction of relations, expulsion, seizure, or force.[6]

Using quarterly trade data and summing events data for each quarter allows us to give more fine-tuned analysis. In the main models, we examine the effect of negative events lagged by one quarter to account for the likely delay of response. Each model is estimated first with quarter fixed effects to control for common shocks to the economy across dyads in a given period and including the standard gravity model variables to explain country variation with robust standard errors clustered by country. A second estimation drops the time-invariant variables and uses country fixed effects to control for country-specific features in addition to the quarter fixed effects. This specification analyzes how variation of events over time within a particular dyad relationship influences their economic exchange.

The results in Table 1 indicate that there is no significant relationship between negative events and economic relations. In none of the U.S. models do political tensions measured by the negative events score of the dyad or hostile events as proportion of total events reach standard significance levels, and the sign is in the wrong direction for the models that do not include country fixed effects. Further analysis suggests there may be a negative effect on U.S. exports, but the results are sensitive to specification and substantively small.[7] U.S. imports and FDI flows appear impervious to tensions and the relative level of hostility. The Japanese evidence is even more surprising—looking at the data, political tensions are associated with an increase of exports and FDI! Since the events data are lagged, it seems unlikely there is reverse causation where an increase of FDI or exports causes negative events. Increasing the lagged period for events variables up to one year or adding a lagged dependent variable does not substantively change the conclusion. In a further robustness check, we examine the subsample of developing country trade partners. One might expect that power asymmetry would increase the likelihood that governments manipulate economic policies for political goals. Even for these asymmetric dyads, however, the political tensions are not significant (results not shown).

These results are surprising and highlight the need to look more closely at specific cases of political tensions where one can identify the timing and nature of the shock to political relations and follow the reactions of states and private actors.

Evidence from Two Case Studies of Political Tensions

The Franco-American and Sino-Japanese relationships over the past decade provide recent instances of political tensions arising between states with deep economic ties. Differences between the pairs permit exploration of the hypotheses with variation in security relations as we compare political tensions between two allies and between two regional power rivals.

The Franco-American Dispute over Iraq

Observing political tensions. Political relations between France and the United States became tense in the fall of 2002 over the proposed invasion of Iraq. This Franco-American rift reached its apex in March 2003, when France publicly opposed the American decision to go to war and mounted an antagonistic campaign in the United Nations. Hostility lingered until the end of 2003. Such acrimony took place against a background of increasing mistrust between France and the United States throughout the late 1990s and early 2000s over American unilateralism, as illustrated in climate change, the International Criminal Court, and trade disputes. Yet the time series of quarterly events data shown in Figure 1 illustrates that clearly 2003 represented an extreme increase of negative events relative to the past decade. Whereas the average Goldstein-scaled negative event count was 35, the negative scores began to increase in the last quarter of

so cannot be analyzed in log form. U.S. FDI data begin in 1994, and Japanese FDI data begin in 1996.

[5]The events data are available at http://GKing.Harvard.edu. See Goldstein (1992, 376) for full the weighting scheme.

[6]Iraq is omitted from the analysis because of limited GDP data and highly skewed values of the "negative events" count. Our goal is to examine tensions rather than war.

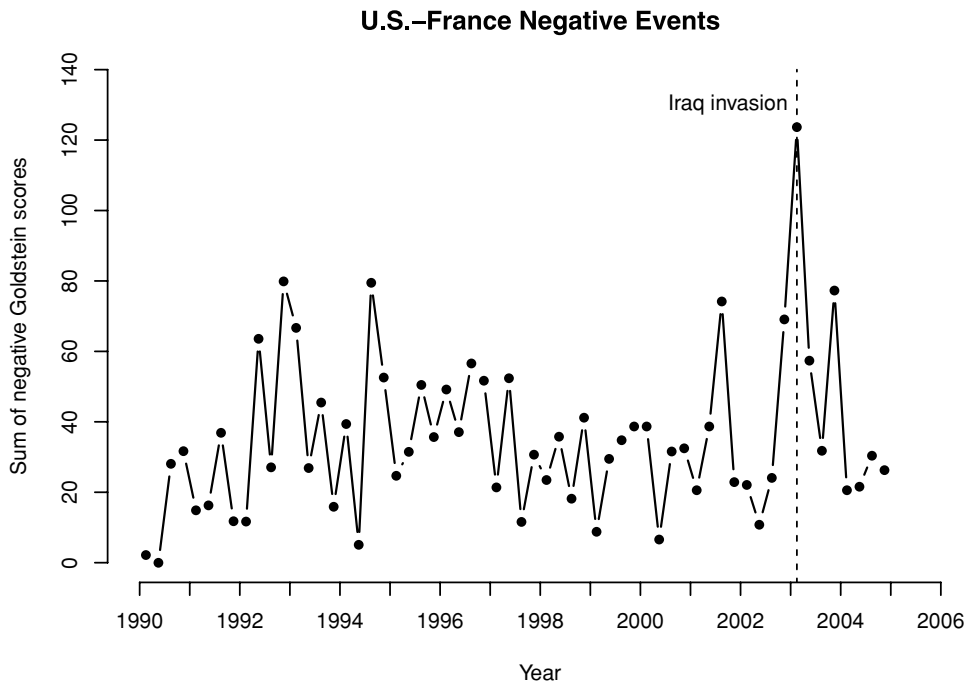
[7]Negative events only are significant for country fixed effects model of U.S. exports when excluding hostility variable; then the coefficient is −0.015 (s.e. 0.007, p-value 0.025), which means a 10% increase of events is associated with less than 1% decrease of U.S. exports.

