

**BUSINESS AS USUAL:
ECONOMIC RESPONSES TO POLITICAL TENSIONS**

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Introduction

Do rising political tensions impact the level of economic exchange between states? When two countries display animosity and antagonism towards each other, how does this affect their patterns of bilateral trade and investment? The relationship between economic interdependence and war has been a central debate in the international relations literature, with well-known arguments that trade prevents war and that alliance relations motivate trade. But short of war, less is known about whether smaller shifts in the affinity between states produce corresponding shifts in economic affairs. Yet such tensions are much more prevalent than wars. While the potential economic implications of negative opinion polls and public discord between top leaders capture headlines through sensational reports about boycott movements, they have not been the focus of scholarly research.

This paper examines whether periods of heightened political tensions produce any measurable effect on economic transactions –especially trade and investment. By political tensions, we mean hostility between leaders, which can be observed in critical public statements and decline of summit meetings, and rising negative sentiment in the general population, which is reflected in public opinion, demonstrations, and media coverage. One can place bilateral political relations on a continuum from normal relations, political tensions, economic sanctions, threats of force, to war. While most analysis of conflict behavior in international relations focuses on the higher intensity conflicts represented by sanctions or militarized disputes, we analyze the shift at the lower level from normal relations to political tensions. Although the stakes are smaller and usually not distributional conflicts, political tensions represent a more frequent occurrence than conflict disputes. Moreover, few states will move from normal relations to war without passing through a period of political tensions. It is important to understand the effects of political tensions both for policy evaluation and for exploration of the microfoundation of theoretical arguments.

We study the bilateral relationships between the United States and France and between Japan and China over the decade from 1995 to 2005. We closely examine the timing of shifts in political relations to observe any impact on economic measures, and compare them with the political and economic relationship with third countries. Franco-American political tensions have grown since the end of the Cold War, from the trade wars in the WTO and the criticisms of globalization to the rift over Iraq. Yet the predicted economic impact of sour Franco-American political relations has not materialized. On the contrary, in 2004, trade and investment between the United States and France, its nemesis in the United Nations over Iraq, grew as rapidly as U.S. trade and investment with Britain, its loyal partner in Iraq. During the same period, Japan and China have confronted an increasingly hostile political atmosphere created by controversies over history, territorial disputes, and rivalry for influence in the United Nations Security Council. Tensions have led to anti-Japanese riots and boycotts in China

and the suspension of high level diplomatic meetings. At the same time, Japanese investment in China and bilateral trade flows have continued to grow at a rapid pace. Indeed, in 2004 China surpassed the United States as the top trade partner of Japan even while Japan and the United States engaged in closer military cooperation as allies and enjoyed unusually positive political relations.

Why is the trade and investment relationship robust in spite of the political tensions? Why is there no spillover of political tensions into the consumption and investment side? The observation of business as usual counters both public commentary and many theoretical studies that link political and economic relations. We assess the economic implications of political tensions and explore how to explain the paradox of solid, if not stronger, economic ties in the face of weakened political ties. We argue that sunk costs in existing trade and investment relations and competitive pressures in global markets mean that economic transactions show little response to political trends. Nevertheless, we raise the possibility of a threshold beyond which economic ties are no longer insulated from foreign policy disputes.

The paper starts by reviewing the public perception both in the media and in the business community that political tensions are bound to spill over into the economic realm. Next, we analyze how the International Relations literature has studied the linkages between political tensions and economic relations, and we derive from this literature three hypotheses: politics first, economics first, and separation of economics and politics. We then study the impact of political tensions on bilateral economic relations in two cases: the United States and France, and Japan and China. The final section explains the findings and analyzes the conditions under which political disputes between states spill over into the economic relationship.

Public Perception Links Political Relations and Economic Decisions

In public perception, there is no doubt that political tensions have a direct impact on economic relations. Sensationalist media reports about consumer boycotts and alarmist statements by the business community concerned about the potential impact of worsening political relations both contribute to fueling these perceptions. Many anecdotes show the prevalence of these perceptions in the Franco-American dispute over Iraq and in the Sino-Japanese rift over the shrine visits.

The Franco-American Dispute over Iraq

Whenever political tensions arise between two countries, the media like to play these up and portray catastrophic scenarios about their potential economic consequences. This was certainly the case in the dispute between France and the United States over Iraq in the spring of 2003, where the media not only reported numerous instances of sensational consumer boycotts, but also took an active part in launching the boycott campaign.

The rift between France and the U.S. over the invasion of Iraq reached its apex in the Spring of 2003, when France publicly opposed the American decision to go to war and mounted an antagonistic campaign in the United Nations. But such acrimony did not come out of nowhere; neither did it recede once the crisis over the American intervention in Iraq had tapered. Franco-American political relations had deteriorated throughout the 1990s, with a sharp downturn after the Bush administration took office, over the issue of American unilateralism, as illustrated in climate change, the International Criminal Court, and trade disputes. By the time the Iraq crisis developed, political tensions between France and the United States were already high, whether at the level of public opinion or diplomacy.

Public opinion surveys trace the rise of French mistrust and declining favorable sentiment towards the United States to the late 1990s, when the French started to develop a rising apprehension that the U.S. had too much influence in international affairs and in their own domestic affairs. This growing acrimony was tamed by the events of September 11, 2001, to which the French demonstrated great empathy and expressed solidarity with the Americans. Public opinion tensions started to rise again, however, as the war in Iraq approached and French and American policymakers clashed very publicly over the most favorable course of action. In the spring of 2003, half of the French who had said they favored the United States the previous summer changed their mind and those with positive views dropped from 63 to 31 percent.¹ By April 2003 France (65%) and Spain (69%) led all other Europeans in recording unfavorable views of the United States.² Similar tensions were perceptible at the diplomatic level. After September 11, President Chirac was the first foreign head of state to visit the U.S. and offer in person his sympathies to President Bush and the American people. In the fall of 2002, French diplomats worked hard to find a compromise resolution on Iraq. In early 2003, diplomatic tensions escalated as French policymakers “cornered” Secretary of State Colin Powell and later felt betrayed by the Bush Administration’s decision to go to war in Iraq no matter what. Franco-American diplomatic tensions reached an apex in March 2003, when French diplomacy actively tried to prevent the U.S. from obtaining a resolution from the United Nations and Americans portrayed the French as an overt enemy of the United States.³

Many commentators, both in the popular press and in the business community, expected these political tensions to spill over from the political onto the economic realm. Indeed, most French complaints about the United States in the 1990s were criticisms of globalization, often accompanied by calls for changing consumer behavior and investment decisions.⁴ Similarly, the heightened transatlantic tensions over Iraq led many

¹ Richard Kuisel, “What do the French Think of Us? The Deteriorating Image of the United States, 2000-2004.” *French Politics, Culture and Society*, Fall 2004 22(3), pp. 91-119.

² .S. Department of State, Office of Research, Opinion Analysis, *Key West Europeans Still Mostly Negative about Military Action in Iraq*, 14 May 2003, cited in Kuisel, 2004.

³ Thomas Cantaloube and Henri Vernet, *Chirac contre Bush: L’Autre guerre*. Paris: Jean-Claude Lattès, 2004.

⁴ See for instance Philip H. Gordon and Sophie Meunier, *The French Challenge: Adapting to Globalization*, Washington, DC: Brookings Institution Press, 2001; and Hubert Vedrine, *France in an Age of Globalization*, Washington DC: Brookings Institution Press, 2001.

Americans to call for the boycotting of European products –French wines and German beer were to be the first casualty of Old Europe’s “betrayal” of America. Public opinions on both sides of the Atlantic were going to demonstrate their discontent of the other with their wallets, and governments would punish each other through their public procurement policies.

On both sides of the Atlantic, the media reported widely on instances of consumer boycotts as evidence that transatlantic political tensions were impacting economic relations as well. Anecdote after anecdote showed that European consumers transferred their hostility to the U.S. position on Iraq to American products: some restaurants in Germany stopped selling Budweiser, Coke and Marlboro cigarettes and would not let customers pay with their American Express cards; German bicycle maker Riese und Mueller cancelled all business deals with American suppliers; French youths vowed to stop eating at McDonalds; websites called for European boycotts of American companies, from Microsoft to Kodak; the list goes on.⁵ Indeed, as the *Washington Post* warned, “the boycotts and the surrounding avalanche of negative publicity are a storm warning of what may lie ahead.”⁶

Similarly, Americans manifested their displeasure of the French “betrayal” by boycotting its national products, symbolically pouring French wine down the drain, and changing their travel plans.⁷ In the United States, the most visible figure in the drive to punish European traitors through consumer boycotts was conservative media personality Bill O’Reilly, who launched a “Boycott France” campaign on the air in March 2003. As he wrote a year later to justify the continuing boycott: “So no more brie for me. No more Evian, Air France, Provence and no more escargot, which I don’t like anyway. As a free American, I am using my economic choice to send the French government a message. I am boycotting French goods and services and hope you will do the same.”⁸

The overall impression in the transatlantic media around the time of the Iraq crisis, as summarized by *The Washington Post*, was that “the animosity that has flared of late appears almost certain to seep into transatlantic trade and investment issues”⁹ Certainly the transatlantic tensions, and the resulting consumer boycotts, “have all the potential, if unchecked, to have ugly economic consequences.”¹⁰

The transatlantic business community was the other group, alongside the media, who predicted that the diplomatic rift would be irretrievably poisoning economic ties. In Europe, business leaders worried about the economic impact of transatlantic tensions on specific sectors, such as the food and wine industry, the luxury goods sector, and

⁵ See for instance Noelle Knox and Theresa Howard, “Anti-war protesters take aim at American brands,” *USA Today*, April 4, 2003. Will Hutton, “Goodbye, Coke. Hello, Mecca-Cola,” *The Washington Post*, April 20, 2003.

⁶ “Goodbye, Coke. Hello, Mecca Cola.” *Washington Post*, April 18, 2003.

⁷ Indeed, it was reported that 41% of Americans with French travel plans in the spring 2003 chose to modify them as a result of the Franco-American disagreements over the war. Bruce Horowitz, “Boycott grinds on against French food, wine, travel,” *USA Today*, May 1, 2003.

⁸ Bill O’Reilly, “No More Brie for Me,” BillOReilly.com, July 21, 2004.

⁹ Paul Blustein, “Anxiety over trade rift grows,” *The Washington Post*, March 23, 2003.

¹⁰ Will Hutton, “Goodbye, Coke. Hello, Mecca-Cola,” *The Washington Post*, April 20, 2003.

aircrafts. Europeans were further alarmed when the Bush administration retaliated against France and Germany by excluding their companies from Iraqi reconstruction.¹¹

The fears about a contagion of tensions from the political to the economic realms were greater in the United States. Many American companies publicly worried that Europeans would focus their ire on business as a proxy for hurting governments and that big American consumer brands would be paying the price for the unpopularity of American foreign policy.¹² In addition to consumer boycotts, U.S. corporations became concerned about the erosion of trust in American brands and the rising costs of security.¹³ In January 2004, a group of business executives mostly from the communications and marketing fields formed a group called Business for Diplomatic Action (BDA), designed to mobilize the U.S. business community in addressing and responding to rising anti-Americanism.¹⁴ Since then, BDA, whose motto is “Anti-Americanism is bad for business,” has been quite active in emphasizing to American companies how foreign animosity could hurt businesses in the U.S. and in engaging their members to take some action. Otherwise, the overall picture presented by BDA is bleak: “The costs associated with rising anti-American sentiment are exponential. From security and economic costs to an erosion in our ability to engender trust around the world and recruit the best and brightest, the U.S. stands to lose its competitive edge if steps are not made toward reversing the negativity associated with America.”¹⁵

Sino-Japanese Rift

During his five years in office from August 2001 until August 2006, Prime Minister Junichiro Koizumi’s annual visit to the Yasukuni shrine, which is dedicated to the spirits of Japan’s war dead including those executed as war criminals, sparked a rancorous debate about issues connected to historical memory of Japan’s wartime actions that became a flashpoint to worsen Sino-Japanese relations. Citing his insensitivity to China’s experience as a victim of Japan’s wartime aggression, Chinese leaders refused to meet with Prime Minister Koizumi. Disagreements over territorial claims to islands near major energy resources and broader concerns about changing power positions in East Asia also underlie tensions between the countries. In 2005, China threatened to veto Japan’s long sought goal to gain a permanent seat on the UN Security Council. This five year period of the Koizumi administration was marked by worsening public opinion about the bilateral relationship on both sides and repeated calls in China for boycotts of Japanese products.

