



Bilateral trade and shocks in political relations: Evidence from China and some of its major trading partners, 1990–2013[☆]



Yingxin Du^a, Jiandong Ju^{b,c}, Carlos D. Ramirez^{d,*}, Xi Yao^e

^a China Institute for WTO Studies, University of International Business and Economics, Beijing 100029, China

^b PBC School of Finance, Tsinghua University, China

^c School of International Business Administration, Shanghai University of Finance and Economics, Shanghai, China

^d Department of Economics, George Mason University, Fairfax, VA, United States

^e Guanghua School of Management, Peking University, Beijing, China

ARTICLE INFO

Article history:

Received 17 December 2014

Received in revised form 30 June 2017

Accepted 3 July 2017

Available online 08 July 2017

JEL classification:

F14

F51

Keywords:

Political relations

Bilateral trade

China

Temporal aggregation bias

ABSTRACT

An extensive number of studies investigate the effects of political relations on trade by estimating a gravity model using annual (or quarterly) data. We argue that the use of low-frequency data introduces an aggregation bias because the cycle of moderate political shocks is much shorter (measured in weeks). Using monthly data from 1990 through 2013 for China, we estimate a model of political relations and conclude that political shocks are short-lived. Narrative evidence from two case studies illustrates the transitory nature of these shocks. A VAR model shows that although political shocks influence exports to China, the effects largely vanish within two months. A comparison of the monthly- and annual-frequency gravity equation regressions illustrates the effects of temporal aggregation.

© 2017 Elsevier B.V. All rights reserved.

1. Introduction

The extent to which political relations between nations affect trade has been the topic of a significant amount of research not just in economics but also in political science, especially international relations. Many empirical studies find that political relations, and more specifically deterioration in political relations, significantly affect bilateral trade in a variety of contexts. For example, Long (2008), Hegre et al. (2010), and Morrow (1999) observe that bilateral trade is adversely affected in the presence of military conflicts. Simmons (2005) indicates that disputes over territories likewise tend to reduce trade. And Pollins (1989a, 1989b) finds that the existence of conflicting political objectives lessens bilateral trade. More recently, Che et al. (2015) find that the 1937–1945 Japanese invasion of China had a significant and protracted impact on cross-border trade and investment.

It is perhaps not overly surprising to observe that trade is negatively affected when political relations deteriorate enough that a military confrontation seems inevitable.¹ As Long (2008) points out, when a military conflict is imminent, rational market participants reduce risk by curtailing business transactions with the opposing state.

But most variability in political relations does not involve the extreme outcome of war. In most cases, relations fluctuate along a continuum that ranges from “friendly” to “normal” to “tense,” and occasionally “threatening” (Davis and Meunier, 2011; Yan et al., 2010). Disputes over territory and conflicting political objectives are examples of difficulties in political relations that fall short of war. Given that most of the time changes in political relations operate in the less extreme range, a number of papers have sought to investigate the extent to which political relations in this basically moderate range

[☆] We would like to thank the editor Robert Staiger and two anonymous referees for very valuable comments and suggestions. We also benefited from comments by Yi Lu, Meixin Guo, as well as seminar participants at Tsinghua, IWEP-CASS, UIBE and CUFE.

* Corresponding author.

E-mail addresses: yingxindu@uibe.edu.cn (Y. Du), jujd@sem.tsinghua.edu.cn (J. Ju), qramire2@gmu.edu (C.D. Ramirez), xiyao@pku.edu.cn (X. Yao).

¹ This effect has been empirically verified in numerous other studies. See, for example, Keshk et al. (2004), Goenner (2011), Glick and Taylor (2010), and Martin et al. (2008). There are a few papers, such as such as Morrow et al. (1998), which report an unstable or insignificant relationship between military conflict and trade. Morrow (1999) argues that those results are not necessarily inconsistent with the notion that military conflicts adversely affect trade if agents are rational and forward-looking. Other papers that do not find a consistent conflict-trade relationship are surveyed and thoroughly discussed in Hegre et al. (2010), as well as Long (2008).

also affect bilateral trade. Recent examples of papers in this category are Davis and Meunier (2011), Davis et al. (2014), and Fuchs and Klann (2013).²

The literature that investigates the effect on trade of less than extremely antagonistic political relations generally does so by estimating a traditional gravity model augmented by the inclusion of a metric that captures the strength of political relations between nations (correlation in UN votes, aggregated Goldstein-scaled events, etc.).³ The typical regression model in these papers involves the use of annual (or sometimes quarterly) data on bilateral trade, regressed on a series of variables such as output, exchange rates, etc., as well as the chosen measure of political relations. Inferences about the effect of politics on trade are then made on the basis of the statistical significance (or insignificance) of the political relations variable included in the model.

In this paper, we argue that the annual (or even quarterly) frequency of the data included in many of these models may lead to inappropriate inferences as to the extent and timing of the possible effect of political relations on bilateral trade. The problem stems from the fact that when variations in political relations move within the mild to moderate range, these political “shocks” tend to be relatively short-lived—coming and going in a matter of months, if not weeks. The data, however, are either aggregated or sampled at lower frequencies (for example, quarterly or annually). Thus, if the natural duration of political shocks is shorter than the frequency with which it is measured, a spurious causality may be imposed on the empirical relationship. In fact, it is quite likely that at the observed frequencies, researchers detect an “instantaneous causality”—a contemporaneous correlation between the dependent variable (in the context of this paper, trade) and an independent variable (in this paper, a measure of political relations)—when none exists at the natural frequency. In the time series literature, this type of spurious causality is known as the “temporal aggregation” or sampling bias (Granger, 1966, 1969; Marcellino, 1999; Wei, 1982; Breitung and Swanson, 2002; Taylor, 2001; etc.).

There are sound theoretical reasons for arguing that the duration of mild to moderate political shocks and its effects on trade are indeed short-lived phenomena. The dynamics between trade and political relations among dyads can be described in the context of an infinitely repeated game. In this game-theoretic setting, a combination of healthy trade and peaceful political relations can be identified as the “Pareto perfection” equilibrium (such that players will not have the incentive to deviate in any subgame of the equilibrium) (Bernheim et al., 1987; Fudenberg and Tirole, 1991; Farrell and Maskin, 1989).⁴ When a political shock takes place, thereby threatening the Pareto-dominating equilibrium, players will have an incentive to settle any dispute and restore the superior allocation outcome. In this context, political shocks can be seen as “accidental” deviations from the equilibrium that are rapidly resolved through diplomatic exchanges.⁵

² These references are by no means exhaustive. Other recent work includes Fisman et al. (2014), Berger et al. (2013), Mityakov et al. (2013), and Heilmann (2016).

³ Goldstein scores are weights ranging from -10 to 10 that are applied to reports of international events obtained from news outlets and classified into WEIS (World Events Interaction Survey) types. Negative weights are associated with conflict, while positive ones with cooperation. The more hostile the event is deemed to be, the more negative is the weight. Thus, for example, a weight of -10 is applied to military conflicts or assaults, while an event like halting a negotiation gets a weight of -3.8 . Positive weights are similarly classified, depending on the friendliness of the event. For more details see Goldstein (1992).

⁴ This theoretical construct has an empirical counterpart in the case of China. Since 1978, China has adopted a model of “taking economic development as the central task,” while pursuing “an independent foreign policy of peace, a path of peaceful development and a win-win strategy of opening up.” (Hu Jintao, “Speech at the Meeting Marking the 30th Anniversary of Reform and Opening Up,” 18 Dec. 2008, http://www.bjreview.com.cn/learning/txt/2009-04/27/content_192896.htm. Retrieved Dec. 20, 2016.)

⁵ The classic reference that analyzes the relationship between trade and political conflict within a microeconomic setting is Polachek (1980). His argument is based on the mutual dependence that trade generates. As mutual dependency rises, so does the cost of conflict. Trade, therefore, promotes peace. His model, however, is inherently static. We are unaware of a dynamic, game-theoretic version.

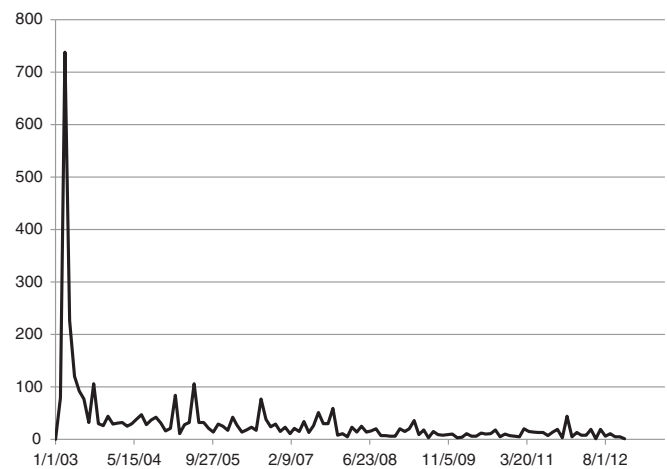


Fig. 1. “Freedom fries”: January 2003 through December 2012. Note: This figure displays the count of newspaper reports of the term “freedom fries” in all U.S. media outlets from January 2003 to December 2012.

Source: Factiva.

Casual observation also suggests that the natural cycle of such mild to moderate political dynamics among nations tends to be relatively short. Consider, for example, the rise in political tension between the United States and France at the time President George W. Bush was considering invading Iraq in 2002. As Davis and Meunier (2011) note, the peak of the Franco-American dispute was reached in March 2003, after France opposed the U.S. decision to invade Iraq. Tension escalated on both ends, and a great deal of it was reflected in media coverage. One direct result of the rise in political tension was the U.S. use of the phrase “freedom fries” in lieu of the more commonly used “French fries.” The rise and fall of the popularity of the term “freedom fries” is a useful proxy for the rise and fall of the Franco-American political tension directly associated with the Iraq invasion. Fig. 1 displays a monthly count of the number of articles in U.S. media that contain the term “freedom fries” from January 2003 through December 2012. As can be easily discerned, the use of “freedom fries” peaked in March 2003 and disappeared rather quickly—after just a month or two.^{6,7}

One natural way of correcting for the temporal or sampling bias discussed above is to use higher frequency data to test the hypothesis that political relations affect trade. Indeed, using such data to test the hypothesis in question is the primary aim of this study. To achieve this goal, we examine the experience of China with other major powers during the period 1990 to 2013.

There are several reasons for focusing on China. First, as is well known, China’s economic growth has averaged more than 8% annually over the last two decades. A sizable portion of this phenomenal growth rate is attributable to the high growth rate of exports. Consequently, the last two decades have seen increasing international involvement for China, particularly with other major powers.

Second, over the past two decades, China has experienced several political disputes with some of these same major powers. For example, the United States has repeatedly expressed its disapproval over how China deals with its own internal problems (Tibet, human rights, etc.). In China, such expressions of disapproval are typically met with dissatisfaction, resulting in a temporary worsening of political relations. In addition, many of China’s main trading partners occasionally make decisions that bring about some political discontent in China. For

⁶ Although the figure does display lingering effects, most of these articles can be classified as “noise.”

⁷ Other papers that investigate the impact of the Franco-American dispute over the Iraq War include Heilmann (2016), Pandya and Venkatesan (2016), and Michaels and Zhi (2010).

example, as Fuchs and Klann (2013) note, meetings of the Dalai Lama with high ranking government officials in other countries are generally met with disapproval in China since, from the Chinese perspective, such meetings indicate that a foreign state is meddling in China's internal affairs. Temporary disputes of this kind generate the variation necessary for successfully identifying the effects of political shocks on trade by using high frequency data.

A third reason for focusing on China is that one of that country's leading scholars of international relations, Yan Xuetong, has constructed a comprehensive dataset measuring China's political relations with other major powers—Australia, France, Germany, India, Japan, Pakistan, Russia, U.K, and U.S.—at a monthly frequency.⁸ This dataset permits our hypothesis to be empirically tested.⁹

Our main findings indicate that political shocks do affect exports, but the effects appear to be short-lived, dissipating after just a few months. Using a vector autoregression analysis, we find that, following a one-standard-deviation adverse shock to the political relations index, export growth to China (from the partner country) tends to deteriorate in the first month following the shock for about half of the sample, or in month two for the remaining half. After the third month, the effect is essentially nil. No long-term effects are detected.