TABLE 1 Negative Events in Gravity Model Estimation of U.S. and Japanese Trade and Investment, 1990–2004

	US EXPORTS		US IMPORTS		US FDI Outflow		JPN EXPORTS		JPN IMPORTS		JPN FDI Outflow	
Variable	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
Political tension	0.084	−0.009	0.015	−0.010	0.281	−0.219	**0.154**	0.014	0.140	−0.010	0.759	0.344
	0.049	*0.007*	*0.063*	*0.012*	*0.444*	*0.224*	***0.068***	*0.015*	*0.104*	*0.018*	*0.446*	*0.409*
Hostility	−0.47	−0.11	−0.056	−0.062	1.927	1.127	**0.597**	0.148	**0.603**	0.005	0.637	−0.066
	0.255	*0.068*	*0.287*	*0.103*	*2.777*	*1.737*	***0.261***	*0.087*	***0.275***	*0.104*	*1.062*	*1.179*
Distance	**−1.201**		**−0.74**		**−7.573**		**−0.848**		**−1.411**		0.020	
	0.183		***0.245***		***2.455***		***0.247***		***0.402***		***0.402***	
GDP	**0.866**	**0.135**	**1.023**	**0.248**	**4.571**	**4.398**	**0.914**	**0.241**	**1.019**	**0.106**	0.704	−0.037
	0.043	***0.028***	***0.055***	***0.037***	***1.251***	***1.109***	***0.042***	***0.035***	***0.072***	***0.044***	*0.347*	*0.650*
Landlocked	**−0.484**		**−0.532**		3.262		**−0.737**		**−0.860**		**−1.417**	
	0.181		***0.302***		*2.15*		***0.238***		***0.344***		***0.413***	
Island	**0.104**		0.213		5.664		**0.746**		0.202		1.645	
	0.157		*0.24*		*3.315*		***0.2***		*0.368*		*1.039*	
Exchange rate	−0.057	**−0.046**	−0.007	**−0.027**	**−1.465**	−0.196	−0.019	**−0.2**	0.001	**−0.167**	−0.391	−0.261
	0.033	***0.01***	*0.045*	***0.013***	***0.517***	*0.193*	*0.085*	***0.025***	*0.136*	***0.034***	*0.195*	*0.179*
GATT/WTO	0.152	**0.102**	0.458	**0.189**	−0.358	−1.641	**0.623**	**0.335**	0.410	−0.049	0.548	**4.585**
	0.212	***0.034***	*0.3*	***0.051***	*2.395*	*1.097*	***0.224***	***0.046***	*0.360*	*0.062*	*0.635*	***1.337***
PTA	0.582	0.079	**0.844**	**0.823**	−0.354	−2.045	**2.832**	**−0.165**	**1.858**	**−0.111**	−0.124	−0.479
	0.304	*0.048*	***0.282***	***0.156***	*5.244*	*3.504*	***0.26***	***0.047***	***0.339***	***0.048***	*1.870*	*1.576*
BIT					−2.078	−0.711					1.283	−0.008
					1.797	*1.098*					*1.300*	*0.656*
Alliance	0.381	**0.313**	0.018	**0.468**	0.944		0.408		−0.146		**15.157**	
	0.203	***0.064***	*0.249*	***0.0545***	*1.715*		*0.287*		*0.412*		***2.473***	
Language	**0.78**		**0.744**		5.854							
	0.165		***0.224***		*3.125*							
Constant	**−7.585**	0.901	**−15.95**	**−2.031**	**−56.73**	**−115.036**	**−12.887**	**−2.551**	**−10.202**	0.296	−21.011	−0.232
	1.763	*0.717*	***2.272***	***0.948***	***24.233***	***30.999***	***2.879***	***0.879***	**4.252**	1.081	11.310	18.046
Adj. R-squared	0.829	0.955	0.753	0.939	0.245	0.425	0.777	0.95	0.661	0.911	0.319	0.356
N	8522	8522	8358	8358	2176	2176	8344	8344	8063	8063	926	926

All models include quarter fixed effects; even models add country fixed effects. Bold indicates 5% significance level. Standard errors in italics.

FIGURE 1 Event Count Measure of U.S.-France Political Tensions



Quarterly time-series plot of Goldstein-scaled negative events between the United States and France from 1990 to 2004.

2002 and spiked to 124 during the first quarter of 2003. By 2004 the scores had returned to below average levels.

Public opinion surveys and media coverage reflected the rise of political tensions. In the spring of 2003, half of the French who had said they favored the United States the previous summer changed their mind and those with positive views dropped from 63% to 31% (Kuisel 2004). In the United States, only 34% of Americans had a favorable view of France (Associated Press 2006). On May 15, 2003, French ambassador in the U.S. Jean-David Levitte formally delivered a letter to administration officials and members of Congress, complaining about a series of false stories that had appeared in the U.S. media over the past nine months, undiplomatically referred to as part of an "ugly campaign to destroy the image of France" by anonymous administration officials (De Young 2003). At the same time, the French media had an increasingly anti-American tone.

Expected economic effects of political tensions. Commentators in the press and business community expected political tensions to spill over into the economic realm. On both sides of the Atlantic, the media reported widely on instances of consumer boycotts. French youths vowed to stop eating at McDonald's, drinking Coca-Cola, and buying American products, from Microsoft to Kodak. Similarly, Americans manifested their displeasure of France's "betrayal" by boycotting its national products, symbolically pouring French wine down the drain, and changing their travel plans. In the United States, conservative media personality Bill O'Reilly launched a "Boycott France" campaign on the air in March 2003. As he wrote a year later to justify the continuing boycott: "So no more brie for me. No more Evian, Air France, Provence and no more escargot, which I don't like anyway. As a free American, I am using my economic choice to send the French government a message. I am boycotting French goods and services and hope you will do the same" (O'Reilly 2004). The overall impression in the transatlantic media around the time of the Iraq crisis, as summarized by *The Washington Post*, was that "the animosity that has flared of late appears almost certain to seep into transatlantic trade and investment issues" (Blustein 2003, A12). A December 2004 survey by Global Market Insite showed that 20% of European consumers polled said they were consciously avoiding American products because of recent American foreign policy (Lobe 2004).

