Economic Diplomacy
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Introduction

Economic Diplomacy: The Issues

This special issue of The Hague Journal of Diplomacy* brings together contributions by specialists and practitioners in the field of economic diplomacy. We believe that it is time to take stock of new insights at the interface of international economics, politics and diplomacy, and that complementary academic perspectives from the disciplines of economics and politics can enrich the study of diplomacy. Economic diplomacy is, of course, not a new phenomenon. From the very beginning of regulated contact between separate polities in the ancient world, economic interests were a driver of emerging diplomatic relations.1 It is fair to say, however, that for much of the modern era the commercial diplomatic activities of the European powers were generally seen to be distinctly inferior to political work. Unsurprisingly, the economic dimension therefore did not receive much attention among traditional students of diplomacy. Today we see a very different picture, in Europe and beyond, and in the worlds of practice and academia. Western governments give greater priority to their commercial diplomacy and foreign ministers see no reason to hide their view that diplomacy should contribute to national welfare and economic security. In a climate of enhanced global competition, practical and indeed also scholarly thinking about the subject is in flux, with many observers reflecting on current threats to, and opportunities for, the global political and economic systems.

It is a truism that the golden decades in which globalization, growth and ‘less government’ appeared to provide the recipe for welfare and less conflict came to an end in 2008/2009. As the global financial crisis unfolded, this shift was visible even in those Western countries that had until then been the staunchest

* Most contributions in this volume originated from the conference titled ‘Economic Diplomacy Beyond 2010: Geo-Economic Challenges of Globalization and Economic Security’, which was co-organized in October 2009 by the Netherlands Institute of International Relations ’Clingendael’ and the International Institute of Social Studies of Erasmus University. The Dutch Ministry of Economic Affairs’ financial support for that conference is gratefully acknowledged.

defenders of the mantra of neo-liberal capitalism. A number of crises and imbalances regarding food, the environment, energy and the global economic and financial system coincided, providing in a sense the ultimate ‘litmus test’ for any country’s ability to influence the rules and institutions of global governance. This concurrence of crises not only exposed a lack of appropriate international governance — economic, financial and political — and the fragility of the global system. It was also a symptom of geopolitical and geo-economic shifts that had been under way since the 1990s, when a new phase of globalization set in. Students and practitioners of economic diplomacy seem to be well placed to understand and foresee the interactions among these different spheres of influence.

Economic diplomacy is a significant part of a much larger set of international arrangements that breed trust between nations. Moreover, positive non-economic spillover effects from economic diplomacy may emerge in the field of high politics. The ‘liberal peace’ school of thought relates increasing bilateral trade and investment to a reduced escalation of conflicts among states. Such external effects are important for economists, since they help them in providing theoretical justifications for government intervention. These effects are equally important for political scientists, because of the implication that the ‘low’ politics of economic and commercial diplomacy, which have long been frowned upon in diplomatic circles, are inseparable from global political relations.

The Rebalancing Act

It is increasingly recognized that the emerging economic powers that make up the so-called BRIICS countries have become invaluable engines of world economic growth and are essential to solve global challenges, including climate change and the scarcity of natural resources. Several of the BRIICS nations and a number of other emerging powers are not (yet) full members of the family of democratic market economies, and at the same time they pose challenges to the United States’ hegemony and the new world order that developed in the post-war era. International policy-making in today’s context is a rebalancing act from the West towards
the East. The search for a new equilibrium that is associated with the changing role of the emerging powers is nowhere more visible than in the G20 group of major economies.

Historically, economic diplomacy has had a large role to play in the context of shifting power balances. Governments are more likely to employ economic tools in the pursuit of foreign policy interests when the legitimacy and power of existing structures of international cooperation decrease. Furthermore, perceptions of weakening adherence to multilateral rules make bilateral policies more attractive. The reconfiguration of geo-economic power encourages governments all over the world to reassess the effectiveness and appropriateness of their national and foreign policies — including those at the interface of international politics and economics (as has been observed over the past decade). This is particularly true for the instruments of economic diplomacy. The changes spur new thinking, such as on the role of commercial diplomats who are active in the field of trade and investment promotion. A larger role for the state in international economics is seen as a necessary condition for success, not least because the new economic powers are typically characterized by a much stronger influence of the state in the domestic private sector. This stands in sharp contrast to (the ideal of) the public-private separation that is seen in most Western countries. Cultural and/or historic reasons may in turn explain why trade partners in the emerging economies expect state involvement from the side of their foreign trade and investment partners. Because of its importance as an emerging economic, political and military power, the example of China nowadays receives most attention from both scholars and practitioners. China’s policies and strategy are addressed by several authors in this special issue of The Hague Journal of Diplomacy.

Regional integration, especially in Europe, limits the scope and influence of individual member states in the international institutions, as well as restricting the policy space for economic policy instruments. This actually leaves much scope

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for bilateral diplomacy in Europe, because EU institutions do not engage directly in promoting the commercial interests of individual EU member states. A subtle trade-off thus exists between the larger impact of Europe as a negotiating partner, which requires renouncing some national autonomy, and the increased scope for bilateral commercial diplomacy.\footnote{See the article by S.B. Woolcock, ‘EU Economic Diplomacy: The Factors Shaping Common Action’, \textit{The Hague Journal of Diplomacy}, vol. 6, nos. 1–2, 2011, 83–99, this issue.}

**The Many Dimensions of Economic Diplomacy**

Economic diplomacy is clearly not just about narrow economic and commercial interests. Rather, it involves broad national interests that include political and strategic as well as economic dimensions.\footnote{A.O. Hirschman, \textit{National Power and the Structure of Foreign Trade}, expanded edition (Los Angeles, CA: University of California Press, 1980, first published 1945); and D.A. Baldwin, \textit{Economic Statecraft} (Princeton, NJ: Princeton University Press, 1985).} It is true that conceptualizing economic diplomacy is by no means easy, as shown by the fact that one article in this volume is dedicated entirely to this subject while most other authors start with a discussion of their understanding of ‘economic diplomacy’. While some of the authors deliberately try to narrow down the object of their investigations, this appears to be for essentially practical purposes, such as when a strict definition is necessary in order to make the concept measurable. By no means does such delimitation imply that the authors neglect the multidimensional nature of the phenomenon, which in our view requires the multidisciplinary approach to which this special issue testifies. Economic diplomacy is neither limited to the economic domain nor to that of diplomacy; comparative cultural, historical and organizational aspects are also drivers of the direction and success of economic diplomatic activities. The better that economic diplomacy bridges these differences between countries, the more effective and successful it appears to be.

**Positive and Negative Economic Diplomacy**

Governments design and pursue economic diplomacy with the aim of promoting national economic welfare and security. Economic diplomacy is thus part of — and at the same time an instrument of — foreign policy, concerned with (decision-making) processes and the employment of political-economic instruments. The body of knowledge about commercial and other strands of economic diplomacy has a curious but rarely noted aspect, namely its bias with respect to positive and negative interactions, respectively.\footnote{P.A.G. van Bergeijk, \textit{Economic Diplomacy and the Geography of International Trade} (Cheltenham: Edward Elgar, 2009), chapter 8.} The empirical evidence that is produced
by economists working on the use and impact of diplomatic exchange in the post-1990 global trade system is mainly limited to the trade and investment impacts of positive diplomatic exchanges, and in particular the diplomatic and commercial infrastructures. Interestingly, international economic exchange in its turn has a beneficial impact in the realm of politics, even when these economic exchanges take place indirectly, as is argued for the relationships between India and Pakistan. In contrast, the empirical evidence on the use of economic relationships as a tool to achieve foreign policy goals is by and large limited to the use of negative sanctions, while we know little about the determinants of failure and the success of positive sanctions. Notwithstanding the bulk of literature on development aid in the fields of political science and regional studies, it is said that development aid has a large political component that is often neglected in the international debate about the economic effectiveness of financial and technical support to other countries.

Concluding Remarks

The contributions to this special issue of The Hague Journal of Diplomacy cover many aspects of economic diplomacy from different angles and perspectives. Rather than collecting a clear, methodologically delineated set of papers, we have solicited a broad spectrum that illustrates the multifaceted character of economic diplomacy, the range of available techniques (running from qualitative case studies to econometric analyses) and the potential for cross-fertilization of different scholarly approaches to the activities and impacts of economic diplomats. The

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17) Dorussen et al., ‘Any Ties That Bind?’, in this issue, pp. 149-169.


20) De Haan, ‘Development Cooperation as Economic Diplomacy?’. 
aim of this collection is to learn from the different methods and to provide a source of inspiration for the multidisciplinary approach that we think is vital for a better understanding of the evolving concept of economic diplomacy. We hope that this special issue of *The Hague Journal of Diplomacy* testifies to the vibrant and intellectually stimulating aspects of that research agenda.

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Conceptualizing Economic Diplomacy: The Crossroads of International Relations, Economics, IPE and Diplomatic Studies

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Summary
This article introduces both a conceptual and an analytical framework of economic diplomacy so as to contribute to sounder understanding of economic diplomacy’s activities, tools and goals. While the state is not regarded as the only player, or as a coherent entity, it is assumed that the state is the primary actor in economic diplomacy. The conceptual framework discerns five strands of economic diplomacy, which involve tools and purposes that are relatively more commercial/economic or political in character and are thereby closer to the ‘business end’ or ‘power-play end’ of economic diplomacy. The analytical framework identifies four essential dimensions of economic diplomacy within which historically contingent change may occur: the context; tools; theatres; and processes. Interaction between these dimensions takes place in multiple ways. Building on the insights provided by these frameworks, the article analyses the foci, assumptions and methodologies of the research fields that are concerned with economic diplomacy, and discusses the strategic and ideological considerations that underpin it.

Keywords
economic diplomacy, commercial diplomacy, economic statecraft, trade diplomacy, official development assistance (ODA), political culture

Introduction

The term ‘economic diplomacy’ appears regularly in scholarly papers and official documents. Even so, relatively few coherent attempts have been made to develop sounder understanding of the meaning and scope of the concept.¹ Both academics

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¹ The author would like to thank several colleagues and two anonymous reviewers for their useful comments on earlier drafts of this article.

and practitioners are talking at cross purposes. That this may cause unwarranted confusion is illustrated by a letter to the Dutch Parliament by (former) Minister for Foreign Affairs of the Netherlands, Maxime Verhagen.\(^2\) In the letter, Verhagen states his intention to give economic diplomacy a more central place in Dutch foreign policy, arguing that research has shown that ‘economic diplomacy increases prosperity by 100 to 200 million Euros a year’ and suggesting that economic diplomacy more broadly has a welfare-enhancing effect. These assertions are misleading, however. The definition of economic diplomacy that is used in the cost-benefit analysis to which Verhagen refers\(^3\) is limited to outgoing trade missions with a cabinet member — which are only one of many instruments of economic diplomacy.

Clearly, there is a need for improved understanding of economic diplomacy’s activities, tools and goals. This article contributes to this debate, and proposes a conceptual and an analytical framework of economic diplomacy. The reasons for this are threefold. First, the distinction between economic diplomacy and related concepts is imperative in order to bring order in the definitional chaos. What differentiates economic diplomacy from economic statecraft, economic security, trade diplomacy, commercial diplomacy and financial diplomacy — and how do these concepts relate? Second, a better conceptualization of economic diplomacy is useful in order to address practical questions, such as how to deal with the artificial distinction between the public and private sectors.\(^4\) Finally, improved understanding of both the theory and practice of economic diplomacy grows in importance because of shifting power balances. Latecomer countries — including Asian, post-colonial and transition states — are strengthening their role and influence in global politics and economics in a system that has long been dominated by Western countries. Confronted with the viscosity of global governance and international political and financial institutions, the governments of these emerging countries primarily use economic tools and commercial relations to strengthen their position in international politics.

The proposed (re)definition of economic diplomacy adds to the existing literature by spurring a meaningful reorganization of the diversity of institutional


\(^4\) While politics and economics can hardly be separated, an analytical distinction between the two sometimes needs to be made in order to make the complex reality intelligible and workable. For example, governments generally distinguish between a ministry of foreign affairs and a ministry of the economy (or the like) — while some countries have experimented with a ministry of foreign affairs and trade, with mixed results — and in academia a distinction is traditionally made between the research fields of political science and economics, which have relatively recently been complemented by the field of (international) political economy, as will be discussed later.
frameworks in the fields of diplomacy, economic studies and security in general.\footnote{For a discussion of economics and security in a narrower sense (largely involving defence, terrorism and conflict), see Alyson J.K. Bailes and Isabel Frommelt (eds.), \textit{Business and Security: Public — Private Sector Relationships in a New Security Environment} (Oxford: Oxford University Press, 2004).} The conceptual and analytical frameworks that are proposed here must therefore be judged by their purpose — that is, to bring order and meaning to a mass of phenomena that would remain disconnected and unintelligible without them. The fundamental questions are, first, what is meant by ‘economic’ in economic diplomacy? That is, are we talking about economic goals (such as enhancing economic prosperity), economic tools (including using deprivation of access to products and funds as political leverage) or economic motives (for example, promoting one’s own industry)? Second, what is meant by ‘diplomacy’? How is diplomacy different from policy, or what distinguishes economic diplomacy from foreign economic policy? Answers to these questions are sought through review and analysis of the available literature in the fields of international relations (IR), economics, international political economics (IPE), and diplomatic studies.

While the majority of the literature discussed in this article is of relatively recent origin and by Anglo-Saxon authors, it should be emphasized that the concept and practice of economic diplomacy has been treated elsewhere and at earlier times. Limitations of time and space are the sole reasons for the narrow focus that is adopted here.

This article is divided into four main sections. The first revisits how innovations in various research fields facilitated more refined enquiry into economic diplomacy, and reflects on historical patterns in economic diplomacy. The second section develops a broad definition of economic diplomacy and introduces a conceptual and an analytical framework, which identify (respectively) specific strands and dimensions of economic diplomacy that are practised by governments. Using these frameworks, the third section looks at the foci and assumptions of the research fields that have contributed to the study of economic diplomacy: mainly IR, economics and IPE, and diplomatic studies. The fourth section addresses the logic of economic diplomacy — that is, the strategic and ideological considerations that underpin it. Finally, the article concludes with observations on why unpacking the notion of economic diplomacy is imperative, not only to elucidate both academic and policy debates, but also to develop a sophisticated forward-looking strategy that is required at this time of shifting power balances.

\textbf{New Theories and Concepts}

The linkage between economics and politics in practice, and — more specifically — the use of economic instruments for political purposes, can be dated back to ancient times.\footnote{This also goes for the linkage between economics and security, and between trade and conflict, which} From the beginning, diplomacy was about war and trade issues,
and the history of consular relations also shows how trade interests loomed large in international relations. Reference to the use of sanctions can be found, for instance, in *The History of the Peloponnesian War* by Thucydides, who mentions a trade boycott imposed by Athens against Sparta’s ally Megara.7 Also, the number of representatives of merchants in the main harbour cities in Southern Europe increased in the wake of expanding international trade in Europe in medieval times,8 when the *Lex Mercatoria* (literally, merchant law) regulated commercial dealings. This is a case of practice preceding theory; the concept predating its label. That being said, the overlap and interrelationship between economics and politics became the subject of serious (empirical) analysis only in the early second half of the twentieth century.

Writing in the early post-Second World War period, scholars such as Jacob Viner, Albert O. Hirschman and Quincy Wright were frontrunners in the study of how politics and economics relate. Hans Morgenthau succinctly argued that:

> It is necessary to distinguish between, say, economic policies that are undertaken for their own sake and economic policies that are the instruments of a political policy — a policy, that is, whose economic purpose is but the means to the end of controlling the policies of another nation. [...] The distinction is of great practical importance, and the failure to make it has led to much confusion in policy and public opinion.9

Confronted with substantial changes in the international order, IR scholars mainly in the United States and (to a lesser extent) Europe developed new concepts and theories that sought to integrate politics and economics more explicitly. The 1970s marked the start of ground-breaking thinking in several sub-fields of international relations studies. Looking back, these innovations can be seen to have facilitated a more refined enquiry into economic diplomacy — a research field that gathered renewed interest from the 1990s. While political scientists working in the fields of IR, IPE and diplomatic studies became increasingly involved in economic diplomacy themes (both explicitly and implicitly — addressing the subject with and without using the label), economists gradually developed more sophisticated empirical studies that strengthened quantitative enquiries into economic diplomacy. As will be shown, this did not result in real

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interaction between the two epistemic communities, even though the breakdown of the artificial distinction between the scholarly fields of politics and economics narrowed.

While the Cold War division continued to define the contours of international relations studies, the consequences of globalization and new economic challenges — including the oil shocks, the collapse of the Bretton Woods system and the emergence of non-Western economies (first of all, Japan) — necessitated a more comprehensive framework of analysis. International economic relations were broadened to include the political sphere, thereby creating the current IR focus on IPE that generated research on international economics, internationalization and globalization. Furthermore, political scientists sought to relate domestic politics and international relations. The so-called ‘two-level games’ or ‘double-edged diplomacy’ of Robert Putnam et al. called for analysis of the combined impact of domestic and international forces in international bargaining. This concept has been much developed since its introduction in 1988. In many ways, the domestic level provides insight into the underpinnings of the power bases and the constitutive process of economic diplomacy, and thereby in the behaviour that results from it. Negotiations among groups of domestic actors thus serve to help us understand the (foreign) policy-making process and the economic diplomacy strategy of governments.

In the post-war period, economists also developed models that were meant to perform cost-benefit analyses of various economic diplomacy instruments through statistical analysis of data sets. Early studies of the trade — conflict relationship focused on the welfare-enhancing effects of international trade, such as the trade-stimulating effect of geographical distance, colonial ties, and (shared) language and currency. Of major importance to the development of research in this field

was the work of Jan Tinbergen, who first introduced the gravity model of trade.\textsuperscript{11} His model became used by the next generation of economists in empirical analyses of the (material) benefits of active political involvement in international trade. This includes the welfare-enhancing effect of certain modes of diplomacy — such as summitry — and diplomatic representation in general. Complementing the gravity approach, other techniques to study trade intensities have also been developed.\textsuperscript{12}

Introducing the concept of ‘triangular diplomacy’, Susan Strange \textit{et al.} called attention to the fact that states must now also negotiate with foreign firms, and that multinational firms themselves increasingly have to become more statesmanlike.\textsuperscript{13} At the same time, multinational firms appear to have become less powerful since the 1980s, and especially in this new millennium.\textsuperscript{14} While certain industries have an indispensible role in tackling global challenges, including climate change, other multinational corporations have fewer issues to negotiate with governments, and more actors are competing for attention on the domestic level.\textsuperscript{15} David Baldwin contributed greatly to the field of IPE with his study on economic statecraft, which he defined as ‘governmental influence attempts relying primarily on resources which have a reasonable semblance of a market price in terms of money.’\textsuperscript{16} Notably, the central actor in his analysis is the state. Linking economics and conflict, Solomon Polachek developed the concept of economic security. He argued that increases in trade and investment reduce the likelihood of conflict.

While contributing greatly to the debate on what comprises economic statecraft and economic security, the questions of when policies towards these ends are successful and how these concepts inform practical negotiations are left unanswered in the works of Strange, Baldwin and Polachek. Political scientists and economists alike have attempted to overcome these shortcomings. Jean-Marc


\textsuperscript{12} For example, Roemer investigates trade patterns using area and sector intensities. He finds that ‘trade intensities in the Western world cannot be explained solely by economic factors, but must result in part from causes that are in the narrow sense not economic’. See John E. Roemer, ‘The Effect of Sphere of Influence and Economic Distance on the Commodity Composition of Trade in Manufactures’, \textit{Review of Economics and Statistics}, vol. 59, no. 3, 1977, pp. 318-327. See also Van Bergeijk, \textit{Economic Diplomacy and the Geography of International Trade}, p. 41.


\textsuperscript{14} Geoffrey Jones, \textit{The Evolution of International Business} (London: Routledge, 1996). This subject is also addressed in Alex E. Fernández and Barbara Hogenboom (eds.), \textit{Big Business and Economic Development} (London and New York: Routledge, 2007).

\textsuperscript{15} Whether the influential power of internationally operating companies increases or remains more or less the same obviously varies not only between industries, but also between countries and regions. Examples of the more powerful internationally operating companies are state-owned enterprises and funds, as well as banks.

\textsuperscript{16} Baldwin, \textit{Economic Statecraft}, pp. 13-14. The overlap and distinction between economic diplomacy, economic statecraft and economic security are discussed in more detail in the next paragraph.
Blanchard and Norrin Ripsman, for example, developed a political model to theorize economic statecraft that calls attention to the importance of the domestic political arrangements of the target as well as the sender state, and the international political variables that can alter the political costs of facing the target state. Peter van Bergeijk produced an elaborate review of the various models that empirically test the (material) benefits of active political involvement in international trade. While the study and analysis of the interrelationship between international politics and economics gains ground on both ends, the subject is studied very differently by political scientists and economists. This may explain the virtual lack of interaction and mutual learning between the two.

**Cycles of Economic Diplomacy**

To say that economic diplomacy received little attention in IR studies until recently is, of course, not to argue that it is a new phenomenon. As noted earlier, economic diplomacy was a tool in foreign relations long before the establishment of the institutions that have become part and parcel of foreign policy and diplomacy practised by states today. Governments’ (relative) attention for economic diplomacy tends to be cyclical, however, and relates to power shifts domestically as well as in the world order. At the national level, new governments typically launch fresh initiatives at an early stage of their time in power. The commercial and trade dimensions of economic diplomacy tend to be prominent in clear-cut and direct policies. At a later stage — heading towards elections — politics become increasingly prominent and strategic issues a greater concern. One should be cautious of generalizations, however, as domestic policies are substantially dependent on macroeconomic conditions and political culture. This brings us to the global cycle of economic diplomacy, which suggests that economic diplomacy takes prominence when acceleration in globalization is accompanied by an absence of agreed rules of conduct. That is to say, governments are more likely to employ economic tools in the pursuit of foreign-policy interests when the legitimacy and power of existing structures of international cooperation decrease.

Changes at the global level have a significant impact on long-term trends in economic diplomacy. Three factors are crucial to understand how policy-makers
(and scholars alike) have treated the relationship between economics and security: the international distribution of material capabilities; the international strategic environment; and the position of the dominant world power in international economic competition.\textsuperscript{20} Applying this to the case of the United States, for example, Mastanduno argues that when the international economic position of the United States is strong, foreign economic policy complements national security policy. When it is weak(er), foreign policy is used for particularistic or national interests.

The profound reconfiguration of the international order that is currently under way explains why economic diplomacy is gaining in importance once again. China is returning to the international stage and poses increased challenges to the hegemony of the United States and the world order that was built by the trans-Atlantic powers after 1945. Barring unforeseen circumstances, Washington will increasingly have to make room at the negotiating table — even if it remains the most powerful actor on the international stage in the decades to come. Adding to the growing importance of economic diplomacy is the fact that the challengers are latecomers in an international system with institutions that are largely dominated by Western countries. These states have fundamentally different ideas about the relationship between the private and public sectors, and follow an approach to foreign policy that emphasizes economic tools as well as political tools for economic purposes. Thus, the shift in the global balance of power encourages governments all over the world to reassess their national and foreign policies — including on the politico-economic front — and interests in international institutions. In the newly emerging multi-polar system, which historically has been more unstable than bipolar or even uni-polar systems,\textsuperscript{21} economic diplomacy is a useful means by which to pursue national interests through peaceful means. The upgrading by the Obama administration of the strategic and economic dialogue with China that was initiated by former US President George W. Bush in 2006 may also be seen in this context. Meanwhile, the European Union has greater difficulty in successfully employing its economic clout in political negotiations with powerful third countries, as it largely fails to interconnect political and economic policy at the Union level.

**Towards a Better Understanding of Economic Diplomacy**

Many different concepts are used in the research fields that contribute to the study of economic diplomacy. The interrelationships, overlaps and distinctions between these concepts are often unclear. The same can be said of the various


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corcepts’ meanings — let alone their position within the broad realm of foreign policy and international statecraft. This goes for economic diplomacy as well as for economic statecraft, economic security, trade diplomacy, commercial diplomacy and financial diplomacy. While the term ‘economic diplomacy’ is most frequently left undefined, those who use ‘economic statecraft’ or ‘commercial diplomacy’ tend not to consider the distinction between these two (and other) alternatives. This situation is a handicap for academics and practitioners. More order is needed if research on economic diplomacy is to move decisively into a more mature phase.