We also compare gravity equation regressions estimated at both monthly and annual frequencies to get a better sense of the bias that temporal aggregation may engender. The monthly-based regressions indicate that political relations affect exports, but the effect is temporary—they typically start one month after the shock, and last about three months. By contrast, the annual-based regressions indicate that the effect of political shocks on exports is observed only on the contemporaneous (current) period (a consequence of temporal aggregation, as we argue below) and is much more persistent.

We complement our empirical tests by investigating the mechanisms that may explain how political shocks affect trade. To do so, we estimate a gravity model at the firm level using data from China's General Administration of Customs for the 2000 to 2006 period. Given our findings that the effects of political shocks last about three months, our gravity regressions are augmented by the inclusion of the political shocks averaged over month 0 to month 3. We find that State-Owned Enterprises (SOEs) display the highest sensitivity of imports to political relations. Imports mediated through privately-owned firms are also sensitive to political shocks, but the magnitude of the coefficient is substantially lower than the one observed for SOEs. Imports transacted through Sino-Foreign Ventures, or through Foreign-Owned enterprises display the lowest sensitivity. These results are consistent with the arguments and evidence from other studies for the case of China (Fisman et al., 2014; Davis et al., 2014; Lin et al., 2016).¹⁰

Overall, our findings validate the concern about the use of low frequency data for examining the effect of political shocks on trade in general. As we note above, temporal aggregation bias is an issue that merits careful attention in any examination of the extent to which political relations affect trade.

The rest of this paper is organized as follows. Section 2 provides an illustration of the temporal aggregation bias. Section 3 discusses in more detail Yan Xuetong's political relations index (measured at a monthly frequency) and derives a parsimonious ARIMA model to explain the index behavior over time. It also provides a brief analysis of the spectral distribution function, done to ascertain the relative importance of the high-frequency cycles in the series. Section 4 presents two case studies to illustrate the dynamics of political relations shocks in China. Section 5 lays out the empirical VAR model, while Section 6

discusses the main results. In Section 7 we compare estimates of the effect of political relations on exports from a gravity model with monthly data with the estimates obtained using annual data to get a clearer sense of the temporal aggregation difficulties discussed in previous sections. Section 8 offers some concluding remarks. Two appendices—one listing data sources, and another providing a temporal aggregation derivation—are provided at the end.¹¹

2. Consequences of temporal aggregation: an illustration

Generally speaking, temporal aggregation bias refers to inappropriate inferences about economic behavior stemming from the data collection and aggregation process. When the data are aggregated over a time interval that is larger than the duration of the actual decision-making being modeled a variety of difficulties are introduced in the empirical results. This section provides a brief, and undoubtedly incomplete, overview of this topic. Our purpose is not to do a comprehensive survey of the literature, but rather to illustrate the sort of complications that can arise with temporally aggregated data.¹²

Over the past four decades, researchers investigating this issue have identified the implications of temporal aggregation for structural estimation (Christiano et al., 1991), lag order specification (Telser, 1967; Amemiya and Wu, 1972; Tiao, 1972; Marcellino, 1999), causality (Sims, 1971; Wei, 1982; Lütkepohl, 1987; Breitung and Swanson, 2002), parameter identification (Telser, 1967; Thornton and Chambers, 2013); measurement of persistence (Rossana and Seater, 1995), forecasting (Lütkepohl, 1987), etc. Besides these difficulties, Rossana and Seater (1995) find that aggregation (or even averaging) modifies the time series properties of the data at every frequency, removing particular characteristics of the underlying series while simultaneously introducing others. In addition, Priestly (1981) notes that temporal aggregation generates an aliasing problem, since it is not possible to identify cycles that take place within the aggregated intervals. Thus, the general consensus is that the time series properties are not invariant or robust to temporal aggregation.

To understand one of the key consequences of temporal aggregation we provide a simple example. To that end, assume that export growth (x) and political shocks (y) form a bivariate, restricted VAR system that is generated at a monthly frequency by the following process:

$$\begin{aligned} x_m &= \alpha_0 + \alpha_1 x_{m-1} + \beta y_{m-1} + \varepsilon_m \\ y_m &= \gamma_0 + \gamma_1 y_{m-1} + \varphi x_{m-1} + \eta_m \end{aligned}$$

where subscript m denotes the month, and ε_m, η_m are mutually uncorrelated random disturbances with variance-covariance matrix Σ . For simplicity, we assume that both y and x are stationary. This model can be written in matrix form as follows:

$$\mathbf{z}_m = \mathbf{Bz}_{m-1} + \mathbf{u}_m \tag{1}$$

where $\mathbf{z}_{m-j} = (1 \ x_{m-j} \ y_{m-j})'$ $m, j = \{0, 1, \dots\}$

$$\mathbf{B} \equiv \begin{pmatrix} 1 & 0 & 0 \\ \alpha_0 & \alpha_1 & \beta \\ \gamma_0 & \varphi & \gamma_1 \end{pmatrix}$$

$$\mathbf{u}_m = (0 \ \varepsilon_m \ \eta_m)'$$

Model (1) follows a straightforward AR(1) process. Suppose that the researcher uses data aggregated at the annual level to estimate

⁸ These countries account for approximately 35% of China's total imports in 2013. Except for Pakistan, all are in the top 20 list of China's imports by country of origin. Source: <http://atlas.media.mit.edu/en/profile/country/chn/> (Retrieved: July 15, 2015.)

⁹ The data are available from Yan and Qi (2009) and Yan et al. (2010). The following section describes Yan's series in more detail.

¹⁰ The mechanisms section is included as an Online Supplementary Material in order to limit the number of tables and figures. See "Online Supplementary Material."

¹¹ All robustness checks and other supplementary regressions are included as Online Supplementary Material.

¹² For a more comprehensive overview see Marcellino (1999) and Silvestrini and Veredas (2008).

(1). In this case, the aggregation period, denoted by p , is 12 since the researcher employs yearly data to conduct the analysis. Let t denote the year. With this notation, the aggregation can be expressed as follows:

$$\mathbf{z}_{t-k} = \sum_{j=0}^{p-1} \mathbf{z}_{m-pk-j} = \left(\sum_{j=0}^{p-1} L^j \right) \mathbf{z}_{m-pk} = (\mathbf{I}-L^p)(\mathbf{I}-L)^{-1} \mathbf{z}_{m-pk} \quad (2)$$

$k = \{0, 1, \dots\}$

where L is the lag operator and \mathbf{I} is the (3×3) identity matrix. By lagging Eq. (1) back $p - 1$ periods, and substituting forward the last term of the period we can re-write (1) as:

$$\mathbf{z}_m = \mathbf{B}^p \mathbf{z}_{m-p} + \sum_{j=0}^{p-1} \mathbf{B}^j \mathbf{u}_{m-j} \quad (3)$$

The last term in (3) can be simplified further as follows:

$$\sum_{j=0}^{p-1} \mathbf{B}^j \mathbf{u}_{m-j} = \left(\sum_{j=0}^{p-1} \mathbf{B}^j L^j \right) \mathbf{u}_m = (\mathbf{I}-\mathbf{B}^p L^p)(\mathbf{I}-\mathbf{B}L)^{-1} \mathbf{u}_m \quad (4)$$

Hence, (3) becomes:

$$\mathbf{z}_m = \mathbf{B}^p \mathbf{z}_{m-p} + (\mathbf{I}-\mathbf{B}^p L^p)(\mathbf{I}-\mathbf{B}L)^{-1} \mathbf{u}_m \quad (5)$$

Multiply both sides of (5) by $(\mathbf{I}-L^p)(\mathbf{I}-L)^{-1}$ to obtain:

$$(\mathbf{I}-L^p)(\mathbf{I}-L)^{-1} \mathbf{z}_m = \mathbf{B}^p (\mathbf{I}-L^p)(\mathbf{I}-L)^{-1} \mathbf{z}_{m-p} + (\mathbf{I}-\mathbf{B}^p L^p)(\mathbf{I}-\mathbf{B}L)^{-1} (\mathbf{I}-L^p)(\mathbf{I}-L)^{-1} \mathbf{u}_m \quad (6)$$

We can then use (2) (for $k = 0$ and 1) to re-write (6) in its temporally aggregated form:

$$\mathbf{z}_t = \mathbf{B}^p \mathbf{z}_{t-1} + (\mathbf{I}-\mathbf{B}^p L^p)(\mathbf{I}-\mathbf{B}L)^{-1} (\mathbf{I}-L^p)(\mathbf{I}-L)^{-1} \mathbf{u}_m \quad (7)$$

A regression using annual data, $\mathbf{z}_t = \tilde{\mathbf{B}} \mathbf{z}_{t-1} + \tilde{\mathbf{u}}_t$, will produce inconsistent estimates of \mathbf{B}^p because, as (7) shows, the covariance between \mathbf{z}_{t-1} and the error term $\tilde{\mathbf{u}}_t$ will not be zero, as the resulting equation takes on a moving average structure of the monthly (and unobserved) white noise process.

This point can be articulated more clearly using a straightforward illustration. To that end, let $p = 3$. In this case, $\tilde{\mathbf{u}}_t$ becomes:

$$\begin{aligned} \tilde{\mathbf{u}}_t &= (\mathbf{I}-\mathbf{B}^3 L^3)(\mathbf{I}-\mathbf{B}L)^{-1} (\mathbf{I}-L^3)(\mathbf{I}-L)^{-1} \mathbf{u}_m \\ &= \mathbf{u}_m + (\mathbf{I} + \mathbf{B}) \mathbf{u}_{m-1} + (\mathbf{I} + \mathbf{B} + \mathbf{B}^2) \mathbf{u}_{m-2} + (\mathbf{B} + \mathbf{B}^2) \mathbf{u}_{m-3} \\ &\quad + \mathbf{B}^2 \mathbf{u}_{m-4} \end{aligned}$$

Note that \mathbf{z}_{t-1} can also be expressed as a moving average structure of \mathbf{u}_m using (1) and (2):

$$\begin{aligned} \mathbf{z}_{t-1} &= (\mathbf{I}-L^3)(\mathbf{I}-L)^{-1} \mathbf{z}_{m-3} = (\mathbf{I}-\mathbf{B}L)^{-1} (\mathbf{I}-L^3)(\mathbf{I}-L)^{-1} \mathbf{u}_{m-3} \\ &= \mathbf{u}_{m-3} + (\mathbf{I} + \mathbf{B}) \mathbf{u}_{m-4} + (\mathbf{I} + \mathbf{B} + \mathbf{B}^2) \mathbf{u}_{m-5} \\ &\quad + \dots + (\mathbf{B}^{i-2} + \mathbf{B}^{i-1} + \mathbf{B}^i) \mathbf{u}_{m-i-3} + \dots \end{aligned}$$

Hence, the covariance between \mathbf{z}_{t-1} and $\tilde{\mathbf{u}}_t$ in this case is:

$$\begin{aligned} \text{cov}(\mathbf{z}_{t-1}, \tilde{\mathbf{u}}_t) &= (\mathbf{B} + \mathbf{B}^2) \text{var}(\mathbf{u}_{m-3}) + \mathbf{B}^2 (\mathbf{I} + \mathbf{B}) \text{var}(\mathbf{u}_{m-4}) \\ &= (\mathbf{B} + \mathbf{B}^2 + \mathbf{B}^3) \Sigma \end{aligned}$$

As noted above, an additional complication that arises with temporal aggregation is the aliasing problem, which makes it impossible for the

researcher to detect the presence of higher frequency cycles within the aggregated intervals (Priestly, 1981; Rossana and Seater, 1995).

3. Measuring the dynamics of China's political relations

The political relations index (PRI) developed by Yan Xuetong and colleagues (Yan and Qi, 2009; Yan et al., 2010) is based on reports of bilateral political events from the Chinese newspaper *Renmin Ribao* (People's Daily), as well as information from the Ministry of Foreign Affairs of the People's Republic of China. The index measures the overall level of relations between China and nine major countries (Australia, France, Germany, India, Japan, Pakistan, Russia, U.K, and U.S.) from 1950 through 2013. The political events identified in the newspaper reports and in the information from the ministry include military conflicts, protests against the foreign country, diplomatic events, etc., and they are weighted by severity (similar to the Goldstein scale, which is widely used in political science research). The reports are amassed monthly. The coding process involves converting events related to the political relations between China and the foreign country into a uniform scale bounded above by 9, the highest degree of friendship, and below by -9 , the most severe degree of confrontation. Although the index takes on a continuous variable in the $[-9.9]$ range, it can be represented as a diagram (see Fig. 2) encompassing various categories in the political relations spectrum.¹³

The most straightforward way of modeling the PRI series is to use the Box and Jenkins (1976) methodology of model identification and selection. This methodology involves testing for stationarity, as well as the use of autocorrelation and partial autocorrelation plots to identify a parsimonious autoregressive component and a moving average component of the underlying process. Formally, it is assumed that the stochastic generating process takes the following form:

$$\phi(L^p) \Delta^d \text{PRI}_t = \theta(L^q) \varepsilon_t \quad (8)$$

where underlying PRI_t series are differenced d times ($d \geq 0$) to achieve stationarity, and the $\phi(L)$ and $\theta(L)$ are lag polynomials of degrees p and q respectively. The outcome of this modeling methodology delivers a parsimonious ARIMA (p,d,q) process that best explains the time series behavior of the modeled series.