The transatlantic business community also predicted that the diplomatic rift would poison economic ties. In Europe, business leaders worried about the economic impact of transatlantic tensions on the food and wine industry, the luxury goods sector, and airlines. Europeans were further alarmed when the Bush administration retaliated

against France and Germany by excluding their companies from Iraqi reconstruction (Bumiller 2003). American companies worried that Europeans would focus their ire on business as a proxy for hurting governments and that big American consumer brands would pay the price for the unpopularity of U.S. foreign policy (Tomkins 2003).

In January 2004, a group of business executives formed a group called Business for Diplomatic Action (BDA), designed to mobilize the U.S. business community to address rising anti-Americanism. Since then, BDA, whose motto is "Anti-Americanism is bad for business," has been quite active in emphasizing to American companies how foreign animosity could hurt businesses in the United States and in engaging their members to take action (Reinhard 2004). The picture presented by BDA is bleak: "The costs associated with rising anti-American sentiment are exponential. From security and economic costs to an erosion in our ability to engender trust around the world and recruit the best and brightest, the U.S. stands to lose its competitive edge if steps are not made toward reversing the negativity associated with America."[8]

Assessing the economic consequences of political tensions. Over the past decade, transatlantic trade and investment has grown steadily, apparently unaffected by the political tensions that surrounded the launch of the Iraq war in 2003. In particular, U.S. trade and investment with France has grown at a comparable rate to other European countries. Consumer boycotts on both sides of the Atlantic lacked impact. At the aggregate level, the economic relationship between France and the United States is stronger than ever—whether measured in trade, investment, or foreign affiliate sales.

To probe the effect on trade flows, we conduct regression analysis that allows us to control for other factors that affect bilateral trade. Essentially, this analysis allows us to predict the amount of trade that would have occurred between the two countries irrespectively of their degree of political animosity. We can then examine whether the period where that animosity was most acute leads to any significant deviations from regression predictions. As in the analysis of events data, we apply a gravity model specification using OLS to estimate bilateral U.S. trade flows with quarterly data. Whereas the events data ended in 2004, for this analysis we extend to cover the period from 1990 to 2006, which includes both a substantial period before the Iraq war spike of tensions and three years after a return to normal relations in 2004.

Table 2 presents the results for analysis of U.S. trade. First, in Models 1 and 4 we look at the time series of U.S.-France exports and imports (67 observations of quarterly data), using only the time-variant factors GDP and exchange rates as explanatory variables and an indicator variable for the period of political tensions. Next, in Models 2 and 5 for exports and imports, respectively, we examine U.S. trade with all trade partners. Finally, Models 3 and 6 include both country and time fixed effects while dropping variables that do not vary by country.

We measure political tensions as an interaction between the specific trade partner and the period of time in which political tensions were high. The variable *Iraqpt∗France* measures the period of high political tensions between France and the United States over the invasion decision beginning with the final quarter of 2002 and continuing through the end of 2003. In the cross-national sample, the *Iraqpt* interaction term for Spain and the United Kingdom provides a benchmark for comparison by looking at the same period of time with two other European countries that had low political tensions with the United States as members of the U.S. coalition in Iraq.

The first model for U.S. exports to France suggests a strong pattern of trade following the flag with a negative and significant coefficient for the Iraq political tensions variable.[9] Yet the hypothesis of politics first has implications for differentiation of trade among allies and adversaries, which calls for comparison with other countries. In the cross-national analysis of U.S. trade, we find that there was a negative but not statistically significant effect on U.S. exports to France and U.S. imports from France. The model tells us that when conditioning on country, time, and standard variables used to explain trade patterns, trade with France was no different during the period of political tensions than if there had not been political tensions. More surprising is the finding of a significant and large negative effect for U.S. exports to Spain and the United Kingdom respectively during this same period.[10] A significant negative effect on U.S.-France trade in the cross-national sample appears when we measure tensions as the quarter after the U.S. invasion (not shown). But again, U.S. exports with allies in the Coalition of the Willing experienced a *larger* decline. Although we hesitate to put any causal interpretation to these results, the analysis shows that there was no substantively important

[8]http://www.businessfordiplomaticaction.org (accessed December 16, 2008).

[9]Michaels and Zhi (2010) also find deterioration of relations between the United States and France reduced bilateral trade. They estimate the effect of crisis as change of trade shares after 2002, whereas we assess the rise and fall of tensions impact on trade levels.

[10]In Model 2, the −0.054 coefficient for Iraqpt ∗ France and −0.118 coefficient for Iraqpt ∗ UK indicates that the period of tensions corresponds to a 5% decrease of exports to France relative to an 11% decline of exports to the United Kingdom.