In his seminal book on economic statecraft, Baldwin asserted that ‘whereas economic statecraft is defined in terms of means, alternative concepts are usually defined in terms of actual or intended effects of a policy or in terms of the process by which the policy was made.’ This article agrees that economic diplomacy is primarily about processes and practices while economic statecraft is primarily about structures. Contrary to Baldwin, however, economic diplomacy is here defined in terms of means — like economic statecraft. Furthermore, while most studies of economic statecraft focus their attention on coercive instruments such as sanctions and boycotts, economic diplomacy is thought to involve also the employment of economic instruments in non-coercive ways. In its broadest sense, economic diplomacy is considered as the narrow stem of a funnel through which all expressions of the interrelationship between IPE and diplomatic studies are channelled.

A major issue in the study of economic diplomacy originates in the study of diplomacy at large, and concerns the extent to which economic diplomacy is tied to the state or, alternatively, involves a broader range of private and other

22 This challenge is by no means confined to economic diplomacy; it can be argued that studies of diplomacy more generally also largely fail to address the difference between diplomacy and statecraft.

23 This is illustrated by the opening paragraph of this article, as well as by discussions at the international conference on economic diplomacy that took place at the Clingendael Institute in October 2009. For the conference proceedings, see online at http://www.clingendael.nl/cdsp/events/20091015/.

24 Other alternative concepts are foreign economic policy, international economic policy, economic leverage, economic sanctions, economic warfare and economic coercion. See Baldwin, Economic Statecraft, pp. 33-40.

25 See, for example, Taylor, American Sanctions; Blanchard and Ripsman, A Political Theory of Economic Statecraft. An exception to this rule is Kelton, who uses economic statecraft in an analysis of preferential trade agreements, in an apparent attempt to bolster the strategic, politico-military angle of the study; see Maryanne Kelton, ‘US Economic Statecraft in Asia’, International Relations of the Asia-Pacific, vol. 8, no. 2, 2008, pp. 149-174.

Mastanduno tries to overcome the ‘narrow’ application of economic statecraft to coercive sanctions, and distinguishes between negative sanctions and positive sanctions (inducements). He notes that ‘more often than not, policy-makers treat economic sanctions as part of a package of foreign policy measures. Nonetheless, scholarly analysis thus far has not addressed systematically the interaction of sanctions and other instruments of statecraft’. This article answers his call, but uses ‘economic diplomacy’ rather than ‘economic statecraft’ as the umbrella term. See Michael Mastanduno, ‘Economic Statecraft, Interdependence and National Security: Agendas for Research’, Security Studies, vol. 9, nos. 1 and 2, 1999, pp. 288-316 (quoted on p. 299).
(non-governmental) actors. This is another important point that distinguishes economic diplomacy from economic statecraft, which generally considers actions taken unilaterally by the state and — in its initial form as set forth by Baldwin — does not address the domestic context. The most thorough attempt made to date to analyse economic diplomacy from an IR and diplomatic perspective, by Nicholas Bayne and Stephan Woolcock, addresses this same issue. The authors argue that in economic diplomacy, governments try to reconcile three types of tensions: (1) the tension between politics and economics; (2) the tension between international and domestic pressures; and (3) the tension between government and other actors, such as private business and NGOs. While economic diplomacy may be largely concerned with actions taken by the state, it also considers the dynamic environment in which the state operates. Economic diplomacy thus cannot be seen as separate from the domestic context (of both the sender and the receiving state) and the activities of the state as influenced by other actors, such as private business and other interest groups.

Building a Conceptual Framework

Taking these insights into account, the state is here not regarded as the only player, nor as a coherent entity. It is assumed, however, that the state is the primary actor in economic diplomacy. Understood in such a state-centric realist framework, economic diplomacy has been defined as the pursuit of economic security within an anarchic system. If economic security is thought to comprise the economic prosperity and political stability of a nation, it follows that economic diplomacy pursued by a government involves a variety of instruments that are relatively more economic or more political in character. In other words, economic diplomacy involves a ‘business end’ and a ‘power-play end’, and all tools (in mirror view: expressions) of economic diplomacy can be placed somewhere in between these two extremes. Fig. 1 illustrates this. At the ‘power-play end’ are instruments which generally involve actions and negotiations that are primarily political in character. In other words, economic diplomacy involves a ‘business end’ and a ‘power-play end’, and all tools (in mirror view: expressions) of economic diplomacy can be placed somewhere in between these two extremes. Fig. 1 illustrates this. At the ‘power-play end’ are instruments which generally involve actions and negotiations that are primarily political in character, such as sanctions (and the lifting thereof). The primary drivers behind these activities are the strategic goals of a government, and the

27) Some scholars of economic statecraft have recently incorporated the domestic interest groups in the target and/or sender state in their research. See, for example, Blanchard and Ripsman, ‘A Political Theory’; and Taylor, American Sanctions. In certain cases the emphasis on process rather than means begs the question of whether the term ‘economic diplomacy’ instead of ‘economic statecraft’ would not more accurately reflect the subject that is discussed.
29) Lee and Hocking, ‘Economic Diplomacy’.
underlying cost-benefit calculations follow a political logic. Activities aim primarily to contribute to a stable international environment and are often referred to as economic statecraft. At the ‘business end’ of economic diplomacy are found the cooperative efforts by government and business that aim to achieve commercial objectives that advance national interests, including trade and investment promotion (commercial diplomacy). Here, cost-benefit calculations primarily follow an economic logic, and maximizing business opportunities is the primary driver behind activities. In between these ends are activities that may be more or less economic or political, such as economic or development aid (and aid suspension), bilateral and multilateral negotiations on trade agreements (trade diplomacy), and financial and monetary policy/negotiations (financial diplomacy). Differences notwithstanding, it should be emphasized that the distinction between the different strands is fluid and that strands may overlap — implying that economic diplomacy is not a linear, but more of a network concept.

The two ends of the spectre are also implicit in the definition of well-known scholars in diplomatic studies, Geoff R. Berridge and Alan James, who defined economic diplomacy as (1) diplomacy concerned with economic policy questions; and (2) diplomacy that employs economic resources, either as rewards or sanctions, in pursuit of a particular foreign policy objective. While the latter part of this definition is about economic tools that are used for political purposes, the former part is about political tools — while the objectives remain unspecified. The definition adopted here tries to overcome this weakness. Thus, economic diplomacy is understood as the use of political means as leverage in international negotiations, with the aim of enhancing national economic prosperity, and the use of economic leverage to increase the political stability of the nation. Paraphrasing Gilpin, the essence of economic diplomacy is to interrupt, employ and direct commercial and political intercourse.

Most expressions of economic diplomacy involve multiple goals and can, in principle, be classified under more than one category. Generally, however, one

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31) This follows Kopp, Commercial Diplomacy and the National Interest. It should be noted, however, that the distinction between official development assistance (ODA) and other commercial activities in which the government is involved is more explicit here.

32) This latter sub-field is growing in importance and requires much more research in order to discern better the means and intentions involved.

33) Geoff R. Berridge (with Alan James), Dictionary of Diplomacy (Basingstoke: Palgrave-Macmillan, 2nd edition, 2003), p. 91. Various instruments can be used to perform economic diplomacy actively. Most commonly referred to in this regard are economic aid or ‘carrots’ and economic sanctions or ‘sticks’. Bayne and Woolcock argue that economic diplomacy is concerned with the (decision-making) processes rather than structures, and with international economic issues. In economic diplomacy, governments try to reconcile three types of tensions: between politics and economics; between international and domestic pressures; and between government and other actors. See Bayne and Woolcock, The New Economic Diplomacy, ch. 1.

34) With reference to Hirschman’s earlier work, Gilpin argued that ‘the essence of economic power, or at least one form of it, is the capacity to interrupt commercial intercourse’; see Robert Gilpin, The Political Economy of International Relations (Princeton NJ: Princeton University Press, 1987), p. 76.
can make a reasonable judgement as to what category best characterizes the primary goal or basis of a particular expression of economic diplomacy. Few would dispute, for example, that sanctions primarily serve political and strategic goals, while export promotion aims to strengthen one’s own industry and, thus, primarily serves the nation’s economic prosperity. The primary goal of aid and trade negotiations is relatively more dependent on the specific circumstances of a case and tends to vary more between countries. This fluidity is illustrated by the arrows in Fig. 1. For example, while development aid from European countries and the United States is on the whole more political in character and purpose (aiming to promote good governance, democracy and human rights), Asian countries use such funds primarily to spur the economic strength of the aid recipient and the aid provider, through trade and investment. In this context, it is telling that Japan, China and India prefer to speak of economic cooperation rather than of development aid. In a similar vein, trade negotiations can be more or less political in character. Here the roles are reversed, compared to the aid example: while trade diplomacy is often more political in the Asian context — where trade and financial agreements play a role in the competition for influence in the region — European countries more often have commercial objectives and enhanced cost-effectiveness in mind when negotiating bilateral or regional trade agreements. The classification presented in Fig. 1 is thus particularly representative of Western countries, and would have to be adjusted slightly if it was to represent other (groups of)

35) Moral drivers of ODA policy — or the high political symbolism of such a policy — may also influence a government’s approach to development aid. Such drivers partly explain the emphasis in ODA policy, especially of Western countries, on political rather than commercial goals. See also the practitioner’s perspective of Arjan de Haan, A. de Haan, ‘Development Cooperation as Economic Diplomacy’, *The Hague Journal of Diplomacy*, vol. 6, nos. 1-2 2011, pp. 203-217, this issue.
countries or regions, especially in Asia and the Middle East.\footnote{For more on this see Maaike Okano-Heijmans, ‘Power Shift: Economic Realism and Economic Diplomacy on the Rise’, in Enrico Fels, Jan-Frederik Kremer and Kathrina Harmat (eds.), Power in the 21st century — International Security and International Political Economy in a Changing World (forthcoming, 2011).} Again, the dotted lines in Fig. 1 represent such variations between countries.

The different strands also inform the methodology of study — especially whether certain expressions within a specific strand can be studied through quantitative or qualitative analysis. While the more economic expressions of economic diplomacy can be researched relatively better by applying economic models to extensive data sets, more political expressions are commonly studied through case studies. That being said, the distinction is obviously not as neat as suggested by this simplification of reality, and some exceptions and a variety of studies operating on the borders of the two can be found. The proposed conceptual framework may also be useful in this respect, for it facilitates the research of economic diplomacy by illuminating the various angles from which international economic and foreign policy can be studied and analysed.\footnote{A review of the literature reveals that the primarily economic and commercial expressions studied by economists, categorized on the ‘business end’ of economic diplomacy, are studied through quantitative, empirical analysis relatively more often. The growing availability of statistical data in these fields makes for an increasing body of literature on this front. The more that politics is involved, the more difficult ‘objective’ analysis of economic diplomacy becomes. Strategic interests pursued through economic means such as ODA and sanctions can be subjected to quantitative analysis to the extent that statistics are available on the levels of assistance and the impact of sanctions on trade.}

Each strand of economic diplomacy involves a wide variety of activities and expressions, as Table 1 illustrates. Countries are more successful in economic diplomacy if they increase the number of activities, conceive of new ways to conduct economic diplomacy, or terminate activities that have proven unsuccessful. But, to paraphrase Porter, economic diplomacy is more than the sum of a country’s activities.\footnote{This section draws on Porter’s analysis of the competitive advantage of firms in global industries, which suggests that the complex environment of interlinked economic diplomacy activities of a country may be likened to the series of primary and support activities that make up the operations of a firm. While firms seek competitive advantage in an industry or industry segment by being more efficient or creating better value (resulting in lower costs or differentiation, respectively) than competitors, countries seek success in economic diplomacy by using political tools to enhance economic prosperity and by employing commercial instruments to achieve and maintain political stability. See Michael E. Porter, The Competitive Advantage of Nations (London: Palgrave, 1998).} The multitude of activities within the different economic diplomacy strands form an interdependent system or network of activities. These activities are connected by linkages, which occur when the way in which one activity is performed affects the cost or effectiveness of other activities. It follows that linkages create trade-offs in performing different activities that must be optimized. For example, imposing an embargo or suspending aid reduces opportunities for trade and investment, while granting a country membership to an international financial institution may increase commercial opportunities in/with
the target country. To be successful in economic diplomacy, any government must resolve such trade-offs in accordance with the balance of national interests and its foreign policy strategy at large. Careful management of linkages and continuous investigation of existing and potential economic diplomacy activities are thus of utmost importance.

**Building an Analytical Framework**

The conceptual framework helps us to distinguish various strands of economic diplomacy and to begin to understand the relationship between, and diversity of tools within, those strands. This is one important step in untangling the pieces of the economic diplomacy puzzle. The next challenge is to identify essential dimensions of economic diplomacy, within which historically contingent change may occur. Four key elements of economic diplomacy are proposed: the context; tools; theatres; and process. These dimensions spell out the analytical angles that altogether provide a complete understanding of a country’s economic diplomacy — that is, how economic diplomacy is embedded in the pursuit of a balance of (national) interests. Fig. 2 shows how the concepts (at the three angles, 

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39) Substituting ‘the national interest’ for ‘a balance of interests’ has triple significance: (1) it indicates that one particular balance is struck from among several options; (2) it indicates human agency; and (3) it includes the possibility of human fallibility and the prospect of course corrections. See Ramesh Thakur, ‘A Balance of Interests’, in Andrew F. Cooper, Jorge Heine and Ramesh Thakur (eds.), *The Oxford Handbook of Modern Diplomacy* (Oxford: Oxford University Press, forthcoming 2012).
the side and the core of this triangular analytical framework) are separate, yet interdependent.

Each research field in which economic diplomacy is studied is largely representative of one dimension of the analytical framework, although this distinction is also not as neat as the simplified model may seem to suggest. The environment in which (a specific strand of) economic diplomacy is pursued is understood best through an IR approach to economic diplomacy. For example, it is mainly IR scholars who inform us about different levels that define the context in which economic diplomacy is exercised — namely, the interplay (respectively) between the domestic and international sphere, and between politics and economics. Such analysis provides little insight, however, into the variety and efficacy of instruments that can be used, where certain activities take place, or the ways and motivations of agents who practise economic diplomacy — that is, on the relationships themselves. For this, it is useful to look at analyses from the economics, IPE and

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40 One is tempted to believe that the three elements may even be connected to the familiar triad in IR approaches: realism (context); liberalism (tools); and constructivism (process). This facilitates analytical eclecticism at yet a different level, but is beyond the scope of this article’s discussion.
diplomatic studies traditions, respectively. The interest of economists in the effectiveness of activities generally results in a focus on the tools of economic diplomacy — that is, what instruments do governments use and do they bring about the intended effect? IPE is largely concerned with structures and institutions in international relations, which facilitates an assessment of the theatres (negotiating fora, such as international institutions) relevant to economic diplomacy. Work by scholars from this field can be placed somewhere in between IR and economics, or IR and diplomatic studies. The former includes studies that are concerned with how one or more strands of economic diplomacy are practised by a country or group of countries, while the latter involves research on the interplay between public and private actors, in specific countries or strands of economic diplomacy. The more practical processes by which economic diplomacy is constructed and practised are addressed primarily by scholars of diplomatic studies. This includes analysis of how negotiations proceed in different modes and environments (such as in summits, regional diplomacy, and bilateral and multilateral economic or monetary institutions), which tactics are used towards what strategic ends, as well as the motivations and the interests of the actors involved. Other (sub-)fields where studies on economic diplomacy can be found are international law, business studies and foreign-policy analysis. These are included here in the fields of IR, economics and diplomatic studies respectively.

Economic diplomacy actors are subject or object of analysis in each of the four fields. Since diplomatic behaviour is embedded in both international and domestic structures and norms, the ongoing process in which ideas and culture play a central role influences the mode of economic diplomacy that is practised by a government. Although the state is the primary actor and thereby at the core of this process, many other actors have a say in (what eventually becomes) foreign and economic policy. Domestic politicians and economic interest groups — including multinational corporations — exert the largest effective influence on (the formulation of) economic diplomacy. To understand a country’s economic diplomacy thus requires an understanding of evolving schemes of thought, identities and actions that move governments, domestic politicians, economic and other interest groups — as well as the relative power balance among these actors. Diverging social realities of policy-making influence the extent to which actors are successful in shaping the parameters of a government’s economic diplomacy. Such differences are most apparent in comparisons between regions — such as European, Asian and Middle Eastern countries — but can also be found within regions.41

A question that needs to be addressed next is: how do these analytical lenses relate? This is of importance if one is to make the most of analytical eclecticism, which regards existing research traditions fluidly and is willing to borrow selectively from each to construct accounts that travel across the sides of the triangle. Interaction takes place in multiple ways. Policy-makers select the economic tools and theatres that are most appropriate to pursue (perceived) national interests, in consideration of the country’s unique position in the world and their judgement of how power can be exerted or projected optimally. The context thus shapes the judgement of agents about how their interest can be advanced most effectively. Moreover, the assessment of how this context is constructed informs policy-makers’ choices of the instruments by which, and the places where, to promote a balance of interests.

The use of certain instruments and ongoing negotiations will, in the medium to long term, alter the context in which agents operate. The four lenses are thus not only interrelated, but also complementary. This implies that economic diplomacy is most effective when based on inclusive strategic thinking that considers analysis of all four concepts and their interactions. Put differently, the questions of ‘when’ (context), ‘what’ (instruments), ‘where’ (theatres) and ‘how’ (process) inform the question of ‘why’ economic diplomacy exists as a strategy by which states pursue national interests, comprising economic prosperity and political stability.

Clearly, each angle (and concept) of the analytical framework incorporates many sub-themes. These are too extensive and too complex to be dealt with comprehensively in any one study. Indeed, most available studies focus on a certain contextual element, one or more tools or theatres, or a specific element of the processes of economic diplomacy by one or more states. The analytical framework provides the larger picture in which these studies may be placed and thereby facilitates comparative research.

Four Fields of Literature

A review of the literature is presented to substantiate the underlying assertion that — exceptions notwithstanding — researchers from certain fields largely tend to focus on specific dimensions and strands of economic diplomacy. In itself, this finding may be hardly surprising since, for example, IR scholars are primarily

42) The approach adopted here differs from Katzenstein and Sil in the sense that three out of four research traditions/dimensions are here positioned at the corners of the triangle, while Katzenstein and Sil place them along the sides. The underlying logic is not fundamentally different, however, as the characterization introduced here represents a relative rather than an absolute focus. See Peter J. Katzenstein and Rudra Sil, ‘Rethinking Asian Security: A Case for Analytical Eclecticism’, in J.J. Suh, Peter J. Katzenstein and Allen Carlson (eds.), Rethinking Security in East Asia: Identity, Power and Efficiency (Stanford, CA: Stanford University Press, 2004), p. 17.
interested in the power-play end, while economists are mostly engaged with the ‘business’ of economic diplomacy. Again, this is not to deny that exceptions obviously do exist, as do scholars who operate on the borders of various research fields.

The literature is categorized here by the strand(s) and dimensions that it discusses, often with a focus on a particular country, group of countries or region(s). A functional approach is adopted, meaning that the classification of writings follows from their content rather than the author’s training or affiliation. The analytical framework of economic diplomacy helps to position a particular case in its wider context and, thereby, to judge the comprehensiveness of economic diplomacy policies of the given case. After all, in most instances (case) studies can be regarded as specific examples of a more general category of events rather than as unique historical phenomena. The conceptual framework is used as yet another way to position a case within the broad economic diplomacy field, and to untangle the relationship between various studies, which in turn may also help in identifying the strand(s) of economic diplomacy that are taken up in a study. This strand is not necessarily made explicit by the original author — and, where explicitly stated, may differ from the interpretation of the various concepts here.

Economic Diplomacy in International Relations

Economic diplomacy studied through an IR lens is primarily concerned with high politics and issues related to national security, where national interests are primarily defined in terms of (inter)national stability. When considered in the broader field of economic diplomacy, this strand of research is characterized by an interest in power elements rather than policy and process. Illustrative is Baldwin’s introduction to his study on economic statecraft, which reads that it ‘is a study of economics as an instrument of politics’. The high politics or power-play element explains why political scientists who study the interrelationship between international politics and economics regularly employ the term ‘economic statecraft’, or tend to discuss the subject without linking it to any concept at all. In the former case, the focus is often on sanctions — negative or positive — while research of the latter kind tends to address the relationship between foreign policy on the one hand and trade or investment on the other.

Three research foci can be distinguished in IR scholarship on economic diplomacy. The first concerns conceptual analysis that aims to improve general understanding of the interrelationship between international economic relations and foreign and military policy. This includes books and articles on economic power

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(Knorr), economic statecraft (Baldwin), economics and security (Mastanduno; and Sandler and Hartly), historical patterns in economic diplomacy (Coolsaet) and the political theory of economic statecraft (Blanchard and Ripsman).45

The second category comprises case studies that discuss the economic diplomacy practice of particular (groups of) countries or specific economic diplomacy expressions. This includes analysis of Japan’s development aid (Arase), EU sanctions (Portela), ‘normative trade policy’ (Orbie), Chinese investment in North Korea (Kim), the United States in the Cold War period (Kunz) and Myanmar’s foreign trade and its political consequences (Alamgir).46 Within this category, the body of research on financial and monetary expressions of economic diplomacy in particular is growing. This includes conceptual work (Steil and Hinds), and work on currency issues — exchange-rate policies and currency wars — as well as changes in financial institutions (the International Monetary Fund and the World Bank) that result from the rise of emerging economies. Country case studies include those on the United States (O’Hara; and Tsokhas), China (Drezner) and Japan (Hook et al.).47

The final category of economic diplomacy research from an IR perspective, which is slightly distinct from the others but nevertheless included here because of its international focus, deals with legal issues — that is, international law. This includes work on legal institutions governing international trade (Hudec; and Reich) and on commercial law, originating in the Lex Mercatoria (Sealy and Hooley).48


In contrast to IR perspectives, the economic approach to economic diplomacy is grounded in an understanding of national interests as defined in economic terms. It is concerned with all of the ways by which governments deliberately and directly intervene in the market, whether the economic (trade and investment) or financial fields. The focus here is on economic diplomacy as a tool to enhance economic prosperity, and the leading question is whether specific economic diplomacy tools are cost-efficient in the sense that they have a welfare-enhancing effect. Political aims may be considered, but are by and large not (as) explicit — let alone the focus of attention. Most studies in this field employ (a mixture of) the term(s) ‘economic diplomacy’, ‘commercial diplomacy’ and ‘trade diplomacy’, while ‘economic statecraft’ is hardly employed.49

Economic diplomacy of the primarily economic realm can be divided into three categories. The first concerns studies on the effects of specific economic diplomacy activities on international trade. Such analysis employs economic and econometric models — often the gravity model of trade, but also the social welfare function, bilateral trade model, elasticities and market shares, or a combination of these — for cost-benefit analysis of one or more tools of economic diplomacy. This includes studies on embassies as export promoters (Rose), state visits (Nitsch) and a variety of financial tools to promote one’s own business abroad (Van den Berg et al.).50 A second category of research of economic diplomacy from an economic perspective employs macroeconomic and micro-data studies for an economics-based interpretation of larger conceptual questions, such as on the relationship between trade and conflict or cooperation (Polachek) and general aspects of trade uncertainty (Van Bergeijk).51 The third category of research, which is slightly distinct from the above two but included here because of its link to international economics, tackles economic diplomacy from a business studies’ perspective. It addresses the complex political environments in which internationally operating companies conduct business from these firms’ point of view. Such research deals, for example, with the effectiveness of so-called ‘business
diplomacy management’ (Saner et al.), the export-related expertise of manufacturing firms and the gap between governmental export-promotion efforts and private sector needs (Kotabe and Czinkota).

Economic Diplomacy and International Political Economy

International Political Economy is primarily concerned with the ways in which political forces shape the systems through which economic interactions are expressed, and, conversely, the effects that economic interactions have upon political structures and outcomes. More than the other research traditions, the work of IPE scholars on economic diplomacy thus involves a mix of foreign policy objectives and commercial tools, and commercial objectives and political tools in a certain environment where economic diplomacy is shaped or practised.

The literature in this field can be divided into studies that focus on — what has been labelled here as — trade diplomacy and commercial diplomacy (positioned on the IR-economics side of the analytical triangle) and conceptual work (positioned on the IR-diplomacy side). The former is about economic diplomacy that focuses on trade liberalization and domestic forces, and employs trade statistics not combined with econometric models. Examples are studies on Japan’s foreign economic policy (Solís and Urata), trade diplomacy (Drysdale; and Pekkanen, Solís and Katada) and East Asian regionalism (Ravenhill). Applied work on commercial diplomacy by IPE scholars includes studies of government programmes involving trade finance, trade facilitation, trade advocacy (Stremlau) and trade missions, or a combination of these (Garten, Zoellick and Shinn).