Standard Dicky-Fuller, as well as augmented Dicky-Fuller tests, reveals that the PRI series are non-stationary in levels, but the first differences are stationary. For that reason, the original series are differenced once, before optimal p and q parameters are identified for each China-foreign country dyad.

The PRI_t series is designed to capture all events that relate to political relationships between China and other major countries. These events inevitably include those related to trade. For example, the signing of a trade pact or a trade agreement can be categorized as an improvement in political relations, thereby leading to an increase in the PRI series. Although it is important to quantify the extent to which events with a relationship to trade ultimately affect trade, it is equally important to investigate the extent to which non-trade-related political shocks also influence trade.

To that end, we construct the "Trade-filtered PRI" series, which removes all trade-related events from the original PRI measure. Formally, "Trade-filtered PRI" consists of the residuals from the following regression:

$$\text{PRI}_{i,t} = \alpha_0 + \alpha_1 (\text{Trade_News_Index}_{i,t}) + \varepsilon_{i,t}$$

¹³ Some scholars have criticized the construction and interpretation of the Yan and Qi (2009) and Yan et al. (2010) index. For example Johnston (2011, 15) notes that when events are being coded, preceding events are used to quantify the weights. This may introduce autocorrelation in the constructed series. Of course, such features of the series can be modeled in an ARIMA process.



Fig. 2. Range of categories in the political relations spectrum. Note: This diagram lists the complete range of the political relations index between China and other major powers as developed by Yan et al. (2009), Yan et al. (2010). The index ranges from -9 , which represents the relationship characterized by the most severe rivalry, to $+9$, which represents the friendliest level of political relations.

where the “Trade_News_Index” tracks all trade-related news that involves China and partner country i , reported in month t . Formally, the index is constructed as follows:

$$\text{Trade_News_Index}_{i,t} = \frac{\# \text{Trade_News}_{i,t}}{\# \text{Morning}_t}$$

In the equation above, the numerator, $\# \text{Trade_News}_{i,t}$, is the count in month t of all articles that contain the following three keywords: “trade,” “China,” and “[partner country i],” where [partner country i] = {Australia, France, Germany, India, Japan, Pakistan, Russia, UK, and U.S.}. The denominator, $\# \text{Morning}_t$, is the count of all articles in month t that contain the keyword “morning.”¹⁴ This deflator is included in order to normalize for all nominal effects (media coverage volume, seasonal cycles, etc.). In a sense, the deflator is the equivalent of normalizing trade volume by an aggregate variable, such as GDP.

As noted, the main objective of the constructed Trade News Index is to track trade-related news about the relationship between China and the nine major countries listed above. Hence, among U.S. media outlets that give ample coverage of international news and events, we selected the three most important: the *New York Times* (printed and online versions), the *Wall Street Journal* (printed and online versions), and the *Washington Post* (printed and online versions).¹⁵ These three newspapers are among the top 10 in terms of circulation in the U.S.¹⁶

We use the “Trade-filtered PRI” series as our measure of non-trade-related political relations. To study the trade-filtered index dynamics, we apply the Box-Jenkins methodology to this variable as well.

The results of the Box-Jenkins methodology are presented in Table 1. The first column reports the results for the PRI series, while the second column reports the results for the “Trade-filtered PRI” series. The results indicate that the PRI series follow an ARIMA (0,1,0) process for all countries—that is, the autoregressive and moving average components are 0 after the series are differenced once. This result suggests that political shocks are unpredictable from one month to the next. Therefore, in every case, the political relations index follows a random walk.¹⁷

The implications of this result can be quite important. As Working (1960) shows, if the underlying series follows a random walk, then aggregating it to lower frequencies (say, annual) will produce a (constructed) annual series with a first-order serial correlation in the differences. As a result, the estimated coefficient from a regression of (annual) trade on the (annual) measure of political relations will tend to be inconsistently estimated.

The second column indicates that the “Trade-filtered” PRI series can be represented by a parsimonious ARIMA process. For every dyad, standard unit root tests suggest that the series need to be differenced

¹⁴ The keyword “morning” was chosen randomly. To ensure robustness, we normalized the index using another randomly selected keyword: “Monday.” Both versions, however, displayed a very similar pattern. Indeed, the correlation between them is 0.94. More details are provided in an Online Supplementary Material.

¹⁵ As a robustness check, we also performed the same search using all sources (including other international newspapers) at an annual frequency and compared it with the annualized “Trade_News_Index.” The series were indeed highly correlated. More formal tests are provided in the Online Supplementary Material. Nonetheless, we preferred to stay with the three major newspapers as the main source in order to ensure uniformity in coverage.

¹⁶ Combined, these three newspapers account for approximately 46% of the circulation of the top 10 newspapers in the U.S. source: <http://www.cision.com/us/2014/06/top-10-us-daily-newspapers/>. We use the Factiva electronic search engine to retrieve all news.

¹⁷ Augmented Dickey-Fuller tests confirm this result.

once before stationarity is achieved. However, the autoregressive and moving average components vary somewhat with the partner country. For example, the Box-Jenkins methodology suggests that no autocorrelation or moving average components are necessary when the series is modeled for the U.S. or Pakistan. But for Australia, Germany, France, and the UK, the differenced series follow an ARMA(1,1) process, while for Russia and Japan the process is best modeled with an ARMA(2,2). Regardless, the results indicate that both the PRI series and the “Trade-filtered” PRI series display shocks that are short-lived. It therefore follows that examining the effect of political relations shocks on trade is more appropriately done using monthly data.

To get a better sense of the relative importance of the high frequency cycles in the PRI and the trade-filtered PRI series, we also conduct an analysis of the spectral density distribution. This distribution is typically used to describe the properties of a series in the frequency domain. The cumulative periodogram is a diagnostic tool for evaluating the relative prominence of cycles at different frequencies.¹⁸

Table 2 presents the results of the spectral density analysis for the PRI and the trade-filtered PRI series. Since the Box-Jenkins analysis revealed that both the PRI and the trade-filtered PRI series are integrated with order 1, we conduct the analysis on the integrated series. For each of the series, the table presents three statistics. The first one is the Bartlett’s test of white noise based on the spectral periodogram. The null hypothesis for this test is that the series are essentially white noise. In such a case, all sinusoids are equally important. A rejection of the null hypothesis, therefore, suggests unevenness on the relative importance of the frequencies describing the series. The second statistic, “Low Freq Cycles,” is the proportion of the cumulative periodogram for the relatively low frequency cycles (12 months or longer). The third statistic, “High Freq. Cycles,” is the proportion of the cumulative periodogram for the relatively high frequency cycles (3 months or shorter).

The results of the test reveal that for virtually all partner countries, high-frequency cycles are an important component of the dynamics in the PRI and the trade-filtered PRI series. Even when the Bartlett’s statistic is not significant at standard levels (for the integrated PRI series of all countries except Japan and the U.S.), the results of the cumulative periodogram suggest that about a third of the distribution is explained by cycles of relatively high frequency (3 months or shorter).

This finding is even more pronounced in the trade-filtered PRI series, where the proportion of the distribution explained by cycles of relatively high frequency is even higher. When we filter trade-related events from the political relation series, we are removing movements in the political index that tend to take place in the lower range of the frequency spectrum (e.g. trade policy negotiations, etc.), as these variables tend to be slow moving, with cycles generally measured in years, not weeks or even months.¹⁹ As a result, the cumulative spectral periodogram ought to shift towards the higher end of the frequency range. This is precisely what the table shows—Bartlett’s test for white noise become more significant, and the proportion of the cumulative spectrum in the relatively high frequency increases in the majority of the cases.

¹⁸ See Harvey (2001, p. 260–1) for more details. For a comprehensive derivation see Priestly (1981).

¹⁹ Generally speaking, trade policy variables or measures of trade protection move in the lower frequency range. Indeed, research that study the dynamic behavior of such variables use annual data. See for example Rose (2012).

Table 1
Dynamics of China's political relations: optimal ARIMA model selection.

Country	PRI	Trade-filtered PRI
Australia	(0,1,0)	(1,1,1)
Germany	(0,1,0)	(1,1,1)
Great Britain	(0,1,0)	(1,1,1)
France	(0,1,0)	(1,1,1)
India	(0,1,0)	(1,1,1)
Japan	(0,1,0)	(2,1,2)
Pakistan	(0,1,0)	(0,1,0)
Russia	(0,1,0)	(2,1,2)
United States	(0,1,0)	(0,1,0)

Note: This table presents the optimal ARIMA model selection based on the Box and Jenkins (1976) approach. In each cell, entry (p,d,q) represents the optimal autoregressive parameter (p), whether integration was necessary (d = 0 or 1); and the optimal moving average parameter (q). "PRI" represents the Political Relations Index of Yan et al. (2009), Yan et al. (2010). "Trade-filtered PRI" is the PRI series after trade-related news has been removed.

The fact that a significant proportion of the movements in the PRI series occur at relatively high frequencies underscore the aliasing concern addressed above—with temporally aggregated series it is not possible to detect important dynamics that are taking place within the aggregated intervals.

4. Case studies

The empirical findings discussed in the previous section indicate that the dynamics of PRI shocks can be modeled with low-order ARIMA processes and that high-frequency cycles form an important portion of the dynamics of PRI shocks. This section presents two examples of significant political shocks between China and another major power to illustrate the temporary aspects of the shocks. By implication, less significant shocks dissipate even more rapidly.

The two cases we explore are (1) the U.S. bombing of the Chinese embassy in Belgrade in May 1999, and (2) the Senkaku boat collision incident (involving Japan) in 2010. The reasons these cases were chosen are twofold. First, both resulted a substantial shock to the political relations between China and the foreign country. Second, sufficient time has elapsed since the occurrence of these incidents to allow for a thorough evaluation of their effects on trade.

4.1. U.S. bombing of the Chinese embassy in Belgrade in May 1999

The U.S. bombing of the Chinese embassy in Belgrade in May 1999 marked one of the most serious adverse political shocks to China–U.S. relations since 1990. In fact, according to Yan and Qi (2009) and Yan et al. (2010), it resulted in the largest drop in the political relations index during the sample period (see Fig. 3). Below, we summarize the main events surrounding this incident, from its inception to its diplomatic conclusion.

On May 7, 1999, during the NATO bombing of the former Yugoslavia, five US JDAM (Joint Direct Attack Munition) guided bombs hit the Chinese embassy in Belgrade, killing 3 Chinese nationals and injuring at least 25 others. The Chinese government made a statement on May 8 condemning the event, and expressed its utmost indignation in the strongest possible form. Despite President Bill Clinton's personal apologies beginning on May 10, stating that the bombing was an accident, the reaction in China was one of unparalleled indignation and sheer anger.²⁰ The Chinese public was outraged. In major cities such as

²⁰ President Clinton made several apologies following the event, beginning with an official letter to Chinese President Jiang Zeming on May 9, continuing with several personal apologies in subsequent days. For example, on May 10 a news report from Reuters mentions: "美国总统克林顿首次亲身就误炸中国大使馆一事向中国和中国人民道歉." (U.S. President Bill Clinton for the first time issues a personal apology to China for the accidental bombing of the Chinese Embassy.) On May 11, another report from the same agency notes: "美国总统克林顿向中国人民道歉,北京仍施压促彻查恶凶." (U.S. President Bill Clinton apologizes to the Chinese people. Beijing demands a thorough investigation of the incident.)

Table 2
Spectral density analysis of integrated political relations index.