TABLE 2 Iraq War Tensions in Gravity Model Estimation of U.S. Trade, 1990–2006

	EXPORTS						IMPORTS					
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
Variable	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
France			−0.169	0.235					−0.342	0.213		
Iraqpt ∗ France	**−0.153**	**0.0460**	−0.054	0.059	−0.085	0.067	−0.065	0.033	0.049	0.073	−0.042	0.047
Spain			**−0.420**	**0.205**					**−0.953**	**0.200**		
Iraqpt ∗ Spain			**−0.271**	**0.107**	**−0.150**	**0.062**			−0.043	0.121	−0.051	0.052
UK			**−0.596**	**0.237**					**−0.918**	**0.335**		
Iraqpt ∗ UK			**−0.118**	**0.048**	−0.087	0.048			−0.069	0.064	−0.061	0.041
Distance			**−1.069**	**0.214**					**−0.727**	**0.211**		
GDP	0.007	0.1011	**0.895**	**0.042**	**0.163**	**0.028**	0.333	0.179	**1.044**	**0.052**	**0.262**	**0.035**
Landlocked			**−0.455**	**0.177**					−0.503	0.281		
Island			0.230	0.171					0.263	0.236		
Exchange rate	**−0.144**	**0.0430**	**−0.070**	**0.034**	**−0.034**	**0.009**	**−0.268**	**0.080**	−0.012	0.040	−0.019	0.012
GATT/WTO			0.253	0.208	**0.094**	**0.032**			0.487	0.290	**0.236**	**0.049**
PTA			0.597	0.346	0.048	0.036			**0.769**	**0.237**	**0.499**	**0.110**
Alliance			0.354	0.189	**0.218**	**0.031**			0.014	0.173	**0.076**	**0.034**
Common language			**0.757**	**0.167**					**0.721**	**0.219**		
Constant	**8.392**	**3.1008**	**−9.512**	**1.875**	0.389	0.724	−1.048	5.496	**−16.583**	**2.064**	**−2.122**	**0.914**
Fixed effects			Quarter		Quarter and country				Quarter		Quarter and country	
Adj. R-squared			0.824		0.953				0.764		0.938	
N	67		9487		9487		67		9295		9295	

Note: The unit of analysis is a directed dyad with the United States and its trade partner for a quarter time period, and the dependent variable is the natural log of U.S. exports to the trade partner (measured in 2000 U.S. dollars). Models 1 and 4 present the time series for U.S.-France trade with Newey-West standard errors to adjust for autocorrelation up to a four-period lag. Other models include the full sample of U.S. trade partners. Models 2 and 5 include quarter fixed effects and show robust standard errors clustered by trade partner. Models 3 and 6 include both quarter and country fixed effects (not shown). Coefficients in bold type are significant at the 5% level.

differential effect on trade from the heightened political tensions in a standard regression model of trade.

We also examined industries more likely to be subject to consumer boycott effects due to their association with national origin and substitutability. Using annual industry data (5-digit SITC), we tested the same model on U.S. imports of five luxury products associated with France: blue cheese, champagne, wine, leather handbags, and perfume. None of these products experienced a decline of imports from France during 2003 to 2004 relative to the previous two years. In regression analysis (see Supporting Information), the interaction term for U.S.-France trade during the year of peak tensions (2003) is not significant except for the positive coefficients for wine and leather handbags, for which France experienced robust sales in the United States. Even in these high-salience industries, we are unable to find economic harm from political tensions.

Yet trade is just the tip of the iceberg of the Franco-American economic relationship. Franco-American economic interdependence is even stronger when measured through foreign direct investment. American companies provide about 580,000 direct jobs for French workers (Embassy of France in the United States 2007; Hamilton and Quinlan 2004, 164). There are at least 2,400 French subsidiaries in the United States providing more than 500,000 direct jobs. FDI figures show similar absence of pattern linking politics and economics. The largest percentage increase of U.S. FDI between 2003 and 2004 in Europe was in France (22%), where the United States ranked as the leading FDI source in 2005 (Koncz and Yorgason 2005).

Sales of high-profile American firms do not reveal negative impact from boycotts. In research on anti-Americanism, Peter Katzenstein and Robert Keohane compared revenues of major U.S.-based and Europe-based consumer products firms in Europe between 2000 and 2004 (Katzenstein and Keohane 2006). These firms include four American firms often mentioned as potential targets of anti-American boycotts (Coca-Cola, Pepsi, McDonald's, and Nike) and three European competitors (Adidas-Salomon, Cadbury-Schweppes, and Nestlé). If anti-Americanism had a significant impact on sales, one should find U.S.-based firms' sales falling in 2003–2004, when anti-American views rose sharply in Europe, compared to 2000–2001, when the United States was still very popular there. Yet Katzenstein and Keohane find that all four American firms increased the *share* of their revenues in Europe in 2003–2004. Indeed, the average sales gain for the four American firms was about 44%, compared to 24% for the three European firms. McDonald's has been performing particularly well over the past five years in France, which is the world's second most profitable market for McDonald's after the United States (Meunier 2006). Whether in aggregate terms or at the level of individual firms, it has been "business as usual" in the Franco-American economic relationship.