¹¹ See for instance Elisabeth Bumiller, “Bush defends barring nations from Iraq deals,” *The New York Times*, December 11, 2003.

¹² See for instance Richard Tomkins, “Anti-war sentiment is likely to give fresh impetus to the waning supremacy of U.S. brands,” *Financial Times*, March 27, 2003.

¹³ Keith Reinhard, “Testimony before the House Subcommittee on National Security, Emerging Threats, and International Relations,” August 23, 2004.

¹⁴ Business for Diplomatic Action, <http://www.businessfordiplomaticaction.org/index.php> (last accessed October 18, 2005).

¹⁵ <http://www.businessfordiplomaticaction.org/who/index.html> (last accessed October 18, 2005).

Public opinion surveys show a marked increase of political tensions. In China, surveys conducted by China's Public Survey Network showed that the percent of urban Chinese residents who disliked Japan rose from 46 percent in the year 2000 to 59 percent in 2005.¹⁶ Very similar results are found on the Japanese side where polls conducted by the Prime Minister's office showed that the percent of Japanese who did not feel close to China rose from 47 percent in the year 2000 to 58 percent in 2004.¹⁷ Tension at the level of the government was most evident from strong public statements criticizing Prime Minister Koizumi for visiting Yasukuni shrine and the refusal to meet with him for a formal summit meeting during the five years of his administration after the single summit held in October 2001 of his first year in office.

As Sino-Japanese relations worsened, the media on both sides reported commentary about potential harm to economic relations. After years of repeating the slogan that Sino-Japanese relations were "cold in politics" and "hot in economics," many began warning that spillover from political problems had begun to cool economic relations. Under the title "Political Chilliness Begins to Affect Economic Ties" the People's Daily Online cited a warning from Chinese Minister of Commerce Bo Xilai that prolonged "disharmony in political relations" between Japan and China would damage bilateral trade and economic cooperation.¹⁸ Evidence of the fear that political relations would harm economic relations can also be seen by the large number of officials and commentators in China who made statements trying to discourage boycotts and pointing out the mutual benefits from the economic relationship.¹⁹ The Japanese media readily picked up on the reported warnings of potential economic harm.²⁰

Anecdotes about actual incidents causing economic costs were widely reported. During April 2005, protesters rallying against Japan's bid to gain a permanent seat on the UN Security Council destroyed a Japanese retail store Ito-Yokado in Sichuan Province.²¹ Some Chinese retail stores were said to have stopped selling Asahi beer after boycotts targeted Asahi Breweries and several other Japanese companies that were alleged to have provided funding for a controversial textbook reform council in Japan.²² Negative sentiment toward Japan in China was said to obstruct economic relations in even more subtle ways as Japanese firms were unpopular among Chinese job-seekers and Chinese consumers reacted with more extreme responses to product defects by Japanese firms.²³ As foreign banks acquired Chinese financial institutions, analysts reported that Japanese banks were lagging behind because political problems made Chinese banks prefer other

¹⁶ 2005 Public Survey on Chinese Views Toward Japan, 2000 Public Survey on Chinese Views Toward Japan based on sampling, available at www.comrc.cn

¹⁷ *Zenkoku yoron chosa no genjo* (The state of current national public opinion), Tokyo: Cabinet Office, 2004, p. 16.

¹⁸ Xinhua, "Political chilliness begins to affect economic ties: Bo Xilai" 24 April 2005, People's Daily Online available at <http://english.people.com.cn>.

¹⁹ "Trading Blows," *South China Morning Post*, 3 May 2005.

²⁰ "Disputing the argument about separation of politics and economics," *Asahi Shimbun* 6 September 2006.

²¹ "China boycott threatens firms" *The Daily Yomiuri*, 4 April 2005.

²² Xinhua Net, 25 April 2005 available at <http://news.263.net/20050425/00476199.html>

²³ Kanshi Yu, "Cold Political Relations harm hot economic relations," *Chuo Koron* 119: 11 (November 2004): 68-71.

partners over Japanese banks.²⁴ Some even attributed the relative decline in Japan's portion of China's trade to political problems.²⁵

Business leaders in Japan and China expressed fears of economic harm. In a survey sent to 100 executives of leading Japanese companies (95 responded), 51 expressed concerns that Sino-Japanese tensions would harm their business interests in China.²⁶ Many Japanese business leaders urged the prime minister against visiting Yasukuni shrine because the political controversy would damage economic interests. Kakutarō Kitashiro, the Chairman of the Japan Association of Corporate Executives (*Keizai Doyukai*) said at a news conference "Prime Minister Koizumi's visits to Yasukuni Shrine could spread negative views about Japan (in China) and cause adverse effects on Japanese companies activities there," and the organization passed a resolution in May 2006 urging the prime minister to reconsider his policy of visiting the shrine.²⁷ As Japanese business leaders watched European and American leaders actively engaging with China and encouraging business deals for their industries, many feared that the freeze on meetings between Japan and China's top leadership would leave them excluded from new opportunities and slow down prospects for strengthened economic partnership agreements. Others began to express concerns about the risk of investment in China.²⁸ At the same time, Chinese businessmen warned that contracts for business projects with Japanese companies in China might be delayed.²⁹ While some in China raised the possibility of adverse economic consequences from political tensions as a threat to Japan, others cautioned that reluctance by Japanese firms to invest in China would reduce much needed jobs and capital.

After many years in which the separation of politics and economics had been taken for granted as a feature of Sino-Japanese relations, the rising tensions surrounding the Yasukuni shrine visits prompted many to question this assumption. Both media reports and complaints from business raised the specter that political tensions were beginning to have a negative impact on economic relations.

Theoretical Perspectives on Economic Interdependence and Conflict

Unlike the media's dire warnings of boycotts and the business community's worries about political tensions, the political science literature has not been particularly

²⁴ David Ivison, "Clamour to boost China stakes reveals Japan anomaly," *Financial Times*, 21 October 2005.

²⁵ Jiang Ruiping, "Economic Cost of Sino-Japanese Political Cold (translated from Chinese)," *China's Economic Times* 11 January 2006.

²⁶ "Over half of top firms fret Japan-China ties," *The Japan Times*, 3 August 2005.

²⁷ "National interests should dictate Tokyo's posture," *The International Herald Tribune/Asahi Shimbun*, 14 December 2004. "Keizai Doyukai urges Prime Minister to reconsider shrine visits (translated from Japanese)" *Asahi Shimbun*, 10 May 2006.

²⁸ David Pilling, "Japanese companies in China rethink" *Financial Times*, 10 June 2005.

²⁹ Cheung, Gary and Dennis Eng, "Hong Kong won't be spared if business ties are damaged," *South China Morning Post*, 19 April 2005.

concerned about the economic consequences of political tensions. This is not surprising given the long line of traditional scholarship that separated international politics and international economics. Realist scholars from Hans Morgenthau to Kenneth Waltz and liberal scholars such as Stanley Hoffmann argue that states are the central actors and security is their primary concern. Taken to their extreme, this perspective portrays foreign policy and economic flows as belonging to two independent spheres that are insulated from one another. The “low politics” sphere is concerned with economic, social and cultural issues, as opposed to the “high politics” sphere, concerned with the high stakes issues of war, peace, and sovereignty. International economic relations have no systematic bearing on political conflict, and vice versa. This view gains support from evidence during the periods leading up to WWI and WWII when trade seemed unaffected by trends in international politics until war actually broke out among trade partners.

Nevertheless, a substantial body of scholarship has countered these views about separation of politics and economics. Liberal theories long emphasized the commercial peace argument that economic interdependence created vested interests that would prevent war. Realist theories have disputed these claims, but also suggest connections between economics and politics through the mechanism of alliance interests as states prefer to trade with allies over adversaries. This section will discuss the implications of these studies to generate hypotheses about the expected effect of political tensions on economic exchange.

Alliances, security, and trade

To the extent that realist theories examine linkages between politics and economics, they have supported the view that economic policy operates as a tool in the service of security goals. Hirschman’s influential study showed Hitler’s use of economic policies to make allies dependent and more cooperative with his expansionary goals.³⁰ In a related argument, Joanne Gowa and Edward Mansfield argue that interstate alliances determine the pattern of international trade.³¹ The central claim is that trade allows states to employ domestic resources more efficiently, which generates a security externality by freeing resources for military uses. Since income from trade enhances the potential military power of both trade partners, trade with an ally provides a positive externality. Therefore, allies have an incentive to sustain trade because the potential military strength of each participant in the alliance increases with the aggregate economic resources of its members. In contrast, trade with an adversary creates a negative security externality that poses a security threat. The differentiation between allies and adversaries is most important during the stable alliances of bipolar periods, while less so during multipolar periods when alliances were more fluid.³² Using bilateral trade flow data between the

³⁰ Hirschman, Albert. *National Power and the Structure of Foreign Trade*. Berkeley, CA: University of California Press, 1980 [1945].

³¹ Joanne Gowa, *Allies, Adversaries, and International Trade*. Princeton: Princeton University Press, 1994. Joanne Gowa and Edward D. Mansfield, “Power Politics and International Trade,” *American Political Science Review*, Vol. 87, No. 2, June 1993.

³² Joanne Gowa, “Bipolarity, Multipolarity, and Free Trade,” *American Political Science Review*, Vol. 83, No. 4, 1989: 1245-1256.

major powers from 1907 to 1991, Gowa and Mansfield find that alliances exert a large, significant effect on trade.³³

Other scholars bring in the expectation of business actors as a mechanism that would lead economic exchange to follow trends in political relations. Brian Pollins, analyzes the impact of political conflict and cooperation on bilateral trade, and concludes that “trade follows the flag.” Based on assumptions about importers’ preferences, this argument is two-pronged. First, importers may choose to trade with friendly countries in order to manage risk and minimize potential economic disruption, knowing that ties with adversary nations might be ruptured by foreign policy.³⁴ Second, consumers “express goodwill or solidarity toward those whom they identify as friends, while shunning or punishing those they perceive as foes.”³⁵ Overall, import decisions are affected by the general foreign policy orientation of the importer vis-à-vis the exporter and by the recent status of relations between their countries. As a result, bilateral trade is lower when the participants are engaged in conflictual than in cooperative political relationships.

William Dixon and Bruce Moon estimate the effects of common political systems on trade flows and argue that the similarity in political systems and in foreign policy orientations are important determinants of trade flows.³⁶ They find that states holding similar policy positions on most global issues are more likely to trade. Similarly, Bliss and Russett assess the effect of shared democratic institutions on trade between states and find that internal political factors affect trade flows.³⁷ Exporters and importers find it less risky to deal with countries that have similar economic and political systems, because they are more knowledgeable about consumer tastes, business trends, and government regulatory constraints. Moreover, they can make the long-term investments necessary for trade (such as marketing, product design, and establishing a client base) knowing that the political risk that trade will be disrupted is minimal. A recent study of trade among EU member states has shown that even when controlling for standard predictors of trade levels in a sample of states with common political orientation, states with higher trust measured by Eurobarometer surveys have statistically significant higher levels of trade, portfolio investment, and direct investment.³⁸ In further study of the political determinants of international trade, James Morrow, Randolph Siverson and Tressa

³³ Joanne Gowa and Edward D. Mansfield, “Alliances, Imperfect Markets, and Major-Power Trade,” *International Organization*, 58, Fall 2004, pp. 775-805.

³⁴ Brian M. Pollins, “Does Trade Still Follow the Flag?” *The American Political Science Review*, Vol. 83, No. 2, June 1989.

³⁵ Brian M. Pollins, “Conflict, Cooperation, and Commerce: The Effect of International Political Interactions on Bilateral Trade Flows,” *American Journal of Political Science*, Vol. 33, No. 3, August 1989.

³⁶ William J. Dixon and Bruce E. Moon, “Political Similarity and American Foreign Trade Patterns,” *Political Research Quarterly*, Vol. 46, No. 1, March 1993, pp. 5-25.

³⁷ Harry Bliss and Bruce Russett, “Democracy and Trade: Ties of Interest and Community,” in Gustaaf Geeraerts and Patrick Stouthuysen eds., *Democratic Peace in Europe: Myth or Reality*, Brussels: Free University Press, 1998.

³⁸ Luigi Guiso, Paola Sapienza, and Luigi Zingales. “Cultural Biases in Economic Exchange,” NBER Working Paper No. 11005 (2004).