Country	Δ PRI			Δ Trade-filtered PRI		
	WN test	Low freq cycles	High freq cycles	WN test	Low freq cycles	High freq cycles
Australia	1.109	0.130	0.360	3.318***	0.035	0.567
Germany	0.942	0.162	0.261	3.010***	0.029	0.504
Great Britain	0.546	0.161	0.311	3.883***	0.041	0.588
France	0.822	0.202	0.315	2.637***	0.063	0.434
India	0.399	0.186	0.328	2.917***	0.034	0.482
Japan	2.496***	0.332	0.221	1.774***	0.277	0.272
Pakistan	0.372	0.153	0.321	0.525	0.144	0.321
Russia	0.776	0.188	0.281	3.253***	0.031	0.426
United States	1.399**	0.269	0.309	1.435**	0.272	0.314

Note: This table presents three statistics that analyze the spectral density of the integrated Political Relations Index (Δ PRI) and the integrated Trade-filtered Political Relations Index (Δ Trade-filtered PRI). The first statistic is the Bartlett's test of white noise based on the series' spectral cumulative periodogram. Failure to reject the null suggests that cycles are important at every frequency. A statistically significant test (indicated with *** at the <1%, and ** at the <5%) rejects the null of a white noise process, in favor of unevenness in the prevalence of cycles at different frequencies. The second statistic, "Low Freq. Cycles", reports the cumulative spectral distribution function at "low" frequencies (cycles of 12 months or longer). Thus, a figure like 0.130 for the integrated PRI series for Australia indicates that 13% of the cycles occur at frequencies of 12 months or longer. The third statistic, "High Freq. Cycles", reports the cumulative spectral distribution function at "high" frequencies (cycles of 3 months or shorter). Thus, a figure like 0.567 for the integrated, trade-filtered PRI series for Australia indicate that nearly 57% of the cycles occur at frequencies of 3 months or shorter.

Beijing, Shanghai, and Chengdu, students and other residents protested the bombing in marches outside the U.S. embassy and consulates. On the same day as the bombing, the Chinese Ministry of Foreign Affairs announced the suspension of high-level military contact with the United States, as well as the suspension of all negotiations dealing with nuclear nonproliferation, arms control, and international security. It also terminated the Sino-American dialogue with respect to human rights. Unquestionably, the China-U.S. relationship took a deep dive, becoming very tense during that month. Indeed, news media reported that the incident dealt a very serious blow to relations between the two countries.²¹

But despite the seriousness of the incident, the Chinese reaction dissipated quickly. In fact, market indicators in China seem to have brushed the entire event aside within days. For example, although the Shanghai Stock Exchange index dipped about 4% on Monday May 10 (the first trading day after the bombing), on Tuesday May 11 market commentators opined that, despite the increase in political tension between the two countries, the fallout on financial markets would be very limited as in fact proved to be the case.

Yet diplomatic cooperation between Beijing and Washington continued, with the result that tensions eased within two months. Even though Beijing never accepted Washington's explanation that the embassy bombing was a mistake, by the end of the summer the two countries had worked out the first stage of a settlement. In August, the U.S. government made a "voluntary humanitarian payment" of \$4.5 million to the families of the 3 Chinese nationals who were killed and to the 27 injured in the bombing. On December 16, 1999, the two governments reached a settlement under which the United States would pay \$28 million as compensation for damage to the Chinese embassy facility, and China would pay \$2.87 million in compensation for damage inflicted on the U.S. embassy and other diplomatic facilities in China.²² On January 22, 2000, Chinese Lieutenant General Xiong Guangkai, the Deputy Chief of Staff of the Army and the head of China's National Security Council, visited the United States, marking the formal resumption of military contact between Washington and

²¹ For example, on May 10, 1999, Reuters in China reports: "中国中止与美国军事等交流,双方关系陷入20年来最低点,对北约提公开道歉等四要求,美也暂停所有官员访中活动." (China suspends military exchanges with the U.S. Bilateral relations now at a 20 year low. Beijing also indicates that all official visits to the U.S. would be suspended.) 10 May 1999路透社-中文新闻 (Reuters-Chinese news).

²² See article by Kerry Dumbaugh entitled: "Chinese Embassy Bombing in Belgrade: Compensation Issues." Congressional Research Service, April 12, 2000.

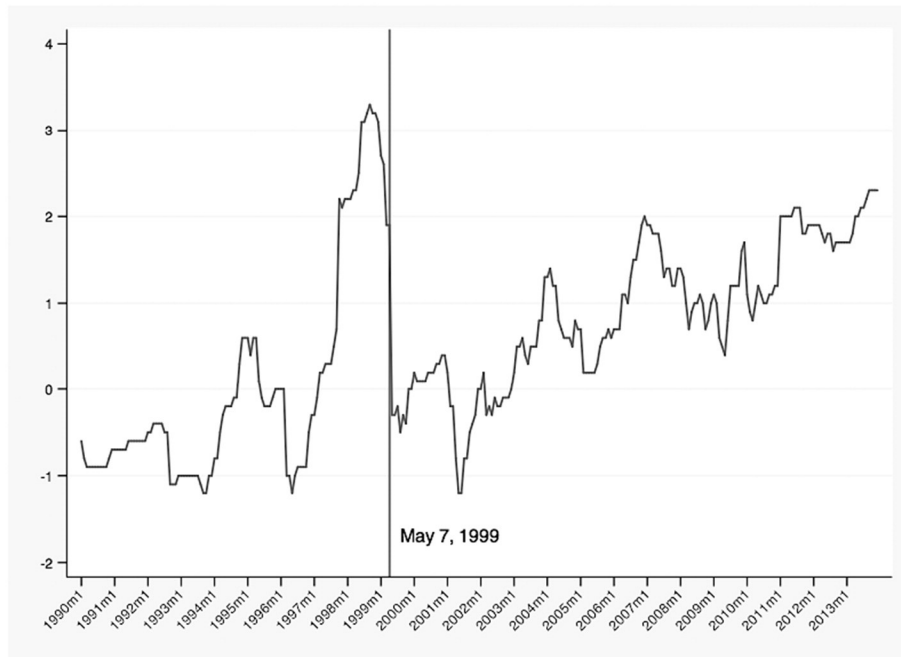


Fig. 3. PRI between the U.S. and China: January 1990 through December 2013. Note: Vertical line marks the date of the Belgrade bombing incident.

Beijing (as noted above, China's immediate response to the embassy bombing had included suspending all high-level military contact between itself and the United States). By the time of Xiong's visit, the conflict around the embassy bombing was essentially settled, and the military relationship had been largely restored.

Newspaper reports suggest that the effect of this incident on bilateral economic relations was very limited. For example, on May 19, just 10 days after the bombing, a trade delegation from China visited the U.S. to strengthen economic ties. The detachment of the bombing incident from economic ties was evident as one of the delegation members, Mr. Ye Jian, then the director general of the Economic Relations and Foreign Trade Commission from Jiangsu province, remarked "The Governor, Lieutenant Governor [of Jiangsu province] and myself have been very dismayed at the incident committed by U.S.-led NATO... But I deal with the economy and trade, so I must come."²³

4.2. The Senkaku boat collision incident in 2010

On September 9, 2010, a Chinese trawler seeking to flee the scene collided with several of the Japanese Coast Guard's patrol boats in disputed waters near the Senkaku Islands (known in Mainland China as the Diaoyu Islands); Japanese authorities arrested the trawler's captain, Zhan Qixiong, and accused him of obstructing Japanese public officers during the performance of their duties. The incident resulted in a serious shock to Sino-Japanese political relations, as Fig. 4 illustrates.²⁴ Beijing protested and demanded the captain's immediate and unconditional release. Japan, by contrast, claimed to be handling the incident "in accordance with domestic law," insisting that the Senkaku Islands "are clearly an inherent territory of Japan."²⁵

²³ See article entitled "China Trade Group Ready for Business" from the May 20, 1999 issue of the *New York Times*, p. 17.

²⁴ This incident in by no means the only one that has affected Sino-Japanese relations in recent years. In 2012, for example, bilateral relations endured the most significant blow after the Japanese government purchased three of the Senkaku islands from a private owner. This event is also illustrated in Fig. 4.

²⁵ "Statement by the Press Secretary on the Collision between Japan Coast Guard Patrol Vessels and a Chinese Fishing Trawler in Japan's Territorial Waters off the Senkaku Islands," September 25, 2010. Ministry of Foreign Affairs of Japan. Retrieved from http://www.mofa.go.jp/announce/announce/2010/9/0925_01.html.

The incident provoked diplomatic jousting between Beijing and Tokyo, as well as large-scale protests in both China and Japan. On the day the captain was arrested, public protests began in many major Chinese cities. But China's repeated demands were refused; instead, the Japanese government extended the captain's detention for an additional 10 days, to September 19. The Chinese government reacted by canceling all official meetings with Japan at the ministerial level and above. In addition, on September 20, China detained four Japanese employees of Fujita Corporation for allegedly filming military targets in Hebei province. And on September 23, China suddenly halted exports of rare earth minerals to Japan. Though neither country linked the export restriction to the case of the detained captain, the restriction certainly seemed to be a consequence of the rising tension between China and Japan stemming from the arrest.

Just a day later, on September 24, the Japanese government released the captain, thereby avoiding further deterioration of bilateral relations. But on both sides, outrage and anger on the part of the government and public alike had still not diminished. Beijing was demanding an apology and compensation from Tokyo, while Japan was demanding compensation for damage done to its coast guard ships. On October 2, in Tokyo and six other major Japanese cities, anti-China protesters gathered to criticize what they saw as their government's weak-kneed handling of the event.²⁶

A few days later, however, the two countries began mending their relationship. On October 5, for example, Chinese Premier Wen Jiabao and Japanese Prime Minister Naoto Kan met informally on the sidelines of the Asia–Europe Meeting in Brussels. According to the Xinhua news agency, Wen and Kan "agreed to step up people-to-people exchange and communication between the governments, and hold China–Japan high-level meeting at an appropriate time."²⁷ On October 9, China released all the Fujita employees. Although protests still took place throughout China during the month, they began to dwindle after the

²⁶ "Tokyo Protests Blast China's Response to Collision," *Wall Street Journal*, October 3, 2010, <http://online.wsj.com/news/articles/SB10001424052748704419504575527664218726440>.

²⁷ "Japan Expecting to Improve Ties with China: Top Gov't Spokesman," *Xinhua News*, October 5, 2010, http://news.xinhuanet.com/english2010/china/2010-10/05/c_13543179.htm. "Conversation between Prime Minister Kan and Premier Wen Jiabao," Ministry of Foreign Affairs of Japan, October 5, 2010, http://www.mofa.go.jp/region/asia-paci/china/summit_conv1010.html.

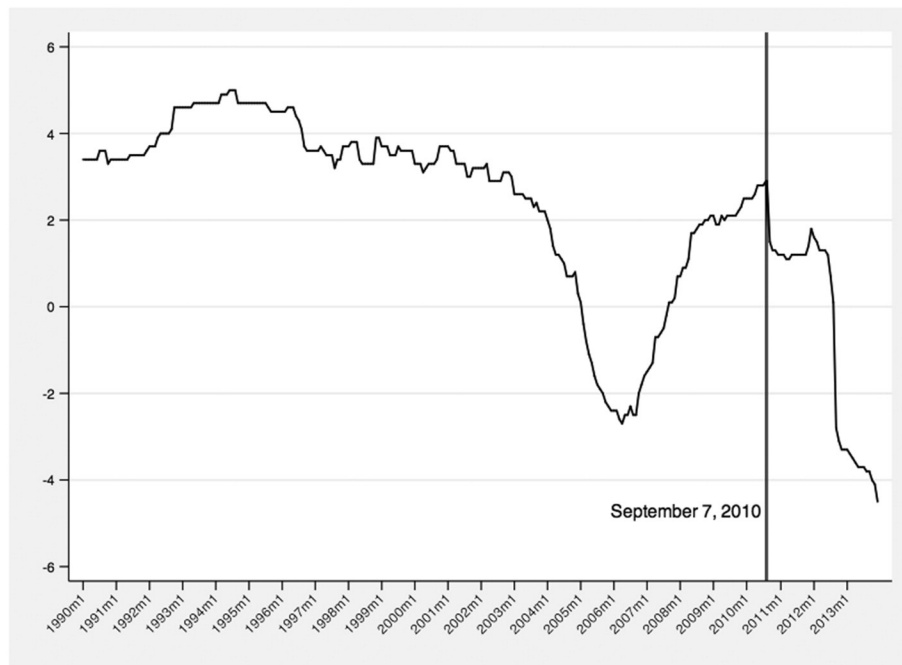


Fig. 4. PRI between China and Japan: January 1990 through December 2013. Note: Vertical line marks the date of the Senkaku boat collision incident.