Last but not least, the more conceptual work in this research tradition includes work on state–firm diplomacy and firm–firm diplomacy (Strange), and commercial diplomacy (Rothknopf; and Kopp).


Bayne and Woolcock focuses on trade, investment and finance negotiations, it may also be included in this category.  

*Diplomacy and Negotiation: Foreign Policy and National Interests*

Starting from the 1980s, diplomacy and international negotiation (the latter also included in Putnam’s analysis) became subjects of serious scholarly attention. The main trigger for this was the characterization of diplomacy as an institution that contributes to order in international society, next to the balance of power, international law, war and the great powers. Paralleling developments in structural IR analysis starting in the 1970s, significant steps were made in the study of actors, interests and processes in international relations. Constructivism was posited next to (neo-)realist and (neo-)liberal theories of IR. Different strands of this school call attention to various elements of the ‘social reality’ of international relations — such as goals, threats, cultures and identities — as social constructs of actors. These insights can be seen to have contributed also to the study of diplomacy by academics and practitioners. As diplomatic studies matured, so enquiries into economic diplomacy from this particular perspective grew. Studies of economic diplomacy by scholars from the diplomatic studies tradition share an emphasis on the procedural rather than structural aspects of economic diplomacy. Obviously, no study of economic diplomacy can neglect this angle, but these studies stand out for their relative emphasis on actors and processes.

Analysis within this research tradition broadly involves three categories. The first is conceptual analysis that focuses on economic diplomacy at large (Lee and Hocking; and Bayne and Woolcock) or on a specific strand, such as commercial diplomacy (Lee and Hudson; and Kostecki and Naray). Other categories have a narrower focus and discuss, respectively, various aspects of negotiations and one or more actors. The former includes modelling of international economic negotiations, with a focus on strategies and incorporating markets (Odell) and multilateral economic diplomacy at the Kennedy Round of the General Agreement on Tariffs and Trade (GATT) (Lee). Economic diplomacy is pursued by governments but shaped by a range of domestic state and non-state actors. Analysis of actors in economic diplomacy include studies on the international chamber of

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commerce (Kelly), business in UK diplomacy (Lee), Indian economic diplomacy from a diplomat’s perspective (Rana), and state and non-state actors — such as non-governmental organizations and consumer groups (Woolcock; and Saner and Yiu). Also worth mentioning is the literature on diplomacy that includes (a brief) discussion of commercial and economic issues (Hamilton and Langhorne; Marshall; Barston; and Pigman), for this provides insight into the role of economic diplomacy within diplomatic practice at large.

The edited book by Bayne and Woolcock entitled *The New Economic Diplomacy* provides the most elaborate analysis of economic diplomacy to date, both theoretically as well as empirically. This warrants a short elaboration into how the underlying study relates to that book’s findings. Two observations should be made in this respect. First, whereas Woolcock (in his individual chapter) implicitly posits economic diplomacy as forming part of IPE, the two are explicitly distinguished here. The reason for this is that while the ontological starting point of economic diplomacy and IPE is much the same, the epistemology of the two research fields differs fundamentally. That is to say, scholars of IPE and economic diplomacy look at the same reality, but use different coloured glasses and therefore see (or focus on) a different reality. Looking at the World Trade Organization, for example, an IPE scholar may take an interest in the workings of the institution within the world trade system, while an economic diplomacy scholar would consider why and how a government negotiates a deal on tariff reductions, as well as how negotiations form part of the broader context of diplomatic practice. Rather than viewing one field as part of the other, the two are thus posited at the same level under the same IR umbrella. This article further differs from Bayne and Woolcock in that it distinguishes between economic diplomacy on the one hand and economic statecraft and commercial, trade or ‘dollar’ diplomacy on the other. The former is understood as the umbrella term, while the latter terms

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are considered as ‘power-play end’ and ‘business end’ derivatives of economic diplomacy, respectively.

**Unwarranted Intervention or a Necessary Evil?**

A government or any other economic diplomacy actor’s views on the rightfulness and usefulness of economic diplomacy in practice depends partly upon one’s ideas about the separation of the public and private spheres — which is, in turn, commonly influenced by a country’s level of development. In an attempt to bridge the theory–practice divide, this section addresses the key considerations that shape the standpoints of government and other actors.

Political culture and historical consciousness have a significant impact on the way that economic diplomacy is framed, both at the national and practical levels. In turn, diplomacy is directly related to the way in which a state goes about projecting its ideology and strategic interests. Few may disagree that diplomacy requires deterring power, good judgement and opportunity, but ideas on what this means for diplomatic practice differ substantially between countries and regions. States or state-like entities that prefer or rely (out of necessity) on non-military means to exert international power generally follow an approach that emphasizes economic tools and tend to use positive incentives rather than pressure — or ‘carrots’ instead of ‘sticks’. Motivations for taking a particular approach differ widely. In the case of the European Union, for example, the fact that economic integration has proceeded much quicker and gone much further than politico-military integration is an explanatory factor, while Japan’s relative emphasis on economic diplomacy is explained, at least in part, by its formal renunciation of military means for offensive purposes.

For advocates of free trade and proponents of a strict separation of politics and economics (including many economists, especially in Western countries), economic diplomacy in all its different forms is little more than an undesirable, market-distorting government intervention. According to this view, economic diplomacy benefits the powerful rather than the powerless, is unnecessary (private business and free markets would do), encourages big government and corruption, and may conflict with the promotion of human rights and non-proliferation. In various ways, it is argued, economic diplomacy distorts the ‘level playing field’ and can hardly be successful in correcting (perceived) market failures. Indeed, economic diplomacy by definition prioritizes (at times narrow) domestic economic

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64) For more on the case of Europe, see for example Orbie, *Europe’s Global Role*, especially pp. 12-17. For Japan, see Makoto Iokibe (ed.), *The Diplomatic History of Postwar Japan* (New York: Routledge, 2010).
65) For a more detailed discussion of this in the context of commercial diplomacy, see Garten *et al.*, *Riding the Tigers*, pp. 3-4.
conceptualizing economic diplomacy

interests and intervenes in markets for political and strategic purposes. This is inevitable if economic resources are employed in pursuit of foreign policy objectives. To balance economic and political objectives is no easy task for any government. Moreover, whether a policy is deemed legitimate or not touches upon practical and normative concerns. Policies that constitute justifiable government intervention (in general or on a specific occasion) for one party can be regarded by others as undesirable protectionism. The ‘Buy American’ clause in the economic recovery package of the Obama government, the negative response of the Chinese government to calls to allow its currency to appreciate and (large parts of) the European Common Agricultural Policy are but a few examples of this.

The main underpinning of economists’ enquiries into economic diplomacy is the desire to come to an effective cost-benefit analysis from a welfare-theoretic point of view. Insights gained accordingly serve as a guide to the considerations of politicians and government officials who engage in economic diplomacy. Noticing that a priori the market is most efficient without government intervention, it is from this perspective ‘quite understandable that economists are very suspicious about commercial policy and economic diplomacy’.66 After all, government intervention could divert rather than create trade, firms in principle should be able to cope with (international) market pressures on their own, and consumer interests may be armed by intervention. The argument continues that intervention is thus only justified when a market failure exists or when this intervention generates more benefits than costs. However, even to those who adopt this relatively narrow, economic perspective on the conduct of foreign relations, economic diplomacy is not in all ways trade-distorting, since benefits may arise at the macroeconomic level — through the impact of trade on GDP and/or its growth rate — and at the microeconomic level.67

Few scholars, however, limit their analysis of foreign policy to economic factors alone. So while economic diplomacy may constitute unwarranted government intervention from a purely economic perspective, political scientists with a (neo-) realist inclination would be prone to argue that economic diplomacy is, on balance, a necessary evil. From this viewpoint, economic diplomacy is just one of many tools that governments use to strengthen the economic, political and security capacities of their country, in a world dominated by the power struggles of nation-states. Private and other non-governmental actors gain in importance, and compete with and complement the role of the state. The sometimes blurry boundaries between public and private actors of a growing number of (newly developing) countries — with state-owned enterprises and sovereign wealth funds — and the idea that governments may have a growing role in protecting private companies

66) Van Bergeijk, Economic Diplomacy and the Geography of International Trade, p. 70.
67) See, for example, Van Bergeijk, Economic Diplomacy and the Geography of International Trade, pp. 70-71.
from corporate espionage by foreign actors has led governments of some industrialized countries to reconsider the relationship between the state and the market.\(^{68}\) Moreover, the Asian financial crisis of the late 1990s and the global financial and economic crisis of recent years have shown that even the most liberal governments intervene when supposedly free markets malfunction and threaten to disrupt the social order.

Should governments not engage in economic diplomacy at all? This rhetorical question is of little meaning, if it is accepted that governments are ultimately responsible for national interests and the well-being of their citizens. Cynics might say that a world without economic diplomacy is as desirable and unlikely as a world without war or competition between states and peoples. The more useful way to address the issue may be to accept that economic diplomacy is a reality of the world in which we live, and that understanding of the concept should be enhanced in order to recognize, control and optimize its expressions and outcomes. Discussion on the sometimes conflicting interests of human rights and trade, and the self-serving dimension of economic assistance, for example, are better understood when addressed in the open, instead of negated.

Acceptance of economic diplomacy as a tool of foreign policy is not unconditional and raises many pertinent questions. Most would agree that the promotion of national interests to the extent that it undermines international political, economic and financial agreements and institutions is undesirable. Even here, however, differences in ideology and levels of development make for different standards and modes of economic diplomacy.\(^{69}\) Are tariffs and subsidies acceptable to protect weak domestic businesses? Can foreign assistance be used as leverage in competing for business opportunities? Are economic sanctions an acceptable way to influence foreign governments even when they hurt innocent citizens in the target country? Is discrimination of certain (state-owned) foreign investors acceptable — in general or in specific sectors? There are clearly no clear-cut answers to these questions, which involve moral as well as practical considerations. The choices that governments (and different actors within government) make in addressing these questions profoundly influence the interaction between these

\(^{68}\) See, for example, ‘EU-Kommissar Tajani: “Der Schutz unseres Wissens ist unverzichtbar”’, Handelsblatt (online), 27 December 2011. The World Investment Report 2010 notes that ‘A dichotomy in investment policy trends is emerging. It is characterized by simultaneous moves to further investment liberalization and promotion on the one hand, and to increase investment regulation in pursuit of public policy objectives on the other’; see World Investment Report 2010: Overview (UNCTAD/WIR/2010), p. ix and pp. 18-23, 22 July 2010, available online at www.unctad.org.

\(^{69}\) This is directly related to how one perceives the legitimacy of existing agreements and institutions. For example, Chang convincingly argues that virtually all of today’s developed countries did not practice free trade when they were developing countries themselves; see Ha-Joon Chang, Kicking Away the Ladder: The "Real" History of Free Trade, FPIF Special Report, December 2003. Mahbubani argues that ‘[t]he iconization of democracy — an unquestionably virtuous idea — became an ideological crusade that insisted democracy could be exported to any society everywhere in the world, regardless of its stage of political development’; see Kishore Mahbubani, The New Asian Hemisphere (New York: PublicAffairs, 2008), p. 6.
actors at the national and international levels. And there can be little doubt that as an increasing number of countries with political and economic systems that are fundamentally different from the West enter the diplomatic stage, differences between countries will become more explicit and conflicts increasingly likely. As an expression of this, references to ‘currency wars’, ‘trade wars’ and ‘economic warfare’ are already increasingly heard.\textsuperscript{70}

Goals and Effectiveness

These almost philosophical reflections bring the discussion to another important question, namely whether economic diplomacy is generally successful and provides value for money. An answer to this question requires choices concerning the measurement of success: should success be regarded in economic terms, or in political or even strategic terms? And how can standards be defined for any of these, if incentives are often inexplicit and in most cases involve primary, secondary and tertiary motives?\textsuperscript{71} Adding to this complexity is the equally important and difficult question of whether to look at immediate effects or at the long(er) term. It is clearly a thorny task to count the measure of success in other than economic terms — and even that is difficult since statistics are often not readily available, and when they do exist they are often not easily comparable between countries. In certain cases — mostly instances of commercial and trade diplomacy — the returns of economic diplomacy can be quantitatively measured. The evaluation of effective or desirable economic diplomacy of economists’ analysis is then derived from cost-benefit analysis that is based on financial and material, rather than political, considerations.

When economic diplomacy is pursued primarily for strategic reasons, it is even harder to measure effectiveness with statistical data or in ‘dollar terms’. The question that needs to be answered is whether policy has been successful in achieving broad foreign policy goals or transmitting values. If success is regarded in terms of increases in power, an important distinction is that of effects on power in trade (the capacity to defend one’s own interests in international commercial negotiations) and power through trade (the ability to employ trade as the backbone of power to influence more broadly).\textsuperscript{72} A rare example of a policy-maker making this latter consideration explicit is US Trade Representative Robert Zoellick’s statement that the US targets free-trade-agreement partners based on criteria including strategic concerns, seeking ‘cooperation — or better — on foreign policy and


\textsuperscript{71} One may, of course, question to what extent measurement is an academic or a practical issue of concern to governments.

security issues’. Such ‘linkage politics’ was revived after the terrorist attacks in 2001 as the United States endeavoured to bolster its position in the international system. Importantly, however, policies and attempts to influence do not always succeed, while success in using economic techniques is not always due to the economic bases of power. Complicating matters further is the tendency of observers to treat the capabilities of states (power resources) as if they were property rather than relational concepts.

Conclusions

Economic diplomacy is a foreign policy practice and strategy that is based on the premise that economic/commercial interests and political interests reinforce one another and should thus be seen in tandem. At stake are broad national interests that include political and strategic as well as economic dimensions. Differentiation is required between policy expressions and between tools and purposes to bring order and meaning to the mass of phenomena that economic diplomacy encompasses. These distinctions and syntheses have largely remained under-explained, however, in earlier fragmented studies that address one or a few particular element(s) of the whole. Starting from the premise that better understanding of such links is vital to explain the complex processes that economic diplomacy involves, this article has proposed a conceptual and an analytical framework to further study in this burgeoning field. The frameworks can be viewed as a menu from which specific hypotheses can be derived and tested in individual cases. Furthermore, they map out which factors researchers and practitioners ought to consider, and propose how these factors are logically connected within the model. In this way, improved understanding of the whole should facilitate academic and practical discussions of what are the more and less important factors in a particular case or situation.


75) Baldwin, Economic Statecraft, pp. 23-24. For example, while levers, policy and weapons are property concepts, leverage, power and war are (the corresponding) relational concepts.

76) That is, statesmen are often described as ‘employing’ or ‘using’ their capabilities as if these were possessions of one state — while in fact policy instruments should be treated as the properties of a single state and thus discussed without implying anything whatsoever about the probable effectiveness of an attempt to influence by employing a particular instrument. These observations remain valid even more than two decades after Baldwin first presented them.
The conceptual framework of economic diplomacy facilitates distinction between diverging strands — and thereby between broad categories of perspectives from which economic diplomacy can be studied. A ‘business end’ and a ‘power-play end’ are distinguished and policy expressions are positioned along two axes, which represent the tools and goals of activities. Certain overlap notwithstanding, policies can thereby be grouped based on a reasonable judgement as to what constitutes the primary goal or basis of a certain expression of economic diplomacy. The different categories also inform the methodology of study and the extent to which a specific expression of economic diplomacy can be qualitatively analysed.

Governments pursue economic diplomacy with the aim of promoting overall economic prosperity and political stability. The primary analytical perspective of economic diplomacy is thus foreign policy, which is concerned with (decision-making) processes and the employment of political-economic instruments in international negotiations in specific theatres, and defined by the global, regional and bilateral context. The analytical framework presented here helps to elucidate these four dimensions and the many linkages among them. To be successful, any government must resolve trade-offs between different economic diplomacy activities in accordance with the balance of national interests. Crucial in this respect are careful management of linkages and continuous investigation of existing and potential economic diplomacy activities.

The underlying effort of reflecting on the theory and practice, as well as challenges and opportunities, of economic diplomacy can also be seen to contribute to the improved policy response of any government that operates in today’s changing environment of shifting balances in global power. Earlier research has shown that economic diplomacy takes a more prominent place in foreign policy during periods when international society seems to be in flux. Thus, considering the emergence of new centres of economic and political power, and the decline in the relative importance of the transatlantic powers, it is no surprise that economic diplomacy has been gaining in importance in recent years. The newness of the present day lies in the fact that variations in countries’ domestic political cultures and ideologies, as well as levels of development (particularly between the established powers and the challengers), are now bigger than at almost any time in history. We are thus in for a turbulent period, in which criticisms of perceived misuse of economic diplomacy will arise more frequently.

The patterns described here support many of the theories that have been developed to explain the links between economics and politics, public and private, and domestic and international occurrences. But they also elucidate many (new) puzzles. Here lies an important task for scholarship: to evaluate and explain policies of the past that may inform the future of economic diplomacy theory and practice. If successful in doing so, economic diplomacy students and practitioners
may be able to make a humble contribution to proving history wrong, by empha-
sizing the feasibility of a *peaceful* remake of the world order.

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Globalism Ascendant, Regionalism Stagnant: Japan’s Response to the Global Financial Crisis

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Summary
Japan’s response to the global financial crisis has emphasized global initiatives and downplayed the regional agenda, in sharp contrast with its approach to the Asian financial crisis. This rebalancing in Japan’s economic diplomacy reflects the greater political space that it has enjoyed at the global level since its long-held views on the benefits of flexible International Monetary Fund (IMF) lending practices and controls on volatile capital flows became mainstream. Meanwhile, at the regional level Japan faces stiff competition from China in shaping the regional integration agenda and unchartered territory in co-leading a multilateral Chiang Mai Initiative. Despite its enhanced profile, Japan’s new globalism is uneven: it has made a very significant financial contribution to expand the IMF’s resources and to restore trade financing; but Japan has not played a major role in the debate surrounding the most pressing issues of a future financial architecture, such as tackling global imbalances and promoting foreign exchange-rate cooperation. Japan’s muted voice, despite its large financial commitments, reflects its difficult adaptation to the G20 summity process, as well as political volatility at home, which prevents it from developing measures to deal with the global downturn.

Keywords
global financial crisis, Japanese economic diplomacy, regional integration, global financial architecture, free-trade agreements, Japanese politics

Introduction
The global financial crisis (GFC) of 2007-2009 greatly upset Japan, as the country experienced the worst economic contraction of the post-Second World War era and as the government was forced to reassess its priorities regarding global and...
regional initiatives. The contrast with Japan’s response to the past episode of financial turmoil — the Asian financial crisis (AFC) of 1997-1998 — could not be starker. At that time, Japan openly sparred with the United States on the causes and optimal solutions to the financial crisis in Asia, was deeply sceptical of the *modus operandi* of the IMF and proposed an alternative regional institution (the Asian Monetary Fund, or AMF, which never came to fruition), and launched an unprecedented regional economic diplomacy for financial cooperation (the Chiang Mai Initiative, or CMI, for bilateral currency swaps) and trade integration through free-trade agreements (FTAs). Recently, however, Japan adopted a conciliatory position on the acrimonious debate on the causes of the GFC, staunchly defended the position of the US dollar as the key reserve currency, and came to the rescue of the IMF; meanwhile, its regional initiatives were lacklustre, as the CMI mechanism was not activated and a region-wide trade bloc seems a distant possibility.

Why has there been this transformation in Japan’s economic diplomacy? What kind of global contribution has Japan made to solving the crisis? Why has regionalism lost steam? In order to answer these questions, this article highlights the very different set of opportunities and constraints that Japan faces in this latest episode of global financial crisis.

Japan finds that while it has more space at the global level — since its long-held views on the benefits of flexible IMF lending practices and controls on volatile capital flows have now become mainstream — at the regional level it faces competition from China in shaping the regional integration agenda as well as unchartered territory in co-leading a newly multilateral Chiang Mai Initiative. Despite its enhanced profile, Japan’s new globalism is uneven. While Japan has made very significant financial contributions to expand the IMF’s resources and to restore trade financing, it has not, however, played a major role in the debate surrounding the most pressing issues of a future financial architecture, such as tackling global imbalances and promoting foreign exchange-rate cooperation. Japan’s muted voice, despite its large financial commitments, reflects its difficult adaptation to the G20 summitry process, whereby Japan lost the privileged position that it had enjoyed in the G8 as the single Asian representative, as well as the political volatility at home that prevents long-term planning. Indeed, this article also underscores the domestic constraints that hamper Japan’s leadership potential at both the global and regional levels: the inability to shift to a domestic-demand growth model and to open the internal market to foreign imports to speed up global recovery, and the political paralysis that has engulfed Japan with a rapid succession of prime ministers and a gridlocked legislature.

The first section of this article explores the origins of the GFC and in particular highlights why a crisis that originated in the lack of prudential financial regulation in the United States ended up provoking one of the largest economic contractions for Japan’s post-war economy. Next, the article assesses Japan’s actions at the global level in diagnosing the crisis and advocating reforms to the
global financial architecture. The third section assesses Japan’s attempts to deepen regional integration through a more robust regional liquidity mechanism and the much more ambitious project of region-wide trade integration. The final section underscores the two major impediments to a proactive Japanese economic diplomacy in the aftermath of the GFC: the inability to offer a market of last resort, and the internal political paralysis that hampstrings Japan’s international leadership.

The Impact of the Great Recession on Japan

The bursting of the US sub-prime mortgage market in December 2007, and especially the collapse of the firm Lehman Brothers in September 2008, exposed the severe vulnerabilities of the US financial sector, where lax regulation had allowed corporations to develop and trade ‘toxic assets’. As Tellis explains, US banks exploited regulatory loopholes to develop new financial products, primarily low-interest loans with adjustable rates to customers with weak credit scores, and promoted the securitization of mortgages to bundle the sub-prime housing loans with sounder financial instruments.1 The development of complex financial instruments (such as derivatives and credit default swaps) also made it difficult for a very fragmented US financial regulatory system to assess the systemic threat that these toxic assets represented, and — when the housing bubble finally burst — US financial institutions suffered colossal losses.2 The problems in the financial sector soon affected the real economy as growth rates took a plunge (a –7.9 per cent GDP growth rate in the fourth quarter of 2008) and unemployment swelled (from 5 per cent in January 2008 to 10 per cent in October 2009).3 Given the central role of the United States in the global economy, the crisis soon turned international through several contagion channels: a sharp contraction of financial flows; the drop in equity values; the drying up of trade finance; and the reduction of corporate investment, etc. The global recession that ensued has been the most significant contraction in economic activity since the Great Depression of the 1930s. The IMF, for instance, estimated a decline of world GDP of 1.1 per cent (in purchasing power terms) for 2009, and a reduction in world trade of almost 12 per cent.4

Even though East Asian countries introduced reforms in the aftermath of the AFC that greatly improved the soundness of their banking systems and the quality of financial supervision, they were seriously affected by the recession, despite the fact that the exposure of East Asian banks to the sub-prime assets was minimal. According to the Asian Development Bank, the GDP growth rate for ‘emerging Asia’ dropped from 10.3 per cent in the second quarter of 2007 to 1.8 per cent in the first quarter of 2009. China’s growth during this period slowed significantly (from 14 per cent to 6.2 per cent), but ASEAN-4 (that is, Cambodia, Laos, Burma/Myanmar and Vietnam) and countries with newly industrializing economies (NIEs) took a much larger hit with negative growth rates in the first quarter of 2009 (–0.4 per cent and –6.2 per cent, respectively). In particular, many countries in the region experienced a very sharp contraction in their exports. The year-on-year percentage change in exports in the last quarter of 2008 was –24.6 per cent for Taiwan, –22.3 per cent for the Philippines, –12.9 per cent for Singapore, –12.6 per cent for Malaysia and –10.2 per cent for Thailand.

These figures reveal that East Asia experienced a ‘trade shock’ in the aftermath of the global financial crisis, as external demand in the industrialized markets of the West collapsed. The severity of the trade shock surprised many, given the recent popularity in regional policy circles of the ‘decoupling thesis’. Citing the growth in the share of intra-regional trade, advocates of the decoupling argument posited that the region was much less vulnerable to extra-regional downturns given the diminishing trade links with Western industrialized countries, the emergence of China as a regional engine of growth, and the accumulation of massive foreign reserves by several governments in the region. The deep blow to Asian economies in 2008–2009 put the decoupling thesis to rest, however. Intra-regional trade shares were, in fact, inflated because of heavy component trade, as production networks spread in the region with Japanese companies establishing subsidiaries in South-East Asia to manufacture components that were assembled in China into export products for extra-regional markets. Final consumption of the goods produced in East Asia still rests heavily on the advanced Western markets, which experienced their worst post-war economic recession in 2008–2009.