Tabares find that common interests and similar political institutions, which reassure economic agents wary of political risk, increase trade flows.³⁹

These related arguments discuss how different dimensions of political cooperation and similarity foster trade. The implication is that improving political relations would encourage more trade, while worsening political relations would reduce trade. States concerned about security externalities will be more confident to trade with an ally that shows strong alliance commitment than one that appears to be drifting away from the alliance and will be averse to trading with a state perceived as an emerging rival with hostile interests. In short, to the extent that the differences over Iraq weakened U.S. confidence in France as a reliable ally, it could reduce U.S. support for expanding trade with France relative to expanding trade with its staunch alliance partners such as Britain. For Japan and China, worsening political tensions only served to highlight that each views the other as a potential rival and security threat which would suggest the states would be concerned about a security externality from trade and favor a reduction of economic interdependence. From the perspective of private economic actors, political tensions would act as a signal of potential future disruption in relations that could threaten investments. All else equal, business would be expected to respond to political tensions by risk diversification and transfer of exchange to markets where governments had more positive political relations.

Yet these studies operate at a higher level of analysis with a focus on alliance relations and conflict potential, so one could also draw the conclusion that smaller spats between states would have little effect. The observation that trade and investment continue to grow strong between Europe and the United States suggest that private actors still believe that the political risks of a transatlantic fallout are fairly low and the potential disruption of business for political reasons very limited. If the former transatlantic partners were truly drifting apart, then trade and investment would be affected; since they are not, it must mean that the intra-alliance conflict that crystallized around Iraq in 2003 is just an internal squabble and not evidence of a deep-seated rift. Nevertheless, such an interpretation would call for additional explanation about what represents a break in relations substantial enough to trigger economic effects – in theory the sensitivity of states to security externalities and the sensitivity of business to shifts in political environment should have a continuous effect over both small and large movements in political relations.

The commercial peace argument

Another strand of International Relations literature has analyzed the links between economic and political relations to present arguments for a “commercial peace.” From Montesquieu to Adam Smith to contemporary liberals, scholars have argued that free trade encourages peace.⁴⁰ While emphasizing the effect of economic relations on political

³⁹ James D. Morrow, Randolph M. Siverson, Tressa E. Tabares, “The Political Determinants of International Trade: The Major Powers, 1907-1990” *American Political Science Review*, Vol. 92, No. 2, pp. 649-661, September 1998.

⁴⁰ See for instance Solomon Polachek, “Conflict and Trade,” *Journal of Conflict Resolution*, Vol. 24, pp. 55-78, 1980. Ruth Arad and Seev Hirsch, “Peacemaking and Vested Interests: International Economic

relations, the various causal mechanisms that underlie commercial peace arguments assume that a break in political relations would have negative effects on economic ties. It is the threat of such harm that allows economic interests to represent an incentive for improving political relations.

The “commercial peace” literature has been recently surveyed, among others, by Katherine Barbieri and Edward Mansfield and Brian Pollins.⁴¹ They find at least three different arguments made by liberals showing how open international markets and heightened economic exchange inhibit interstate hostilities. One argument is that economic interdependence renders military conflict obsolete.⁴² Economic exchange and military conquest are assumed to be substitute means of acquiring the resources necessary for growth and security. When trade and foreign investment allow states to meet their material needs more efficiently than through conquest, they diminish the incentives for imperialism and territorial expansion. A second argument is that private actors will restrain the state from engaging in conflict. Firms and consumers realize the efficiency gains generated through commercial openness, and they become dependent on the perpetuation of free trade. Therefore they are wary of military conflict. Through democratic institutions, they put constraints on their political leaders for fear of the costs of severing economic links. Hence, free trade encourages cooperation among states by creating conditions that make war unappealing or unnecessary.⁴³ A third argument often associated with the “commercial peace” hypothesis is that the probability of conflict is decreased by the growing transnational ties acquired through free trade and foreign investment.⁴⁴ Increased economic interdependence also increases understanding among societies, which fosters cooperative relations. While these arguments emphasize how trade changes interests in a way that reduces conflict, others show that economic exchange also promotes peace as an information mechanism. States with deep economic ties have policy tools short of war by which to signal their dissatisfaction with another state and demonstrate their own resolve.⁴⁵

Transactions” *International Studies Quarterly*, Vol. 25, pp. 439-468, 1981. Gasiorowski and Polachek, 1982; O Neal and Russett 1997; Polachek and McDonald 1992.

⁴¹ Katherine Barbieri, *The Liberal Illusion: Does Trade Promote Peace?* Ann Arbor, MI: The University of Michigan Press, 2002. Edward D. Mansfield and Brian M. Pollins eds., *Economic Interdependence and International Conflict: New Perspectives on an Enduring Debate*, Ann Arbor, MI: The University of Michigan Press, 2003.

⁴² See for instance Solomon Polachek, “Conflict and Trade” *Journal of Conflict Resolution*, No. 24, 1980, pp. 55-78. John O Neal and Bruce Russett, “The Classical Liberals were Right: Democracy, Interdependence, and Conflict 1950-1985” *International Studies Quarterly*, 41, No. 2, pp. 267-295, 1997.

⁴³ See for instance Erik Gartzke, “Economic Freedom and Peace”, in James Gwartney and Robert A. Lawson eds., *Economic Freedom of the World*, CATO Institute. William Kinkade Domke, War and the Changing Global System, Yale University Press, 1988. Paul Papoyouanou. “Economic Interdependence and the Balance of Power,” *International Studies Quarterly* 41 (1997). Edward Mansfield argues that the effects of trade complement balance of power to change the calculation of leaders and raise the costs of war. *Power, Trade, and War* (Princeton: Princeton University Press, 1994).

⁴⁴ Patrick McDonald, “Peace through Trade of Free Trade?” *Journal of Conflict Resolution*, Vol. 48, No. 4, August 2004.

⁴⁵ Paul Papoyouanou. *Power Ties: Economic Interdependence, Balancing, and War*. Ann Arbor: University of Michigan Press, 1999. Gartzke, Li, and Boehmer (2001), “Investing in the Peace: Economic Interdependence and International Conflict, *International Organization* 55, no. 2: 391-438.

The “commercial peace” arguments focus on the trade-to-politics causality. Yet they rely upon the assumption that political tensions represent a potential threat to economic relations. Fear of economic harm from deteriorating political relations motivates economic interests to support good political relations. If successful, one may not observe economic effects because private actors will put sufficient pressure on their leaders to soften their foreign policy rhetoric so that business can go on as usual. The question is whether the anticipation and mobilization mechanism operate smoothly enough to obviate any economic downturn, or whether actual short term economic losses act as the trigger for business to begin paying attention to political ties.

Sticky Economic Ties

The above sets of arguments that support linkages between politics and economics rest upon different images of state society relations. The first portrays the state having substantial control over economic actors while the second portrays economic actors with substantial influence over political leaders. Yet debates on comparative political economy point to the need for a more nuanced approach. Development of a global economy with capital mobility and multinational firms has constrained the ability of states to direct trade or investment flows to meet national goals. In highly competitive markets, businesses must maximize profits. At the same time, governments respond to diverse interests and may not heed business lobby warnings. It is likely there would be considerable friction in the transmission belt connecting politics and economics from both directions.

Instead of responsive linkages between economic and political trends, we may observe path dependence of economic relations as competition forces businesses to maximize profits and they consider sunk costs in existing trade and investment flows. Such stickiness in economic transactions would resist any reversal prompted by realist concerns, but also undermines the credibility of the commercial peace mechanism – if everything goes forward with business as usual regardless of politics, there is no pressure applied for improving political relations. Politics and economics are separate.

Hypotheses

From these different arguments, we derive three hypotheses about the economic consequences of political tensions.

Politics first: Rising political tensions will reduce economic interactions as states take measures to restrict economic interdependence and business actors respond to negative signals about future prospects for stable bilateral relations.

Economics first: Rising political tensions will cause worry among business actors, who will then lobby their governments to improve political relations in order to avoid harm to economic interests, leading to a receding of political tensions.

Separation of Politics and Economics: Political tensions will have little effect on market interactions as business actors respond only to economic information about investment opportunities. The extent of this separation depends on two factors:

- *Industry variation:* industries with high transnationality, low substitutability, or low government regulation are less vulnerable to political tensions.
- *Temporal threshold:* when political tensions persist and turn into lingering animosity, they will begin having an effect through shift in consumer loyalty and brand perception.

Evidence from Two Recent Instances of Political Tensions

The Franco-American and Sino-Japanese bilateral relationships over the decade from 1995 to 2005 provide two recent instances of political tensions amidst strong economic ties. Through interviews, newspaper articles, and analysis of business surveys, we closely examine the timing of shifts in political animosity to observe any impact on their economic relations, considering the three hypotheses derived from the International Relations literature. In both cases, we find very little overall impact of political tensions on bilateral economic ties.

The Franco-American relationship

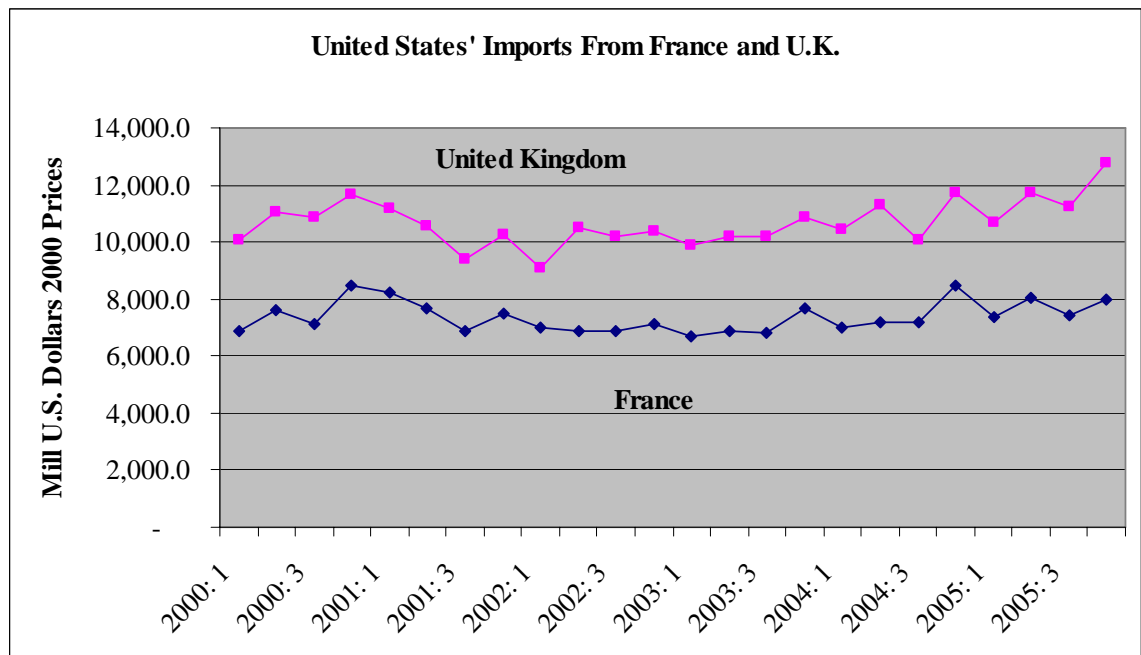
Over the past decade, transatlantic trade and investment has grown steadily, apparently unaffected by the political tensions that surrounded the launch of the Iraq war in 2003. In particular, trade and investment between France and the US seems to have grown at a comparable rate as the one between the US and other European countries, as shown on the following five figures. The widely held predictions about the inevitable leap from politics to economics did not materialize, at least not in the three years following the Franco-American crisis over Iraq. O'Reilly's assertions of boycott success notwithstanding, consumer boycotts on both sides of the Atlantic remained largely symbolic.⁴⁶ The bilateral trade and investment ties between the U.S. and France are extensive and still growing, and their economic interdependence has not been affected by a worsening of political relations.⁴⁷ At the aggregate level, the economic relationship between France and the US is stronger than ever –whether it is measured in trade, in foreign investment, or in foreign affiliate sales.

⁴⁶ On April 27, 2004, O'Reilly asserted that the boycott had cost France billions of dollars, according to the *Paris Business Review*. However, the media watchdog group Media Matters for America investigated this claim and found not only that French exports to the U.S. had increased during that period, but also that there was no evidence of a publication named the *Paris Business Review*. See Media Matters for America, "O'Reilly boycotts truth to spin French boycott," <http://mediamatters.org>.

⁴⁷ Raymond Ahearn, "U.S.-French Commercial Ties," CRS Report for Congress, RL32459, May 19, 2006.