Chinese government discouraged further protests. By October 28, when a final demonstration was reported, anti-Japanese sentiment had substantially cooled. In Japan, however, anti-China protests and demonstrations continued for a while longer,²⁸ after a video showing the collisions, filmed by the Japanese coast guard on September 7, was leaked on YouTube on November 4.²⁹ Many Japanese citizens interpreted the video as demonstrating that the Chinese trawler deliberately rammed the Japanese coastguard vessels.

The aftermath of the incident was largely over by the end of 2010. On January 20, 2011, Japanese prosecutors officially dropped all charges against Zhan Qixiong, and the next day the video leaker was also exempted from charges. The tensions caused by the Senkaku boat collision incident had subsided in less than five months.

Media reports indicate that the adverse effects on trade were short-lived. Although two weeks after the incident there were reports of an increase in Customs inspections of merchandise from Japan, thereby slowing trade, other reports indicate that by January 2011, Japanese exports to China had increased significantly, especially in automobiles and luxury goods.³⁰

5. Dynamic model of political relations on trade

As mentioned in the introduction, most the studies that investigate the effect of political shocks on trade do so within the context of the gravity model (Anderson and van Wincoop, 2003). This model posits that bilateral trade is an increasing function of economic activity in both countries and that it decreases with geographical distance. Often

other covariates (such as bilateral exchange rates or population) are included in the model as well.³¹ The chosen measure of political relations is, of course, also added to the model.

Our model, too, is motivated by this framework. However, since we seek to investigate the extent to which political shocks affect bilateral trade over time, we adopt a vector autoregression (VAR) model. This modeling technique is particularly useful in our context because it is designed to quantify the magnitude of the effect at different time periods, enabling us to make inferences about the dynamic impact of the shocks. In addition, its flexibility permits the symmetric treatment of all covariates as endogenous variables in the system.

Formally, our model is

$$\mathbf{x}_{j,m} = \mathbf{c}_j + \sum_{i=1}^n \mathbf{A}_{j,i} \mathbf{x}_{j,m-i} + \mathbf{e}_{j,m} \quad (9)$$

$$\mathbf{x}_{j,m} = (\Delta \mathbf{ex}_{j,m}, \Delta \mathbf{PRI}_{j,m}, \Delta \mathbf{y}_{c,m}, \Delta \mathbf{y}_{j,m}, \Delta \mathbf{er}_{j,m})'$$

where subscript “j” represents the country = {Australia, Germany, France, India, Japan, Pakistan, Russia, U.K., U.S.}, “m” represents the month = {Jan. 1990, ..., Dec. 2013}. The column vector \mathbf{x} contains (i) the percentage change in partner j’s exports to China at time m ($\Delta \mathbf{ex}_{j,m}$); (ii) the change in the China–partner j’s political relations index at time m ($\Delta \mathbf{PRI}_{j,m}$); (iii) the percentage change in the industrial production index for China at time m ($\Delta \mathbf{y}_{c,m}$); (iv) the percentage change in partner j’s industrial production index at time m ($\Delta \mathbf{y}_{j,m}$); and (v) the change in the ratio of partner j’s real effective exchange rate to China’s real effective exchange rate at time m ($\Delta \mathbf{er}_{j,m}$).³²

²⁸ For example, “Japan Protesters Rally over China, Kan as APEC Looms,” Reuters, November 6, 2010, <http://in.reuters.com/article/2010/11/06/idINIndia-52713420101106>.

²⁹ According to the report by Reuters, the Japanese government had decided not to make the video public and released it for viewing only by a small number of lawmakers for fear of inflaming anti-Chinese sentiment (“Japan Investigating China Collision Video,” Reuters, November 5, 2010, <http://in.reuters.com/article/2010/11/05/idINIndia-52690020101105>).

³⁰ The increase in Customs inspections is reported in an article entitled “China steps up checks on Japanese shipments” printed in My Paper (Singapore Press Holdings), on September 28, 2010. The rise in Japanese exports to China is reported in an article entitled “Japanese Firms Thriving on Chinese Demand” printed on Nikkei (NKR), on January 5, 2011.

³¹ We include a measure of exchange rates in the model, but do not include population or distance variables because our model is identified with time series, and those two variables are either completely time-invariant (e.g., geographical distance) or nearly so in the short-run (e.g., population).

³² All percentage changes are computed as differences of log transformations. For variables that can take on negative values (such as the political relations index), a sufficiently high positive constant is added before the log transformation is computed to ensure that its value is well defined. Export and industrial production data are seasonally adjusted. We use industrial production (for China as well as the partner countries), as GDP figures are available on a quarterly basis only. Data sources are listed in Appendix 1.

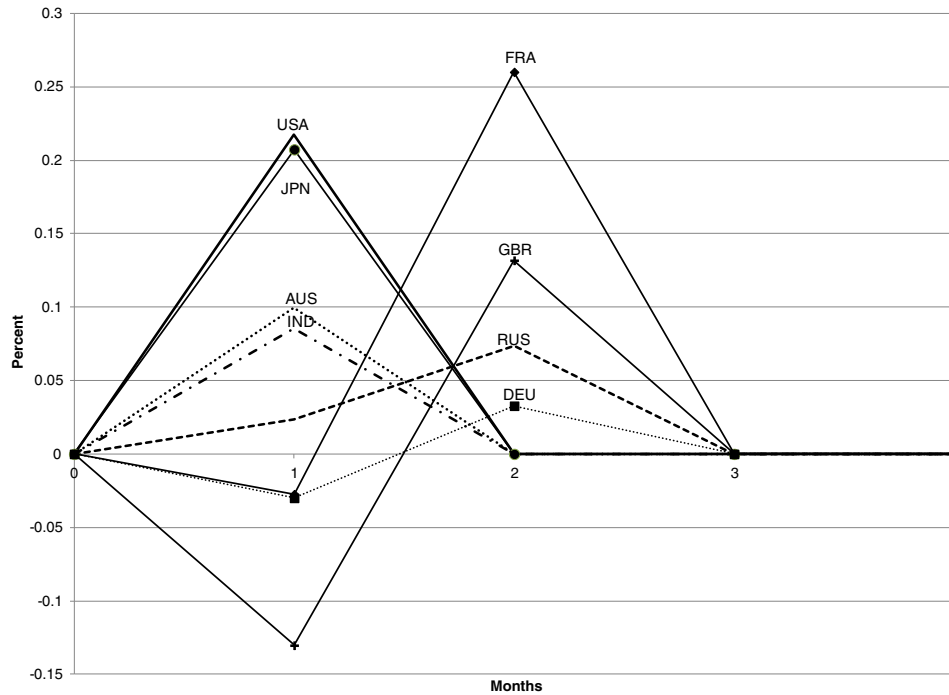


Fig. 5. Impulse response function of a PRI shock on exports to China from eight foreign countries. Notes: This figure depicts the dynamic effect of a one standard deviation shock to the PRI series on a country’s export growth to China as implied by the 2-lag VAR model (Eq. (9) in the text). For visual clarity, the displayed effects are those that are statistically significant at the 90% level or higher. In none of the cases the estimated effect is significant at month 3 and onwards.

The $A_{j,i}$'s in Eq. (9) are 5×5 matrices of the VAR model coefficients, and $E[ee']$ is the 5×5 variance-covariance matrix of contemporaneous error terms. The lag order (“ n ” in Eq. (9)) was selected using the standard information criteria: the Final Prediction Error (FPE), the Akaike information criterion (AIC), the Bayesian (Schwarz) information criterion (BSIC), and the Hannan-Quinn information criterion (HQIC). Although different criteria recommended different lag orders, these tended to vary between 2 and 4 lags.³³

Our model (Eq. (9)) is estimated in changes for two reasons. First, all the variables included are non-stationary in levels, but stationary in first difference.³⁴ Second, since our aim is to investigate the extent to which political shocks affect the dynamics of partner j 's exports to China, estimating the model in changes maintains a natural congruency with the logic of the test.³⁵

6. Empirical results

The effect of a political shock on trade can be measured using orthogonalized impulse response (OIR) functions.³⁶ OIR functions illustrate the change that occurs over time to the value of one variable

in the model as another variable is shocked.³⁷ Since we have eight partner countries, we estimated eight sets of OIRs.

Fig. 5 displays the impulse response functions of the partner countries' export growth to China when PRI experiences a one-standard-deviation shock. Fig. 6 displays the analogous functions for the trade-filtered PRI shocks. Each figure depicts the results for eight countries.³⁸ We combine the impulse responses into one figure for two reasons: (a) it facilitates visual comparison of the estimated effects across countries. Hence, patterns across countries as well as relative differences in magnitudes are more easily identifiable. (b) It economizes on the number of figures and tables presented. For visual ease and clarity, standard error bands are not included. Instead, only impulse responses that are statistically significant at the 90% level or higher are depicted. Since in none of the eight countries we find a statistically significant effect at month 3 and onwards, none are displayed.

A glance at the figures reveals that, across all eight countries, political relations shocks do affect export growth to China, but the effects are short-lived, lasting about two months. Although different countries display slightly different dynamic patterns, the magnitude and duration of the effects are generally similar: adverse PRI shocks tend to result in a short-term decline in exports. Moreover, we find that the effects are overall small. A one standard deviation shock in PRI leads to an average (over all eight countries) 0.05% decline in exports in month 1, and an additional decline of 0.06% in export just a month after that. By the

³³ The results presented are those with a lag order 2. However, we estimated the model with 4 lags in order to ensure robustness. The results, however, were very similar. We did not include those results to avoid an excessive number of figures. For interested readers, these additional results are available in an Online Supplementary Material.

³⁴ We found no evidence of cointegration between PRI (or Trade-Filtered PRI) and any of the other variables in the model.

³⁵ It is worth pointing out that estimating a gravity model in first differences is not unusual. See for example, Baier and Bergstrand (2001), Bayoumi and Eichengreen (1997), and Wei (1996).

³⁶ To facilitate understanding, a political “shock” is discussed from the perspective a negative shock to PRI.

³⁷ To obtain a structural model with orthogonal innovations we use the Cholesky decomposition with the political relations variable placed as the most exogenous one in the system, consistent with the notion that political shocks are exogenously-driven events. It is worth mentioning that we tried different orders, and although the dynamic pattern changed somewhat from one country to the next, the estimated effects were never observed to last more than one or two months. In fact, in some specifications, the estimated effect of PRI on exports was effectively nil.

³⁸ The VAR results for Pakistan indicate that PRI shocks were never significantly different from zero at standard levels. Thus, no impulse response functions for this country are depicted in the figures.

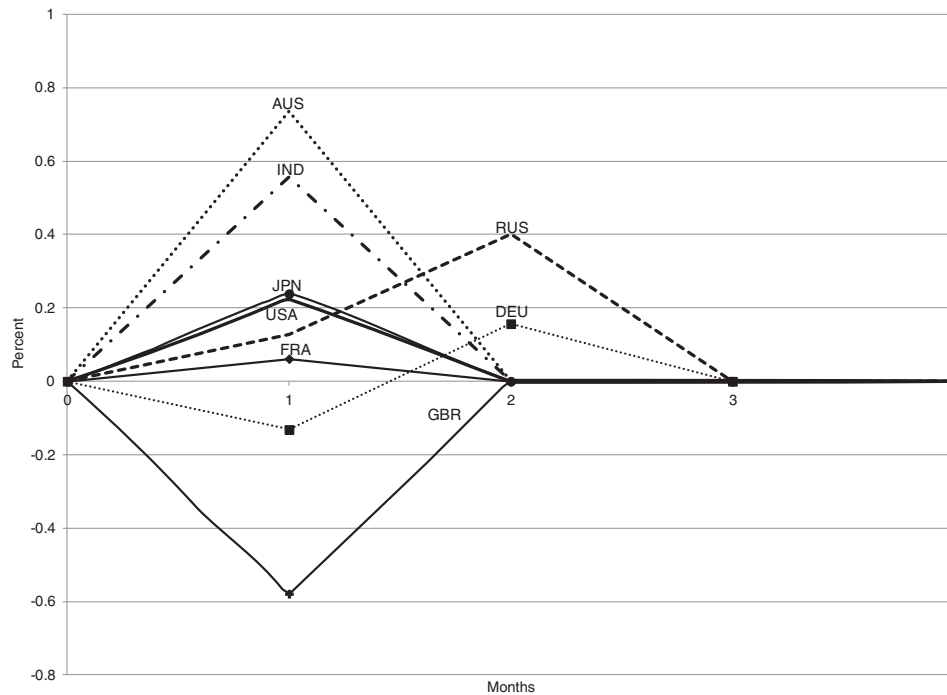


Fig. 6. Impulse response function of a Trade-filtered PRI shock on exports to China from eight foreign countries. Notes: This figure depicts the dynamic effect of a one standard deviation shock to the Trade-filtered PRI series on a country's export growth to China as implied by the 2-lag VAR model (Eq. (9) in the text). For visual clarity, the displayed effects are those that are statistically significant at the 90% level or higher. In none of the cases the estimated effect is significant at month 3 and onwards.

third month, however, the effects have dissipated. We do not find any statistically significant long-term cumulative effects. For the trade-filtered *PRI* series, although the observed pattern is similar to the pattern observed using the original *PRI* series, the magnitudes are, perhaps not surprisingly, somewhat larger.³⁹ The duration of the effects is, however, analogous—the effect of trade-filtered *PRI* shocks on exports is short-lived, lasting no longer than two months.