5) Defined as the ASEAN-4 (Cambodia, Laos, Burma/Myanmar and Vietnam), newly industrializing economies (NIEs) and China.


This vulnerability to the vagaries of extra-regional demand haunted Japan the most. Initially, Japanese public officials had remained confident that the financial troubles in the United States would not unduly affect the Japanese economy, given the strengthening of its banking system in the aftermath of the 1990s’ banking crisis and that Japanese banks (like their Asian counterparts, as mentioned above) had not partaken in transactions with toxic assets. The IMF, for instance, estimated Japan’s sub-prime related losses to be around US$ 8 billion, in contrast to worldwide losses of more than US$ 1 trillion.9 Reflecting this optimism in the early stages of the crisis, a Japanese cabinet minister estimated the effect on Japan to be equivalent to a ‘bee sting’.10 Far from this, in late 2008 and early 2009 Japan was gripped by an economic recession of unprecedented proportions. Japanese exports plummeted: in December 2008, they were 35 per cent lower than they had been the previous year; they were down 45.7 per cent in January 2009; and 49.4 per cent in February 2009. In other words, Japanese exports at that point in time were only half of what they had been the year before.11 The drop in exports was so severe that for the first time in 26 years (and for four months) Japan actually recorded a trade deficit.12

Japan’s GDP growth rate also plunged, with an annualized rate of –13.5 per cent on a quarter-to-quarter basis, the worst ever contraction for Japan and surpassing the former record of –13.1 per cent in the aftermath of the first oil shock. The brunt of this contraction was primarily because of the collapse of external demand (–12.6 per cent).13 These abysmal numbers meant that Japan was the only advanced economy to experience negative growth, as the GFC put an end to the modest recovery that the Japanese economy had experienced since 2002. With hindsight, it is clear that the drivers of the recovery at the turn of the twenty-first century placed Japan in a very vulnerable situation a few years later. In a nutshell, Japan’s economic upturn had been based on the well-tried formula of an export push centred on a number of key products, such as automobiles, electronics and general machinery, with the United States as a main destination market. On every single front, Japan had increased its vulnerability to an external shock. First, Japan’s economy became ever more reliant on foreign trade, with the exports to GDP ratio increasing from 11 per cent in 2000 to 17 per cent in 2008. Second, Japan’s export profile was based almost entirely (90 per cent) on

income-elastic products whose demand falls quickly during downturns. And third, Japan’s export drive was predicated on robust US consumption, either through direct exports (for instance, 30 per cent of Japanese car exports go to the United States) or through indirect exports of components to subsidiaries in East Asia that are assembled into final products and sent to the United States.

When US demand stumbled and the Japanese yen appreciated rapidly, the fragility of this recovery formula was exposed. The GFC therefore presented Japanese policy-makers with three formidable challenges: a) how to reactivate the national economy given that the traditional export-led growth model seems exhausted; b) what are Japan’s global responsibilities towards reconstruction of the international financial architecture and growth of the world economy?; and c) should Japan respond to this crisis as it did in the previous Asian financial crisis by emphasizing regional economic diplomacy?

Japan and Global Financial Governance

Japan’s Global Responsibilities: The G20 and a New Financial Architecture

As with other episodes of international financial crisis, a heated debate has ensued over the causes of the financial meltdown, with a deep divide across the Pacific. Some Western observers (in particular US Federal Reserve Chairman Ben Bernanke) have emphasized Asia’s ‘savings glut’ and the excessive accumulation of foreign exchange reserves (principally by China) as enabling factors that encouraged the consumption binge and speculative real-estate deals in the United States; whereas Asian observers have focused mainly on the financial regulatory failures of the United States. The Chinese government, in particular, balked at the suggestion that it was responsible for the crisis, pointing instead to US failings in terms of over-consumption, low savings, and an over-leveraged financial system. Japan, on the other hand, adopted a much more conciliatory posture. While the

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15) Indirectly, the GFC affected Japan in another way: as US institutional investors liquidated their overseas assets, the drop in the Japanese stock market increased the ratio of bad loans and enticed banks to tighten their credit. See Kojima, ‘Japan and the Global Financial Crisis’, p. 20; and Kawai and Takagi, ‘Why was Japan Hit so Hard by the Global Financial Crisis?’, p. 3.
GFC clearly supports Japan’s critique of unrestrained high-risk capital flows, as it first articulated a decade ago, and in November 2008 Japanese Prime Minister Taro Aso did identify the failure of US financial regulation in keeping up with the globalization of finance as a major cause of the crisis, he also argued that global imbalances are at the root of the problems that the world economy is confronting.\(^{18}\) In addition, in one more area Japan has been broadly supportive of the existing international financial system: this time around Japan has come to the rescue of the IMF (with a major contribution to the Fund’s resources, as discussed in more detail below), instead of advocating an institutional alternative to the IMF as it did during the AFC.

Moreover, Japanese officials have consistently expressed their support for the continued role of the US dollar as the key reserve currency. For instance, Takehiko Nakao, Director-General of the International Bureau at Japan’s Ministry of Finance, asserts that only the US dollar has the ability to fulfil the required roles of a reserve currency to store value, make international payments, and act as a unit of account. Other currencies are still unable to perform these roles: the euro zone has a fragmented national market for government bonds; China still has a long way to go in liberalizing its capital account and allowing its currency to float; and Japan’s slow growth and poor returns on yen-denominated assets have forestalled the campaign to ‘internationalize’ the yen.\(^{19}\) In sharp contrast, China has been openly sceptical of the viability of the dollar-based monetary system, proposing instead to broaden the currency base of the IMF’s special drawing rights (SDRs) to use them as an international reserve currency.\(^{20}\)

In the aftermath of the GFC, Japan therefore attempted to bridge opposite views on the causes of the crisis, and to shore up the international financial and monetary systems. To this end, the Japanese leadership soon identified five key priorities: national fiscal mobilization to reactivate the economy; expand the resources of the IMF and other multilateral development banks to assure liquidity; avoid trade protectionism; strengthen the monitoring and regulation of financial markets; and IMF reform.\(^{21}\) Regarding priority number one, Prime Minister Aso argued that Japan’s fifteen years of experience in battling the collapse of the bubble and the banking crisis demonstrated the need for active government spending in order to spur growth (and he noted that European leaders (in particular Germany’s), reluctant to engage in fiscal mobilization, lacked this experience).\(^{22}\) Consequently, and despite Japan’s weak fiscal position (with


\(^{22}\) ‘Transcript: FT Interview with Taro Aso’.
government debt approaching 200 per cent of GDP), Japan did put together a hefty fiscal stimulus package totalling US$ 568 billion (equivalent to 11.5 per cent of GDP). Most of the subsidies came in the form of lower road tolls, fuel discounts, tax breaks, cash disbursements to families and loans to green businesses, etc. In Asia, Japan’s stimulus package was second only to China’s, which amounted to US$ 585 billion or 13.3 per cent of GDP. And yet, while China’s stimulus package has attracted wide international attention and has been positively credited with China’s recovery in 2009, Japan’s fiscal mobilization effort has been much less successful, partly because it came in the form of separate smaller packages every few months, and because it mostly targeted non-spending measures, given Japan’s fiscal constraints.

Japan did flex its financial muscle internationally in November 2008 when, on the eve of the first G20 meeting in Washington, it announced a key loan for US$ 100 billion to replenish the IMF’s resources. There was great concern at the time that the IMF’s resources might be insufficient to rescue a significant number of countries that were gripped by financial crisis. Japan’s actions were hence considered to be extremely useful in boosting confidence in the IMF and helped the G20 to realize its later plea of April 2009 at the London Summit to triple IMF resources from US $250 billion to US$ 750 billion. Other regions and countries that followed suit with loans to the IMF include the European Union (US$ 100 billion), Switzerland and Canada (with US$ 10 billion each), and China (with US $40 billion). Japan has also pushed for an increase in funding to the Asian Development Bank (ADB) by 200 per cent, and in order to avoid a collapse of trade and to prevent a recession in developing Asia, it offered US$ 22 billion in trade finance globally and an additional US$ 20 billion in economic assistance to Asian countries. In terms of providing liquidity to the world

26) The G20 was first established in 1999 as a gathering of finance ministers to promote cooperation. In the aftermath of the GFC it was upgraded to a leaders’ meeting, becoming the premier forum to propose solutions to the crisis in the short term and to devise a new international financial architecture in the medium and long term. Its members are: Argentina; Australia; Brazil; Canada; China; France; Germany; India; Indonesia; Italy; Japan; Korea; Mexico; Russia; Saudi Arabia; South Africa; Turkey; the UK; the United States; and the EU.
28) Sanford and Weiss, ‘The Global Financial Crisis’, p. 11. All these loans are made to the IMF’s ‘New Agreement to Borrow’ in order to boost the IMF’s resources during a crisis and do not constitute quota increases that could lead to voting shares’ rearrangements.
29) ‘Transcript: FT Interview with Taro Aso’.
GLOBALISM ASCENDANT, REGIONALISM STAGNANT

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economy to assist countries experiencing financial travails and to keep the wheels of international trade running, Japan played an exemplary role.

Japan’s financial activism was facilitated by the shift in the global debate in the direction that Japan had long advocated: towards closer regulation of hedge funds, credit rating agencies, and systemically important financial institutions; the benefits of temporary capital controls at times of sharp swings of capital flows; and the need for IMF reform. Japan had first expressed such concerns in the aftermath of the AFC, when it had argued that Asian countries experienced a liquidity crisis because of the volatility of capital flows, and that the IMF had misdiagnosed the problem and had aggravated it with strict conditionality policies that deflated Asian economies. In this regard, the G20’s calls for stricter national regulation of financial sectors are clearly a step in the right direction from Japan’s point of view.

Recent changes in the IMF’s lending practices also seem to be in broad accord with their views. In spring 2010, Japan’s Minister of Finance Naoto Kan summarized Japan’s priorities regarding IMF reform. The first item in the agenda was, in fact, a change in the IMF’s mandate (amending article 1) to include financial stability as a core mission of the Fund. Kan also argued that the Fund’s surveillance operations must be strengthened and expanded to include the soundness of a country’s financial sector in addition to the traditional evaluation of fiscal and monetary policies. Moreover, Kan noted that the IMF still suffers from a serious problem in Asia: the stigma associated with resorting to the Fund’s bailout packages. Because of the high political cost of fulfilling strict conditionality rules (and what many in the region view as intrusive reform policies), East Asian nations are very reluctant to turn to the IMF after the bitter experience of the AFC. Indeed, in addition to the lack of sufficient resources, one of the major challenges that the IMF faces is that countries are attempting to bypass it by negotiating bilateral and/or regional currency swaps. The IMF has responded to

31) The only issue in which Japan has resisted tighter international regulation is a tightening of Basel II provisions, since it fears that they will force Japanese banks once more to undertake costly adjustments that could compromise international competitiveness. See Katada, ‘Mission Accomplished, or a Sisyphean Task?’, p. 143. When the Basel Committee finally announced new bank rules in September 2010 that will require banks to triple their core capital to 7 per cent with a long phase-in period until 2019, the consensus in Japanese financial circles was that the new rules were not as tough as feared and that Japanese banks would not struggle much in meeting them. See ‘Bank Stocks Climb on Relief after New Capital Rules Released’, Nikkei News Online, 16 September 2010.
33) Arihito Ono, ‘IMF kaikaku o meguru shoten wa nanika: London G20 kinyû samitto o fumaete’ [What is
this problem by developing a new flexible credit line (FCL), whereby pre-approved countries can receive conditionality-free loans that are not capped by the size of a country’s IMF quota.34

Finally, the latest episode of financial crisis has also brought to the surface again the thorny issue of IMF governance reform: the quota/share of voting rights and representation at the Executive Board.35 Industrialized countries hold the bulk of the votes (60 per cent), while emerging nations and developing countries hold approximately 20 per cent each. European countries have been over-represented on the Executive Board, with an established tradition of also appointing the Fund’s head.36 Although Japan actively campaigned in the past to increase its voting share in the IMF, it had basically been satisfied, since it acquired the second largest position in 1990, and in the more recent debate it endorsed the G20’s proposal to transfer 5 per cent of the votes from over-represented to under-represented nations. This time it was China who led the charge for IMF governance reform, with further reallocation of voting rights to emerging economies in the G20 summit process.

Japan’s global responses to the global crisis show a country that is willing to utilize a well-tried formula in its economic diplomacy toolkit: flexing its financial muscle abroad (by injecting funds to international financial institutions) and at home (to spur domestic growth, albeit with very few results). Moreover, this time Japan has not had to press for flexible IMF lending practices or temporary capital controls given the emerging multilateral consensus on these issues. However, Japan has not articulated a distinct position on the most pressing issues confronting the G20: global imbalances and foreign exchange-rate management.

South Korea and China have had a much more visible role. South Korea hosted the G20 meeting in November 2010, introducing the notion of financial safety nets and a new focus on international development,37 and supporting the original US proposal for numerical targets on current account surpluses (which was eventually nixed). China has greatly influenced discussions in the G20 on the indicators to assess imbalances — effectively rejecting the use of exchange rates and currency reserves. In contrast, Japan ‘has been conspicuously absent from hot debates regarding reforming global financial architecture, and agenda-setting in the G20 summit process’.38 On the exchange-rate front, Japan — like others —

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has resorted to unilateral measures, intervening in the foreign-exchange market in September 2010 (for the first time in six years) to quell the rapid appreciation of the Japanese yen, while at the same time criticizing China for the slow pace of Chinese Yuan reform and South Korea for intervening in the exchange market frequently.39

Grimes attributes Japan’s low profile in the global debates about the new financial architecture to a lack of vision,40 and Katada underscores both domestic and international factors: domestically, the fragmentation of the Japanese financial sector pre-empted the emergence of a powerful lobby that can push the Japanese government to play a more active role in the drafting of international financial regulations; and internationally, the transition from the G8 to the G20, whereby Japan lost the ability to speak on behalf of Asia in the most influential international forums for financial and macroeconomic policy cooperation.41 Indeed, this has proven a difficult transition, as Japanese officials continue to emphasize the relevance of the G8, would like to ascribe a junior role to the G20 and have further resisted efforts to institutionalize the G20 by establishing a permanent secretariat, while Japan’s support for further expanding the membership of the G20 is perceived by some as an attempt to dilute its influence.42 But domestic factors are also important in understanding Japan’s financial activism and muted voice in global responses to the crisis. One of the advantages of contributing to the crisis resolution through a large injection of funds to the IMF, from the point of view of Japanese officials, was the low political cost of this option, since it did not require a vote in the legislature.43 The policy paralysis that has gripped Japan’s legislative body since 2007 therefore weighs in the international options considered by the government.

The article now turns to analysis of Japan’s regional economic diplomacy, where it has stumbled in its efforts to deepen integration in the aftermath of the crisis.


41) Katada, ‘Mission Accomplished, or a Sisyphean Task?’, pp. 146 and 148. In fact, China had not been interested in membership in the G7, as it perceived it as a forum dominated by Western countries that would press China to make concessions, but China finds the G20 a format that is much more conducive to exerting international influence. See Ming Wan, ‘The Great Recession and China’s Policy toward Asian Regionalism’, Asian Survey, vol. 50, no. 3, 2010, pp. 520-538.
Japan and Defensive Regionalism

Has the Time Come for a Revived Asian Monetary Fund?

Financial regionalism emerged in East Asia mostly as a defensive measure, as the region was engulfed by the AFC and Asian governments were disenchanted with the lack of a more proactive US response and the strict conditionality of IMF loans. Japan announced a bold initiative in 1997 — an Asian Monetary Fund — whereby it would provide half of the proposed US$ 100 billion initiative. Among the benefits of the AMF, in the view of the Japanese government, would be an increase in the amount of resources available to help countries in distress, faster disbursement of funds at the regional level that would not be bound by country quotas (as many Asian countries had smaller quota shares in the IMF, they could not expect hefty rescue packages), and resources would be allocated without the strict IMF conditionality but with the purpose, rather, of rapidly injecting liquidity in order to quell financial speculation. The Japanese AMF initiative was short-lived because of strong opposition from the United States (which feared a weakening of the IMF with the existence of an alternative lender of last resort) and from China, which had not been consulted in advance by Japan and was not eager to see Japan achieve a major position of leadership in one bold stroke.44

East Asian financial regionalism did not die, however, but morphed. First, many countries felt a strong imperative to accumulate foreign-exchange reserves in order to confront future episodes of currency speculation and capital outflow. China and Japan now hold the world’s largest reserves of US$ 2.4 trillion and US$ 1.5 trillion, respectively. Second, Japan and China did manage to reach an understanding at the ASEAN+3 meeting45 in 2000 to launch the Chiang Mai Initiative (CMI), a series of bilateral currency swaps that countries can activate as lifelines in case they are confronted with a liquidity crisis. By 2005, the value of these bilateral swaps had doubled, totalling US$ 80 billion. While the CMI undoubtedly constitutes an unprecedented step in regional financial cooperation, several caveats limit the scope and autonomy of this regional liquidity mechanism: bilateral swaps have not been established among all potential dyads; not all of the swaps are two-way arrangements; the terms of each swap vary depending on the negotiations between the two contracting parties; and the amounts available


45) The ten members of the Association of South-East Asian Nations, plus the three East Asian nations of China, Japan and South Korea.
to specific countries are rather modest (the largest amount available to a South-East Asian country was US$ 11 billion for Indonesia).46

But the most discussed feature of the CMI is the link to the IMF. As part of the 2005 reforms, the ceiling for releasing funds before requesting the debtor country to negotiate a stand-by agreement with the IMF was increased to 20 per cent. In other words, the CMI is clearly nested within the multilateral framework for financial crisis management, as most of the funds will not be released without the IMF’s seal of approval. The link to the IMF was important in gaining US acceptance of the Chiang Mai Initiative, but it also accommodates the interest of the two regional creditors (Japan and China) in avoiding moral hazard while outsourcing enforcement of policy conditionality.47 On the eve of the global financial crisis, therefore, a number of critical issues regarding the future evolution of the CMI were on the table: increasing the overall size of the bilateral swaps; further institutionalization by developing a permanent secretariat and strengthening surveillance capabilities; and multilateralization in order to evolve from the hopscotch of bilateral arrangements towards a genuine regional fund.

The onset of the GFC did not bode well for the CMI. Although South Korean banks had not partaken in the sub-prime market, as Western financial institutions limited their overseas exposure, the value of South Korean stocks dropped and speculative attacks against the Korean won multiplied. In fact, South Korea’s foreign-exchange reserves decreased markedly from US$ 264 billion in March 2008 to US$ 200 billion in November 2008.48 South Korea’s government decided to bypass both the IMF and the CMI and instead turned to the US Federal Reserve to alleviate its dollar shortage. It signed a bilateral swap with the Fed in October 2008 for US$ 30 billion, and local currency swaps with Japan and China in December 2008 for the equivalent of US$ 20 billion and US$ 26 billion, respectively.49 The currency swap with the United States was critical in bringing stability to the South Korean economy, but the fact that the CMI remained dormant at this time of crisis did not help the task of consolidating the regional liquidity mechanism.

This concern helped paved the way for the much awaited ‘multilateralization’ of the CMI (henceforth known as CMIM). In spring 2009, ASEAN+3 leaders agreed to establish a reserve pool of US$ 120 billion, with clearly defined quotas and voting shares: China and Japan both with 32 per cent; South Korea with 16 per cent; and ASEAN with 20 per cent. However, as Grimes notes, the

multilateralization process is less than complete because each country retains control of the funds in its national foreign reserves, voting takes place only on procedural issues, the IMF link remains in place, and it is still unclear whether China and Japan will be able to work effectively as co-leaders of the CMIM.\textsuperscript{50}

The CMIM clearly does not yet embody a revived Asian Monetary Fund. Further institutional enhancements and autonomy from the IMF would be required for that to happen. Kawai, for instance, argues that the lesson from South Korea’s experience would be precisely to eliminate the link to the IMF, so that the Asian liquidity fund can operate similarly to the newly minted flexible credit line in the multilateral system. In his view, the CMIM should pursue institutional deepening in two areas: by turning the surveillance unit into a permanent secretariat; and by allowing the proposed advisory panel of experts to evolve into a board of executive directors. Strengthening the CMIM’s surveillance function and devising rules for activating the disbursement of funds would also be required in this transformation.\textsuperscript{51}

Whether East Asian countries can accept the trade-off in sovereignty that more extensive surveillance would entail, whether consensus can be achieved on the activation clauses, and whether the creditor nations are prepared to forego the comfort of letting the IMF impose conditionality and pay themselves the political costs of enforcing adjustment measures on neighbouring countries whose financial difficulties go beyond liquidity problems, are all crucial unsolved matters. Japan, in particular, has been emphatic on the need to reinforce surveillance and enhance the CMIM’s analytical capabilities to assess members’ needs and prescribe policy adjustments before watering down the IMF link.\textsuperscript{52} On this matter, there is significant disagreement with China. As part of the CMIM deal, it was agreed to establish in Singapore the ASEAN+3 Macroeconomic Research Office (AMRO) in order to monitor members’ economies.\textsuperscript{53} China, however, is not keen on a rigorous surveillance mechanism. In the words of a Chinese Ministry of Finance official: ‘we should prevent AMRO from intervening in other countries’ internal affairs’.\textsuperscript{54}

The GFC, therefore, has brought new challenges to Japan’s financial regionalism. On the one hand, the one mechanism that Japanese economic diplomacy laboured to establish as a response to the AFC — the Chiang Mai Initiative — remains unused. On the other hand, Japan’s shifting position on the thorny issue


\textsuperscript{52} Henning, ‘The Future of the Chiang Mai Initiative’, p. 6.

\textsuperscript{53} For a summary of the CMIM agreement, see http://www.aseansec.org/documents/JMS_13th_AFMM+3.pdf.

\textsuperscript{54} Wen Jin Yuan and Melissa Murphy, ‘Regional Monetary Cooperation in East Asia: Should the United States Be Concerned?’, report of the CSIS Freeman Chair in China Studies, available online at http://csis.org/files/publication/101129_Yuan_RegionalCoop_WEB.pdf, accessed 11 March 2011.
GLOBALISM ASCENDANT, REGIONALISM STAGNANT

of policy conditionality has come to the surface. While it criticized the IMF for rigidly imposing adjustment packages, it has been reluctant to forego the link to the IMF in its role as regional creditor in the CMIM, even if this prevents the realization of a fully autonomous Asian Monetary Fund. Moreover, significant challenges loom ahead in reconciling Japan’s preferences with China’s as they co-manage the CMIM. As discussed next, realizing Japan’s vision for regional trade integration has not been easy either.

Can East Asia Buy into Japan’s Vision for Trade Integration?