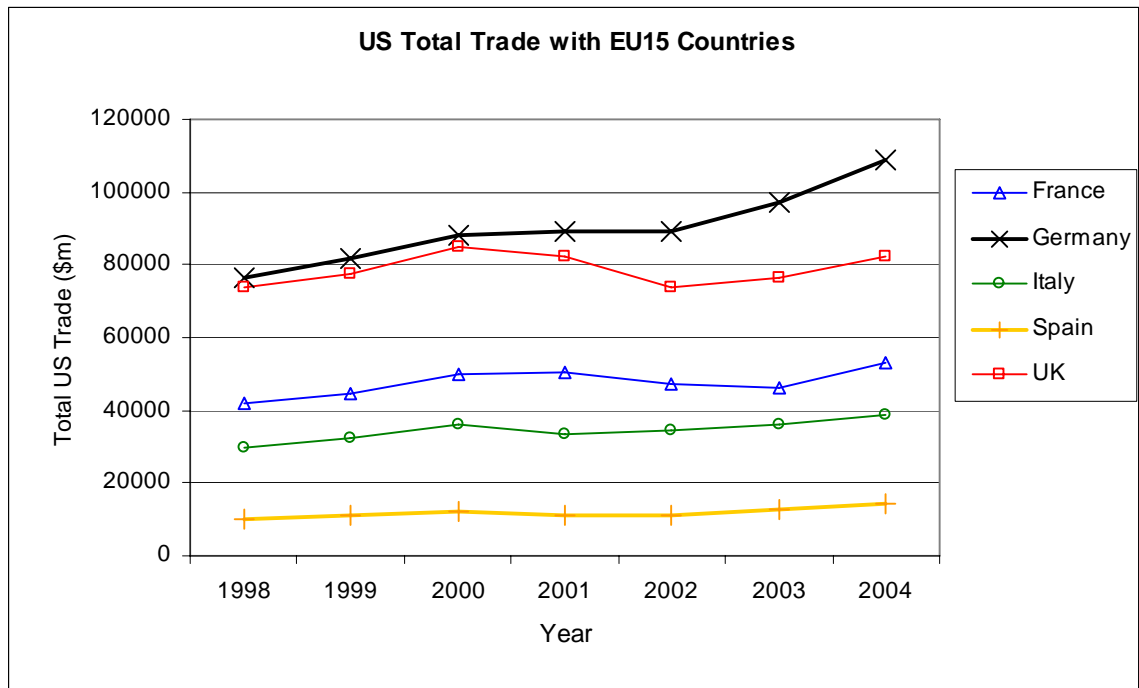
Figure 1 shows semi-annual data on U.S. imports from France and the UK. It is hard to detect any obvious effect of the deterioration of political relations on trade between the U.S. and France. On the contrary, it is indeed quite striking how similar has been the evolution of American imports from France and from the UK, in spite of their divergent positions on Iraq in early 2003 and of the currency difference (the pound vs. the euro). As confirmed on Figure 2, the trade patterns of the last few years do not suggest a strong foreign policy dimension to trade between the U.S. and specific European countries. The trade figures for 2003 and 2004 do not mimic the political coalitions that formed at the time of the Iraq invasion. On the contrary, as shown on Figure 2, it seems that U.S. trade has increased less with Spain and Italy, nonetheless members of the “coalition of the willing,” than with Germany and France, the backstabbers from Old Europe.

Figure 1



Source: OECD International Direct Investment by Country, www.sourceoecd.org

Figure 2



Source: U.S. Bureau of Economic Analysis

Yet trade is just the tip of the iceberg of the Franco-American economic relationship. Transatlantic economic interdependence is even stronger when measured through foreign direct investment. Today Europe accounts for nearly three-fourths of all foreign investment in the U.S.⁴⁸ As a result, European firms are critical sources of employment for U.S. workers, as well as essential sources of taxes for state and local governments. In a similar way, American multinational companies are major sources of jobs for European workers, and Europe is a critical source of revenue for leading U.S. firms.⁴⁹

Foreign Direct Investment figures show similar patterns than trade –or rather lack of pattern linking politics and economics. American investment in Europe increased 11% between 2003 and 2004 –compared to a 15% increase total in the world. Within Europe, the largest percentage increase during this period was in France (22%), followed by Ireland (17%), Germany (16%), Italy (13%) and Spain (12%).⁵⁰ Figures 3 and 5 show that American FDI in France does not seem to have been affected by the worsening of political relations in 2003. Similarly, European investment in the United States during the same period does not reflect political alignments on foreign policy. In 2004, the largest investment positions in the U.S. were held, respectively, by the UK (16.5%), Japan (11.6%), the Netherlands (11%), Germany (10.7%) and France (9.7%). Between 2003

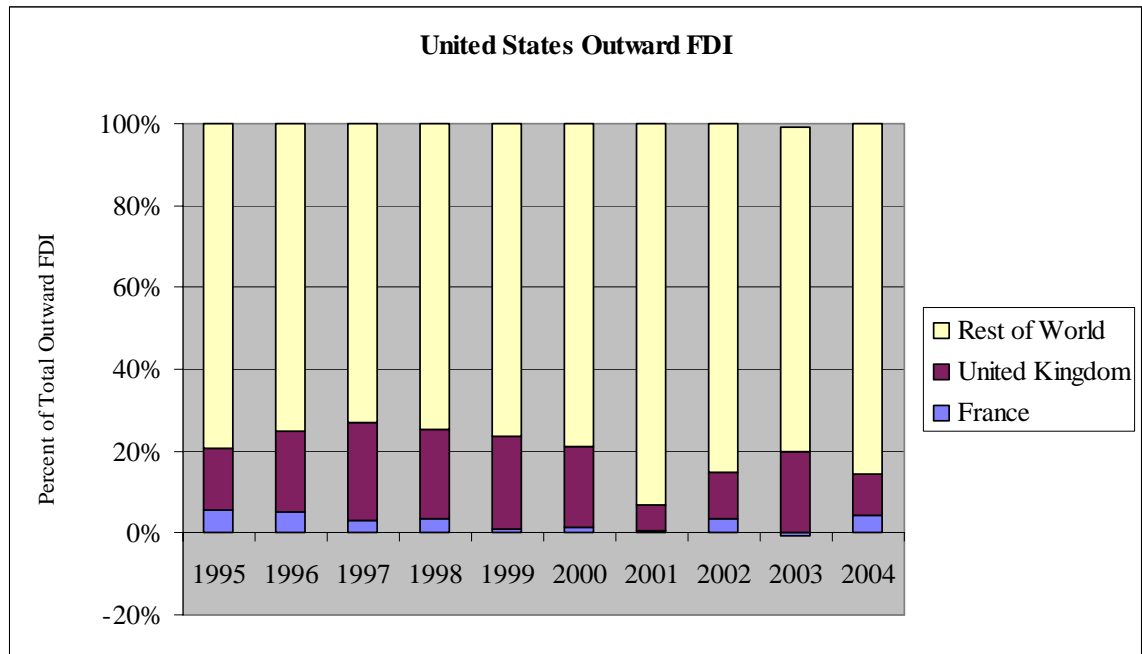
⁴⁸ Hamilton and Quinlan, 2004, p. 29.

⁴⁹ Hamilton and Quinlan, 2004, p. 164.

⁵⁰ Source: Jennifer L. Koncz and Daniel R. Yorgason, “Direct Investment Positions for 2004: Country and Industry Detail,” Bureau of Economic Analysis, July 2005.

and 2004, U.S. affiliates with parents in Europe accounted for the largest dollar increase in foreign direct investment in the U.S.: the UK had the largest increase, followed by the Netherlands, France and Germany.⁵¹ Figure 4 and 6 show that French investment in the US has fluctuated less than British investment over the past five years, with no visible long-lasting impact of the 2003 tensions.

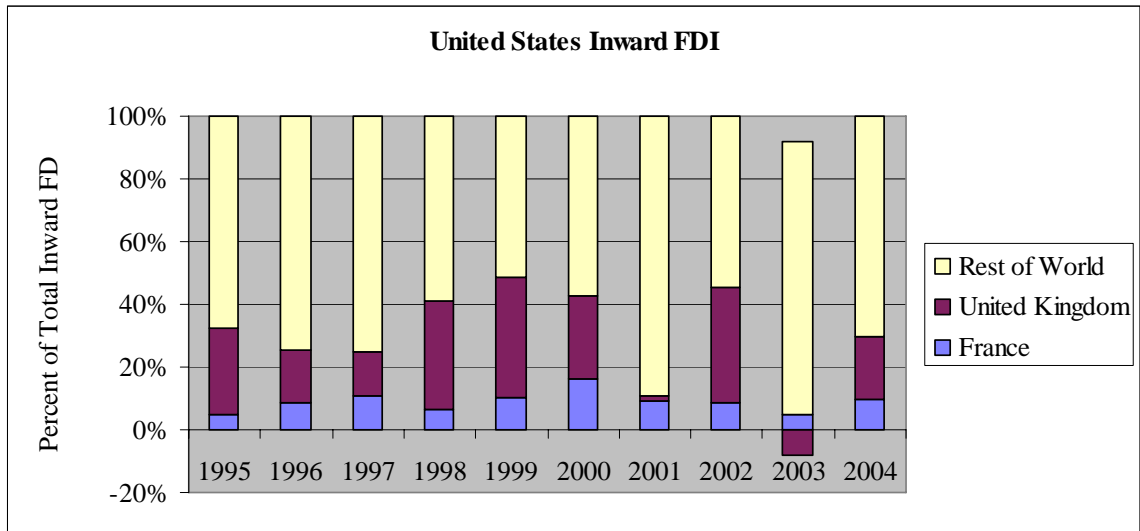
Figure 3



Source: OECD International Direct Investment by Country, www.sourceoecd.org

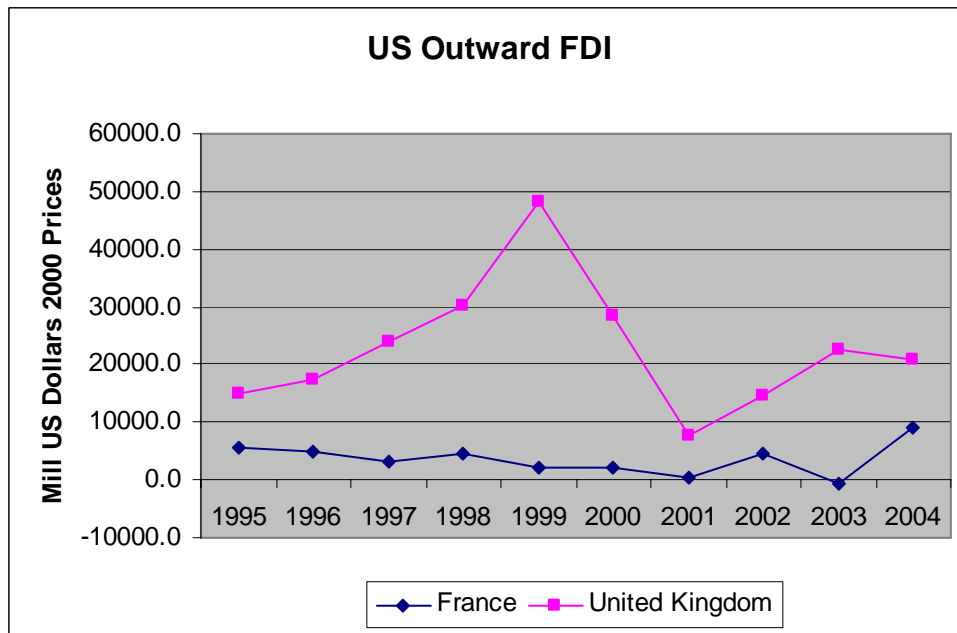
⁵¹ Jennifer L. Koncz and Daniel R. Yorgason, "Direct Investment Positions for 2004: Country and Industry Detail," Bureau of Economic Analysis, July 2005.