Although we argue that the estimated dynamic effects (magnitude and duration) are overall limited and short-lived, we do observe some differences in the patterns across countries. For example, according to Fig. 5, the impact of *PRI* shocks on exports peaks in month 1 for the USA, Japan, Australia, and India, while it peaks in month 2 for the remaining countries in the sample (France, Great Britain, Russia, and Germany), and as noted above, it is never statistically significant for Pakistan. In addition, Fig. 5 indicates that for the cases of Germany, France and the U.K. an adverse *PRI* shocks appears to accelerate exports in month 1, before slowing it down in month 2.

In fact, it is natural to expect different effects across countries as there exist important heterogeneities not explicitly modeled, such as differences in industrial structure, differences in duration of contracts across industries or firms, etc. In an online appendix,⁴⁰ for instance, we document that the effect of political shocks on China's imports differs by the type of firms transacting the purchase in China. In particular, we find that, relative to other types of firms (e.g. privately-owned firms, foreign-owned enterprises, and Sino-Foreign joint ventures),

state-owned enterprises (SOEs) display the highest sensitivity of imports to political relation shocks. This finding, in combination with the fact that there are cross-country differences among the type of Chinese firms importing commodities can help explain such dynamic variations.

The case of imports from Great Britain into China can be used as an illustration. We find that, controlling for product category, imports from the U.K. are much more likely to be transacted by privately-owned firms in China. These firms may be better positioned to strategically alter their trade pattern (strategically accelerate imports) following a political relations shock. For instance, firms may rationally decide to speed up imports if they anticipate that a deterioration in bilateral relations would result in an increase in transactions costs as merchandise moves through customs.⁴¹ By contrast, SOEs may not be able to alter their trade pattern to the same degree since they are under more direct government control.⁴²

Altering the timing of imports may also be due to other (unobserved) heterogeneities. For example, the existence of agreements or contracts among firms may force shifting the timing of imports following an adverse political relations shock.⁴³ Thus, to the extent that the composition of exports to China differs across countries (driven by firm-type differences, or by contract-length differences, or other unobserved heterogeneities), the different dynamic patterns that are observed across countries in Figs. 5 and 6 are not particularly unusual.

Regardless of the different dynamic patterns, however, they suggest that the effects are transitory. To confirm the temporary nature of the

³⁹ As discussed in Section 3, the trade-filtered *PRI* is the political relations index (*PRI*) after removing trade-related news. As noted above, trade-related events (such as trade policy negotiations, etc.) tend to be slow moving, with cycles generally measured in years. By contrast, trade-filtered *PRI* displays cycles that take place at relatively higher frequencies (less than three months). Since the VAR model is estimated with monthly (and thus, relatively high frequency) data, the "slow-moving" component of the *PRI* will tend to impart an attenuation bias, resulting in a smaller estimated magnitude.

⁴⁰ See appendix entitled "Online Supplementary Material."

⁴¹ For anecdotal evidence of the rise in transaction costs at customs, see note 30 above. The "Online Supplementary Material" appendix provides additional details.

⁴² For more evidence on how SOEs imports respond to political shocks see Davis et al. (2014).

⁴³ Unfortunately, we do not have information pertaining to contract length at the product level to evaluate this issue.

Table 3
Long term effects on export growth.

Country	PRI shock	Trade-filtered PRI shock
AUS	0.017	0.163
DEU	−0.016	−0.031
FRA	0.085	0.272
GBR	−0.021	−0.035
IND	0.103*	0.879
JPN	0.272	0.307
PAK	0.000	0.000
RUS	0.075*	0.374
USA	0.873	0.857

Notes: This table displays the cumulative effects of a PRI shock on export growth implied by the VAR models. The long-term horizon is two years.

* Indicates significance at the 90% level.

results, we computed the cumulative long-term effects of the PRI shocks on exports implied by the VAR model. Examining the cumulative effect on the changes is a straightforward way of evaluating whether there are long-lasting effects on levels. The estimated effects are reported in Table 3. The results indicate that in all but two cases (India and Russia) the long-term effects of a PRI shock are not statistically different from zero. For the trade-filtered PRI series, no long-term effects are detected for any of the countries.⁴⁴

The fact that we detect long-term effects for India and Russia when using the unfiltered PRI series, but not when using the trade-filtered PRI one, suggests that some of the dynamics in the unfiltered political relations series are driven by trade-related events, such as negotiations and agreements. As shown in Section 3, these events tend to impart a slow-moving component to the series. Indeed, the spectral analysis results reported in Table 2 are consistent with this observation, as the cases of India and Russia represent two of the three largest declines in the “low-frequency cycle” component of the trade-filtered PRI series.

The upshot of our VAR results—that the effect of PRI shocks lasts one to two months and that the magnitudes are generally small—underscores one of main the complications that arises with temporal aggregation and which was highlighted in Section 2—the aliasing problem. Researchers using temporally aggregated data are unable to detect the short-lived dynamics present in the disaggregated time series. The following section elaborates more on this issue.

7. Gravity equation models: monthly versus annual frequencies

In the previous section, we show that the effect of political shocks on export growth tends to be short-lived. We also argue that using annual data to test the hypothesis of a linkage between political relations and trade is likely to result in a measured effect that is inconsistently estimated. In this section, we examine in more detail the implications of aggregation by comparing regression estimates using monthly and annual data.

Our starting point is the gravity equation that is generally used in the literature to investigate the trade-political relations sensitivity. In its log-linear form, the model stipulates a contemporaneous relationship between trade and other independent variables, including the chosen measure of political relations. We augment the traditional gravity equation to model the dynamic effects that may be present in the relationship.

Formally, we estimate the following regression at the monthly (*m*) frequency⁴⁵:

$$\Delta ex_{j,m} = \alpha_0 + \gamma(\Delta ex_{j,m-1}) + \sum_{k=0}^n \alpha_k (\Delta PRI_{j,m-k}) + \beta_1 (\Delta y_{j,m}) + \beta_2 (\Delta er_{j,m}) + time + c_j + \eta_{j,m} \quad (10)$$

where the variables are defined as in Section 5, except for $\Delta y_{j,m}$, which is now the percentage change in partner *j*'s measure of output (industrial production or GDP); and $\Delta er_{j,m}$, which is now the percentage change in partner *j*'s nominal exchange rate relative to the U.S. dollar. Eq. (10) includes a lagged dependent variable to model the dynamic feedback of export growth. Because we have a pooled time-series, cross-section dynamic model, Eq. (10) is estimated using system GMM regressions (Blundell and Bond, 1998, 2000).⁴⁶ The presence country and time fixed effects impedes the inclusion of the growth rate in China's output (either industrial production or GDP), which is normally incorporated in standard gravity models. Because this variable does not vary by country, its effect is completely absorbed by the time fixed effects. Also, because country fixed-effects are included in the model, we do not incorporate distance, another variable normally considered in gravity models. The monthly-frequency regressions include up to four lags of the PRI variable to allow for the possibility that political relations affect trade, but not necessarily contemporaneously.⁴⁷

To assess the effect of temporal aggregation, we also estimate the gravity equation at the annual-frequency. The effect of temporal aggregation is gauged by comparing the contemporaneous (current) PRI coefficients in the monthly and annual gravity regressions. The reason is that, in the presence of an autoregressive process there is no straightforward way of comparing the lagged monthly and annual PRI coefficients. Intuitively, because the coefficient in the annual regression absorbs the effects that take place at the monthly frequency, the lagged coefficients of the PRI variable in the annual regression are a non-linear function of the coefficients of the PRI variable in the monthly regression as well as the autoregressive process. In the absence of a temporal aggregation bias, the contemporaneous PRI effect should be the same in both frequencies. Thus, differences in these coefficients (contemporaneous PRI variable in the monthly regression, versus the same variable in the annual regression) would be attributable to the inconsistency that the temporal aggregation introduces through the moving average it brings onto the estimation (as shown in Section 2).

This argument is derived more formally in the Derivation Appendix 2. There are at least three key insights from that derivation: 1. In the presence of an autoregressive process, temporal aggregation affects the coefficients from the annual-frequency regression in a non-linear way, except for the contemporaneous (current) coefficient. 2. Temporal aggregation introduces a moving average in the error term. Consequently, the standard errors of the coefficients in the annual regression will tend to be biased; 3. The use of annual-frequency data masks the dynamics that

⁴⁵ The standard practice in the literature is to estimate a gravity equation in levels. Using levels is appropriate when using cross-section data, or when using longitudinal data with relatively short panels (e.g. large N, small T). However, in our case, we have long panels for a limited number of countries. Because in this setting the identification takes place primarily through the time series, we conducted panel unit root tests to ensure that the series are stationary. For virtually all covariates included in the model, the panel unit root tests indicate that the data are non-stationary in levels, but stationary in first differences. For that reason, we estimate our model in (log) differences.

⁴⁶ The typical alternative to system GMM regressions is to use one-step or two-step (Arellano-Bond) GMM estimators (Arellano and Bond, 1991). However, these estimators may be inconsistent when the autoregressive process is persistent (Blundell and Bond, 2000). System GMM regressions use lagged variables as instruments in the difference equation to model the fixed effects. Although all possible lags can be used, we restricted them to no more than 8. Because the time component of our data is relatively long, using an increasing number of lags lead to a computationally onerous matrix of instruments, and, on occasion, to a matrix that could not be inverted. The choice of up to 8 lags was made to minimize the sum of squares of the differenced residuals.

⁴⁷ In addition, four lags of PRI serve to ensure that we span the timing detected in the VAR model.

⁴⁴ The long-term horizon considered is two years. However, it is worth pointing out that, following a PRI shock, no cumulative, statistically significant effects are detected after three months for most of the countries. Aside from India and Russia, only Japan took slightly over a year for the cumulative effect to dissipate. This result can be explained by the Sino-Japanese conflict over the Senkaku Islands, which although appears to be temporary, has experienced setbacks, as Fig. 4 illustrates.

Table 4
Gravity equation model regression results.

	(1)	(2)	(3)	(4)	(5)	(6)
	Monthly			Annual		
$\Delta EXP_{j,t-1}$		−0.396*** (0.022)	−0.520*** (0.023)		−0.134 (0.119)	−0.178 (0.114)
$\Delta EXP_{j,t-2}$			−0.284*** (0.023)			−0.177 (0.134)
$\Delta PRI_{j,t}$	0.026 (0.019)	0.023 (0.033)	0.015 (0.031)	0.067** (0.028)	0.068*** (0.026)	0.051** (0.026)
$\Delta PRI_{j,t-1}$		0.075** (0.034)	0.073** (0.032)			0.002 (0.038)
$\Delta PRI_{j,t-2}$		−0.009 (0.034)	0.004 (0.031)			0.008 (0.035)
$\Delta PRI_{j,t-3}$			0.033 (0.030)			−0.004 (0.034)
$\Delta PRI_{j,t-4}$			−0.007 (0.030)			
$\Delta y_{j,t}$	0.479*** (0.116)	0.340*** (0.062)	0.271*** (0.058)	0.342 (0.238)	0.701 (0.443)	0.815* (0.422)
$\Delta e_{j,t}$	0.483** (0.181)	0.485** (0.229)	0.550*** (0.213)	0.140 (0.304)	0.025 (0.216)	0.339 (0.208)
Constant	0.045 (0.049)	0.005 (0.049)	0.031 (0.046)	0.060* (0.029)	0.126*** (0.041)	0.115** (0.047)
Observations	2392	2392	2392	196	195	179
R-squared	0.286	0.381	0.414	0.420	0.395	0.461
State FE	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes

Dependent variable: Change in the log of country *j*'s exports to China: $\Delta EXP_{j,t}$; Independent variables: Up to two lags of the dependent variable, denoted as $\Delta EXP_{j,t-1}$, and $\Delta EXP_{j,t-2}$; $\Delta PRI_{j,t-k}$, which is the change in the political relations index between China and country *j* at time *t-k*, *k* = 0, ..., 4; Change in the log of country *j*'s measure of output (either industrial production or GDP) at time *t*, $\Delta y_{j,t}$; Change in the real (PPP-adjusted) exchange rate between China and country *j* at time *t*, $\Delta e_{j,t}$. Regressions with lagged dependent variable are estimated using system GMM for dynamic panels. Standard errors are included in parentheses.