A little over a decade ago, one of the most significant departures in Japanese trade policy took place, as Japan launched the negotiation of free-trade agreements (FTAs) that award market preferences to contracting parties and therefore represent an exemption to the multilateral system’s non-discrimination principle. Japan’s dramatic trade policy shift was a response to the proliferation of such trade agreements in the global economy (which put Japanese companies at a disadvantage since they did not enjoy such preferential treatment) and the stagnation of the World Trade Organization (WTO), which created an incentive for countries to open up new trade forums to advance their economic interests.55

FTAs have proliferated rapidly in the world economy because of the multiple advantages that they offer to the governments that negotiate them (and the interest groups back home that push for such trade deals). First, these trade agreements can confer important economic advantages. Defensively, they are essential in restoring the level playing field for companies that have been excluded from existing preferential trade areas, thereby mitigating the negative effects of trade and investment diversion.56 More proactively, FTAs can be used to achieve economies of scale, expand market share because of preferential market access, and displace rival firms from third parties through restrictive rules of origin. Second, as tools of economic statecraft, FTAs are useful in achieving political and diplomatic goals: to consolidate alliances; to isolate rivals; and to consolidate a country’s position as regional leader by offering a focal point in the integration process and awarding side payments to smaller economies. Third, FTAs have emerged as a key venue for the generation of new rules of trade and investment given the deadlock in the WTO’s negotiation process.57

Japan’s FTA policy has aimed to score points on all three fronts. It has aimed to restore the competitive advantage of Japanese companies suffering from discriminatory treatment from prior FTAs — for instance, by negotiating with Mexico to neutralize the clauses in the North American Free-Trade Agreement (NAFTA) that were deemed harmful to Japanese economic interests (such as the elimination of duty-drawback benefits in Mexico’s export promotion programme), or by pushing for a trade agreement with the European Union (so far to no avail) to avoid trade diversion from the Korea–EU FTA. Japan has also used the preferential trade deals to hone its regional leadership credentials vis-à-vis China, by reaching out to South-East Asian nations and inviting extra-regional partners to integration talks to balance China’s influence. Finally, Japan is interested in disseminating a distinct formula on preferential economic integration that is different both from the American and Chinese FTAs. In order to achieve these goals, Japan has therefore embarked on the construction of an FTA network. The Japanese government first started deliberating on the merits of FTAs in late 1998 and by autumn 2010 it had launched sixteen such trade negotiations. In East Asia, Japan’s string of bilateral FTAs include: Singapore (in force in 2002); Malaysia (in force in 2006); Thailand (in force in 2007); the Philippines (in force in 2008); Indonesia (in force in 2008); Brunei (in force in 2008); and Vietnam (in force in 2009); while negotiations with South Korea are now suspended. The one sub-regional FTA that Japan has inked so far is with ASEAN, which entered into force in 2008. Beyond East Asia, Japan has negotiated trade agreements with India (agreement in principle reached in September 2010), Australia (under negotiation since 2007), three Latin American countries (an FTA with Mexico entered into force in 2005, one with Chile was enacted in 2007, and negotiations with Peru started in 2009), with the Gulf Cooperation Council (since 2006), and in Europe with Switzerland (in force in 2009).

As mentioned earlier, the Japanese government has articulated a distinct project for trade integration in the region. First, regarding the scope of the trade agreements, Japan aims for high standard deals with multiple WTO plus commitments in services, investment, finance, government procurement and intellectual property. Moreover, the Japanese government has pitched the idea that it offers a unique package in its trade negotiations by including an economic cooperation chapter when it negotiates with developing nations. This chapter usually covers areas such as human resource development, promotion of small and medium-sized enterprises, support for science and technology, and improvement in the business climate. Japan hence refers to its preferential trade deals as Economic Partnership Agreements (EPAs). Regarding the geographical reach of

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Japan’s FTA policy, Japan initially gave priority to the negotiation of bilateral agreements with the largest nations in South-East Asia, had difficulties in hammering out an agreement with ASEAN as a whole (in part because of disagreements over cumulative rules of origin, but also differences on other issues, as discussed below), and finally in spring 2006 put forth a project for region-wide integration with the ASEAN+6 format. Japan therefore adopted a more expansive view of the region to encompass not only South-East Asia (the ten ASEAN nations) and North-East Asia (China, Japan and South Korea), but also India, Australia and New Zealand.

The latest elaboration on Japan’s vision for economic integration in East Asia came in the guise of a proposal for an East Asian Community (EAC) by soon-to-be Prime Minister Yukio Hatoyama in summer 2009. Hatoyama’s proposal was clearly influenced by the unfolding GFC, as he noted that the economic crisis had exposed the dangers of the unrestrained market fundamentalism that had been advocated by the United States, and that as part of the effort to mitigate the excesses of this globalized capitalism, Japan should return to the notion of ‘fraternity’ and endeavour to establish the EAC. Hatoyama modelled his EAC proposal on the European experience, by suggesting that functional integration on different areas such as trade, energy and the environment could be used to generate traction for deeper integration later on; and that just as France and Germany had reached an understanding on the European Coal and Steel Community, a similar breakthrough could occur between Japan and China on the exploration of gas deposits in the East China Sea.

Japanese officials face an uphill battle, however, in persuading the rest of East Asia to buy into their vision for regional integration. With regards to South-East Asia, Japan’s unwillingness to liberalize its agricultural market and to permit the arrival of foreign workers in any significant way has dulled the appeal of its trade agreements. Moreover, the economic cooperation clauses appear hollow to many, since they are not in any way binding commitments to undertake specific assistance projects, but rather promises of goodwill. Especially important is the fact that Japan’s agenda of incorporating WTO-plus rules might not receive wide support given Japan’s inability to obtain such commitments on services, investment and government procurement in the ASEAN-wide FTA. Actually, China’s FTA approach (with a much narrower scope of issues and lower levels of legalization) may be more in accord with the ASEAN way.

Japanese FTA policy has gained even less traction in North-East Asia, although there are recent signs that the diplomatic climate to launch trade talks has been

61) It is true that Japan was much more successful in incorporating the WTO-plus issues in bilateral FTAs with some South-East Asian countries, but the larger point is that when Japan negotiates with ASEAN collectively in expanding the FTA into a region-wide agreement, it is likely to confront similar resistance.
improving somewhat. Japan and South Korea launched trade negotiations in 2003, but they soon reached an impasse over Japan’s meagre agricultural offer (covering only 50 per cent of tariff lines) and South Korea’s concern with the adjustment burden on small enterprises and a worsening of its trade deficit with Japan. The talks remain frozen, although from time to time officials from both governments have attempted to restart them (so far unsuccessfully). Japan has also waivered on the possibility of negotiating a bilateral FTA with China. This is undoubtedly the wish of the internationalized business sector in Japan, which has deep trade and investment connections with China and sees the benefit of abolishing tariffs, simplifying customs procedures, establishing investment rules and protecting intellectual property.\(^62\) However, concerns over a massive inflow of agricultural commodities and labour-intensive manufactures, as well as worsening diplomatic relations over historical and territorial frictions, have prevented the Japanese government from giving the green light to these bilateral negotiations. Although the bilateral FTA initiatives in North-East Asia have petered out, the GFC may have opened a window for a possible trilateral FTA. In December 2008 China, Japan and South Korea launched a Trilateral Summit, where leaders discussed the importance of stimulus plans, the need to avoid protectionism and the launch of a trilateral FTA feasibility study whose results will be ready in 2012.\(^63\) This is undoubtedly a positive development, but it is equally noteworthy that trade integration in North-East Asia is still on the planning board stage.

The same is true for Japan’s other regional trade integration initiatives. As mentioned earlier, Japan launched the ASEAN+6 proposal in 2006, but so far no negotiations to bring about its realization have started. Japan’s proposal is in direct competition with China’s preferred ASEAN+3 FTA, and in fact many believe that Japan’s predilection for a larger membership is because of its interest in diluting Chinese influence. By inviting three established democracies — Australia, India and New Zealand — the weaker spots in China’s bid for regional influence would be highlighted.\(^64\) Japan’s campaign for the inclusion of these three countries in the trade integration process began at the time of the inaugural East Asian Summit (EAS) in December 2005. Although Japan did manage to secure an invitation for Australia, India and New Zealand to join the EAS, East Asian leaders announced that ASEAN+3 would remain the main vehicle for integration, while the EAS would play only a supplementary role. So far, the EAS has moved only to commission a feasibility study of Japan’s proposed ASEAN+6 FTA.\(^65\) In addition, Hatoyama’s EAC plan has faded: first, because it became

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\(^64\) Solís, ‘Japan’s Competitive FTA Strategy’.

clear that the proposal lacked specificity (on crucial issues such as whether the United States would be invited or not); and, subsequently, because Hatoyama fell from power less than one year into his administration.

The one regional trade integration blueprint that Japan conceived in the midst of the GFC has therefore fallen by the wayside. And Hatoyama’s successor — Naoto Kan — has given priority to joining an Asia-Pacific trade grouping (the so-called Trans-Pacific Partnership Agreement, or TPP) in part because of the difficulty that Japan’s regional trade integration is experiencing in gaining traction. As Japan attempts to retool its regional economic diplomacy, however, significant domestic challenges stand in the way.

**Domestic Constraints on Japanese Economic Diplomacy**

*No Market of Last Resort*

Fuelled by fiscal stimulus packages and monetary easing policies, many East Asian countries and in particular China were able to engineer a V-shaped recovery from the GFC. For instance, in the first quarter of 2010, emerging East Asia registered a 10.8 per cent GDP growth rate, and China 11.9 per cent. However, as East Asian countries start to unwind their stimulus packages in order to avoid speculative bubbles and restore fiscal balance, the need to lessen excessive reliance on export-led growth and instead to nurture internal and regional demand is all the more pressing. Japan’s ability to act as an engine of growth by reactivating its economy, and to operate as a market for distressed goods to help sustain economic dynamism in the region, has consequently emerged as an important leadership test as East Asia rethinks its development strategy.

However, Japan’s ability to meet this challenge is compromised by two factors: 1) Japan’s absorption of East Asian imports has decreased over time and the FTAs have not made much of a dent in opening the Japanese market; and 2) the Japanese economy has fallen into deeper recession and the shift to domestic demand has proven very difficult. Regarding the first point, in the past decade Japan has

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67 It is important to note that China also has difficulty in passing this leadership test. China is not yet a major consumer of East Asian final products. On the contrary, it has emerged as an assembly centre of components that are manufactured in the region, and the final products are exported to industrialized markets. The share of parts and components in China’s imports from East Asia has, in fact, grown over time from 18 per cent in 1994-1995 to 44 per cent in 2006-2007. See Athukorala and Kohpaiboon, ‘Intra-Regional Trade in East Asia’, p. 14. In addition, the challenge of transitioning to a domestic-demand model is particularly steep for China, since domestic consumption only represents 35 per cent of GDP and the international average is 50-70 per cent. See Gregor Eder, Michaela Grimm and Gabriele Steck, ‘Asia: Outlook after the Crisis’, Allianz Working Paper, no. 138, May 2010, available online at https://www.allianz.com/static-resources/en/economic_research/images_englisch/pdf_downloads/working_papers/asien-e0510.pdf, accessed 9 August 2010.
receded as a destination market for developing Asia’s exports. For example, data from the Asian Development Bank shows that the share of emerging East Asia’s exports — which includes fourteen nations — that were directed to the Japanese market fell from 14.64 per cent in 1990 to 12.26 per cent in 2000, and to 8.21 per cent in 2008.68 Moreover, entrenched resistance from the agricultural lobby in Japan has significantly curtailed the market concessions that Japan is prepared to make during preferential-trade negotiations. For this reason, 1) Japan has so far negotiated with mostly small economic partners (the sixteen FTAs in place cover only 15.6 per cent of Japanese exports);69 2) there is a marked asymmetry in Japan’s liberalization commitments, with modest liberalization in agriculture when compared to manufacturing (for instance, the Japan–Malaysia tariffs will be eliminated in ten years for 81 per cent of manufacturing tariff lines, but only 28 per cent of agricultural tariff lines); and 3) the most sensitive products (such as rice, sugar and dairy) remain completely off limits in trade negotiations.70

In addition, the prospects for a sustained Japanese recovery have dimmed. Two years after the Lehman Brothers’ shock, the Japanese economy has lost momentum again (GDP growth rate contracted 0.3 per cent in the fourth quarter of 2010, with the unemployment rate at 4.9 per cent). Dramatic yen appreciation (reaching a fifteen-year peak in autumn 2010) has once again compromised Japan’s export drive. The Japanese government again responded with monetary easing (through loans from the central bank) and a modest stimulus plan of US$ 10.9 billion, once more constrained by the large size of the already existing public debt.71 Japan’s slow growth was also because of slackening consumption. While some posit that the main culprit for weak domestic demand is the persistent deflation problem (since it is hard to encourage consumption when 35 per cent of the population expects prices to remain flat or to be lower in the next five years),72 Richard Katz argues instead that stagnant income is at the crux of the problem. Japanese consumers are not shopping actively because of the drop in real wages per worker every year for the past decade.73 Tapping domestic demand as a growth engine has therefore remained an elusive goal, despite the fact that the

68) Data from Asia Regional Integration Centre, Integration Indicators Database, available online at http://aric.adb.org/indicator.php, accessed 16 September 2010.
73) Richard Katz, ‘Saving Japan’, The International Economy, vol. 24, no. 2, spring 2010, pp. 44-49. Moreover, the erosion of the life-time employment system and the ageing of the population also create incentives for precautionary savings.
Japanese government first acknowledged the need for this shift more than twenty years ago at the time of the Maekawa Report.74

**Political Paralysis**

Solving Japan’s conundrum — that is, whether to stimulate domestic growth and consumption through an aggressive stimulus package or to repair the fiscal balance with an increase in the consumption tax — would require extreme political talent.75 However, in its current state, Japanese politics — with sharp fluctuations in electoral results, citizens’ deep distrust of the political class and constant turnover in the office of the prime minister — has become an additional burden to the task of restoring growth and displaying international leadership.

Japanese politics for most of the post-war period were, in fact, characterized by stability, as the conservative Liberal Democratic Party (LDP) remained in power since its creation in 1955 and managed to deliver economic growth and enhanced standards of living for the Japanese population. As T.J. Pempel has argued, this was a successful marriage of the politics of productivity and pork, since the LDP both aimed to boost productivity and exports by large and competitive enterprises, and protect and compensate the lower-productivity sectors in farming and small businesses.76 Other reasons for the longevity of the LDP’s rule included its ability to mitigate intra-party factional competition, to cultivate the personal vote, to tap a constant stream of political contributions from big business, and its ideological flexibility and ease in co-opting the opposition’s causes to its electoral advantage.77

However, the burst of the real-estate bubble and the ensuing recession put the political and socio-economic pact under severe strain. The subsidization of non-competitive sectors was much harder to sustain in a low-growth environment, the ability of the party — and the bureaucrats on whom they relied — to deal with

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74 Commissioned by Prime Minister Nakasone in 1986 in order to map a new growth strategy in the post-yen-appreciation era, the Maekawa Report advocated a shift to internal demand, deregulation and market opening. However, the report was never implemented because of opposition from many vested interests. See T.J. Pempel, ‘Between Pork and Productivity: The Collapse of the Liberal Democratic Party’, *Journal of Japanese Studies*, vol. 36, no. 2, summer 2010, pp. 227-254.

75 For Katz, the choice is clear: Japan is not facing a government bond crisis given that net government debt is much lower, the country is running a trade surplus, most government bonds are in domestic hands, and interest payments on the public debt are at a sustainable level. A tax increase (such as that of 1997) could bring about a recession. See Katz, ‘Saving Japan’, pp. 48-49. But current Japanese Prime Minister Kan is intent on fiscal repair (with consequent increases in consumer taxes) even though it cost him the DPJ’s majority in the Upper House in the summer 2010 election. A related and important discussion is, of course, what type of government spending is likely to generate growth, given the poor record of Japanese stimulus packages during the 1990s.


the banking crisis and restore growth was much in question, and the ever-growing corruption charges undermined the LDP’s credibility. As the party suffered its first main setback and was out of power briefly in 1993-1994, a new set of electoral rules was adopted (a mix of single seat and proportional representation seats), affecting the fundamental rules of the political game: by forcing candidates to appeal to broader constituencies (and not the narrow support of interest groups in the so-called iron triangles) and by encouraging a shift in party competition away from personalized politics and more in the direction of issues and party platforms.\(^{78}\)

Two main traits in Japanese politics were of significance during the 2000s: severe intra-party rifts in the LDP and the ascendancy of an opposition party (the Democratic Party of Japan or DPJ). During the tenure of LDP Prime Minister Junichiro Koizumi (2001-2006), the concern with boosting productivity and undertaking structural reforms was paramount. This pitted Koizumi directly against the pork-and-barrel politicians, and this confrontation was epitomized in the battle to privatize the postal service, which resulted in the expulsion of the ‘postal rebels’ from the party in 2005.\(^{79}\) An increasingly divided LDP was also now confronted with the emergence of a coherent opposition in the DPJ, contrary to the pattern in the 1990s of constant regrouping of opposition forces in short-lived parties. The DPJ’s challenge to LDP rule was first evident when it gained a majority of the Upper House seats in 2007 and proceeded to block most legislation, and finally in September 2009 when in a landslide electoral victory it brought 54 years of LDP rule to an end.

The ascent of the DPJ has been dubbed a regime change that is likely to bring a two-party system and changes in policy-making, with greater control by politicians over the bureaucracy. However, as Aurelia George puts it, Japan has been ‘stuck in transition’, unable to accomplish these changes, and the DPJ is equally divided among redistributive politicians and those that want to move away from ‘money politics’.\(^{80}\) The first DPJ Prime Minister, Yukio Hatoyama, had to resign months after his inauguration over corruption scandals and his flawed handling of the relocation of the US military base. His successor, Naoto Kan, suffered a major defeat when the DPJ lost its majority in the 2010 Upper House election (which has again brought about legislative gridlock), and was subsequently challenged (unsuccessfully) over his position as head of the DPJ and hence as prime minister of Japan.

Japan’s unfinished political transition has severely constrained its ability to go beyond financial commitments in solving the global crisis. On the trade front, as the electoral competition between the LDP and DPJ intensified, both parties


tried to court rural voters by granting more generous direct payments and rebuking free-trade proposals, making it more difficult for Japan to become a market of last resort. Moreover, Prime Minister Kan’s recent attempt to join the TPP has again exposed another fracture within parties, as politicians have scrambled to signal their support or opposition. The frequent cabinet reshuffles and the initial animosity between DPJ politicians and bureaucrats prevent the development of coherent countermeasures to deal with the global economic downturn. As noted before, Japanese Ministry of Finance officials have relied on measures (such as the loans to the IMF) that can avoid the fractious policy-making process at home with its legislative gridlock. Finally, the extreme instability at the top of the Japanese political system (in the past two decades there have been fourteen prime ministers, and since Koizumi the average tenure of each prime minister has been less than one year) pre-empts Japanese leaders from developing a rapport with their counterparts at the G20, a key asset in international diplomacy. Three different Japanese prime ministers have attended the summits since autumn 2008, prompting Brazil’s former President Lula’s remark: ‘You say “good morning” to one prime minister and “good afternoon” to a different one’.81

Conclusions

A country’s economic diplomacy is critically tested during periods of global and/or regional economic hardship. For Japanese leaders in particular, the GFC of 2008-2009 has posed extraordinary challenges on: a) how to move away from an exhausted export-led growth model and rely instead on internal and regional demand as key engines of growth; b) the best way to boost the IMF’s operations and mitigate high-risk international financial flows; and c) the feasibility of realizing Japan’s vision for enhanced financial and trade integration in East Asia in order to decrease the region’s vulnerability to external shocks.

This article has underscored the profound economic impact that the GFC exerted in Japan as the country experienced its worst post-war economic contraction in late 2008 and early 2009. It generated a soul-searching effort on devising the best national measures for economic recovery, and on displaying international leadership by supplying global/regional public goods in the form of hefty financial contributions and a market of last resort to sustain economic recovery. Japan did flex its financial muscle when it offered a loan of unprecedented scale to the IMF, it made funds available for trade finance so that global commercial flows would not seize up, it put together the world’s third largest stimulus package, extended additional economic assistance to Asian developing nations, and offered a yen currency swap to help South Korea to stabilize its economy in late

2008. And yet, for all the financial contributions that Japan has made, it has not played a major role in the G20 process in tackling global imbalances and promoting exchange-rate cooperation. Rather, Japan has played a passive role, as it has lacked a vision on the new international financial architecture.

The massive contribution of financial resources with little benefit in terms of enhanced international stature should be uncomfortably reminiscent for Japanese officials of earlier episodes of ‘chequebook diplomacy’ (when Japan’s contribution of US$ 13 billion to pay for the First Gulf War generated little international acknowledgement). The GFC has also been a wasted opportunity to enhance bilateral relations with the United States. Contrary to the deep disagreements between the United States and Japan during the AFC, Japan has adopted a conciliatory position on the causes of the GFC (blaming US financial regulation but also recognizing the role of global imbalances), has come to the rescue of the IMF, and has supported the continued role of the US dollar as the key reserve currency for the global economy. And yet, instead of cooperation over the GFC emerging as a key theme in US–Japan relations, friction over proposed military base relocations dominated bilateral exchanges.

The GFC has also added urgency to a key theme of Japanese economic diplomacy — that is, to avoid being eclipsed by China’s rise. The quick economic recovery in China after a massive stimulus package, the emergence of the G20 forum where China is well placed to play a leadership role on behalf of emerging economies, and China’s vocal position on IMF governance reform have helped China capture the global limelight. Moreover, China’s views on trade integration seem to be more attuned to ASEAN’s preferences than Japan’s insistence on high-standard WTO-plus commitments (but limited agricultural concessions). In addition, now that China and Japan have equal voting rights in the CMIM, it is unclear how easily bilateral cooperation on regional financial crises will ensue. To be sure, China faces its own challenges in the pursuit of enhanced international leadership. With a less-developed financial system, it is unlikely to play a leading role in the discussions on financial regulation, and it faces a steep challenge in reorienting its economic model to become a major consumer of Asian final products. But for Japan’s economic diplomacy, the GFC is a key test in asserting its global and regional salience vis-à-vis China.

A key concern for this article has been to emphasize the domestic constraints in Japanese economic diplomacy. In a worldwide recessionary climate, a key leadership test for any country is to act as an engine of growth with a vibrant and open economy. Japan scores poorly in this test, given that its economy has floundered, the string of free-trade agreements has not tackled the most sensitive Japanese products, and that Japan has receded in importance as a market of destination for emerging Asia. For Japan to lead it also needs political stability, and this has been sorely lacking as the political system is in the midst of transition (with the collapse of the original pact between pork and productivity). Japan’s response to
the global economic crisis therefore offers precious insight of the set of domestic and international challenges with which Japan’s economic diplomacy is confronted in this era of global financial instability and regional integration.

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‘Great Power Style’ in China’s Economic Diplomacy:
Filling the Shoes of a Benign Hegemon?

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Summary
China’s ascendance attracts concern, even though Beijing claims to be a responsible great power and tries to demonstrate its ‘great power style’ in economic diplomacy. This article therefore discusses the following questions: to what extent does the current notion and practice of Chinese ‘great power style’ in economic diplomacy comply with, or differ from, the criteria of benign hegemony; and what are the major constraining factors? Conceptually, China’s ‘great power style’ is rooted in ancient Chinese political philosophy and institution, but it highly resembles the Western notion of benign hegemony. Empirically, China has started to provide more public goods in trade, finance and aid, and it seeks voting powers at international institutions. However, it is still far from being a benign hegemon because of its level of development, domestic political constraints, and tension between political and economic interests.

Keywords
‘great power style’, benign hegemony, China, economic diplomacy

Introduction
Once positioning itself as a victim of imperialism and capitalism, China has changed its stance in international relations in recent years. China watchers have been discussing how to deal with ‘China rising’ or the day ‘when China rules the world’,¹ while others think that China is ‘fragile’ or even ‘collapsing’.² This article does not try to predict whether China will assume supremacy in economic and military power, but it analyses China’s aspired image of ‘great power style’, its

*) The author wishes to thank organizers of the ‘Economic Diplomacy Beyond 2010’ conference, and to thank anonymous reviewers and guest editors for their useful comments.


similarities with, and differences from, benign hegemony, and the constraints that China has in achieving that image.

Dismissing criticisms of self-interested economic diplomacy, Beijing has lauded itself for ‘great power style’ (大国风范, da guo feng fan) on numerous occasions. The term ‘great power style’ is most frequently used in economic diplomacy, such as when China maintained the value of its renminbi (RMB) during the 1997-1998 Asian financial crisis, when it exempted Africa from US$ 10 billion in debts in 2000, and when Chinese leaders went on shopping sprees across continents during the recent global financial crisis.

Economic diplomacy here refers to the use of economic means to achieve foreign policy objectives, as well as the use of diplomacy to pursue economic benefits. In Chinese rhetoric, ‘great power style’ is closely related to ‘responsible great power’ (负责任大国, fu zeren daguo), an image as well as a status to which China aspires as the paramount objective for foreign policy, but ‘great power style’ is in particular used in relation to smaller or developing countries, in particular in Asia, Africa and Latin America. Such praise is ostensibly used in contrast to other great powers, and the United States in particular, implying that the United States shows predatory, selfish behaviour. It is notable that China’s self-portrayal of ‘great power style’ bears resemblance to ‘benign hegemony’, a form of leadership that is considered crucial, if not optimal, for order by some Western theories. It seems to suggest the single existence of a benign hegemon, which had been sorely desired in international society before the arrival of China.

It is not clear, however, what China means by ‘great power style’; nor is it clear to what extent China has behaved like a benign hegemon in practice. Since economic diplomacy is the policy area where China most frequently refers to this style, and it is arguably the most heavily used instrument for pursuing great power status, it is a hard case for investigating China’s distance from its desired status as a benign hegemon. This article therefore explores the following questions:

- To what extent does the current notion and practice of Chinese ‘great power style’ in economic diplomacy comply with, or differ from, the criteria of benign hegemony?
- What are the major constraining factors?