Sino-Japanese Rift over Yasukuni Shrine Visits

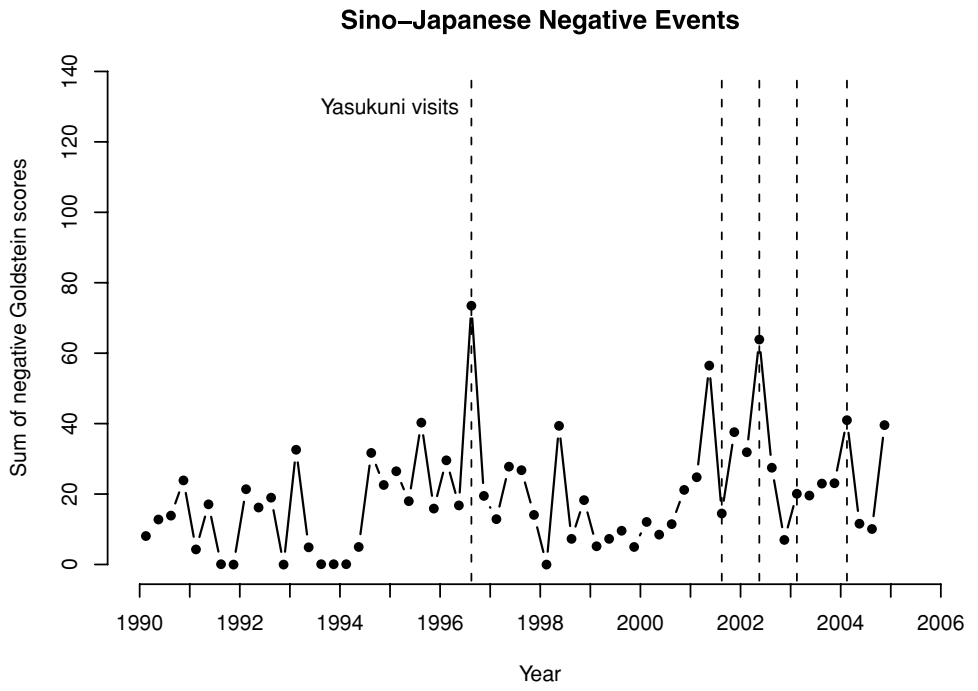
Observing political tensions. In July 1996, Japanese Prime Minister Ryūtarō Hashimoto caused outrage in China when he visited Yasukuni shrine, which is dedicated to the spirits of Japan's war dead, including those executed as war criminals. He announced he would not make another visit during his term as prime minister in order to avoid harming diplomatic relations. During his five years in office from April 2001 until September 2006, another prime minister, Junichirō Koizumi, made it his stated policy to visit Yasukuni shrine every year. Each visit sparked tensions in Sino-Japanese relations. The visits were provocative in light of China's experience as a victim of Japan's wartime aggression. Disagreements over territorial claims to islands near major energy resources and broader concerns about rivalry in East Asia also underlie tensions between the countries. This five-year period of the Koizumi administration was marked by worsening public opinion about the bilateral relationship on both sides and repeated calls in China for boycotts of Japanese products.

Figure 2 shows the trend of negative events between Japan and China from 1990 to 2004. The quarterly time periods with visits to Yasukuni shrine by a prime minister have an average negative score of 43, which is more than double the average score of 19 for the entire period. The visit by Hashimoto in 1996 corresponds with the highest recorded negative events with a score of 74, and the Koizumi administration was marked by higher negative scores than other periods (mean score of 26 relative to mean score of 17 for the prior decade).

Public opinion surveys show the increase of political tensions. In China, the percent of urban Chinese residents who disliked Japan rose from 46% in the year 2000 to 59% in 2005.[11] Data measuring Chinese feelings of amity on a scale of 1–100 (higher values indicate more positive feelings) show that Chinese amity toward Japan dropped from neutral levels of 50 in 1998 during the first year of the survey to a low of 30 in 2004 (Johnston and

[11] Public Survey on Chinese Views Toward Japan, 2000 and 2005, available at www.comrc.cn.

FIGURE 2 Event Count Measure of Political Tensions between Japan and China



Quarterly time-series plot of Goldstein-scaled negative events between Japan and China from 1990 to 2004.

Stockmann 2007).[12] Similar deterioration of public opinion is found on the Japanese side, where the percent of Japanese who did not feel close to China rose from 47% in the year 2000 to 58% in 2004 (Cabinet Office 2004).[13] Japanese evaluations of the direction of Japan-China relations turned negative for the first time in 2004, with a jump from 43% believing relations were going in a negative direction in 2003 to 61% holding such pessimistic views in 2004. Tension at the level of the government was evident from strong public statements by Chinese officials criticizing Koizumi for visiting the shrine and the refusal to meet with him for a formal summit meeting during the five years of his administration after the single summit held in October 2001 of his first year in office.

Expected economic effects of political tensions. After years of repeating the slogan that Sino-Japanese relations were "cold in politics" and "hot in economics," the media began warning that political problems had begun to cool economic relations. Chinese Minister of Commerce Bo Xilai warned that prolonged "disharmony in political relations" between Japan and China would damage bilateral trade and economic cooperation (Xinhua 2005). The Japanese media readily picked up on the reported warnings of potential economic harm (Asahi Shimbun September 6, 2006).

Anecdotes about actual incidents causing economic costs were widely reported. During April 2005, protesters rallying against Japan's bid to gain a permanent seat on the UN Security Council destroyed a Japanese retail store, Ito-Yokado, in Sichuan Province (The Daily Yomiuri 2005). Negative sentiment toward Japan in China was said to obstruct economic relations in even more subtle ways as Japanese firms were unpopular among Chinese job seekers and Chinese consumers reacted with more extreme responses to product defects by Japanese firms (Yū 2004). As foreign banks acquired Chinese financial institutions, analysts reported that Japanese banks were lagging behind because political problems made Chinese banks prefer other partners over Japanese banks (Ibison 2005).

Business leaders in Japan and China expressed fears of economic harm. In a survey sent to 100 executives of leading Japanese companies (95 responded), 51 expressed concerns that Sino-Japanese tensions would harm their business interests in China (The Japan Times 2005). Some Japanese business leaders urged the prime minister against visiting Yasukuni shrine. Kakutarō Kitashiro, the

[12]The authors thank Alastair Iain Johnston for sharing the survey data from the Beijing Area Study, an annual randomly sampled survey of Beijing residents.