*** *p* < 0.01.

** *p* < 0.05.

* *p* < 0.10.

take place at the monthly frequency. Without a priori knowledge of those effects, it is not possible to back out the timing and magnitude of the underlying (monthly) dynamics from the annual regressions.

We present the new gravity regressions in Tables 4 and 5. Table 4 presents the results for the PRI variable, while Table 5 presents the results for the trade-filtered PRI series.⁴⁸ Although the exact timing of the effects differs somewhat between the two set of results, they are qualitatively similar in the sense that both are temporary. In addition, both set of results offer evidence of the aggregation bias.

In each table, there are six regressions. The first three regressions show the results using monthly data with three different autoregressive models. As pointed out above, we include up to four lags (in months) of the political relations variable to ensure that we span the timing detected in the VAR models. The last three regressions show the results using annual data (again, with different autoregressive models, and with up to three lags (in years) of the political relations variable). We start out with zero autoregressive components and zero lags of the political relations variable for both set of regressions (monthly and annual). These are Regressions (1) (monthly) and (4) (annual). These two regressions aim at establishing benchmark results against which the other regressions results can be compared. The next set of regressions (Regression (2) for the monthly, and (5) for the annual), includes one autoregressive process of the dependent variable. The inclusion of this process captures the dynamics of export over time following a political relations shock. A negative coefficient in the autoregressive process implies a fast-moving,

⁴⁸ The regressions in Table 5 use the trade-filtered PRI series normalized by the keyword "Monday," as opposed to the keyword "morning." While both set of regressions show evidence of an aggregation bias, the resulting sum of squares differenced residuals of the Monday-normalized system GMM regressions were slightly smaller. This variation can be attributed to different usage frequencies of the two words in the newspapers.

Table 5
Gravity equation model regression results.

	(1)	(2)	(3)	(4)	(5)	(6)
	Monthly			Annual		
$\Delta EXP_{j,t-1}$		−0.383*** (0.022)	−0.487*** (0.022)		−0.156 (0.122)	−0.183 (0.117)
$\Delta EXP_{j,t-2}$			−0.256*** (0.022)			−0.126 (0.115)
$\Delta TFPRI_{j,t}$	0.010 (0.006)	0.014 (0.010)	0.015 (0.010)	0.025*** (0.006)	0.039** (0.019)	0.031* (0.018)
$\Delta TFPRI_{j,t-1}$		0.022* (0.012)	0.020* (0.011)			−0.013 (0.022)
$\Delta TFPRI_{j,t-2}$		0.000 (0.011)	0.001 (0.011)			0.024 (0.024)
$\Delta TFPRI_{j,t-3}$			−0.001 (0.011)			−0.020 (0.024)
$\Delta TFPRI_{j,t-4}$			−0.018* (0.010)			
$\Delta y_{j,t}$	0.477*** (0.114)	0.326*** (0.062)	0.264*** (0.059)	0.347 (0.236)	0.549 (0.448)	0.641 (0.441)
$\Delta e_{j,t}$	0.483** (0.177)	0.622*** (0.229)	0.672*** (0.214)	0.221 (0.276)	0.175 (0.211)	0.393* (0.213)
Constant	0.045 (0.050)	0.003 (0.049)	0.015 (0.046)	0.048 (0.033)	0.132*** (0.041)	0.072* (0.043)
Observations	2392	2392	2392	196	195	179
R-squared	0.286	0.381	0.414	0.399	0.373	0.442
State FE	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes

Dependent variable: Change in the log of country *j*'s exports to China: $\Delta EXP_{j,t}$; Independent variables: Up to two lags of the dependent variable, denoted as $\Delta EXP_{j,t-1}$, and $\Delta EXP_{j,t-2}$; $\Delta TFPRI_{j,t-k}$, which is the change in the trade-filtered political relations index between China and country *j* at time *t-k*, *k* = 0, ..., 4; Change in the log of country *j*'s measure of output (either industrial production or GDP) at time *t*, $\Delta y_{j,t}$; Change in the real (PPP-adjusted) exchange rate between China and country *j* at time *t*, $\Delta e_{j,t}$. Regressions with lagged dependent variable are estimated using system GMM for dynamic panels. Standard errors are included in parentheses.

*** *p* < 0.01.

** *p* < 0.05.

* *p* < 0.10.

mean-reverting effect for exports after the shock takes place. Regression (2) also includes 2 lags (months) of the political relations variable to allow for a delayed monthly effect of the political shocks. Regression (5) (annual regression with the first lagged dependent variable) does not include lags of the political relations variable. This is done to highlight the importance of contemporaneous (current) PRI coefficient (in order to focus on the temporal bias issue), even after one lag of the exports variable has been included. Finally, Regressions (3) (monthly) and (6) (annual) display the results after including two autoregressive lags for exports, as well as various lags of the political shocks variable. The inclusion of a second autoregressive lag aims at ensuring robustness in the results. Both regressions also include a distributive lag of the political shocks variable: up to a 4-month lag for the monthly equation, and up to a 3-year lag for the annual equation.⁴⁹

Comparing the results of regressions (3) and (6) best illustrate the difference in the dynamics between the monthly and annual effect. For instance, in Table 4, Regression (3) indicates that a one-unit decline in PRI adversely affects export growth by 0.073 a month later. However, in the second month after the PRI shock, export growth increases by 0.038 (= −0.52 × 0.073). Thus, after just two months, the cumulative effect on exports is 0.035 (= 0.073 − 0.038). Additional dampening effects take place in month 3 and onwards as the second lag of the dependent variable and higher-order effects of the first lag of the dependent variable further impart an (attenuating) impact. This timing and observed dynamic pattern is consistent with the one detected in the VAR results. By contrast, Regression (6) (annual regression) indicates

⁴⁹ Adding further lags of the political relations variable did not appreciably change the magnitude of the contemporaneous coefficient in neither the monthly nor annual regressions. However, the standard errors increased slightly.

that a one unit decline in PRI affect export growth by 0.051 in the same year, and for the entire year. Furthermore, since lagged exports do not appear to instill an effect, the results imply that the PRI effect on exports is essentially permanent.

Our gravity equation findings can be summarized as follows: 1. With monthly data, the current period change in political relations of has no significant effect on exports. However, with annual data, the current period change in political relations does have a positive and significant effect. 2. With monthly data, we find that political relations have a delayed and relatively modest effect on exports. Furthermore, that the effect is short-lived, lasting approximately 3 months. These results substantiate the concern about the practice of using temporally aggregated data to investigate the effect of political relations on trade. Result 1 (comparing the contemporaneous coefficients), indicate that there is an aggregation bias. Result 2 highlights the fact that with temporally aggregated data, it is not possible to unmask the natural dynamics of the effect.

8. Concluding remarks

A sizable number of studies in the political science and economics literature find that politics is an important determinant of trade flows. There are many solid theoretical reasons for expecting to observe an effect. For example, shocks in political relations among countries can stir nationalistic sentiments among citizens, thereby affecting consumer preferences and ultimately, trade. Political shocks may also influence government behavior in ways that are detrimental to trade. In addition, political shocks introduce uncertainty, and uncertainty is, after all, associated with lower economic activity.

But although the theoretical underpinnings modeling the relationship between politics and trade is solid, the empirical strategy that many researchers have followed to identify an effect—estimating a gravity model with a measure of political relations using, for the most part, annual data—is potentially problematic.

This paper argues that the underlying problem is that a sizable portion of political shocks are relatively short-lived—with spectral densities of months, if not weeks—whereas researchers have been using data aggregated at much lower frequencies for identifying an effect. Such aggregation can introduce a “temporal aggregation” bias. Hence, to properly investigate whether politics affects trade flows, it is necessary to rely on higher-frequency data.

Using China as our case study, we find that the aftermath of political shocks to the relationships with major trading partners indeed tend to be short-lived; that trade is responsive to political shocks; and that the trade effects of the shocks are likewise short-lived. Based on a vector autoregression analysis, the effects of political shocks on trade are detected only in the first two months following the shock. By the third month, the effects are effectively nil. Results from gravity equation regressions likewise indicate that the effects are temporary, lasting approximately three months. These results validate our concern about using low frequency data to examine the effect of political shocks on trade in general. Temporal aggregation bias is an issue that deserves careful consideration in any investigation of the extent to which political relations affect trade flows.

We also discuss and empirically explore the most commonly highlighted mechanisms through which political shocks affect trade using firm-level import transaction data from China’s Administration of Customs. We find that the sensitivity of imports to political relations is highest for SOE firms. We also find that the sensitivity significantly declines, in order, for privately-owned firms, Sino-Foreign joint ventures, and lastly for Foreign-owned enterprises. This ranking is consistent with the mechanisms the literature has highlighted mediating the effect of political relations on trade for the case of China.

In light of our results stressing the importance of temporal aggregation, it seems prudent to investigate how the prevalence of different mechanisms is likewise affected by the temporal aggregation bias. In future research, we plan on investigating this issue in more detail.

Appendix 1. Data sources

Variable	Description	Source
<i>PRI</i>	Political relations index	Yan et al. (2009), Yan et al. (2010); http://www.imir.tsinghua.edu.cn/publish/iis/7522/index.html
<i>ex</i>	Partner country's export to China (in mill of current US\$)	IMF Direction of Trade (DOT)
<i>y</i>	Industrial production (monthly and annual) or GDP (annual)	National Bureau of Statistics of China (industrial production value added); OECD iLibrary (industrial production index); World Bank GEM Database (industrial production and GDP).
<i>er</i>	Real effective exchange rate between partner country and China	IMF International Financial Statistics (IFS) and Bruegel.org
<i>TNI</i>	Trade News Index	Factiva
<i>Firm-level imports</i>	Imports transacted by firms in China from 2000 to 2006.	General Administration of Customs of China

Appendix 2. Derivation

2.1. Comparing coefficients from monthly and annual frequency regressions

Under an autoregressive process, the monthly model of export growth and changes in PRI can be described as follows:

$$y_m = \alpha_0 + \gamma y_{m-1} + \beta x_m + \varepsilon_m \tag{A.1}$$

where subscript *m* represents the month, *x_m* represents the change in PRI, *y_m* the change in exports, and *ε_m* is the error term.⁵⁰

The temporally aggregated (at the annual level) version of *y* and *x* are:

$$y_t = (1-L^{12})(1-L)^{-1}y_m \tag{A.2}$$

⁵⁰ Eq. (A.1) is robust to a more general dynamic process, including a distributed lag on the PRI variable. For instance, if one or more lags of the PRI variable are part of the model, we would have: $y_m = \alpha_0 + \gamma y_{m-1} + \beta_0 x_m + \beta_1 x_{m-1} + \varepsilon_m$. Notice, however, that with an appropriate lag operation, (e.g. $\beta \equiv (\beta_0 + \beta_1 L)$), the model can be transformed into an isomorphic version of (A.1). Thus, there is no loss of generality in considering (A.1).

and

$$x_t = (1-L^{12})(1-L)^{-1}x_m \quad (\text{A.3})$$

thus, the monthly to annual frequency operator is: $(1-L^{12})(1-L)^{-1}$.

Note that

$$y_{t-1} = (1-L^{12})(1-L)^{-1}y_{m-12}$$

A similar equation applies for x_{t-1} .