The article argues that China’s concept of ‘great power style’ has some similarities with benign hegemony, in so far as they both emphasize the provision of public goods across finance, trade and aid policy. However, China is far from a benign hegemon. It has neither the domestic capacity nor context for projecting an altruistic image or for leading international institutions.
‘Great Power Style’ and Benign Hegemony

This section will discuss what China means by ‘great power style’ and provides an overview of Western theories on benign hegemony. This serves as a conceptual foundation for the empirical analysis of China’s exercise of, or distance from, benign hegemony.

The Way to Rule and the Way of Hegemony

China came up with the concept of ‘great power style’ to counter the ‘China threat’ rhetoric that was heard in some parts of the world. It was framed by Chinese elites as ‘the way of leadership’ (王道, wang dao) instead of the way of hegemony (霸道, ba dao). The concept of ‘great power style’ can be retrieved from ancient Chinese debate between ‘rule by morality’ and ‘rule by coercion’, as well as the practice of the tributary system. To put it simply, good emperors rule by morality and lead by example, while hegemonic emperors rule by coercion. In fact, the debate between wang dao and ba dao often took place in the Chinese royal courts and among Chinese intellectuals. In practice, the pursuit of military and economic power ran throughout Chinese history and was sometimes explicit and violent, for instance during the Spring-Autumn and Warring States periods (770-221 BC) when China was divided into numerous kingdoms. Balancing and alliance were dominant strategies used by the kingdoms for survival or hegemonic ambitions. Political philosophers such as Legalists (法家, fa jia) and Political Strategists (纵横家, zongheng jia), represented by Han Fei Zi and Su Qin, prioritized hard power and aggression over soft power and self-enlightenment in foreign policy. However, within the kingdoms, moral power was still considered important for the king’s reign, and the influence of Confucianism overpowers other philosophies in informing contemporary Chinese diplomacy.

According to the arguments of wang dao, the emperor should be the example of filial piety, loyalty and kindness, and the country achieves power and prosperity through self-cultivation. The relationship between the ruler and his people is like father and son, and the emperor should spend his whole life in the search for the way to rule. Virtuous emperors are believed to last long, while coercive ones soon demise from rebellions. The tenets of wang dao mostly reside in Confucianism. Confucius writes that if people far away do not respect (a country), its leaders and people should cultivate themselves with knowledge and morality in order to attract them (远人不服, 则修文德以来之). Confucius also believes that a country should make neighbours happy and attract people from far away (近者说, 远者来), which resonates with contemporary Chinese ‘good neighbourly’ diplomacy and the promotion of China’s soft power among developing

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3) Lun Yu [The Analects of Confucius], chapter 16: ‘Ji Shi’.
countries. The respect and visits paid by other countries were seen by Chinese emperors as an indication of the nation’s moral superiority and prosperity. As Confucianism was the dominant political ideology during the Han, Tang, Song, Ming and Qing dynasties, not least because of its emphasis on loyalty and order, such ideals about the ruler have a deep influence on contemporary Chinese political thinking. It is not surprising that Confucianism, among the many ancient Chinese political philosophies, has been chosen by the current Chinese government as the cultural foundation for building a harmonious society and harmonious world. The proposal of a harmonious world for international relations is an ostensible reminder of the conflicts and wars that exist under the current international order, which is led by the United States and Western countries. It also points to the inequality between developed and developing countries, and contains a call for global distributive justice.

Confucianism was a foundation in ancient Chinese tributary systems, which had existed since the Han dynasty and prospered during Ming and Qing. In contemporary regional diplomacy, Chinese policy-makers and commentators have highlighted China’s generosity and sense of responsibility as a big country in regional cooperation. Since Eric Teo suggested that China was trying to revive the tributary system in Asia, China has denied this observation and emphasized equality among Asian countries. According to Chinese officials, under the tributary system China guaranteed security of, and non-violence against, its smaller neighbours and received material goods in return, while under the current ‘good neighbourly diplomacy’ (睦邻外交, mu lin wai jiao) China gives material goods to neighbours in search for a safe strategic environment. As will be discussed later, whether or not South-East Asian countries are concerned about a possible revival of the Chinese tributary system, it is difficult to dissolve their ‘China threat’ perspective because of China’s practices.

It is true that diplomacy between China and other Asian nations is no longer conducted under legally hierarchic terms with China as the imperial centre and others as subordinate ‘tributaries’. However, similar thinking can be found between ancient and contemporary times. First, order is at the centre of diplomacy. Not only did ancient China promise non-invasion, but also sought from its ‘tributaries’ a safe strategic environment, or ‘shou zai si yi’ (守在四夷, order in four directions of barbarian land). China was the first country to accede to the Treaty of Amity and Cooperation in South-East Asia in 2003, and a safe environment is at the core of China’s current regional diplomacy. The shift in time is that ancient Chinese emperors sometimes mediated between conflicting ‘tributaries’, while China now respects the principles of sovereignty and non-interference. Second, it is built upon an exchange of material goods, with China usually ‘giving more and receiving less’, or ‘hou wang bo lai’ (厚往薄来). This practice was maintained even during times of economic hardship in China. There were even regulations to prevent ‘tributaries’ from paying deference too often in order to reduce China’s costs. Third, China now wishes to achieve the symbolic status of a great power, both in economic and military strength and in cultural and moral achievements.

In short, the contemporary concept of ‘great power style’ in Chinese diplomacy has historical and cultural roots in ancient political philosophies and institutions, in particular Confucianism and the tributary system. The concept of ‘great power style’ underlines moral superiority, which is supported by superior material power. China’s moral superiority is based on Confucianism and in particular the concept of giving more and receiving less. In other words, the motivation is claimed to be altruistic and holistic, rather than self-interested, introverted or narrow-minded. Moral superiority, complemented with material power, is considered as the foundation of China’s legitimacy to claim leadership in international relations. In practice, a great power thus provides public goods in the form of material goods as well as maintaining order. Since international relations have been conducted under different terms since the establishment of modern sovereign states, the image and status that now China seeks should be framed in the modern international system.

Having kept a low profile immediately after 1989, or ‘tao guang yang hui’ (韬光养晦, hide the sharpness while accumulating strength), China has in recent years become more proactive in diplomatic approaches and advocates other guidelines by Deng Xiaoping — ‘you suo zuo wei’ (有所作为, achieve something) — in particular in economic diplomacy. In response to the ‘China threat’

rhetoric, the concept of ‘peaceful rise’ was proposed by Zheng Bijian in 200311 and adopted by the Chinese government as its international trajectory. Although the word ‘rise’ has been replaced by ‘development’ in official language to avoid its revisionist connotation that China seeks to change the existing international order, the discussion about China’s hegemonic ambitions has not abated, either at home or abroad. China started to emphasize its responsible attitude in international affairs when it kept the value of the renminbi and delivered aid to countries hit by the Asian financial crisis. Since US Deputy Secretary of State Robert Zoellick prescribed the role for China of a ‘responsible stakeholder’ in the international system,12 the emphasis of China being a responsible member in the region and in global society has become increasingly prominent in Chinese official language. ‘Great power style’ and ‘responsible great power’ are common phrases in China’s self-portrayal. China has been ambiguous over whether it is a regional or global great power, or whether it aspires to become a global great power, which reflects its changing identity and diplomatic strategy. China has studied the rise of empires in world history,13 a signal that China is preparing for its great power status. Recent international events have provided China with an opportunity to promote its great power image. The United States’ unilateralism in Iraq, the lack of support from the International Monetary Fund (IMF) to countries hit by the Asian financial crisis, and trade protectionism in developed countries are all used by China as a contrast with its own policies. A central claim from the contrasts is that China is not a predatory coercive power (with the United States as the implied example), or a hegemon, but will lead by example, generosity and responsibility.

To what extent China has practised such leadership and other countries’ views on China will be discussed later. Conceptually, it is relevant to compare the concept and practice of Chinese ‘great power style’ with those of Western ‘benign hegemony’. The following section will first summarize the theory of benign hegemony and its root in hegemonic stability theory, although a wide survey of the vast literature regarding the latter is beyond this article’s scope.

Benign Hegemony

The concept of benign hegemony is mostly associated with hegemonic stability theory. Its founder, Charles Kindleberger, writes in his influential book The World in Depression: 1929–1939, that ‘for the world economy to be stabilized, there has

to be a stabilizer — one stabilizer’. For others, it may be too difficult and risky to have a global hegemon, but several regional hegemons should be encouraged.\textsuperscript{14} The importance of hegemony, or preponderance of power, for order has been underlined by different schools of international relations theory. For some neo-realist, a unipolar structure is the most stable. The English School talks about the responsibility of great powers in upholding international society,\textsuperscript{15} and Constructivists underline the importance of discursive and ideational power for hegemonic legitimacy.\textsuperscript{16} Although neo-liberals challenge the necessity of hegemony for sustaining order, they question less, if not assume, the role of a hegemonic power in the establishment of institutions, by providing public goods and rules of the game.\textsuperscript{17}

Theorists of hegemonic stability disagree on the motivation and means of a hegemon in keeping order. However, they generally divide hegemons into two categories: malevolent and benign. A malevolent hegemon uses the current order to exploit other countries for its own benefits, and leadership is exercised through coercion. A benign hegemon, on the contrary, identifies shared interests with other countries in the current order, provides public goods such as being the lender of last resort, a huge domestic market, establishes institutions and exercises leadership through diplomacy and persuasion.\textsuperscript{18}

Despite much criticism of the hegemonic stability theory, it is relevant today to compare Chinese diplomacy with benign hegemony. First, the theory of hegemonic stability remains one of the most influential ideas in international political economy, and the recent global financial crisis is widely explained by the decline of American hegemony. The Governor of the Chinese Central Bank, Zhou Xiaochuan, notably cited the failure of the United States to carry out its responsibilities and its selfish behaviour as a cause of the global financial crisis, and he called for reform of the international monetary system.\textsuperscript{19} Second, it can be argued


\textsuperscript{15} Bull, \textit{The Anarchical Society}.


that China subscribes to the hegemonic stability theory and wishes to be perceived as a benign hegemon. On domestic politics, China attributes its post-1989 political stability and determinism in economic reform to the authoritarian political system. On international affairs, although China claims never to pursue hegemony, it uses the term *ba quan* (霸权) here to refer to coercive power. The concepts of ‘great power style’ and ‘responsible great power’ tell of China’s ambition to be a leader, and they have been frequently used, first in Asia but increasingly in world affairs.

Comparing the two concepts based on the discussions above, ‘great power style’ and benign hegemony share significant foundational similarities. Both have one country with a benevolent image and strong material power at the centre of their system, they give more material goods to smaller countries or provide more to the system than what they receive, and in return other countries pay deference and comply with the rules set by the hegemon. Although hegemonic stability theory explains the behaviour of a hegemon with both rationalist and altruistic motivations, the concept of benign hegemon coincides with ‘great power style’ in its emphasis of the voluntary and idealist motivation, as well as virtuous and exemplary behaviour.

There are some differences between the two concepts. First, the ‘great power style’ does not have a clear delineated sphere of influence, whereas benign hegemony occurs within a system of states with clear boundaries, usually global but also possibly regional. Second, a benign hegemon creates and maintains institutions, be they informal or formal. In the domestic political and tributary systems of ancient China, the emperor or the Chinese state also had such a role, but the institutions were formal and legally hierarchical. The modern concept of ‘great power style’, however, does not automatically imply the great power’s formal role in institutions.

Despite the above differences in emphasis and the form of the hegemonic order, the similarities are more fundamental: about how order is decided; and the material and ideational foundations on which the order is based. As will be discussed later, the conceptual similarities are foundations for China’s potential to assume benign hegemony, while the differences inform the gap between Chinese behaviour and the ideal of a benign hegemon. Although one cannot say with certainty that China is either altruistic or selfish, the following section provides various examples of self-interested behaviour, which is either underplayed or conducted under the ‘win-win’ slogan. At the same time, this gap is also caused by domestic factors such as political economic conditions and policy-making institutions. The next section will provide a bird’s-eye view of Chinese economic diplomacy in order to identify its distance from the criteria of a benign hegemon, together with an analysis of the underlying factors.
Is China Filling the Shoes of a Benign Hegemon?

As mentioned earlier, hegemonic stability theory ascribes two kinds of responsibilities to a benign hegemon: to provide public goods; and to create international institutions. The term public goods refers to the materials, funding and resources used freely by all members of society or by a group arrangement. In economic policy, the benign hegemon is expected to import foreign goods, be the lender of last resort and give aid to poor countries. In other words, providing a domestic market for foreign exports through trade arrangements, and giving financial assistance and foreign aid through bilateral or multilateral channels is a demonstration of benign hegemony. These criteria will therefore be used to assess China’s contribution to public goods in three areas of economic diplomacy: trade; finance; and aid. In each area, China’s role in the creation and maintenance of international institutions will also be examined, as it is expected of a benign hegemon. The focus will be on China’s diplomacy towards smaller and developing countries because, as mentioned previously, China’s ‘great power style’ diplomacy is targeted towards these countries and is portrayed in contrast with developed countries such as the United States. Therefore, although China engages in economic diplomacy with major developed countries, in North-East Asian Free-Trade Agreement talks and purchasing tours in Europe, it is not included as a major case study for ‘great power style’ diplomacy. The wide survey of these three areas means that an in-depth case study is not possible within the scope of this article, but in order to capture the overall performance of China’s attempts to fit into the image of a benign hegemon, this article adopts a bird’s-eye review.

Trade

China opened its door to trade in 1978, and even before that China was not completely isolated. However, active trade diplomacy has mostly been conducted at negotiations of multilateral and bilateral treaties, or the World Trade Organization (WTO), free trade agreements (FTA) and over special tariff reductions.

China obtained WTO membership in December 2001 after fifteen years of hard negotiations, when it tried its best to defend its economic interests as a developing country. Concessions were made to other countries in order to obtain WTO membership, because it was considered to bring export opportunities and equal trading rights that a big economy with national pride deserved. WTO membership was also pursued to propel domestic reforms, as it had already become extremely difficult for (then) Chinese Premier Zhu Rongji to revamp China’s vested interests. China has maintained a tough position since 2002, in particular over agriculture, services and intellectual property rights (IPRs). In the Doha development round, China criticized the United States, European Union and Japan for failing to reduce agricultural tariffs or subsidies, while China itself had difficulty in committing to more concessions. China does not wish to be
labelled as the leader of developing countries because ‘the distribution of interests at the WTO is very complex and changeable’.\textsuperscript{20} China has successfully created a category of ‘newly acceded members’ at the WTO to avoid further concessions.

Beijing’s reluctance to give significant concessions at the WTO’s Doha Round may result from its pessimism about the WTO’s efficiency, or fewer ‘photo opportunities’ among the hundreds of WTO countries than at FTA negotiations, or less political symbolism than discriminative bilateral treaties. What is certain is that since its accession to the WTO, China has been much more active in forging bilateral FTAs, despite wide criticism that they have ‘spaghetti bowl’ or ‘noodle bowl’ effects on world trade.\textsuperscript{21} Just as US bilateralism in the 1990s launched a second wave of FTAs, Chinese activism seems to have tumbled another domino. Most of China’s FTAs have been forged with developing countries. Beijing claims to take less from, and give more to, smaller countries, as exemplified in the Early Harvest Programmes with ASEAN (the Association of South-East Asian Nations) and with Pakistan. However, such arrangements cannot completely convince ASEAN countries of China’s benign intentions. For instance, while the Early Harvest Programme boosted ASEAN’s exports of tropical produce to China, the increased Chinese exports of temperate produce and manufactured goods to ASEAN countries adversely affected local producers and stirred up fears of Chinese domination once again.\textsuperscript{22}

China has also unilaterally reduced tariffs for some goods from least-developed countries (LDCs). As of 1 July 2010, 60 per cent of the goods from 26 African countries enjoy zero tariffs into China, and such a list will expand to 95 per cent of goods from all the 30 African LDCs with which China has diplomatic relations. Beijing emphasizes that such measures are ‘unitary, voluntary and giving out benefits’.\textsuperscript{23} However, cheap Chinese goods — such as textiles and apparel — have driven out some African local producers, for instance those in Ghana and Zambia.\textsuperscript{24} Combined with its active extraction of natural resources, China is seen by some Africans as a new imperialist or colonialist.

\textsuperscript{20} Author’s interview with MOFCOM officials, Beijing, May 2006 and July 2009.
\textsuperscript{24} Fantu Cheru and Cyril Obi, \textit{The Rise of China and India in Africa} (Uppsala and New York: Zed Books, 2010).
Two difficulties remain for the approach of giving more to and taking less from the ‘great power style’ diplomacy. One is whether China can (continue to) give more and take less. The Chinese economy depends heavily on exports and needs multiple markets, even those of smaller or developing countries. The decision to stop the appreciation of the renminbi in mid-2008 during the global financial crisis showed again China’s reliance on exports. China also resumed tax rebates for the export of labour-intensive products, which are in more direct competition with products from developing countries than those from developed countries. The factor behind such policies lies in China’s domestic political economy, which is unlikely to change in the near future. China believes that because it has only had limited success in moving away from the labour-intensive export-led growth model, reduced exports would mean unemployment and possibly social unrest. Beijing’s resumed support for labour-intensive exports clearly demonstrates that a ‘harmonious society’ precedes a ‘harmonious world’.

The other difficulty lies in the choice between political and economic interests. In trade diplomacy, this involves coordination between China’s Ministry of Foreign Affairs (MFA) and other economic agencies such as the Ministry of Commerce (MOFCOM), various industry-line ministries and national economic commissions. Although China’s MFA still plays a significant role in initiating bilateral cooperation, it mainly acts as the reviewer of the ‘political qualifications’ of a potential partner country. In other words, it prioritizes countries in which the Chinese government has political trust, and penalizes countries that violated China’s political taboos by halting trade talks, as it did with Singapore. However, specific terms for the FTAs are negotiated by MOFCOM, and MOFCOM is easily lobbied by industrial ministries. Compared to its predecessor MOFTEC (the Ministry of Foreign Trade and Economic Cooperation), MOFCOM enjoys less autonomy in trade negotiations. At the same time, protectionist industries (such as agriculture, heavy industries, telecommunications and financial services) and agencies (such as the National Development and Reform Commission and national business associations) have gained power in Chinese domestic politics. In particular, partial reform has resulted in monopoly profits and rents in some sectors — such as telecommunication, finance, energy, transport, construction and agriculture — and they are extremely difficult to break.25 The strategic pursuit of political interests and pragmatic pursuit of economic interests consequently sometimes clash, and this affects the consistency of Chinese trade diplomacy.

Finance

As in trade, China’s record of exercising ‘great power style’ in the financial field has been mixed, although some progress can be seen in the past decade. Since it

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gained a lot of political capital by maintaining the value of the renminbi during
the Asian financial crisis, China has tried to demonstrate its ‘great power style’ in
financial diplomacy. In East Asia, although China did not support Japan’s proposal
of an Asian Monetary Fund in 1997, it became more active in the Chiang Mai
Initiative (CMI). At the initial stage of CMI, China regarded the CMI as largely
symbolic: the premium sum of China’s bilateral swaps was said to be relatively
high; there was no multilateral decision-making mechanism; and China preferred
a rigorous activation process, with 100 per cent linkage of the CMI’s funds to
IMF conditionality.26 However, China’s attitude changed because of pressure
from its neighbours, a more accommodating attitude from the IMF towards
Asian financial regionalism, and an important realization that China cannot gain
regional leadership without due contributions.27 Moreover, China believed that it
could take credit in creating the first real East Asian institution limited to
ASEAN+3 and in helping East Asia to take part in the reform of the international
financial system.

Although the initial proposal of CMI Multilateralization (CMIM) came from
Japan,28 China applied to carry out the study on reserve pooling, which sup-
ported the proposal, and it worked hard to get other countries on board CMIM.
Other contributions from China included offering training courses for ASEAN+3
officials (that is, for officials from ASEAN countries, plus China, Japan and South
Korea) and providing financial assistance for commissioned studies. Such mea-
sures help China to gain influence through cultivating pro-China elites and
affecting second-track expert opinion.

The global financial crisis has brought China new opportunities to demon-
strate ‘great power style’. In May 2009, China agreed to contribute the same
amount of money as Japan (US$ 38.4 billion each) to the expansion of the CMIM
reserve pool. China signed bilateral swap arrangements (BSAs) from December
2008 to March 2009 with South Korea, Hong Kong, Malaysia, Belarus, Indone-
sia and Argentina worth a total of RMB 650 billion. A Chinese phrase that the
Chinese leaders often quote goes ‘A long road shows the power of a horse, and a
long time shows the heart of people’ (路遥知马力, 日久见人心, luyao zhi mali, rijiudianrenxin), implying that China’s friendship towards its neighbours and
other developing countries has stood the test of time, while some Western coun-
tries failed.

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26) Jennifer Amyx ‘Regional Financial Cooperation in East Asia since the Asian Financial Crisis’, in
A. Macintyre, T.J. Pempel and J. Ravenhill (eds), Crisis as Catalyst: Asia’s Dynamic Political Economy
Regionalism in Support of the Global Financial Architecture? The Political Economy of Regional Nest-


28) Tadahiro Asami, ‘After the Chiang Mai Initiative’, IIMA Newsletter, no. 5, August 2001, available
online at http://www.iima.or.jp/pdf/nl_05_2001e.pdf.
It should be noted that BSAs are a shallow form of financial cooperation and carry low risk for the potential lender. For deeper and riskier forms of financial cooperation, such as exchange rate coordination, China has lacked enthusiasm because of its closed capital account, ‘managed floating’ exchange rate policy and lack of confidence in its financial institutions. China has been resistant to the idea of an Asian currency and reluctant to build an independent surveillance mechanism in East Asia. China has started to use the renminbi with several trading partners, including Russia, Brazil and South Korea and in border trade with North Korea and ASEAN, but this is aimed at stabilizing trade in the short term and to promote the renminbi as one of the international reserve currencies in the long term.

At the IMF, China takes pride that it has not had to borrow since 1986. With growing economic size and international ambitions, China complains that it is under-represented. During the global financial crisis, China stated that it has filled its quota at the IMF and that if other countries wanted China to contribute more, the IMF should increase China’s voting power. On financial matters, China is clearly speaking as the leader of the emerging economies. China has called for reform of the international financial institutions to reflect the power of emerging economies more, and it takes credit in the creation of the G20. As a success of the developing countries, the G7 Financial Stability Forum was expanded to include emerging economies and became the Financial Stability Board in 2009, of which China is a founding member. Speaking at G20 Summit in June 2010, Chinese President Hu Jintao stated:

We need to continue to push forward the reform of international financial institutions, move more quickly to adjust IMF quotas, allow more people from emerging markets and developing countries to take senior posts at international financial institutions, and increase the representation and voice of developing countries.

On the controversial topic of China’s exchange rate policy, China refutes Western criticism of its manipulation and undervaluation of the renminbi, and uses the

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excuse of financial crises to rebuke the logic of a floating exchange rate and open capital account. Beijing points out that the imposition of conditions by the IMF and World Bank on developing countries has destroyed more than ten national economies, including those of Argentina and Indonesia, particularly thanks to neo-liberal economic doctrines embedded in the Washington Consensus, in combination with the ensuing modern financial industry and greed. In contrast, China emphasizes its stabilizing effect on the world economy. It claims that the stimulus packages and the prompt fashion in which they were installed in China’s domestic economy benefit the world and demonstrate China’s ‘great power style’. The Chinese government and academia also reiterates that China never attaches conditionalities to its aid or loans to other developing countries and that China does not intervene in domestic politics. However, China does ask for political support and natural resources in return for aid and loans, as will be discussed in the next section.