Figure 4



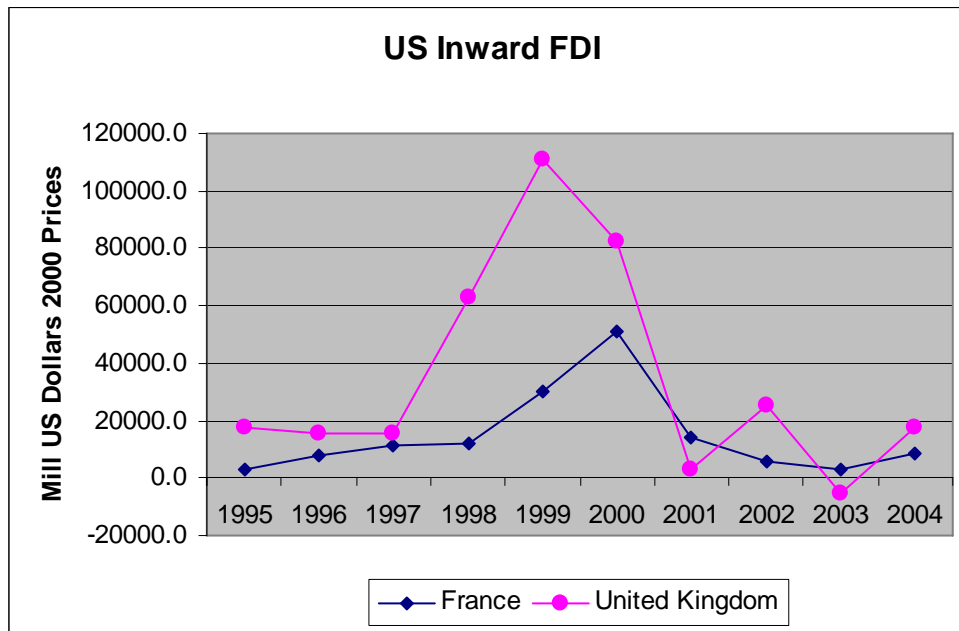
Source: OECD International Direct Investment by Country, www.sourceoecd.org

Figure 5



Source: OECD International Direct Investment by Country, www.sourceoecd.org

Figure 6



Source: OECD International Direct Investment by Country, www.sourceoecd.org

Finally, as Hamilton and Quinlan rightly emphasize in their excellent study of transatlantic economic relations, the last benchmark measure of the health of the transatlantic economy is represented by foreign affiliate sales. “Foreign affiliate sales, not exports, are the primary means by which U.S. firms deliver goods and services to customers in Europe. The same holds true for European firms delivering products in the United States –trade flows are secondary to foreign affiliate sales.[...] Lost in the transatlantic debate is the fact that the U.S. and European companies invest more in each other’s economies than they do in the entire rest of the world.” In 2001,⁵² foreign affiliate sales amounted to \$2.8 trillion versus \$549 billion in total trade.⁵³

The trend in trade and investment data indicates that Franco-American economic relations were not affected negatively by the worsening of their political relations. Yet such aggregate level data may mask areas where there is more direct impact. Therefore it is useful to look at specific firms and analyze whether their business has been affected in a negative way by political tensions. The alarmist warnings of groups such as Business for Diplomatic Action may have been based on survey results suggesting that anti-Americanism in Europe is affecting consumer behavior towards American products. For instance, a December 2004 survey by Global Market Insite showed that 20% of European consumers polled said they were consciously avoiding American products because of recent American foreign policy.⁵⁴ Firms perceived as most subject to consumer boycotts

⁵² last year for which the figures are currently available.

⁵³ Hamilton and Quinlan, 2004.

⁵⁴ www.worldpoll.com.

included American Airlines, United Airlines, General Motors, Wal-Mart, CNN, American Express, McDonald's, Coca-Cola, Pepsi, and Marlboro.

Yet in spite of this declaratory grandstanding about boycotts, the impact can hardly be felt. In their recent study of the consequences of anti-Americanism, Peter Katzenstein and Robert Keohane examined the compared revenues of major US-based and Europe-based consumer products firms in Europe between 2000 and 2004.⁵⁵ These firms include four American firms often mentioned as potential targets of anti-American boycotts (Coca-Cola, Pepsi, McDonald's, and Nike) and three European competitors (Adidas-Solomon, Cadbury-Schweppes, and Nestle). If anti-Americanism had a significant impact on sales, one should find U.S.-based firms' sales falling in 2003-04, when anti-American views rose sharply in Europe, compared to 2000-2001, when the United States was still very popular there. This fall in the sales of American firms should occur both in absolute terms and relative to the performance of European firms. Yet Katzenstein and Keohane find that American firms in Europe do not seem to have suffered in the aftermath of the Iraq war. The following tables show, on the contrary, that all four American firms increased the *share* of their revenues deriving from Europe between 2000-01 and 2003-04. Indeed, the average sales gain for the four American firms was about 44 percent, compared to 24 percent for the three European firms.

In France, ironically, McDonald's has been performing particularly well over the past five years, so much so that the former president of McDonald's France was promoted president of McDonald's for all of Europe.⁵⁶ Neither the anti-globalization actions calling for destroying McDonald's outlets in the late 1990s, nor the anger against the U.S. over the invasion of Iraq in early 2003 seem to have destroyed the French's appetite for U.S.-style fast food. Whether in aggregate terms or even at the level of individual firms, it is thus "business as usual" in the Franco-American economic relationship.

⁵⁵ Peter Katzenstein and Robert Keohane, "Consequences of Anti-Americanism," in Katzenstein and Keohane eds., *Anti-Americanisms in World Politics*, Cornell University Press, forthcoming 2006.

⁵⁶ See Sophie Meunier, "The Distinctiveness of French Anti-Americanism," in Katzenstein and Keohane, 2006.

Table 1: Sales of Selected American and European firms (with percentages of total firm sales in Europe).

	2000-01 ave.	2002	2003	2004	2003-04 ave.
US firms:					
Coca-Cola	3,945 (23)	5,262 (27)	6,556 (31)	7,195 (33)	6,875 (32)
McDonalds	4,753 (33)	5,136 (33)	5,875 (34)	6,736 (35)	6,105 (35)
Nike**	2,495 (27)	2,731 (28)	3,241 (30)	3,834 (31)	3,538 (31)
Pepsi***	7,400 (33)	8,524 (36)	9,594 (36)	9,862 (33)	9,728 (35)
Euro firms:					
Adidas-Solomon	3,349 (50)	3,616 (49)	3,802 (54)	3,921 (54)	3,857 (54)
Cadbury Schweppes	3,200 (42)	3,847 (43)	3,970 (36)	4,928 (43)	4,449 (40)
Nestle'	22,530 (42)	23,858 (31)	24,288 (32)	28,563 (33)	26,415 (33)

Table 2. Sales as percentages of 2000-01 average sales

	2000-01 ave.	2002	2003	2004	2003-04 ave.
US firms:					
Coca-Cola*	100	133	166	182	174
McDonalds	100	108	123	141	128
Nike**	100	109	130	154	142
Pepsi***	100	115	130	133	132
Euro firms:					
Adidas-Solomon	100	108	114	117	115
Cadbury Schweppes	100	120	124	154	139
Nestle'	100	106	108	127	117

Source: Katzenstein and Keohane, 2006⁵⁷

⁵⁷ All figures are in millions of dollars for the European market. Figures derived from SEC/Annual Report filings

* US figures include Canada; European figures include Euroasia and Middle East.

** European figures include Middle East and Africa.

*** In the Europe column are all international

The Sino-Japanese Relationship

The economic relationship between Japan and China has become increasingly interdependent over the same period that political relations worsened. For years the asymmetrical economic relationship was seen as largely to the benefit of China which received large flows of development assistance and investment from Japan. Indeed, some in Japan voiced concerns about a hollowing out of Japanese industry as firms moved factories to China in order to take advantage of lower labor costs. Yet as the Japanese economy finally returned to positive growth, many admitted that demand from China's surging economic growth had helped to pull Japan out of recession.⁵⁸

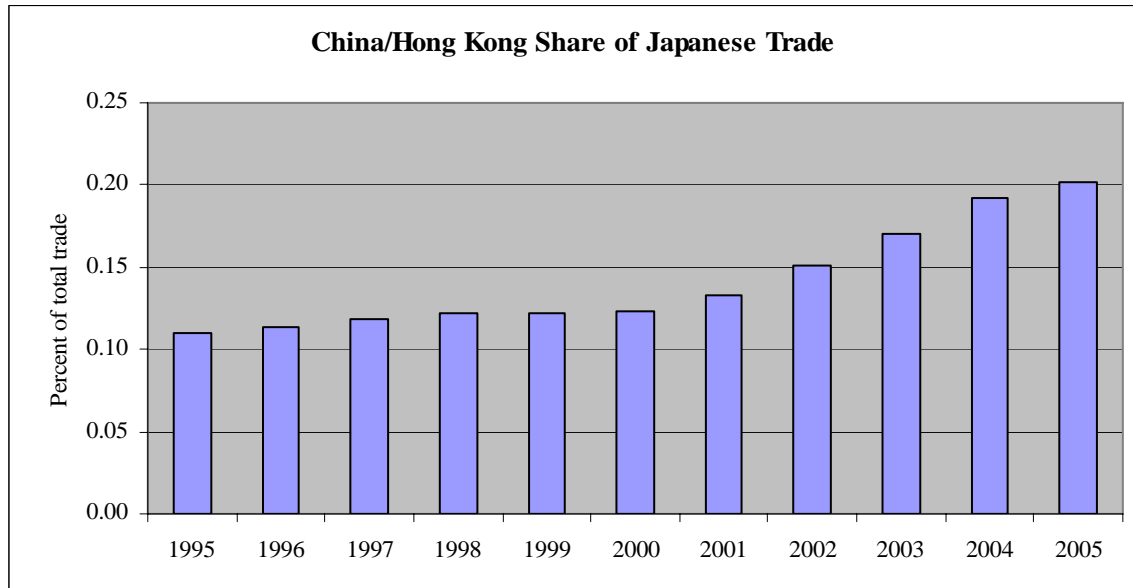
As shown in figure 7, a steadily increasing share of Japanese trade has been with China. Many factors contribute to this trend, and in particular, one must note China's accession to the WTO in December 2001, which was accompanied by liberalization that created new market access opportunities. In 2004, China replaced the United States as Japan's biggest trading partner as total trade with China (including Hong Kong) reached \$213 billion dollars relative to \$197 billion in trade with the United States.⁵⁹ This turning point came even as the rate of increase in exports from Japan to China slowed to 9.5 percent annual growth after several years of 20 percent annual growth in exports to China. Given that political tensions were most intense on the Chinese side with anger against Prime Minister Koizumi's visits to Yasukuni shrine, it is useful to look more closely at whether Chinese imports from Japan on a quarterly basis show any decline as a possible sign of negative impact on the willingness of Chinese consumers and firms to purchase Japanese goods. Figure 8 shows that Japanese imports followed a steady upward trend. The trend of the quarterly data does not reveal any break during the periods of Prime Minister Koizumi's visits to Yasukuni shrine, which typically generated heightened tensions and calls for boycotts. The slowdown in growth at the end of 2004 was attributed to a temporary decline in Chinese demand for industrial equipment and cars from Japan.⁶⁰

⁵⁸ Kanshi Yu, "Cold Political Relations harm hot economic relations," *Chuo Koron* 119: 11 (November 2004): p. 70.

⁵⁹ David Pilling, "China replaces US as Japan's biggest commerce partner with \$213 billion trade," *Financial Times*, 27 January 2005. One has to note, however, that in an era of globalization the national origins of trade flows are as complicated to define as the national origins of products. Bilateral trade flows also include intra-firm trade as Japanese firms export parts to factories in China, where value is added and products are then exported elsewhere. As much as a third of Japan's exports to China reach the US as their final destination.