By backward substitution of Eq. (A.1) we obtain:

$$y_m = \alpha_0 \left(\sum_{j=0}^{11} \gamma^j \right) + \gamma^{12} y_{m-12} + \sum_{j=0}^{11} \gamma^j \beta x_{m-j} + \sum_{j=0}^{11} \gamma^j \varepsilon_{m-j} \quad (\text{A.4})$$

The terms with the sums can be simplified as:

$$\begin{aligned} \sum_{j=0}^{11} \gamma^j \beta x_{m-j} &= \sum_{j=0}^{11} \gamma^j L^j \beta x_m = (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \beta x_m \\ \sum_{j=0}^{11} \gamma^j \varepsilon_{m-j} &= \sum_{j=0}^{11} \gamma^j L^j \varepsilon_m = (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \varepsilon_m \\ A &\equiv \alpha_0 \left(\sum_{j=0}^{11} \gamma^j \right) \end{aligned}$$

Thus, Eq. (A.4) can be written as:

$$y_m = A + \gamma^{12} y_{m-12} + (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \beta x_m + (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \varepsilon_m \quad (\text{A.5})$$

Multiplying (A.5) by the aggregate operator yields:

$$\begin{aligned} (1-L^{12})(1-L)^{-1} y_m &= (1-L^{12})(1-L)^{-1} A + (1-L^{12})(1-L)^{-1} \gamma^{12} y_{m-12} + (1-L^{12})(1-L)^{-1} (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \beta x_m \\ &\quad + (1-L^{12})(1-L)^{-1} (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \varepsilon_m \end{aligned}$$

We can now use the temporally aggregated versions of y and x , (A.2) and (A.3), to simplify the above equation, obtaining:

$$y_t = 12A + \gamma^{12} y_{t-1} + (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \beta x_t + (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \varepsilon_t$$

or

$$y_t = 12A + \gamma^{12} y_{t-1} + \beta x_t + \gamma \beta x_{t-1} + \dots + \gamma^{11} \beta x_{t-11} + (1-\gamma^{12} L^{12})(1-\gamma L)^{-1} \varepsilon_t \quad (\text{A.6})$$

Hence, the β coefficient of the contemporaneous but temporally aggregated x variable, x_t , displayed in (A.6) is the same as the one from the contemporaneous x variable at the monthly frequency, x_m , displayed in (A.1).

Appendix 3. Supplementary data

Supplementary data to this article can be found online at <http://dx.doi.org/10.1016/j.jinteco.2017.07.002>.

References

- Amemiya, Takeshi, Wu, Roland Y., 1972. The effect of aggregation on prediction in the autoregressive model. *J. Am. Stat. Assoc.* 67 (339), 628–632.
- Anderson, James E., van Wincoop, Eric, 2003. Gravity with gravitas: a solution to the border puzzle. *Am. Econ. Rev.* 93 (1), 170–192.
- Arellano, Manuel, Bond, Stephen, 1991. Some tests of specification for panel data: Monte Carlo evidence and an application to employment equations. *Rev. Econ. Stud.* 58 (2), 277–297.
- Baier, Scott L., Bergstrand, Jeffrey H., 2001. The growth of world trade: tariffs, transport costs, and income similarity. *J. Int. Econ.* 53 (1), 1–27.
- Bayoumi, Tamin, Eichengreen, Barry, 1997. Is regionalism simply a diversion? Evidence from the EU and EFTA. In: Ito, T., Krueger, A. (Eds.), *Regionalism Versus Multilateral Trade Agreements*. University of Chicago Press, Chicago, IL.
- Berger, Daniel, Easterly, William, Nunn, Nathan, Satyanath, Shanker, 2013. Commercial imperialism? Political influence and trade during the cold war. *Am. Econ. Rev.* 103 (2), 863–896.
- Bernheim, B. Douglas, Peleg, Bezalel, Whinston, Michael D., 1987. Coalition-proof Nash equilibria I. concepts. *J. Econ. Theory* 42 (1), 1–12.
- Blundell, Richard, Bond, Stephen, 1998. Initial conditions and moment restrictions in dynamic panel data models. *J. Econ.* 87 (1), 115–143.
- Blundell, Richard, Bond, Stephen, 2000. GMM estimation with persistent panel data: an application to production functions. *Econ. Rev.* 19 (3), 321–340.
- Box, George E.P., Jenkins, Gwilym M., 1976. *Time Series Analysis: Forecasting and Control*. Prentice Hall, Englewood Cliffs, NJ.
- Breitung, Jorg, Swanson, Norman R., 2002. Temporal aggregation and spurious instantaneous causality in multiple time series models. *J. Time Ser. Anal.* 23 (6), 651–665.
- Che, Yi, Julian, Du, Lu, Yi, Tao, Zhigang, 2015. Once an enemy, forever an enemy? The long-run impact of the Japanese invasion of China from 1937 to 1945 on trade and investment. *J. Int. Econ.* 96 (1), 182–198.
- Christiano, Lawrence J., Eichenbaum, Martin, Marshall, David, 1991. The permanent income hypothesis revisited. *Econometrica* 59 (2), 397–423.
- Davis, Christina L., Meunier, Sophie, 2011. Business as usual? Economic responses to political tensions. *Am. J. Polit. Sci.* 55 (3), 628–646.
- Davis, Christina, Fuchs, Andreas, Johnson, Kristina, 2014. State control and the effects of foreign relations on bilateral trade. Discussion Paper Series No. 576. Department of Economics, University of Heidelberg.
- Farrell, J., Maskin, E., 1989. Renegotiation in repeated games. *Games Econ. Behav.* 1, 327–360.
- Fisman, Raymond, Hamao, Yasushi, Wang, Yongxiang, 2014. Nationalism and economic exchange: evidence from shocks to Sino-Japanese relations. *Rev. Financ. Stud.*

- Fuchs, Andreas, Klann, Nils-Hendrik, 2013. Paying a visit: the Dalai Lama effect on international trade. *J. Int. Econ.* 91 (1), 164–177.
- Fudenberg, Drew, Tirole, Jean, 1991. *Game Theory*. MIT Press, Cambridge, MA.
- Glick, Reuven, Taylor, Alan M., 2010. Collateral damage: trade disruption and the economic impact of war. *Rev. Econ. Stat.* 92 (1), 102–127.
- Goenner, Cullen F., 2011. Simultaneity between trade and conflict: endogenous instruments of mass destruction. *Confl. Manag. Peace Sci.* 28 (5), 459–477.
- Goldstein, Joshua S., 1992. A conflict-cooperation scale for WEIS events data. *J. Confl. Resolut.* 36 (2), 369–385.
- Granger, Clive W.J., 1966. The typical spectral shape of an economic variable. *Econometrica* 34 (1), 150–161.
- Granger, Clive W.J., 1969. Investigating causal relations by econometric models and cross-spectral methods. *Econometrica* 37 (3), 424–438.
- Harvey, Andrew C., 2001. *Forecasting, Structural Time Series Models, and the Kalman Filter*. Cambridge University Press, Cambridge, UK.
- Hegre, Havard, O'neal, John R., Russett, Bruce, 2010. Trade does promote peace: new simultaneous estimates of the reciprocal effects of trade and conflict. *J. Peace Res.* 47 (6), 763–774.
- Heilmann, Kilian, 2016. Does political conflict hurt trade? Evidence from consumer boycotts. *J. Int. Econ.* 99, 179–191.
- Johnston, Alastair Iain, 2011. Stability and instability in Sino–American relations: a response to Yan's superficial friendship theory. *Chin. J. Int. Polit.* 4 (1), 5–29.
- Keshk, Omar M.G., Pollins, Brian M., Reuveny, Rafael, 2004. Trade still follows the flag: the primacy of politics in a simultaneous model of interdependence and armed conflict. *J. Polit.* 66 (4), 1155–1179.
- Lin, Faqin, Hu, Cui, Fuchs, Andreas, 2016. How do firms respond to political tensions? The heterogeneity of the Dalai Lama effect on trade. PDF Manuscript available at: <https://www.hhs.se/contentassets/bc7089cd2c364b2cae4c287184ad743b/andreas-fuchs-how-do-firms-respond-to-political-tensions.pdf>.
- Long, Andrew G., 2008. Bilateral trade in the shadow of armed conflict. *Int. Stud. Q.* 52, 81–101.
- Lütkepohl, Helmut, 1987. *Forecasting Aggregated Vector ARMA Processes*. Springer, Berlin, Germany.
- Marcellino, Massimiliano, 1999. Some consequences of temporal aggregation in empirical analysis. *J. Bus. Econ. Stat.* 17 (1), 129–136.
- Martin, Philippe, Mayer, Thierry, Thoenig, Mathias, 2008. Make trade not war? *Rev. Econ. Stud.* 75 (3), 865–900.
- Michaels, Guy, Zhi, Xiaojia, 2010. Freedom fries. *Am. Econ. J. Appl. Econ.* 2 (3), 256–281.
- Mityakov, Sergey, Tang, Heiwai, Tsui, Kevin K., 2013. International politics and import diversification. *J. Law Econ.* 56 (4), 1091–1121.
- Morrow, James D., 1999. How could trade affect conflict? *J. Peace Res.* 36 (4), 481–489.
- Morrow, James D., Siverson, Randolph M., Tabares, Tressa E., 1998. The political determinants of international trade: the major powers, 1907–90. *Am. Polit. Sci. Rev.* 92 (3), 649–661.
- Pandya, Sonal S., Venkatesan, Rajkumar, 2016. French roast: consumer response to international conflict—evidence from supermarket scanner data. *Rev. Econ. Stat.* 98 (1), 42–56.
- Polachek, Solomon William, 1980. Conflict and trade. *J. Confl. Resolut.* 24 (1), 55–78.
- Pollins, Brian M., 1989a. Conflict, cooperation, and commerce: the effect of international political interactions on bilateral trade flows. *Am. J. Polit. Sci.* 33 (3), 737–761.
- Pollins, Brian M., 1989b. Does trade still follow the flag? *Am. Polit. Sci. Rev.* 83 (2), 465–480.
- Priestly, Maurice B., 1981. *Spectral Analysis and Time Series: Multivariate Series, Prediction and Control*. Academic Press, Waltham, MA.
- Rose, Andrew K., 2012. Protectionism isn't counter-cyclic (anymore). NBER Working Paper No. 18062.
- Rossana, Robert J., Seater, John J., 1995. Temporal aggregation and economic time series. *J. Bus. Econ. Stat.* 13 (4), 441–451.
- Silvestrini, Andrea, Veredas, David, 2008. Temporal aggregation of univariate and multivariate time series models: a survey. *J. Econ. Surv.* 22 (3), 458–497.
- Simmons, Beth A., 2005. Rules over real estate: trade, territorial conflict, and international borders as institution. *J. Confl. Resolut.* 49 (6), 823–848.
- Sims, Christopher A., 1971. Discrete approximations to continuous time distributed lags in econometrics. *Econometrica* 39 (3), 545–563.
- Taylor, Alan M., 2001. Potential pitfalls for the purchasing power parity puzzle? Sampling specification biases in mean-reversion tests of the law of one price. *Econometrica* 69 (2), 473–498.
- Telsler, Lester G., 1967. Discrete samples and moving sums in stationary stochastic processes. *J. Am. Stat. Assoc.* 62 (318), 484–499.
- Thornton, Michael A., Chambers, Marcus J., 2013. Temporal aggregation in macroeconomics. (Chapter 13). In: Hashimzade, Nagar, Thornton, Michael A. (Eds.), *Handbook of Research Methods and Applications in Empirical Macroeconomics*. Edward Elgar Publishing, Cheltenham, UK and Northampton, MA.
- Tiao, George C., 1972. Asymptotic behaviour of temporal aggregates of time series. *Biometrika* 59 (3), 525–531.
- Wei, W.W.S., 1982. The effects of systematic sampling and temporal aggregation on causality—a cautionary note. *J. Am. Stat. Assoc.* 77 (378), 316–319.
- Wei, Shang-jin, 1996. Intra-national versus international trade: how stubborn are nations in global integration? NBER Working Paper No. 5531
- Working, Holbrook, 1960. Note on the correlation of first differences of averages in a random chain. *Econometrica* 28 (4), 916–918.
- Yan, Xuotong, Qi, Haixia, 2009. *Zhongwaiguanxidingliangyuce*, [中外关系定量预测: Quantitative Forecasts of China's Foreign Relations]. Shijieheshichubanshe, Beijing, China.
- Yan, Xuotong, ZhuoFangyin, Qi Haixia, Xu, Jin, Zhaijiu, Mei, Liangzhu, Yan, 2010. *Zhongwaiguanxijianlan 1950–2005—Zhongguoyudaguanxidinglianghengliang* [中外关系年鉴1950–2005—中国与大国关系定量衡量: China's Foreign Relations with Major Powers by the Numbers 1950–2005]. Gaodengjiaoyuchubanshe, Beijing, China.