**Aid**

China is graduating from being a receiver to becoming a donor of foreign aid. China is so far the biggest receiver of World Bank loans, and it has benefited from technical and financial assistance from UN organizations (including the World Food Programme, Population Fund and Children’s Fund), the European Union, Asian Development Bank (ADB), and other national governments, including the former Soviet Union, Japan, Germany, Australia, the United Kingdom and Belgium. While international organizations and national governments have reduced or stopped aid to China, China still tries to obtain aid based on its low per capita income and unbalanced development. Although recent economic data show China’s GDP as surpassing Japan’s to become the second largest economy in the world, China can hardly claim to be an economic hegemon with its large population below the poverty line (China currently has 254 million people living on less than US$ 1.25 dollar per day). Importantly, poverty in China is caused not only by its huge population and lack of resources, but also by corruption and unequal distributive policies. There have been problems of corruption in the usage of aid funds at the local level, and questions of abusing the Clean Development Mechanism in recent years.33

As a donor, China has changed its strategies from free aid to an emphasis on mutual benefit, or the ‘win-win’ principle. During Mao Zedong’s era, China gave aid to developing countries based on anti-imperialist or anti-revisionist ideology, or a political position that was both against Western capitalism and against post-Stalin Soviet Union socialism. A milestone of China’s friendship with its Third

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33) The Clean Development Mechanism allows emission-reduction projects in developing countries to earn credits, each equivalent to one tonne of CO2, which can be traded and sold. See Kent, Beyond Compliance, p. 121; and ‘UN Halts Funds to China Wind Farms’, Financial Times, 1 December 2009.
World brothers was the Tanzania-Zambia railway, to which China contributed expertise, materials and the lives of workers. Subsequent Chinese leaders, however, have argued that the strategy of free aid is unhelpful for either party, and the principle of ‘mutual benefit and win-win’ has been adopted instead. In practice, China’s aid and soft loans are usually used to help Chinese companies extract natural resources or sell their products. They also serve political purposes — to obtain political support for China on issues such as Taiwan and Tibet. ‘Image projects’ — that is, presidential palaces in Zimbabwe, Togo and Sudan and more than 52 stadiums in Africa from Angola to Ghana — are obviously part of China’s campaign for closer political and economic relations.34

Overall, Africa has been the major beneficiary of Chinese foreign aid. Since its WTO accession, China has increased its activity on the African continent, from investment, trade and aid, which has invited a lot of controversy.35 The China-Africa Development Fund was established in 2006 by the Chinese government to help Chinese companies invest in Africa. To be sure, China has delivered aid in the form of hospitals, schools, medical, technical and agricultural expertise and infrastructure construction, which has benefited local development.36 However, there have been problems with China’s economic activities in Africa. First, China’s indifference towards local politics in the choice of aid and investment location attracts criticisms of economic centrism or supporting autarchies such as Angola, Sudan and Zimbabwe, which were or are under Western sanctions. China argues that its loans, aid and investment help local infrastructural and economic development, and Beijing has promoted diplomatic ties with oil- or resource-rich countries regardless of their regime type. However, there is much controversy on how much Chinese funds have benefited the wider community rather than the political elite, and some of the funds are suspected to be used by autarchic governments to buy weapons, for example in Zimbabwe. Second, there have been serious labour issues. Chinese companies often prefer to use Chinese labour, which does not contribute to local employment. There have also been scandals of low wages, poor labour conditions and hazardous safety standards. The Tanzania-Zambia railway is today used to transport copper from China-invested Chambishi mine, but a major labour protest broke out there after an accident in 2005.

Subsequent unrest continues there in requests for better labour conditions. Third, as mentioned earlier, cheap Chinese products are driving some local businesses out of the market. African politicians, particularly the opposition parties in national politics, often use China as a target in their election campaigns, calling China neo-imperialist or neo-colonialist. The Chinese government started to pay attention to that image problem in Africa in 2006, but success is limited in this regard because of lack of control over Chinese companies in Africa or a fundamental conflict between China’s economic and political interests, similarly in trade.

With its growing foreign exchange reserves, China seeks bigger quotas and more voting power at multilateral aid agencies. China has been more active in multilateral aid since 1997 and became a donor of the International Development Association in 2007. China’s 2010 budget for foreign aid is 13 billion renminbi. China calls for an increasing voice from developing countries, while continuing to oppose the use of conditions attached to loans. Following the G20 meeting in London in April 2009, the voting power of developing countries was increased at the World Bank, and China has become the third biggest voting power with 4.42 per cent of the vote, following the United States and Japan. At the ADB, China is also the third biggest donor, but has less than half the voting power of the United States or Japan. A major development project that China participates in at the ADB is the Greater Mekong Subregion (GMS) Economic Cooperation Programme. While Chinese local governments regard their roles in this programme as a contribution to cross-border cooperation, and transport has been improved in the GMS, downstream countries complain about the damage on their ecology created by the construction of upstream dams in China. This controversial issue is another indication of inconsistency between political and economic interests in China’s economic diplomacy, and it also reflects the central level’s lack of capacity to monitor local government projects as well as lack of coordination between environmental and economic ministries.

It is notable that China’s ideational influence in developing countries has grown in recent years, which is seen as a challenge to existing international institutions in the eyes of some countries. Chinese leaders often underline China’s commitment to speaking out for justice for Africa in the world arena. Many developing countries, including those in Africa, have expressed their appreciation of China’s non-intervention in their domestic affairs, and their intention to learn from

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37) Author’s interviews with a researcher at NDRC and scholars at the China Academy of Social Sciences, July 2009. Also see Zhongshun He, Xinshiqi zhongguo jingji waijiao: lilun yu shijian [Research on China’s Economic Diplomacy: Theory and Practice], (Beijing: Shishi Press, 2007), p. 268.
China's development model, for instance by establishing Special Economic Zones and encouraging labour-intensive exports, with the help of Chinese loans, investment and experience. When the term ‘Beijing Consensus’ was dubbed by former *Time* editor Joshua Cooper Ramo in 2004, the Politburo of the China Communist Party (CCP) — the core of China’s decision-making power — quickly welcomed the spread of this term and also the term ‘China Model’ in the international media, because they were believed to help enhance China’s soft power. However, after media attention turned to its revisionist connotations that China seeks to challenge and change the existing international order and institutions, the Chinese government denied that China had tried to teach the China Model to other developing countries or to challenge the existing international order. It stated that the China Model means that there is no one model for a country; rather, each country needs to search for its own development or political model. However, explicitly or implicitly, the Chinese government has granted two important connotations to the Beijing Consensus or the China Model: gradualist development; and authoritarian decision-making. China underlines the gradual and experimental fashion in reform and opening as a crucial factor for economic growth and as a shield from economic crises. It also prides itself on political stability and the speed with which the state can make decisions, and attributes them to the authoritarian political system.

As can be seen from China’s contribution to international aid and development, China is actively providing aid to developing countries. Although it does not require receiver countries to carry out neo-liberal or socialist reforms, Beijing tries to obtain natural resources and political support. For international development institutions, on the one hand China seeks to have a louder voice at existing institutions, and on the other hand China does not wish to be seen as a revisionist power. It has not yet fully graduated from being a receiver of aid, and it is careful not to be burdened by the ‘China responsibility’ discourse. A researcher at MOFCOM even announced that the ‘China responsibility’ discourse was just another version of the ‘China threat’ rhetoric, and that China would refuse responsibilities imposed by others for such titles as a surplus country, a debtor country, a savings nation, a big energy consumer, or a big CO2 emission country.

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Conclusion

The image of ‘great power style’ that China wishes to establish through its economic diplomacy resembles the Western concept of benign hegemony, and it is rooted in ancient Chinese political philosophy and institutions. It is informed by the Confucian concept of rule by morality, compassion and generosity, and some practices today are similar to those under the ancient tributary system, both with order and exchange of material goods at the core. Considering the lack of a benign hegemon in the contemporary world, China aspires to assume this role. In its relations with developing countries and smaller Asian countries, China claims to give more and take less, a principle by which it differentiates itself from predatory powers. Based on the size and growth potential of its domestic market, huge foreign reserves, and the ability of the authoritarian government to allocate resources, China has indeed provided some public goods, such as preferential trade, financial assistance and foreign aid.

However, the amount of public goods that China can provide is limited because of its level of economic development, its political priority of domestic stability, entrenched domestic interests, and the constant tension between political and economic interests. As a result, Beijing prefers bilateral to multilateral approaches to economic diplomacy, and avoids risky commitments that compromise sovereignty. China also attaches conditions to its contributions, either in the form of natural resources or political support. The effect of its economic diplomacy is also mixed because of the negative impacts on other developing countries.

Compared with its activities in providing public goods, China’s achievement in creating or reshaping international institutions is much more modest. China has realized the importance of participating in rules-making, and compared with two decades ago, its diplomatic strategy has become much more proactive since the Asian financial crisis. As a latecomer to existing global institutions, China tries to have a louder voice while attempting not to appear revisionist. It has rallied the voice of developing countries and largely expanded the core of the G7 to the G20 in the international financial system, but its footprints at the WTO and multilateral aid agencies are not yet deep. More has been accomplished in regional diplomacy, however, where China is taking the lead in establishing East Asia-only trade and financial institutions.

In short, China is unlikely to assume the role of a global benign hegemon anytime soon. The main target countries of Beijing’s ‘great power style’ diplomacy — small and developing countries — may continue to perceive China as a competitor, threat or even imperialist rather than an altruistic leader, while they appreciate the economic benefits that China brings and the choice of an alternative to those given by Western countries. First, the limitations and constraining domestic factors in China cannot be changed in the short term, in particular the conflict between national economic needs and an altruistic international
image. In foreign policy, China is constantly faced with the dilemma between economic and political interests, and an identity crisis between being a developing country and a great power. Second, China may represent a challenge to US dominance and Western neo-liberal ideals in some developing countries, and some countries may indeed benefit from China’s economic support, but in those countries human development instead of narrow economic growth needs to be considered in order to evaluate China’s impact. There is no real indication that the Beijing Consensus or the China Model of economic liberalism and political authoritarianism is spreading on the world map. On the contrary, there continues to be a high possibility that China is regarded as colonialist in Africa, and Sinocentric in Asia. It is too early to predict whether China will one day resume the glory of the Middle Kingdom and indeed behave like a benign hegemon. For now, it shows some conditional benignity that is far from hegemony.

EU Economic Diplomacy:  
The Factors Shaping Common Action

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Summary  
The current special issue of The Hague Journal of Diplomacy is concerned with economic diplomacy. This article looks at the role that the European Union plays in economic diplomacy and shows that the EU’s role is essentially to facilitate, rather than to promote national companies as EU member state governments do. After discussing the various definitions of economic diplomacy, the article summarizes the areas in which the European Union constrains the scope for certain national policies of the EU member states. The article then discusses the factors that shape EU economic diplomacy and assesses the relative importance of these factors in specific negotiations.

Keywords  
economic diplomacy, European Union, EU member states, EU competence, norms, facilitation versus promotion, commercial constraints, national interest

Introduction  
This special edition of The Hague Journal of Diplomacy is concerned with economic diplomacy. This article looks at the role that the European Union (EU) plays in economic diplomacy. The article aims to provide a general framework for assessing the factors that shape a range of relevant EU policies; it cannot, and does not, deal with specific negotiations, in which a range of sectoral and member state variables would be important. The article first discusses the role that the EU plays in economic diplomacy. This differs from the economic diplomacy that is played by national states in that the EU’s role is essentially to facilitate; unlike national governments, the EU does not promote national companies. With the progressive extension of its competence and internal framework rules, however, the EU has constrained member states’ national champion policies and continues to constrain member states’ commercial policies. Having established the role of the EU in economic diplomacy as essentially a facilitating role, the article then provides an overview of the factors shaping EU economic diplomacy and provides some
general hypotheses for assessing the relative importance of these factors in specific negotiations.

**What is EU Economic Diplomacy?**

Economic diplomacy is taken here to mean decision-making and negotiation in international economic relations.¹ In the case of the EU, economic diplomacy is therefore concerned with these processes in the core areas of international trade and investment, financial markets, development policy and the environment. EU economic diplomacy is clearly external and does not relate to the *acquis communautaire* that provides the framework for competition within the EU’s single market. EU economic diplomacy is therefore concerned with the framework of rules that facilitates the EU’s engagement in international markets. It provides a facilitating role by seeking to open third-country markets to trade and investment. EU economic diplomacy also includes negotiations on the international regulatory framework that shapes such trade and investment, as well as other areas of policy such as international financial market regulation and environmental policies, etc., that impinge on EU trade and investment. This understanding of economic diplomacy, however, should perhaps be distinguished from a number of other related terms, including economic statecraft and commercial diplomacy.

Economic statecraft is a broader concept that encompasses all forms of economic relations between states, both positive and negative, that are employed as part of what approximates to ‘grand strategy’ *vis-à-vis* other major economies.² Economic statecraft therefore requires strategic choices with a view to maximizing relative (economic) gains. For example, the United States could use economic statecraft in its relations with China if it viewed the strength of the Chinese economy and industry as a strategic threat to the United States. The EU has no grand strategy in its relations with its strategic partners, but it conducts economic diplomacy. One could also argue that the EU has a role in Europe’s economic security, whether the term is defined narrowly to include access to key raw materials and energy, or more broadly to include the stability of the international capitalist system.³ In a globalized world, concepts of ‘collective security’ also gain traction, so that the EU’s role in promoting sustainable development as a means of supporting political stability in (North) Africa or elsewhere is important.

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Commercial diplomacy, meanwhile, can be defined as non-binding cooperation between the private and public sectors in the promotion of commercial interests. Examples include the use of diplomatic services to assist national firms in a target market through the provision of information and representation, or trade missions accompanying visits by heads of state or government to trading partners. Commercial diplomacy is still the preserve of the EU member states, which compete with each other as well as with the US, Japanese or Chinese governments in seeking contracts for their national firms. In some areas, as discussed in the following section, the EU can, however, constrain the scope for national commercial diplomacy.

**EU Competence as a Constraint on EU Member States’ Commercial Policy**

No EU institution engages directly in promoting the commercial interests of individual EU member states or individual companies, but by shaping trade and investment relations, EU economic diplomacy constrains the scope that is available for member states’ commercial diplomacy. First and foremost, the EU has exclusive competence for trade and — since the application of the Treaty of Lisbon on 1 December 2009 — investment policy. The promotion of trade and investment by removing tariffs and other border measures has long been an EU competence. EU competences, both *de facto* and *de jure*, have also grown for policy areas concerned with removing regulatory and other behind-the-border barriers to EU trade and investment. The EU thus negotiates multilateral and bilateral agreements that seek to ensure effective access to markets that are blocked by the technical regulations of other countries or by the anti-competitive behaviour of companies on other markets.

With the adoption of the Lisbon Treaty (Treaty on Functioning of the European Union, TFEU), the EU now has exclusive competence for trade-related intellectual property rights (TRIPs) and foreign direct investment (FDI). For some time the EU member states have negotiated as one on TRIPs and the EU has acted against infringements of the property rights of EU-based companies by third parties. The Global Europe Strategy of 2006 placed increased emphasis on the enforcement of such property rights. The inclusion of FDI as an EU exclusive competence with the Lisbon Treaty also means that the scope for EU member states to negotiate bilateral investment treaties (BITs) with third countries is constrained. To date, such BITs have formed part of commercial diplomacy, in the sense that by providing investment protection they were seen as facilitating increased investment and thus access to markets. They have often been signed alongside the signature of major contracts for national companies of the home state. Proposals from the European Commission on how to implement an EU competence in FDI are still under discussion, but it seems likely that existing
BITs will be ‘grandfathered’ (that is, allowed to continue) and member states may well still have the ability to negotiate BITs with (small) third countries that are not the subject of EU negotiations.\textsuperscript{4} The EU will aim to negotiate strategically important BITs with major third countries such as China, India or Canada, either in EU BITs or as part of comprehensive free-trade agreements (FTAs).

EU economic diplomacy also constrains EU member states’ commercial diplomacy when commercial diplomacy is linked to the provision of aid. It has long been the practice — for better or for worse — that aid is tied to exports of high-value-added goods from the country providing aid. In the EU competence for development policy, financial aid for developing countries is shared between the EU and its member states.\textsuperscript{5} EU-controlled funding, including European Development Fund (EDF) assistance provided by the member states but allocated by the EU, is not tied to commerce. There are also efforts to strengthen policy coherence in development (PCD) within the EU, which also reduces the scope for even implicit tying of aid to national commercial interests.\textsuperscript{6} Various other EU policies can provide funding for developing countries. For example, on climate change it is the EU that delivers financial aid under the Clean Development Mechanism of the Kyoto Protocol, even if this is done by unanimity.

Another area in which financial assistance is provided to promote national exports is that of export credit guarantees. These can take the form of a subsidy, mostly for exports to developing countries, and have formed a mainstay of national commercial diplomacy in the past. In order to prevent unfair competition and reduce the danger of developing countries accumulating excessive debt, the Organization for Economic Cooperation and Development (OECD) has developed guidelines on the provision of export credit. These constrain national commercial strategies that might consider a continuation of tied aid. There has so far been no additional EU discipline on export credit. The discipline on EU member states derives primarily from the OECD Guidelines on Officially Supported Export Credit, which are, however, implemented in EU law.\textsuperscript{7}

Moving from specific instruments to the less tangible links between diplomacy and commercial interests, the Lisbon Treaty has created a common European External Action Service (EEAS), which reports to the High Representative of the


EU for Foreign and Security Policy (High Rep). The EEAS, along with a greater role for EU delegations in third countries, will become more visible in the future. While this will not prevent EU member state embassies from helping national companies by ‘smoothing relations’ with host governments, more common EU positions could mean less scope for implicit links between foreign policy and commercial interests.

Factors Shaping EU Economic Diplomacy

If EU economic diplomacy is concerned with decision-making and negotiation in the core policy areas of trade, investment, financial markets, development and environmental policy, what are the main factors shaping EU policy in general? This section discusses these before suggesting some hypotheses to be tested for specific negotiations. The existing literature on the role of the EU in international economic negotiations of the kind involved in economic diplomacy falls under a number of headings. The European integration literature has been concerned with how the EU member states move, or do not move, towards greater coordination or common policies. The literature on the EU as an actor in international relations, has addressed the relevant question of what attributes make the EU an actor. More recently, an effort has been seen to extend this analysis to include economic issues. A great deal has also been written on the specific policy areas, although much of this has been concerned with the substance rather than the policy process. The aim here is to provide a fairly straightforward framework with which one can assess the relative importance of factors shaping EU economic diplomacy or, more precisely, the ability of the EU to pursue a common economic diplomacy. The factors fall under the general categories of external challenges, economic power, recognition, normative power, member state and sectoral interests, decision-making capacity and coherence across policy areas.

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EU economic diplomacy is shaped by external drivers as well as by issues of competence or institutional structures and decision-making procedures within the EU. Where an external challenge exists that touches all EU member states, this has tended to lead to efforts to develop or strengthen common EU action. In the field of trade policy, the European Community (EC) — and subsequently the EU — was repeatedly challenged by the United States for nearly four decades — up to and including the Uruguay Round of negotiations of the General Agreement on Tariffs and Trade (GATT) — to engage in multilateral trade liberalization. The response of the EU member states was to agree to speak with one voice in order to defend the EU’s interests better, even when the issues pushed on to the agenda by the United States were mixed or a member state competence.

In the case of international finance, the historical evolution has been rather different. The continued role of the dollar as an international currency, even after the collapse of the fixed but adjustable exchange-rate regime of Bretton Woods in 1971, meant that pressure for joint action by the EC member states was much less pronounced. Some member states saw the ‘exorbitant privilege’ of the dollar or a search for greater stability as grounds for seeking a European monetary union, but the economic diplomacy response was through member state governments in the G7. External challenges — in the shape of international financial crises — have been important and required urgent but intermittent action, but with the possible exception of the most recent financial crisis, the crises have not had sufficient impact on the EU to precipitate major changes in policy.\(^{10}\)

The external challenge in the field of the environment takes the form of global externalities. In climate change, for example, neither the EU by itself nor individual EU member states can adequately address the problem. The EU has been able to emerge as a leading actor in climate change because of the vacuum left by the absence of US leadership.\(^{11}\) To some extent, the same argument can be made for international trade policy in the late 1990s when the EU sought to assume a leading role.

In development policy, meanwhile, the external drivers seem less important. Certainly for the developing countries in sub-Saharan Africa, development is an urgent need, but this has a less direct bearing on EU policy for a range of reasons. EU development policy has been shaped by obligations or commitments dating from the colonial legacy of some EU member states. This history is not shared by all member states, however, a fact that has not been without implications for EU development policy. A more immediate external challenge has come in the form of political instability in the EU’s near neighbourhood (the Balkans and

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11) See Bretherton and Vogler, ‘The European Union as a Sustainable Development Actor’.
North Africa). External factors could be said to have provided an incentive here for EU economic diplomacy.

**Economic Power**

Contrary to power per se, economic power is relatively easy to measure. In the field of trade, the European Economic Community (EEC) gained economic power in the sense that access to the common market was determined by the common external tariff (CET). Given the nature of trade negotiations based on reciprocal market access concessions, the larger the common market, the greater the EEC’s economic power. The rapid realization of the common market and the resultant threat of trade diversion of third-country exports enabled the EEC to achieve reductions in US tariffs. The widening and deepening of the integration in the 1980s augmented the EU’s relative market power, which probably reached a peak in the late 1980s.\(^{12}\)

Other policy areas also have fairly easily measured metrics of market power. In finance, the EU accounts for a significant share of the world’s financial markets. In 2005 the EU held €7,628 billion in bank assets compared to the United States’ €2,689 billion. The value of insurance premiums paid in the EU — at €1,385 billion — was also higher than in the United States. Equally in non-bank payments, bond market capitalization and debt insurance, the EU was more important than the United States. Only for derivatives equity market capitalization and turnover was the United States a more important market.\(^{13}\) In addition, these relative shares of financial markets do not seem to have been much affected by the global financial crisis. The EU’s ability to use its relative economic clout in the field of finance depends on a range of other factors, including in particular the EU’s ability to pursue common negotiating objectives, a central issue in economic diplomacy.

In development policy, the EU — taken as a whole — accounts for 55 per cent of all official development aid. As noted above, member states still control much of this and coordination between the member state and EU levels, or vertical coherence, has not been very good.

In the case of international environment policy, economic power is important, but perhaps of less immediate importance than the substance of policy. In the sense that the EU links environmental policy objectives with market regulation, it can still wield economic power in the service of environmental policy objectives. The use of environmental standards in the EU, which require exporters to the EU to comply with EU standards, comes to mind. Equally, were the EU to


use some form of border-tax adjustment as a means of compensating for the loss of international competitiveness resulting from higher EU environmental norms, this could be seen as the use of economic power. The fact that the EU is also a major (although not the largest) emitter of greenhouse gases gives it a central role in climate change policy.

In other words, the EU has significant economic power. However, given the growth of other major economies, this economic power may be in relative decline. While the EU market remains considerably larger than those of the ‘emerging powers’ of China, India and Brazil, these markets are growing faster and have relatively higher levels of protection. These two factors combined provide the emerging markets with the potential to shift the relative balance of economic power in their favour.

**Recognition**

The literature on the EU as an actor in international relations places considerable importance on whether the EU is recognized as a *de facto* and/or *de jure* actor. *De facto* recognition of the EU as an actor may in many instances be little more than third countries recognizing that the EU is an important market. Whether it is the EU or the member states that are recognized is clearly important and will help in determining the scope for member states’ economic diplomacy. In the case of trade, there is one voice in the Commissioner for Trade (and Agriculture). In the case of international finance, however, the individual EU member states are recognized by third countries. This is the case in both the International Monetary Fund (IMF) and World Bank, where the EU member state governments have seats on the executive boards. National authorities are also recognized as key actors on issues such as financial market regulation. The European Central Bank is recognized in the field of monetary policy for the eurozone. In the IMF there is some *de facto* and *de jure* recognition of the EU, or at least the eurozone, for when there is an Article IV discussion of the euro in the IMF executive board, the European Central Bank and President of the Eurogroup represent the euro. Informal recognition comes from a degree of policy coordination on IMF issues through the SCIMF (the Sub-Committee of the EU’s Economic and Finance Committee on the IMF) and EUIMF in Washington. Formal recognition is less often the case for the EU, although the EU is a signatory to the World Trade Organization (WTO) alongside the EU member states and thus has legal personality on issues relating to the WTO.

Recognition by third parties clearly depends on the EU’s legal competence under the treaties. If the individual EU member states are competent or there is mixed competence, third parties will still seek out national governments as negotiators. If there is exclusive competence for the EU, third countries may lobby national governments, as the EU is not a unitary actor, but they will have little choice but to negotiate with the EU representative.
The EU has long been recognized as an actor in international trade. Exclusive competence and the well-developed *acquis communautaire* in policy areas that relate to trade have also ensured vertical coherence in the field. In finance, the EU is recognized as an actor in some areas, but not others. The EU is increasingly recognized as an actor in financial market regulation, at least in terms of setting regulatory standards. But national competence for the supervision of compliance with regulatory standards has meant that national bodies have continued to be recognized. In the field of development policy, the EU suffers from a lack of coherence. Despite efforts in recent years to find a division of labour between the EU and member states’ development policies, coordination could still be better. Thus, while the EU has a presence as the largest aid donor, this is not matched by recognition. In the environmental policy area, such as in climate change policy, the EU has gained *de facto* recognition thanks not to its exclusive competence for external environmental policy, but to moves on the part of the EU to develop common ‘domestic’ approaches and policies.