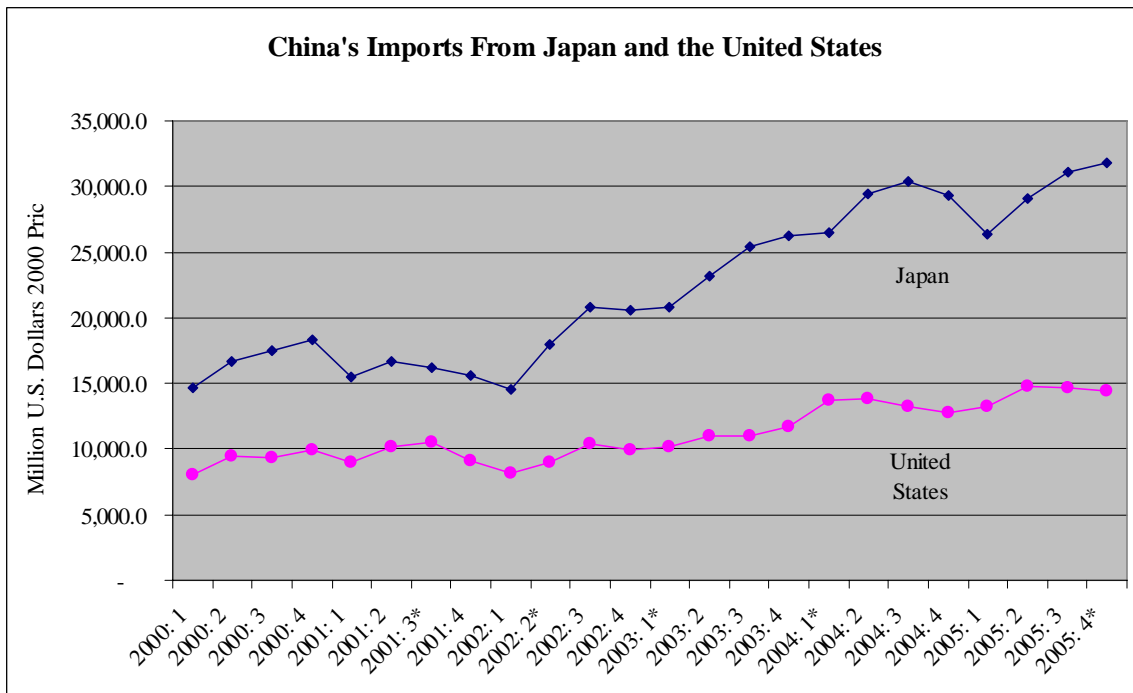
⁶⁰ *Ibid.*

Figure 7



Source: Ministry of Finance, “Trade Statistics of Japan” <http://www.customs.go.jp>

Figure 8

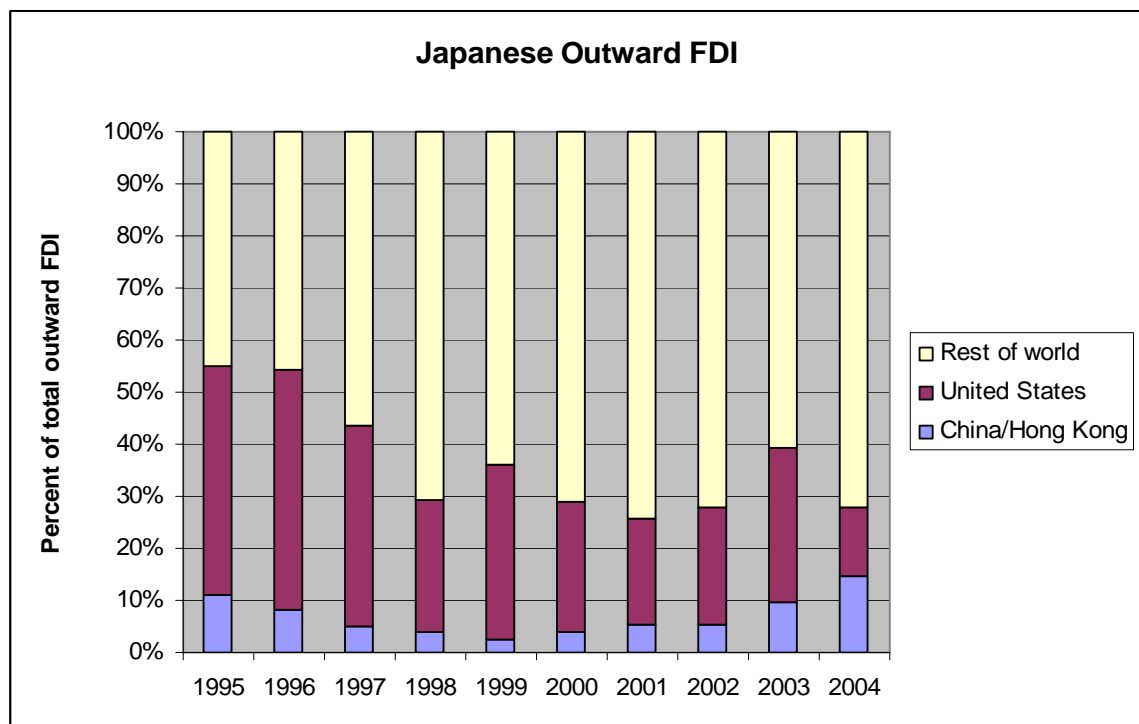


The Figure shows the quarterly imports of China from Japan and the United States. The dates marked with an asterisk indicate the periods that Prime Minister Koizumi visited Yasukuni shrine. Source: IMF Direction of Trade (Global Insight, November 2, 2006).

Direct foreign investment represents a substantial component of the Japan-China economic relationship. After the United States, China is the largest destination for Japanese FDI. Figure 9 shows that during the period of the Koizumi administration when political relations were at their worst, China was taking a growing share of Japan's FDI. For China, Japan has for many years been the largest source of FDI inflows.

Clearly the trend in trade and investment indicates that Sino-Japanese economic relations were deepening over the same period their political relations worsened. Yet one could expect that such aggregate level data conceals areas where there is more direct impact. Therefore it is useful to look at specific firms that are closely identified with Japan and sell directly to consumers, since these are the most likely to be subjected to consumer animosity. Those selling products with substitutes provided by domestic or alternative foreign producers would also be the most vulnerable. Two Japanese firms stand out for this test: Sony and Toyota. Both represent flagship companies for Japan's export industry, and sell products readily substituted with other major multinationals deeply engaged in trade and investment with China.

Figure 9



Source: OECD International Direct Investment by Country, www.sourceoecd.org

There is some evidence from consumer surveys that Japanese firms suffer a penalty. When asked about their confidence in specific companies, Chinese respondents ranked Sony 13th and Toyota 17th after companies such as IBM, Motorola, Volkswagen,

GM, and Samsung.⁶¹ Sony reported a 25 percent drop in sales of items such as digital cameras and personal computers during the second quarter of 2005 when anti-Japanese riots took place in China.⁶² Nevertheless, when those who planned to purchase a digital camera were asked what brand they would purchase, 26 percent chose Sony, which was the highest among all options given (11 percent planned to purchase Samsung while 9 percent planned to purchase Kodak). While Toyota has a small market share in China relative to other foreign auto companies such as GM and Volkswagen, it has seen a rapid increase in sales over the past five years. Toyota's vehicle sales to China rose from a mere 13,400 in 2001 to 183,500 in 2005, which represents a higher growth rate than its sales in the United States or other large developing country markets like Brazil and India. In the Chinese market, Toyota's sales increase outpaced that reported by the two leading major foreign automakers GM and Volkswagen as well as the average growth in total vehicle consumption in the Chinese market.⁶³ Such figures do not rule out the possibility that Sony and Toyota would have done even better given a more positive political environment, but they do cast doubt on hypotheses that leading Japanese exporters would suffer a downturn from worsening relations.

Interviews and surveys about business plans also do not show evidence of a strong reaction to worsening relations. An official of a Japanese financial investment firm heavily involved in business with China said that while there were demonstrations with calls for boycotts in China after every shrine visit by the prime minister, the boycott calls were famous for having no effect.⁶⁴ A representative from *Keidanren* noted that while shrine visits may be followed by sudden cancellation of business meetings or an increase in the price on the table for a contract negotiation, in the long term contracts were not cancelled.⁶⁵ While a survey of companies indicated lessening enthusiasm for expansion of investment in China, the number of firms said to consider downsizing or withdrawal of business remained at a low 4 percent one month after major anti-Japanese riots in China.⁶⁶

The evidence points to an absence of direct economic damage. Trade and investment between Japan and China has been growing at such a rapid pace that spillover from politics has at most manifested itself as a cautious wind cooling optimism about the prospects for interdependence.

⁶¹ “*Chugoku shyohishya no brando ishiki* (Chinese consumers brand awareness)” Tokyo: Searchina Research Center, 2005.

⁶² *Yomiuri Shimbun*, 28 April 2005.

⁶³ Stephen Cooney, “China’s Impact on the U.S. Automotive Industry,” Congressional Research Service Report for Congress, 4 April 2006; data available at http://www.toyota.co.jp/en/about_toyota/pdf2006/index.html.

⁶⁴ Interview, 22 August 2006, Tokyo Japan.

⁶⁵ Interview, 21 December 2005, Tokyo Japan.

⁶⁶ JETRO conducted a survey of 414 companies once in November-December 2004, and again in May 2005 with responses from the same companies. Companies were asked about their business development strategy for the next three years in China. 172 companies had a production base in China. JETRO, “Special Survey of Japanese Businesses in China: Impact of the April Anti-Japan Demonstrations,” June 2005. available at http://www.jetro.go.jp/en/stats/survey/surveys/20050620_special.pdf.

Analyzing the economic effects of political tensions

Evidence from both cases points to a relative immunity between economic and political relations, unlike what has been predicted in the headline-grabbing, sensational scenarios found in the media. These two case studies support our third hypothesis about the separation between economics and politics, according to which political tensions have little effect on market interactions as business actors respond only to economic information about investment opportunities. In this section, we explain why there is a relative firewall between economic relations and political tensions, and we analyze the conditions under which political animosity may translate into negative economic effects. In particular, we examine variation in terms of the role of government control, industry characteristics, and temporal threshold, and we explore their consequences for multilateral economic governance.

Explaining the firewall

The “politics first” hypothesis suggests that states should direct economic flows towards states with whom they share closer political relations. Afraid that political tensions might affect negatively the business environment and poison economic ties, businesses divest and refocus their exchanges with “safer” countries. The evidence from our case studies shows quite the opposite, however, with economic interdependence holding steady or increasing parallel to worsening political relations. One explanation would be that an intensity threshold with implications for security cooperation must be reached before political conflict would motivate a state to intervene in economic policy or raise the risk perception of investors. The United States and France remained committed partners in NATO as well as partners on the ground in Afghanistan throughout their fight over Iraq, and Japan and China were not contemplating war despite the animosity associated with the Yasukuni shrine controversy, so one could argue that this intensity threshold had not been reached. However, this would be underestimating the seriousness of both episodes of tension. Some perceived the Franco-American split over Iraq as shaking the foundations of NATO and the Atlantic alliance, revealing (or confirming) how far Europe and the U.S. had drifted apart after the end of the Cold War, and contributing to fueling anti-Americanism in the world. Certainly relations between Japan and China were tense over both symbolic issues related to history and actual security concerns. For example, at a news conference in December 2005, Japanese foreign minister Taro Aso said China was “a neighboring country with one billion people, nuclear arms, military spending that has shown double-digit growth for the last 17 years, with extremely little transparency. It’s becoming a considerable threat.”⁶⁷ Incidents related to Chinese submarines entering disputed territorial waters have led to protests from Japan, while Japanese statements in support of Taiwan have brought fierce reaction from China. Although far from actual initiation of hostilities, there are clear indications of potential security rivalry.⁶⁸ The intensity of tensions and animosity in both cases should therefore not be minimized.

⁶⁷ *New York Times*, 23 December 2005.

⁶⁸ Kent Calder, “Japan and China’s Simmering Rivalry,” *Foreign Affairs*, March/April 2006.

The “economics first” hypothesis suggests a partial insulation between political squabbles and economic relations because of the role of lobbying. The business actors involved, whether on the commercial or the investment side, have vested interests in making sure that a firewall is erected between foreign policy disagreements and economic exchange. They put constraints on political leaders to try to mend political fences, so that the economic impact remains limited. Thus one could argue that the appearance of business as usual in transatlantic ties and Sino-Japanese relations simply reflects the success of business interests to contain political problems. Yet when we examine the level of business lobbying, it appears to have been neither substantial, nor effective in either case.

In the U.S., the group Business for Diplomatic Action (BDA) was formed with fanfare and business starpower to combat the perceived deleterious effects of anti-Americanism on business, but despite hearings in Congress and wide media coverage, they do not seem to have had much impact to shift the course of the Bush administration’s foreign policy. In the spring of 2003, some business groups (mostly in the wine and luxury goods industry) complained about the potential economic fallout of President Chirac’s hard stance against the U.S., but this did not seem to change the course of French foreign policy either.⁶⁹

In Japan, some businessmen voiced concerns, but the major business organization, Keidanren was noticeably circumspect about directly approaching the issue.⁷⁰ Yinan He concludes that because economic flows were largely unimpeded by negative sentiment, the business lobbying that would operate as the mechanism for a commercial peace restraint did not take place.⁷¹ Neither does it appear that those who lobbied wielded any influence; in one meeting where a business leader directly demanded that the Prime Minister stop visits to Yasukuni shrine because they harmed economic interests, Prime Minister Koizumi rebutted “that is economic logic. Politics has its own logic, according to which the visits to the shrine are important.”⁷² Defiant to the end, in his last month as Prime Minister, Koizumi chose to visit the shrine on August 15th 2006 on the anniversary of the end of WWII, which was perceived in East Asia as the most controversial timing for a visit. Among the LDP candidates to succeed Koizumi, the party selected Shinzo Abe, who is known as a hawk and has made repeated visits to Yasukuni shrine. Other LDP politicians who made improvement of Japan-China relations a priority in speeches and indicated they would not visit the shrine if chosen as prime minister

⁶⁹ Based on interviews with staff members from the French Embassy in the U.S., November 2006.