[13]*Zenkoku yoron chōsa no genjō* (state of current national public opinion), Tokyo: Cabinet Office (2004, 16–17).

chairman of the Japan Association of Corporate Executives (*Keizai Dōyūkai*), said at a news conference, "Prime Minister Koizumi's visits to Yasukuni Shrine could spread negative views about Japan (in China) and cause adverse effects on Japanese companies' activities there," and the organization passed a resolution in May 2006 urging the prime minister to reconsider his policy of visiting the shrine (Asahi Shimbun May 10, 2006; The International Herald Tribune/Asahi Shimbun 2004). As Japanese business leaders watched European and American leaders actively engaging with China and encouraging business deals for their industries, many feared that the freeze on top leadership meetings between Japan and China would leave them excluded from new opportunities and slow down prospects for strengthened economic partnership agreements. Others began to express concerns about the risk of investment in China (Pilling 2005b). At the same time, Chinese businessmen warned that contracts for business projects with Japanese companies in China might be delayed (Cheung and Eng 2005). Some voiced fears that reluctance by Japanese firms to invest in China would reduce much-needed jobs and capital.

Assessing the economic consequences of political tensions. The economic relationship between Japan and China became increasingly interdependent over the same period that political relations worsened. Japanese trade with China has grown steadily. Many factors contribute to this trend—in particular, China's accession to the WTO in December 2001, which was accompanied by liberalization that created new market access opportunities. In 2004, China replaced the United States as Japan's biggest trading partner as total trade with China (including Hong Kong) reached $213 billion relative to $197 billion trade with the United States (Pilling 2005a).

Statistical analysis shows that Japanese exports to China are more than would be predicted by the standard variables that determine trade. Parallel to the analysis of U.S. trade discussed above, we conducted regression analysis of Japanese exports using variables from the gravity model specification and quarterly data from 1990 to 2006. We focus on Japan's exports rather than imports because the boycott calls were one-sided in nature, arising from Chinese public and private condemnation of Japanese government actions, in contrast to the two-sided condemnation that occurred in the U.S.-France dispute. In Table 3, Models 1 and 4 examine the time series of Japan-China trade, while other models include the cross-national sample.[14] Two variables measure political tensions. First, we include a variable to measure the effect of the Koizumi administration, October 2001 to August 2006, on Japan's exports to China. The change of administration improved Sino-Japanese relations as Koizumi's successor, Shinzo Abe, refrained from making public visits to the shrine and top-level summits resumed. Second, we include a variable to measure whether there is any effect on trade between Japan and China during the quarter after a prime minister visits Yasukuni shrine. The fixed effect of Japan-China trade is captured in the China coefficient, while the interaction term measures the effect on Japan's trade with China from the period of political tensions. We find no statistically significant difference in Japan-China trade patterns during either the Koizumi administration or during the quarters after Yasukuni visits when controlling for country, time, and standard variables used to explain trade flows. Using the same models for separate regression analysis of trade flows by industry, we also find that high-salience Japanese exports such as cars, beer, and cameras did not suffer negative impact from the Koizumi administration—to the contrary, there is a positive and significant coefficient for Japanese auto exports (see Supporting Information). Where Chinese consumers could most readily target Japanese goods, we cannot detect any boycott effect.

Direct foreign investment represents a substantial component of the Japan-China economic relationship. After the United States, China is the largest destination for Japanese FDI. During the period of the Koizumi administration when political relations were at their worst, China was taking a growing share of Japan's FDI. In 2001, Japanese FDI to China was 3.3% of total FDI, and by 2006 it had doubled to 6.7%, while over the same years FDI to the United States declined from 46.7% total FDI to a 34.8% share (Japan China Business Guide 2008). For China, Japan has for many years been the largest source of FDI inflows. We are not suggesting that political tensions perversely increase investment, but rather that tensions did not prevent other factors that contributed to Japan's booming bilateral investment relationship with China during this period.

Clearly the aggregate trends indicate that Sino-Japanese economic relations were deepening even as political relations worsened. Next we look at whether Toyota suffered from anti-Japanese sentiment as the flagship company for Japan's export industry that competes with other multinationals deeply engaged in trade and investment with China. Toyota's vehicle sales to China rose from

[14]Models 1 and 4 for the Japan-China time series estimate Newey-West standard errors to take into account autocorrelation up to a four-period lag. Models 2 and 5 for the cross-national sample estimate robust standard errors clustered on trade partner and include quarter fixed effects. Models 3 and 6 estimate country fixed effects.

TABLE 3 Koizumi Administration and Yasukuni Shrine Visit Tensions in Gravity Model Estimation of Japanese Exports, 1990–2006

	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
Variable	**Coef.**	**Std. Err.**	**Coef.**	**Std. Err.**	**Coef.**	**Std. Err.**	**Coef.**	**Std. Err.**	**Coef.**	**Std. Err.**	**Coef.**	**Std. Err.**
China			0.624	0.322					**0.694**	**0.314**		
Koizumi	**0.396**	**0.103**	0.219	0.201	**0.571**	**0.083**						
Yasukuni							**0.187**	**0.069**	0.097	0.125	**0.356**	**0.092**
Distance			**−0.889**	**0.228**					**−0.887**	**0.229**		
GDP	**1.180**	**0.181**	**0.943**	**0.040**	**0.268**	**0.035**	**1.537**	**0.142**	**0.944**	**0.040**	**0.264**	**0.035**
Landlocked			**−0.739**	**0.230**					**−0.745**	**0.231**		
Island			**0.840**	**0.202**					**0.844**	**0.202**		
Exchange rate	0.239	3.462	0.065	0.101	**−0.157**	**0.025**	−5.383	3.481	0.067	0.100	**−0.160**	**0.024**
GATT/WTO			**0.544**	**0.226**	**0.348**	**0.044**			**0.553**	**0.225**	**0.374**	**0.044**
PTA			**2.218**	**0.624**	**−0.144**	**0.053**			**2.215**	**0.625**	**−0.152**	**0.053**
Alliance (U.S.)			**0.889**	**0.231**					**0.883**	**0.233**		
Constant	**−25.704**	**5.041**	**−13.286**	**2.751**	**−2.844**	**0.867**	**−35.609**	**3.932**	**−13.349**	**2.766**	**−2.767**	**0.867**
Fixed effects			Quarter		Quarter and country				Quarter		Quarter and country	
Adj. R-squared			0.788		0.951				0.787		0.952	
N	67		9419		9419		66		9286		9286	