⁷⁰ Chairman Okuda was quoted stating that the Prime Minister was making the visits as a personal matter with consideration of international relations *Yomiuri Shimbun*, 12 April 2005. Upon taking the chairmanship, Fujio Mitarai said that the issue of Yasukuni visits was a matter for politicians. *Yomiuri Shimbun* 29 July 2006. He (2006, p. 41) notes that political relations with China has not been added to Keidanren’s criteria for member firms that guide political contributions. An official at Keidanren noted that this was a political issue and Keidanren would not take a common position on it. He said the business of the organizations’ China committee focused mostly on issues related to China’s compliance with WTO agreements. Interview by author, Tokyo 21 December 2005.

⁷¹ Yinan He, “Hot Economy and Cold Politics? Commerce and History in Sino-Japanese Relations,” Paper presented at the ISA annual meeting, San Diego, 2005, p. 31.

⁷² *Yomiuri Shimbun*, 31 May 2005. (translated from Japanese)

gained little support. Those concerned about worsening relations with China could not change the course of foreign policy decisions made for political reasons.

Rather, the evidence is strong that economics and politics remain largely separate spheres, at least at the macro level. Our evidence from aggregate trade and investment flows as well as the sales of leading companies indicates little direct harm from the downturn in political relations.

The government positions of both Japan and China emphasized separation of economics and politics. For example, after three weeks of anti-Japan protests and boycott calls in April 2005 sparked by Chinese opposition to Japan's bid for permanent membership in the UN Security Council, the Chinese Commerce Minister warned citizens not to harm economic development and stated "We don't expect the economic and trade relations between the two countries to be infringed upon."⁷³ Yet at the same time, the government made no effort to change its position on the political issues that divided the country; while trying to avert economic linkage, the government continued on its collision course over political issues ranging from the opposition to Japan's UN bid, repeated incursions in the disputed territorial waters, and strong criticism of Koizumi for his visits to Yasukuni. Similarly, even as Koizumi doggedly persisted in provoking hostile political relations through his Yasukuni visits, he was on the pro-China side for economic affairs as he emphasized the opportunity for Japan from China's economic growth to counter growing fears of economic rivalry within Japan.

Businesses on both sides saw the market opportunities as too great to sacrifice. Surveys show Japanese businesses continued to be optimistic about the opportunities from investment in China and did not plan to curtail their investment plans.⁷⁴ An official of a major Japanese bank branch in Shanghai said, "it is meaningless to think Japanese companies would withdraw and go somewhere else, like Vietnam. The relationship is too big for that already."⁷⁵ With leading firms from Sony to Toyota viewing the Chinese market as the most promising investment opportunity, they are unlikely to scale back operations. Sony officials expect that in a few years sales in China will be greater than Japan, and Toyota officials say they expect China to become the biggest auto market.⁷⁶ On the Chinese side, only a small number of retailers took actions to support the boycott, citing that with complex distribution channels they were importing through mainland suppliers rather than directly from Japan. The chairman of the largest Chinese retailer, Lianhua Supermarket holdings noted that "We do not see the need to change" because sourcing strategies followed market demand and sales of Japanese brand products remained stable.⁷⁷

⁷³ *New York Times*, 23 April 2005, p. 3.

⁷⁴ In a survey of 100 companies, none said they would curtail investment in China while 21 said they had plans to increase investment in China. *Yomiuri Shimbun*, 27 June 2006.

⁷⁵ *New York Times*

⁷⁶ *South China Morning Post*, 11 May 2005, p. 16.

⁷⁷ *South China Morning Post*, 21 April 2005.

While at this aggregate level there appears to be no effect, we argue that one needs to look in much closer detail at industry characteristics and long term effects in order to capture fully the true economic impact of political tensions.

A Closer Look for Conditional Effects at the Micro Level

Even though the overall economic impact of political squabbles on economic ties is limited, it can be consequential at the micro level. Specific economic sectors and individual companies are the first in line to suffer from political friction, and political relations may indeed drive them out of business, with a potential political fallout, even though the aggregate numbers point to “business as usual.” For small French wine producers or for French importers of specialty gourmet foods based in the U.S., the loss of the American market could represent bankruptcy. The industry impact depends on three factors: the degree of penetration by transnational firms, substitutability of goods and services, and the public nature of consumption.

Transnationality: The role of transnational firms in a particular economic sector is a determinant of the potential economic effect of political tensions. Transnationality may be measured by sales of foreign affiliates and joint ventures. It explains in large part the relative firewall between politics and economics in the Franco-American case, since trade accounts for no more than 2% of transatlantic commerce but foreign affiliate sales are the backbone of the transatlantic economy.⁷⁸ The higher the transnationality in a particular industry, the less likely it is that political tensions will have a consequential economic impact. Sectors with higher levels of transnational, intra-firm trade would be less vulnerable to political tensions since firms will not discriminate against their own parent/subsidiary firm. For example, the auto sector may be partially shielded from political tensions because intra-firm trade is high and local production reduces the “foreignness” of global companies.

Substitutability: A second determinant of sectoral impact is the substitutability of goods and services. Not all industries are created equal with respect to consumer boycotts. The higher the substitutability of their goods and services, the more likely they will be the target of boycotts. Therefore one should expect industries producing substitutable goods to try to exert more lobbying pressure on the foreign policy-makers, while businesses with non substitutable goods and services should be disinterested from the foreign policy tensions. In cases where the trade relationship is made up mostly of non-substitutable goods, political tensions will not have an important impact on economic ties.

The industry the most immediately affected by political falling-out in the short-term is usually tourism. Individuals can change their travel plans, substituting one destination for another, to demonstrate their hostility to the foreign policy of the country they were initially planning to visit, thereby depriving them of an important source of revenue. Individuals can also decide not to visit a country for fear that they will be mistreated because of their nationality. This was especially true for the risk averse

⁷⁸ Hamilton and Quinlan, 2004, p. xi.

Japanese travelers worried by news coverage of violent anti-Japanese protests in China. During the period following the protests, one of Japan's major airline companies reported that 1,000 Japanese were cancelling flights to China daily.⁷⁹ As a result, the airline industry along with hoteliers and restaurateurs may be the first economic victims of the deterioration of political relations. Japanese restaurants in China reported loss of customers as no Chinese wanted to be seen entering a Japanese restaurant.⁸⁰ While they may not have huge lobbying power at the national level, they can exert political clout at the local level.

For France, targets of boycotts are typically wines, perfumes and toiletries, travel goods and handbags, and cheese.⁸¹ These are luxury goods: non-essential, replaceable, fashionable items. They have a strong element of brand identification with France. And they have substitutes, whether from the U.S. or from other countries with friendlier foreign policies, such as in the case of wine, where angry consumers can easily replace French wine with Californian, Australian or Italian wine. Indeed, the only industry that really suffered, at least temporarily, from the 2003 Franco-American rift over Iraq has been the French wine industry.⁸² In their interesting study of the impact of the Iraq war on French wine sales in the U.S., Chavis and Leslie find that the public boycott of French wines in the U.S. led to a 13% decrease in sales over six months. They also find a peak in the boycott nine weeks after the first news report of the boycott, with an estimated 26% lower volume of French wine sold. Eight months after the Iraq war started, however, Chavis and Leslie no longer find any significant impact from the boycott on French wine sales and conclude that the boycott has faded away. In Japan, Asahi beer was the most frequently mentioned target of boycott campaigns, and shipments to China were reported to fall slightly.⁸³ In part this was related to its association (denied by the company) with a revisionist history textbook committee. But its easy identification with Japan and the ready substitutes also made it a likely target.

Regulatory Decisions: The third determinant of the industry impact of foreign policy tensions is the amount of government control over a particular industry. Government procurement decisions represent the high end of government control and are likely to be the most easily swayed by political tensions. Defense contracts, in particular, will likely be sparingly handed out to countries with which future political relations are uncertain. Other types of procurement contracts are highly politicized as well, as was the case with the American awards of contracts for the reconstruction of Iraq in December 2003 which explicitly excluded France from the list of countries eligible to compete for these \$18.6 billions worth of contracts.⁸⁴

⁷⁹ *Financial Times*, 19 April 2005, p. 6.

⁸⁰ *Financial Times*, 9 April 2005, p.3.

⁸¹ Raymond Ahearn, "U.S.-French Commercial Ties," CRS Report for Congress, RL32459, May 19, 2006.

⁸² Larry Chavis and Phillip Leslie, "Consumer Boycotts: The Impact of the Iraq war on French Wine Sales in the U.S.," BBER Working Paper 11981, January 2006.

⁸³ *Yomiuri Shimbun*, 10 April 2005. *South China Morning Post*, 3 May 2005, p. 16.

⁸⁴ See for instance Sue Fleming, "U.S. Shuts Out France, Germany for Iraq Work," *Reuters*, 9 December 2003.

Some industries will also be more vulnerable to government intervention to prevent foreign takeovers in which animosity between countries can generate “national security” justification for intervention in FDI. In Europe, decisions on high profile merger and acquisition sales have been politicized. In France, after rumors had floated that the American company PepsiCo wanted to takeover French food giant Danone, in December 2005 the government passed a law on “economic patriotism” preventing foreign takeovers in a variety of industries on grounds of national security.⁸⁵ Leasing of public properties to foreign companies is also likely to be subject to politicization. In the United States, the rejection of the sale of port management rights to an investor from the United Arab Emirates reflected this possibility.⁸⁶

The most frequently cited business casualty of Sino-Japanese tensions was a high profile infrastructure project to build a high-speed railway linking Beijing and Shanghai. A Chinese scholar of the Shanghai Institute for International Studies who recommended Japan’s Shinkansen technology as well-suited to China’s needs said “Experts like me were said to be the betrayers of the nation.”⁸⁷ Delays in the expected Chinese purchase of Japanese technology for high speed rail technology and the change to multinational bidding were attributed to repeated visits by Koizumi to Yasukuni shrine.⁸⁸ When Germany eventually won the bid to supply high speed rail technology to China in October 2004 for the first stage of the project, the choice was attributed to public animosity putting pressure on the Chinese government not to show support for Japan.⁸⁹ During later stages of the rail development, the Chinese government has bundled inputs from Japan as part of a multinational project in order to lower the focus on Japan.⁹⁰ Even on a smaller scale, local government purchase plans in China frequently opted against Japanese products to avoid criticism.⁹¹ Japanese banks are also reported to have greater difficulty getting permission from government to open branches than the banks of other countries.⁹² On the Japanese government side, the government delayed official loans to China in 2006, citing political problems. Although eventually loans were issued, discussion has deepened in the government about when to end these loans that have continued uninterrupted since 1979 as *de facto* compensation for war damage.⁹³

While the evidence of regulatory intervention mentioned here remains anecdotal, it suggests that one should look for economic harm from political tensions in areas with high public involvement in economic decisions. The defense industry, energy sector,

⁸⁵ See for instance Kathrin Bennhold, “France tones down cries of economic patriotism,” *International Herald Tribune*, 6 January 2006.

⁸⁶ See Greg Ip and Neil King Jr., “Port Deal Shows Roadblock for Globalization,” *The Wall Street Journal*, 11 March 2006.

⁸⁷ *The Financial Times*, 30 March 2004, p. 19.

⁸⁸ “The Frontline of Politics: Koizumi Foreign Policy (translated from Japanese),” *Yomiuri Shimbun* 31 May 2005.

⁸⁹ Jin Xide, “High Speed Train in Sino-Japanese Relations (translated from Chinese),” *People’s Daily*, 16 September 2003 available at <http://www.people.com.cn>.

⁹⁰ Interview, Japanese Ministry of Foreign Affairs official, 24 August 2006.

⁹¹ Interview, Representative of Japanese firm involved in assisting Japanese firms to invest in China. 22 August 2006, Tokyo Japan.

⁹² Interview, Japanese Ministry of Foreign Affairs Official, 24 August 2006, Tokyo Japan.

⁹³ *The Daily Yomiuri*, 24 March 2006.

infrastructure projects, and financial institutions would be more vulnerable to such intervention.

A temporal threshold

Our evidence from the Franco-American and Sino-Japanese cases has shown the overall absence of economic effects of political tensions. However, care must be taken to evaluate such effects over time: there may be a temporal threshold beyond which political tensions start seeping into the economic realm, depending on how long the tensions last and how much residual animosity subsists.

If political tensions flare up and then quickly die down, as they did in the case of France and the U.S. over Iraq after only a few months, they should not be expected to have long-lasting economic effects. If, by contrast, the political animosity between two countries does not recede after the incident that originally triggered the political tensions, then we should expect lasting long-term economic consequences.

The marketing literature has studied the long-term impact of political tensions on brands and products. Marketing scholars have developed the “animosity model of foreign product purchase” to analyze whether political animosity between two countries has a significant impact on consumers’ buying decisions.⁹⁴ They find that a product’s origin (signaled by place of manufacture and/or brand name) can affect consumers’ purchase behavior directly and independently of the quality of the product.

In the case of residual animosity, it means that the economic effects of political tensions can be felt long after the initial spark that ignited the tensions, through a ripple effect on the desirability of certain brands and certain products. For the U.S., there is a strong concern that the negative foreign perceptions of current American foreign policy may affect the popularity of U.S. brands, and therefore in turn the state of the American economy. The fact that such impact may occur in the long run, instead of instantly like consumer boycotts, may explain why the fears of the American business community persist in spite of the reassuring numbers. As the *Financial Times* analyzes, “warnings from the marketing industry suggest the risk stems not so much from overt boycotts, but from a loss of cachet among younger consumers. Where once Marlboro cigarettes, Big Macs and a can of coke appeared cool even among French teenagers, a significant percentage may now think twice about the cultural message that US brands project.”⁹⁵

The predicted impact is indeed less instant and more subtle than consumer boycotts, but also potentially more durable, as suggested by various marketing studies.

⁹⁴ Jill G. Klein, Richard Ettenson, and Marlene D. Morris, “The Animosity Model of Foreign Product Purchase: An Empirical Test in the People’s Republic of China,” *Journal of Marketing*, Vol. 62, January 1998, pp. 89-100. For a literature review, see Petra Riefler and Adamantios Diamantopoulos, “Consumer Animosity: A Literature Review and a Reconsideration of its Measurement” *International Marketing Review*, forthcoming 2007.

⁹⁵ Dan Roberts, “US icons lose their cool in Europe,” *The Financial Times*, October 24, 2004.

The one conducted by Roper in 2003, for instance, shows that the popularity of leading American brands was slipping. In Europe in particular, the unpopular American intervention in Iraq and concerns over U.S.-led human rights abuse may be leading to a subtle tarnishing of U.S. brands in the minds of consumers –what marketing specialists call “unconscious brand association.” Indeed, as Dan Roberts of *The Financial Times* asks: “If the American dream played such an important role in the growth of iconic U.S. brands, what happens if significant numbers of consumers begin to think of the U.S. as a bit of a nightmare?”⁹⁶ The growth of anti-American sentiment not only in France but elsewhere in Europe in direct reaction to American foreign policy may indeed be threatening the long-term strength of American brands. According to John Quelch, “we have reached the tipping point where Pax Americana now threatens Brand America.”⁹⁷

Not all brands are treated the same, exuding different levels of “Americanness.” According to a recent study, companies such as Kodak, Kleenex, Gillette and Visa are not perceived as American as Coca-Cola, McDonald’s and American Express.⁹⁸ The products selling the American lifestyle are more vulnerable than products selling the product itself –such as Microsoft software or an iPod.

There may be a generational component as well to this subtle tarnishing of American brands. The younger people may become less attracted to the image of American lifestyle promoted by some American products, and they may grow up more critical of the U.S. in general. In that case, the economic impact of tense political relations may occur gradually and may become more pronounced with time.

This belief in the potential long-term effect of foreign policy disagreements with the United States is shared by many American business leaders. As Keith Reinhardt, founder of the group Business for Diplomatic Action, explains, “research across much of the globe shows that consumers are cooling toward American culture and American brands, but there is still no hard evidence showing direct impact on bottom lines. In marketing, we know that attitude precedes behavior, and the warning signs are there.”⁹⁹ Indeed, the negative association may not occur yet because of a time lag between attitudes and behaviors, but it may (or not) happen in the future, depending on how long anti-Americanism is sustained by current events and on the availability of non-American alternatives.

Similar concerns are seen in Japan. In a survey of Japanese companies conducted in May 2005 after anti-Japan protests and boycott calls in China, “tarnished image of products” was the second most frequently cited concern about harmful impact from demonstrations after decreased sales.¹⁰⁰ Research institutes have conducted detailed

⁹⁶ Dan Roberts, “Is the world falling out of love with US brands?” *The Financial Times*, January 5, 2005.

⁹⁷ “Will American brands be a casualty of war?”, Interview with John Quelch, Working Knowledge, Harvard Business School, <http://hbswk.hbs.edu/item.jhtml?id=3429&t=marketing>.

⁹⁸ Look for reference

⁹⁹ *Corporate Citizen*, 2004. See also <http://www.businessfordiplomaticaction.org/index.php>.

¹⁰⁰ JETRO, “Special Survey of Japanese Businesses in China: Impact of the April Anti-Japan Demonstrations,” June 2005. available at http://www.jetro.go.jp/en/stats/survey/surveys/20050620_special.pdf.

surveys of corporate brand image in China to begin tracking the status of Japanese corporate image in terms of consumer confidence and trust.¹⁰¹ As noted above, leading Japanese firms such as Sony and Toyota lag behind their American and Korean competitors in the perceptions of Chinese consumers.

International economic governance

Finally, political tensions may have a long-term, indirect effect on economic relations through their impact on the shape of international economic governance. One could hold opposite expectations about the direction of the effect of political tensions on cooperation in multilateral venues. On the one hand, international negotiations are the subject to politicization as governments may use a public venue to display their opposition to another country. Such grandstanding would reduce opportunities for cooperation that might have been possible without negative linkages among issues. On the other hand, the rule-guided framework of multilateral venues is intended to prevent such negative linkages and focus on areas where common interests in cooperation bring states together. Decisions made in this setting may be sheltered from political tensions by the shared commitment to upholding the rules and mission of the particular institution. This impact could potentially be felt in opposite directions: towards more individualism or, on the contrary, towards more cooperation. Whether it goes one way or another depends on several factors. We briefly discuss some of these in the context of the Franco-American relationship and Sino-Japanese relationship, but more analysis is necessary in this area to specify the conditions for political tensions to harm or improve cooperation for economic governance.

A Franco-American rift has the potential to affect the willingness of the EU to cooperate with the U.S. at the multilateral level. Tensions in foreign policy could spill over onto other areas, such as trade or environmental negotiations, for instance. Cross-issue linkages could become less possible as the transatlantic partners become less certain of each other's motives. As a result, multilateral economic governance could be affected by having a United States more unilateralist than before and European states less willing to compromise. With respect to trade in particular, this could lead to protectionist temptations and thus have long-term ramifications for the state of the world economy. For policy issues that require high level leadership to make concessions for conclusion of an agreement, political tensions interfere to the extent that leaders are less able to work together for such compromises. In the case of Sino-Japanese relations, regular meetings of officials to negotiate a strengthened bilateral investment treaty and free trade agreement continue (together with South Korea) uninterrupted by political tensions. But many express concerns that the inability to overcome substantive differences on the economic issues on the table results from the lack of engagement by senior leaders.¹⁰²

However, it is possible that in certain circumstances the reverse may happen and bilateral political tensions on the contrary may ease multilateral economic governance.

¹⁰¹ Nomura Research Institute and Searchina Research Institute jointly published a survey "Corporate Brand in China" in 2005 and again in 2006.

¹⁰² Interviews of Keidanren official, 21 December 2005; Foreign Ministry official, 24 August 2006, Tokyo Japan.

Tensions in the political sphere could potentially serve to foster cooperation in the economic sphere. Indeed, some analysts have noted that not only is there a firewall between political relations and multilateral economic negotiations, but also that economic policy-makers often try to overcompensate for the bad state of political relations. For instance, it seems that during the 2003 Cancun meeting of the World Trade Organization, European and American trade negotiators went out of their way to smooth out the bad transatlantic relations over Iraq. Despite several instances of WTO inconsistent policies by China that harm major Japanese export industries, Japanese business and government officials cite reluctance to initiate a WTO complaint against China due to the tense political relations.¹⁰³ Another example can be found in the renewed activism of the Transatlantic Business Dialogue (TABD), an organization of business and government leaders in Europe and the United States working for increasing regulatory cooperation in the economic and financial spheres, since transatlantic political tensions have become more apparent.¹⁰⁴ So far, the growing transatlantic political rift does not seem to have affected cooperation in multilateral economic governance. Transatlantic trade disputes are not bigger or more acrimonious today than they were several years ago. However, the WTO meetings in Hong Kong in December 2005 and in Geneva in July 2006 have shown very little cooperation and willingness to compromise between the EU and the U.S.

Conclusion

This paper asked whether economic ties are insulated from political discord and analyzed under which conditions political tensions spill over into the economic realm. We found the threshold for such spillover to be very high. Overall, economic relations seem to be quite insulated from political relations, and therefore at a macro level political tensions have little effect on economic ties. Yet it does not mean that the firewall between politics and economics is impenetrable. At the micro level, collateral damage from political tensions may appear in particular economic sectors that are more vulnerable to animosity from consumers or intervention by governments. Future effects may also appear through erosion of brand image, as shown by the evidence in studies of consumer animosity.

In both case-studies, we found little short-term economic impact of political tensions. In spite of multiple political disagreements and the impression that they may be drifting apart, France and the United States remain deeply connected economic partners, even stronger than before the rift over Iraq. For the most part, trade and investment have not become politicized pawns in the Franco-American relationship. We saw a similar story for China and Japan. For both pairs of countries, it is business as usual.

Our findings have implications for the debate on economic interdependence and cooperation. While studies have pointed to evidence that trade follows the flag and that interdependence may constrain conflict, more research is necessary to specify the causal

¹⁰³ Interview of METI official, 17 August 2006, Tokyo Japan.

¹⁰⁴ See <http://www.tabd.com/> (last accessed November 8, 2005).

mechanisms and conditions under which the relationship holds. What are the means that governments use to direct economic flows? While we saw some evidence of interference at the margin, none of the governments involved in the political feuds we examine exerted a concerted effort to interfere with economic exchanges. In a period of liberalized economies and multinational companies, governments may find it more difficult to dictate economic outcomes according to political interests. Neither did the actions of private firms and consumers in response to changed political conditions have more than isolated effects. When do private firms and consumers use political information to inform their economic decisions? Given the evidence from our cases that political tensions short of war do not produce economic harm, the business lobbying for improved political relations necessary for a commercial peace may not take place. If severe crisis is the necessary trigger for such lobbying, one must question whether at such a late stage economic interests would be able to pull countries back from the brink.

Given that wars are rare occurrences, the research agenda for studying political and economic relations should give more attention to studying the effects of lower levels of political tension. Our work is preliminary and limited to a narrow set of countries and time. One challenge for expanding research in this area is the need to measure variation in political relations across countries and time. While wars can be objectively identified, political tensions are more ambiguous. The frequently used militarized interstate dispute data looks one level below war, but remains focused on intense *security* conflicts. At the aggregate level, there is a need for more measures such as Erik Gartzke's affinity of nations index that uses similarity of voting positions in the UN to measure political relations.¹⁰⁵ Content analysis of leader statements, VIP visits between countries, and opinion surveys offer other areas for tracking the state of bilateral political relations. A second challenge is the need to assess economic outcomes at the micro-level. Trade flows by industry or individual firm sales performance will be more promising than aggregate economic data. The business management literature has found useful results through survey analysis, and political science could build on this work to further explore the connection between politics and consumer behavior.

¹⁰⁵ See also work on UN voting such as Erik Voeten, "Clashes in the Assembly," *International Organization* 54:2 (Spring 2000): 185-215; and Soo Yeon Kim and Bruce Russett, "The new politics of voting alignments in the United Nations General Assembly." *International Organization*. Aug 1996, 50, (4), 629 - 652.