Note: The unit of analysis is a directed dyad with Japan and its trade partner for a quarter time period. Political tensions are measured by indicators for Koizumi administration period (Models 1–3) and quarter after Yasukuni shrine visit (Models 4–6). Models 1 and 4 are the time series for Japan-China trade and estimate Newey-West standard errors to adjust for autocorrelation up to a four-period lag. Other models include the full sample of all Japanese trade partners in cross-section time-series analysis. Models 2 and 5 include quarter period effects and estimate robust standard errors clustered by trade partner. Models 3 and 6 add country fixed effects. Coefficients in bold type are significant at the 5% level.

a mere 13,400 in 2001 to 183,500 in 2005, which represents a higher growth rate than its sales in the United States or other large developing country markets like Brazil and India. In China, Toyota's sales outpaced the two leading major foreign automakers GM and Volkswagen, as well as the average growth in total vehicle consumption in the Chinese market (Cooney 2006).

Interviews and surveys about business plans also do not show evidence of a strong reaction to worsening relations. A representative from the Japanese business organization *Keidanren* noted that while shrine visits may be followed by sudden cancellation of business meetings or an increase in the price on the table for a contract negotiation, in the long term, contracts were not cancelled.[15] An official of a Japanese financial investment firm heavily involved in business with China said China's boycott calls were famous for having no effect.[16] The number of firms said to consider downsizing or withdrawal of business remained at a low 4% one month after the April 2005 anti-Japanese riots in China (JETRO 2005). Trade and investment between Japan and China have been growing at such a rapid pace that political problems have at most been a cautious wind cooling optimism.

Why a Firewall between Political Tensions and Economic Exchange?

The central finding that there has been no substantial economic fallout from political tensions challenges the realist hypothesis about the primacy of politics and the liberal hypothesis about the mobilization of economic actors. We revisit these hypotheses and explain why high levels of mutual economic interdependence discourage both governments and business actors from letting politics interfere with economics.

The "politics first" hypothesis suggests that states should direct economic flows toward states with whom they share closer political relations, and businesses should shift their exchanges to "safer" countries. The evidence from our case studies shows quite the opposite, however, with economic interdependence increasing parallel to worsening political relations. One explanation would be that the studies predicting "politics first" emphasize long-term structural changes such as alliance shifts and conflict escalation. In our cases, expectations that there would not be a major disruption of political relations may have moderated the response of economic actors. In other words, tensions between France and the United States and between Japan and China were not high enough to trigger a shift in expectations. As shown by Copeland, expectations of future trends condition how actors view interdependence (Copeland 1996). Indeed, the United States and France remained committed partners in NATO. Japan and China were not contemplating imminent war. When governments chose not to intervene in economic activities, this in itself signaled to private actors that political tensions would not further escalate.

However, one should not dismiss the seriousness of both episodes of tension. Some perceived the Franco-American split over Iraq as shaking the foundations of the Atlantic alliance. Certainly relations between Japan and China were tense over both symbolic issues related to history and territorial disputes (Calder 2006). At a news conference in December 2005, Japanese foreign minister Tarō Asō said China was "becoming a considerable threat" (Onishi 2005). The intensity of animosity in both cases should not be minimized. The post–Cold War era risks are identified by Mastanduno as supporting use of economic statecraft, but we observe little evidence of such activity (Mastanduno 1998). Our findings suggest that it requires a very high threshold of political conflict to trigger "politics first" behavior.

The "economics first" hypothesis claims lobbying restrains political squabbles before they cause serious economic damage. Yet when we examine the level of business lobbying, it appears to have been neither substantial nor effective. In the United States, Business for Diplomatic Action (BDA) was formed with fanfare to combat the perceived deleterious effects of anti-Americanism on business. But their mandate was never to lobby the administration in order to shift the course of American foreign policy, and they never tried to do so. In France, some business groups (mostly in the wine and luxury goods industry) complained in early 2003 about the potential economic fallout of President Chirac's hard stance against the United States, but this did not seem to change the course of French foreign policy either.[17] In Japan, some businessmen voiced concerns, but the major business organization, *Keidanren*, was notably circumspect about directly approaching the issue.[18] Since economic flows were largely unimpeded, the business lobbying that would operate as the mechanism for a commercial peace restraint did not take place (He 2008). Neither does it

[15] Interview by author, December 21, 2005, Tokyo, Japan.

[16] Interview by author, August 22, 2006, Tokyo, Japan.

[17] Interview by author, French Embassy, Washington, DC, November 2006.

[18] Chairman Fujio Mitarai said that the issue of Yasukuni visits was a matter for politicians (*Yomiuri Shimbun* July 29, 2006). Keidanren chose not to take any formal position. Keidanren official, interview by author, December 21, 2005, Tokyo, Japan.

appear that those who lobbied wielded any influence. Defiant to the end, in his last month as prime minister, Koizumi visited the shrine on August 15, 2006, on the anniversary of the end of WWII, which was perceived as the most controversial timing for a visit.

In both the Franco-American and the Sino-Japanese cases, governments were unwilling to intervene because they valued ongoing economic ties and trade rules that prohibit arbitrary discrimination against the imports or investment of one country. Boycotts remained unofficial and government-led sanctions were not imposed. For example, after three weeks of anti-Japan protests and boycott calls in April 2005, the Chinese Commerce Minister warned citizens not to harm economic development and stated, "We don't expect the economic and trade relations between the two countries to be infringed upon" (Yardley 2005, 3). A stronger state role in the economy facilitates manipulation of economic policies, and conventional wisdom would suggest that the Chinese communist regime would have the most tools to intervene in ways that would impose economic costs on Japanese business (Naoi 2007; Shirk 1994). Finding no intervention in the Japan-China case is a strong test, although it is consistent with Etel Solingen's findings that regime type does not determine economic liberalization or protectionism (Solingen 1998, 113). Nonetheless, procurement and regulatory policies may be areas where political conflict leads to policy discrimination.

The cases also show that businesses on both sides saw the market as too great to sacrifice. In Japan, Toyota officials say they expect China to become the biggest auto market (O'Neill 2005). The head of a major Japanese private equity firm operating in China said in December 2005, "We are not necessarily optimistic about our China investments, but we would never exclude China from our portfolio" (Abdelal and Lane 2006, 15). On the Chinese side, only a small number of retailers took actions to support the boycott, citing that with complex distribution channels they were importing through mainland suppliers rather than directly from Japan (Li 2005). Consumers were also reluctant to give up their preferred product choice in the name of a boycott. For example, a 2005 survey of Chinese public views showed Sony far behind other foreign companies in a question about favorite companies, but when those who planned to purchase a digital camera were asked what brand they would purchase, 26% chose Sony, which was the highest among all options given (Searchina Research Center 2005).

Transnationality of commercial and financial flows creates mixed interests and identities that reduce the response to political tensions. Firms are not expected to discriminate against their own parent/subsidiary firm. Consumers may also be unable to differentiate foreign-origin products, as local production, reduces the "foreignness" of global companies. Foreign affiliate sales are the backbone of the transatlantic economy. From 2003 to 2007, 42.5% of all U.S. imports and exports to France was related party trade, which approximates intrafirm cross-border trade.[19] The complex regional production networks of Japanese firms in East Asia are characterized by mutual supply of intermediate goods to the point where the national identity in final production is lost and nearly one-fourth of trade flows represents sales to foreign affiliates (Kazuyuki 2002). Japanese FDI in China has been largely focused on serving the Japanese domestic market and global markets, with exports from Japanese multinationals boosting China's overall exports (Xing 2006).

Conclusion

This article asked whether economic ties are insulated from political discord. We found the threshold for such spillover to be very high. Statistical analysis showed that variation in the number of negative events did not change bilateral economic exchange for the United States or Japan in their relations with 152 states. In Franco-American and Sino-Japanese case studies, there was little short-term economic impact of political tensions. Our findings challenge both sides of the debate on economic interdependence and cooperation. While studies have pointed to evidence that trade follows the flag and that interdependence constrains conflict, more research is necessary to specify the causal mechanisms and conditions under which the relationship holds. How much latitude do states have to direct economic flows in this era of globalization? None of the governments involved in the political feuds we examine exerted a concerted effort to interfere with economic exchange. In a period of liberalized economies and multinational companies, governments find it difficult to dictate economic outcomes according to political interests and face greater penalties for doing so. Market actors appeared unfazed by political tensions. Sunk costs in existing economic relationships inhibit firms from switching purchase and investment plans, while consumers remain stuck in their habitual buying patterns.

Given the evidence from our cases that political tensions short of war do not produce economic harm, the business lobbying for improved political relations expected by commercial peace theories may not take place.

[19]U.S. Census Bureau 2008. Related Party Trade sums U.S. imports/exports with France in which U.S. firm holds at least a 6% (10% for exports) equity interest in the French firm.

If severe crisis with high certainty of militarized conflict is the necessary trigger, one must question whether at such a late stage economic interests would be able to pull countries back from the brink of war. Economic interdependence may be unable to prevent conflict as hypothesized by current literature on commercial peace. Nonetheless, the resilience of economic interdependence to political crises creates a buffer zone of normal business interactions that dilute the harm from political tensions.

The customary image of globalization portrays constant flows of information with heightened volatility as actors react to every bit of news or shift in perceptions (Friedman 2005). On the contrary, we find that there are some dimensions on which globalization induces stickiness. Political feuds are contained because sunk costs are sufficient to deter linking economic decisions to the status of political relations. In an era of globalization, economic relations withstand a wide range of gloomy news about political tensions between countries.

These findings notwithstanding, political tensions still have the potential to harm economic relations in a globalized world. Future research should explore the threshold at which tensions begin to harm economic relations. The duration or frequency of political conflict may be important if longer or repeated periods of tension induce indirect effects such as the decline of brand prestige. It is also important to consider different policy dimensions through which governments may influence economic outcomes, most notably public procurement which might be more susceptible to the bilateral political climate. In the cases studied here, however, it was "business as usual" despite political disputes between leaders, boycott calls, and media hype.

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Supporting Information

Additional Supporting Information may be found in the online version of this article:

Table 1: Gravity Model of U.S. Bilateral Imports of High Salience Products, 1990-06.
Table 2: Gravity Model of Japanese Exports of High Salience Products, 1990-06.

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