**The EC as a Normative Power**

Much has been written about the EU as a normative power in international relations. To be a normative power, the EU should ideally have a distinctive set of norms or values. If the EU’s norms are broadly the same as those of other major actors or are derived from agreed international norms, then the EU could be seen more as part of a system of multi-level international economic governance. If the EU is serious about projecting normative power, however, this will only be effective if individual EU member states support the common norms and thus desist from solo policies.

It is perhaps helpful to differentiate among different types of norms, broad norms, what we will call framework norms and more specific standards or codes. In terms of broad norms the EU supports such values as human rights, democracy and the rule of law. Indeed, these values are set down as guiding principles for external action in the EU treaties, but they are clearly not exclusive to the EU. Compliance with such broad norms constrains EU member states’ commercial diplomacy, in the sense that they should not put commercial interests before human rights, something that one hopes no EU member state would do any more. One area in which the EU can lay claim to possessing the attribute of a distinctive norm is in its promotion of economic integration as a post- (or neo-) Westphalian model of international relations that is not based on the nation-state. More specifically in the field of economic diplomacy, the EU has promoted regional integration agreements in other regions. This has been done by linking access to the EU market to progress in regional integration in Latin America,

Africa or Asia. But these region-to-region agreements have not been an obvious success; indeed, an alternative bilateral approach that reflects US norms appears to be in the ascendance.

The EU could be said to have distinctive EU norms in one sense. This is with regard to the balance between markets and regulation. Framework norms are defined here as those that determine the underlying approach to market regulation or the relationship between authority and the market. One example of a framework norm was the broad consensus reached among major EU member states that provided the basis for the single European market (SEM) in the 1980s. For the sake of simplification, this was a compromise between the Anglo-Saxon *laissez-faire* policies that were embodied in the deregulatory and liberal paradigm of the 1980s on the one hand, and French *dirigisme* on the other. The compromise that was reached was something closer to the German *Ordnungspolitik*, in which free markets operate within a framework of rules that are designed to ensure that key social, environmental, competition and prudential policy objectives are satisfied. Agreement on such a framework norm facilitated the extension of the *acquis communautaire* in goods markets during the 1980s and early 1990s. This internal consensus also enabled the EU to play a far more proactive role in multilateral trade negotiations in the Uruguay Round of the GATT during the 1980s and 1990s. Other examples of framework norms would be the consensus that has been achieved over the past couple of decades on environmental policy and, in particular, on the target of low carbon growth or ecological growth. Framework norms in the field of the environment have thus enabled the EU to pursue proactive environmental diplomacy. The impact of the absence of consensus on framework norms can be seen in the financial sector, where differences between (again, a simplification) Anglo-Saxon views on financial markets and continental views delayed the establishment of a genuine single financial market and denied the EU of normative power in international negotiations on financial market regulation.

Specific norms or standards are defined as those that are codified in EU legislation or regulations and other decisions that form the *acquis communautaire*. In economic diplomacy, the EU may use such specific norms as the basis for common positions. It is possible in this way to make operational normative power and to assess the degree to which the EU is successful in persuading or coercing its negotiating partners to adopt EU regulatory standards. The same holds, of course, for framework and general norms, although the more that general norms are used, the harder it is to assess the degree of normative power.

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The single market programme codified many common (specific norms) that relate to trade in goods, such as common rules on trade instruments, technical regulations, rules on competition and government procurement, and to a lesser degree those relating to trade in services and investment. The SEM provides the domestic basis for much of EU external trade policy. These ‘domestic’ rules can then be seen as constituting normative power. A deeper look at the *acquis communautaire* shows, however, that much of it applies norms and standards that have been developed through international dialogue in bodies such as the OECD. A question thus remains as to the degree to which the EU’s *acquis* is distinctive.\(^{17}\)

In the field of international financial markets, the EU appears to have followed international standards rather than having led the way in shaping them. Standards have generally been adopted by national regulators before the EU as a whole has agreed on a common interpretation of the international standard or norm. In other words, the EU’s *acquis* has lagged behind the development of international norms and standards instead of leading it. Although the EU thus has the potential to exert normative power by virtue of the size of its capital markets, it has failed to do so.

In the field of international environmental policy, the EU exhibits more normative power, because it has led the way in adopting measures to counter climate change. As in the case of other policy areas, the EU’s norms in the field of the environment emulate — to an important degree — norms developed elsewhere, but the EU has developed these ideas and carried them forward. Generally speaking, the *acquis* in environmental policy is well developed and based on a consensus of framework norms relating to ecological development (that is, economic growth that is based on environmentally sustainable technological development) that was reached during the 1990s. This general consensus, as well as the developed nature of the *acquis*, has given the EU normative power in the field of the environment.

**EU Member States’ Interests**

The interests of individual EU member states will clearly shape EU economic diplomacy. From an analytical point of view, difficulties exist because member states’ interests will vary along with sectoral interests. It is therefore helpful to differentiate between general member state interests, such as retaining national competence over key areas such as fiscal policy or aspects of energy policy, and the more specific interests in the policy area under discussion. These specific interests are likely to be concerned with the division of any costs and benefits of various

EU policy options among member states. Otherwise heterogeneous member state interests may also be aggregated in the *acquis communautaire* so that greater integration, and thus agreement on framework and more specific EU norms, will tend to mean more homogeneous preferences in external policies that are based on the common *acquis*.

Of the general EU member state interests, retaining national competence in certain sensitive areas is likely to apply to many, if not all, member states. For example, a strong link to foreign policy interests in any policy area will tend to mean a more pronounced desire of member states to retain control. EU development policy provides an example of this. Member states retain development policies that run parallel to those of the EU, in part because they see development aid as a key instrument in their foreign policy *vis-à-vis* developing economies. Compared to trade and environment policies, where foreign policy issues are more remote, there has thus been less coordination and convergence in EU development policy. Fiscal policy is another sensitive area, so any linkage between EU economic diplomacy and tax or fiscal policy will lead to member state resistance to developing common EU positions in external policies. In climate change, efforts to support climate change policy with carbon taxes or the clean development mechanism have been impossible or difficult to agree upon for this reason. In financial regulation, stronger EU-level supervision of pan-EU banking and other financial institutions has been constrained by lack of agreement on *ex ante* financial burden-sharing among EU member state governments for bailouts of any failing bank or other financial institution.¹⁸

Member state interests will also play a role in the sense that the governments’ political utility functions may lead individual governments to promote or block decisions on EU economic diplomacy for reasons that are unrelated to the specific policy concerned. Governments can block decisions for electoral reasons, as was the case in agricultural trade during the final stages of the Uruguay Round negotiations of the GATT. More recently, the British government blocked discussion of EU regulation of hedge funds until after the May 2010 UK general election.

*Sectoral Interests*

Rationalist approaches to economic diplomacy see sectoral interests and the linkage between different policy issues as a key independent variable. Negotiations are seen as involving linkages between issues in value-claiming or value-creating strategies. Sectoral interests can indeed go a long way to explaining the positions of the EU member states in any given negotiation. In some cases there will be a trade-off between the interests of different sectors in a negotiation, such as between

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agricultural and manufacturing interests in the Doha Development Agenda (DDA) trade negotiations. In other cases the costs or benefits of a policy may be more dispersed. In environmental policy, for example, the costs of measures to tackle climate change are fairly concentrated, while the benefits are widely dispersed. The same holds for financial regulation. Such sectoral interests will therefore be important independent variables in specific negotiations.

As in the case of member states’ interests, the level of development of the acquis is important. Generally speaking, the more heterogeneous that sectoral interests are, the more difficult it will be to agree on EU preferences and thus the less efficient EU economic diplomacy, but if there is a well-developed acquis that establishes an agreed internal policy, this will often provide the basis for the EU’s external policies.

**Decision-Making Capability**

It has been argued that cohesion in international negotiations depends on established institutional rules of the game.\(^{19}\) In the case of the EU, the institutional framework is important. While there is formally qualified majority voting on some issues and unanimity on others, most decisions in the Council and its working groups are taken by consensus. When qualified majority voting is a legal possibility, however, member state governments will be under more pressure to reconcile differences more quickly. Shadow voting may take place, in which European Commission proposals go through if the number of member state representatives speaking in favour is enough to gain a qualified majority were there to be a vote.

External institutional structures can also shape EU policy.\(^{20}\) Where the existing representation of EU member states is hierarchical, common policies could be said to be less likely than when there is a greater balance in representation. For example, member states with permanent seats on the IMF’s executive board are unlikely to see obvious benefits in developing common EU positions. The scope for functional integration of any policy issue may also be a factor. EU member states may be willing to cooperate on a fairly narrow topic, but be reluctant to do so when, because of policy linkages, integration could spill over into other areas that are more sensitive for national sovereignty. This may help to explain why EU cooperation in international financial policy has not progressed, as some EU member state governments see fiscal sovereignty as a red line not to be crossed.

The autonomy of the EU negotiator is also a factor. Greater autonomy means greater flexibility and thus a greater capability to conclude agreements. Limited

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19) Jupille and Caporaso, 'States, Agency and Rules'.
autonomy means tight control by the individual EU member states and a greater potential for gridlock when the EU negotiator must continually seek authority from the Council. Three broad options exist for principle-agent relations in the EU that determine autonomy: full delegation to supranational agents in the case of monetary policy (in the eurozone) and competition; supervised delegation in the case of trade and environment policy; and coordination in the case of financial policy and development policy. EU trade policy has for many years functioned with a form of supervised delegation, so full delegation need not be an essential requirement for capability. EU international environmental policy also functions well with supervised delegation, sometimes to the European Commission and sometimes to the Council. Perhaps more important than the form of autonomy, however, is how well established the EU decision-making regime is. Long-established practices and procedures are likely to facilitate capability, because of shared expectations about the way in which decisions are taken. Where decision-making procedures are not well established, differences over procedures can weaken capability.

In the field of trade, decision-making procedures have evolved over half a century. A significant socialization process has been seen within the Trade Policy Committee (ex Art 133 Committee), where the established practice is for discussions to continue until a common position can be found that is acceptable to all. In the external dimension of decision-making, no member state has a privileged position over the others in trade, with all being equal-status members of the WTO. The scope of trade policy has broadened to include new topics and this has created tensions, but it has occurred progressively over decades and has not threatened member states’ core competences.

In the case of financial market regulation, the EU regime is less established. The decision-making and advisory functions for financial markets underwent reform in the 2000s with the Lamfalussy Process, but the global financial crisis came at a time when these reforms were still being implemented. In response to the crisis, efforts have been made to strengthen the EU-level regulatory framework, but it remains to be seen whether this determination outlives the crisis. Qualified majority voting exists for EU financial market regulation, but external institutions have a clear hierarchy among the member states in bodies such as the IMF, Financial Stability Board, the G20 and specialist bodies such as the Basel Committee on Banking Supervision (BCBS). Furthermore, an effective EU policy

22) B. Kerremans, ‘What Went Wrong in Cancun? A Principal Agent View on the EU’s Rationale towards the DDA’, European Foreign Affairs, no. 9, 2005, pp. 363-393.
23) Developed in 2001, the Lamfalussy Process is an approach to developing EU regulations for the financial service industry. It consists of four levels that focus on specific stages of the implementation of regulatory legislation within the EU.
on international finance requires action in a number of interlinked policy areas, including financial market regulation, corporate governance and fiscal policy, which threatens member states' core competence in fiscal policy.

The EU’s decision-making regime for international environmental policy has been established since perhaps the 1980s, so not as long as for trade. Choices of who negotiates for the EU have been based on pragmatism, with the EU represented by a troika of the Presidency, former presidency of the Council and the Commission. Negotiating positions are often shaped by experts from specialist Council working groups such as the IIE (International Issues in the Environment) Group, and it is also not uncommon for lead negotiators to be nominated from such working groups based on their expertise rather than their nationality or institutional (Commission or Council) origins.

EU member state representation in international environmental organizations is not hierarchical, although some environmental issues require coordinated policy responses across a range of policy areas (for example, environmental policy, energy, transport and international markets). Many of these policy areas have a well-established *acquis*, so only topics such as energy policy have difficulties in ensuring coherence.

**Coherence**

It is often argued that the EU needs more coherent external policies if it is to have influence in international affairs. Coherence can take a number of forms. There is vertical coherence between EU policies and those of the individual member states, and horizontal coherence between policies at the EU level. Vertical coherence has much to do, of course, with competence and has been discussed above. At a minimum, the avoidance of clear cases of (horizontal) incoherence is necessary if EU economic diplomacy is to be seen as credible. Much of the debate about coherence has centred on the EU’s Common Foreign and Security Policy, but debate has also been growing in other policy fields, in particular in the field of development policy, where considerable efforts have been put into promoting PCD (policy coordination for development).

While coherence is an important goal, efforts to ensure coherence can complicate policy-making, requiring, for example, extensive inter-service/inter-departmental consultation and coordination. Such complications can then increase the friction or inertia of EU policy-making, so that the EU becomes more of a slow-moving elephant than it perhaps already is. The issue of coherence is likely to assume a more central role following the ratification of the Treaty of Lisbon, which places much EU economic diplomacy together with EU foreign policy.

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Conclusions

It has not been possible in this short article to cover in detail all of the factors that shape EU economic diplomacy, as they vary from case to case. The article’s aim has been to provide an overview of how different factors vary across some of the main policy areas in which the EU conducts, or seeks to conduct, economic diplomacy. Table 1 summarizes these.

Table 1: How Factors Vary across Some of the Main Policy Areas in which the EU Conducts or Seeks to Conduct Economic Diplomacy

<table>
<thead>
<tr>
<th></th>
<th>Trade</th>
<th>Finance</th>
<th>Development</th>
<th>Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>External drivers</strong></td>
<td>Steady pressure over long periods</td>
<td>Intermittent with crisis</td>
<td>Relatively low except in near neighbourhood</td>
<td>Steady increase in pressure because of global externalities</td>
</tr>
<tr>
<td><strong>Economic power</strong></td>
<td>Significant; largest single market but relative decline in last decade</td>
<td>Significant; one-third of global capital market</td>
<td>High; provides 55% of official development assistance and largest market access for developing countries’ exports</td>
<td>Market power, potential funder but smaller emitter than United States or China</td>
</tr>
<tr>
<td><strong>Recognition</strong></td>
<td>High and longstanding</td>
<td>Limited as member states have major role</td>
<td>Mixed; member states provide more funds, but EC determines market access</td>
<td>High, established in last decade</td>
</tr>
<tr>
<td><strong>Normative power</strong></td>
<td>Fairly significant based on acquis but only partially distinctive</td>
<td>Limited, EC has generally followed international norms</td>
<td>Limited, only general norm of regional integration is distinctive</td>
<td>Relatively significant given absence of US leadership, based on domestic policy</td>
</tr>
<tr>
<td><strong>Member state sensitivity to core sovereignty issues</strong></td>
<td>Limited impact</td>
<td>Significant, because of complex link to foreign policy</td>
<td>Significant because of link to foreign policy</td>
<td>Limited impact except when linked to fiscal policy</td>
</tr>
<tr>
<td><strong>Capabilities</strong></td>
<td>Well established, tried and tested</td>
<td>Weak until very recently</td>
<td>Weak because of repeated changes</td>
<td>Established over last 15 years</td>
</tr>
<tr>
<td><strong>Coherence</strong></td>
<td>Trade relatively independent of other policy areas</td>
<td>Issues of coherence within finance</td>
<td>Coherence is central to effective policy but elusive</td>
<td>Some independence but affected by energy and trade</td>
</tr>
</tbody>
</table>
The preceding discussion allows a number of broad hypotheses to be formulated. These will need to be assessed in specific negotiations, in which sectoral and EU member state interests can be taken on board, in order to assess whether the hypotheses are useful in explaining outcomes. First, common policies are more likely when the EU is challenged to negotiate more or less continuously over long periods of time. Second, the EU does indeed have economic power, but this is in relative decline and may not be enough to obviate the need to persuade others of the merits of its policies or the need to form coalitions with other major economies. Third, exclusive competence is not an essential condition for the EU to be recognized as a leading actor. Fourth, EU normative power is most likely to be present when there is agreement on framework norms. Fifth, the degree to which EU decision-making procedures are established, and tried and tested, is as important as competence or voting rules. Finally, there is the question of (horizontal) policy coherence. This is particularly relevant for the future of EU economic diplomacy in a number of fields, as the Treaty of Lisbon brings trade, environment and development under a single external-action heading with EU foreign policy, within the institutional framework of the External Action Service (EAS). The hypothesis here is that EU economic diplomacy will be relatively ineffective if it depends on a high degree of policy coherence.

To conclude, the scope for individual EU member state commercial policy remains, but has become more constrained because of the extension of de facto and de jure EU competence, such as the extension to foreign direct investment with the Lisbon Treaty. Greater recognition for the EU as an actor, in both economic diplomacy and foreign policy, will also mean less scope for the kind of implicit links between member states’ diplomacy and commercial interests that have been used in national commercial strategies.

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The Economic Effectiveness of Diplomatic Representation: An Economic Analysis of its Contribution to Bilateral Trade

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Summary
This article empirically investigates the contribution of different forms of diplomatic representation to the bilateral trade flows (both exports and imports) of a group of 63 countries. The authors report on the construction of a data set that covers 10,524 diplomatic representations. They use these representations as one of the explanatory variables in an applied trade model (the gravity model) for 3,730 bilateral trade flows in order to measure to what extent these representations are economically effective, in the sense that they are associated with larger trade flows. The authors distinguish different forms of international representation in the field of economic diplomacy (such as honorary and career consulates, embassies and embassy branches, and trade and other offices) and find positive and highly significant effects for embassies but mixed results for the other forms of representation. Finally, the authors provide a comparative perspective on the effectiveness of the 63 countries’ foreign services and classify the countries according to the average performance of their network of foreign representations.

Keywords
economic diplomacy, effectiveness, gravity model, trade promotion, consulates, embassies

Introduction
Diplomats and workers at embassies and consulates fulfil different tasks and functions, including decision-making, information-gathering, international representation, and support to domestic firms in entering foreign markets. The promotion of trade with, and investments in, foreign countries is increasingly seen as an essential task of diplomats, embassies and consulates. Some claim that this reflects

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a new trend of diplomacy that is commonly referred to as ‘economic diplomacy’. More generally, however, economic diplomacy can be defined as the use of international political tools — diplomacy — to achieve economic objectives and as such has existed ever since ancient civilizations have engaged in commerce and trade.

In an attempt to move the field from basic narratives and conceptual levels to more empirical studies, this article follows an interdisciplinary approach using relevant elements from economic science and econometrics (the applied gravity model of international trade) and political science methods (the policy analysis on international representation) in order to determine the effectiveness of countries’ international representations. The article focuses on the empirical question of whether diplomatic representation is economically effective, in the sense that representation is statistically associated with trade volumes. The article also considers the questions of which types of diplomatic representation are most effective and which countries deploy these economic diplomatic instruments most effectively across the globe. In answering the latter question, the (sub-)optimality of the geographical pattern of a country’s diplomatic representation is analysed. The article focuses on a specific, narrowly defined aspect of the international diplomatic network of nations and its relationship to the economic diplomacy of international trade, because it is measurable and therefore a practical means to operationalize the broad concept of economic diplomacy. It is important to note from the outset that the results cannot be generalized outside of this domain (which is also relevant in the context of this special issue of The Hague Journal of Diplomacy, since ‘economic diplomacy’ is a very broad concept) and that the authors were unable to differentiate economic representation with respect to, for example, the number and type of activities or the quantity and quality of staff. All such factors are by implication subsumed in the assessment of effectiveness, which basically boils down to the question of whether foreign representations are a statistically significant explanatory variable in international trade.

Economists basically see economic diplomacy as a type of government intervention in international markets. The analysis of why and how a government intervenes in markets is a well-established field of study within public economics. The two key requirements for any government intervention are that the benefits must outweigh the costs of intervention, and that the intervention is targeted as

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closely as possible on the source of inefficiency. This is a difficult and abstract task, since it requires quantifying all the necessary costs and benefits of economic diplomacy.

A first attempt to assess these costs and benefits is a Dutch study looking at a range of financial trade-policy instruments and state visits. For state visits, the study concludes that the net present value (as a simple economic summary measure for the contribution to Dutch welfare) is around €100-200 million. This net present value is likely to be a conservative estimate, since the trade effects of state visits are taken from the bottom range of what we know from the empirical literature, the time horizon that is used is short, and the distortional effects of the taxation that is required to finance the visits are taken into account. The upshot is that economic diplomacy has important benefits for an economy, but since this cost-benefit analysis only deals with the Netherlands, it lacks a comparative perspective on the effectiveness of Dutch economic diplomacy. This leaves important questions unanswered regarding, for example, the extent to which Dutch economic diplomats could have been more effective.

Importantly, while an overall evaluation of the costs and benefits of state visits is the ultimate goal of a properly conducted policy evaluation exercise, there is still substantial empirical uncertainty on the actual trade effects of diplomacy in the first place. This article therefore investigates whether a basic prerequisite for a positive cost-benefit result is fulfilled — namely whether exports and imports are systematically, significantly and positively associated with diplomatic representation abroad. In order to do so, the null hypothesis that foreign representations do not contribute to trade was tested. Since many factors influence trade, other relevant variables were used as controls, such as income, production and population of the trading partners, as well as distance, bilateral trade agreements and other trade-stimulating factors such as common borders and languages.

This article empirically isolates the contribution of diplomatic representation to bilateral trade as an indirect assessment of the extent to which these representations are economically effective. This is undertaken for the different forms of international representation in the field of economic diplomacy and for each foreign service, comparing their impact on trade to the impact of other countries.

The following two sections discuss the motivation and methodology more elaborately, describe the different forms of representation and provide some key statistics regarding the sample of 10,524 economic diplomatic representations. The article then discusses the research strategy and reports on the key findings of

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the empirical analysis with regard to the impact of these representations on 3,730 bilateral trade flows. The econometric details of this study that are provided elsewhere will not be discussed, but rather the article will focus on those empirical results that shed a direct light on the economic effectiveness of foreign representations. The article’s final section draws analytical conclusions, discusses the policy relevance of the findings and offers some suggestions for further research.

Motivation and Methodology

In order to shed light on this article’s main research question, the gravity model is used as the workhorse for analysis. The gravity model is an applied empirical trade model that aims to explain variation in bilateral trade flows. Following the analogy with Newton’s law of gravity, the key drivers in this model that are used to explain variation in the intensity of interaction between two ‘bodies’ (namely, countries) are economic mass and distance. Interaction between countries is assumed to be weaker if distance is larger, and stronger when masses are larger. In other words, a large country with a high GDP and a large population will — ceteris paribus — trade more than a small country. Likewise, countries that are closer to each other trade more. Both regarding mass and distance, a wide variety of proxy variables exists that has been used in practical applications. This reflects the multi-dimensionality of mass and distance that becomes relevant when applying Newton’s model to economic issues. Regarding distance, one can think, for example, about factors such as cultural distance, institutional distance, tariffs and language dissimilarities, etc. Those factors act as trade-resistance factors and thus impede interaction. Trade-enhancing factors can also be distinguished, such as preferential and/or free-trade agreements, a common border, language and/or

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currency, and historical ties (such as in the case of a former colonial relationship). Clearly, such factors are also relevant for foreign direct investments (FDI) and the policy attempts to foster them.9

The analysis in this article is particularly relevant given the huge changes in trade patterns that have been witnessed during the last decade. The increasing trade with (formerly) communist countries such as China and the former Soviet Union poses specific challenges to firms that are planning to enter foreign markets, either by exporting goods, importing intermediates, or by setting up a foreign affiliate. Cultural and institutional differences can pose huge obstacles and the rules of the game can also differ substantially. Government support — if only indirectly — is seen in many cultures as an important signal of the trustworthiness of Western partners. This may require much more active roles from Western governments in facilitating trade and FDI than what these countries were used to until the end of the twentieth century, when most efforts were (rather successfully) targeted at reducing tariffs in the context of the WTO. In this view, economic diplomacy has become more important than ever.

One problem with many analyses of economic diplomacy is that the definition of the subject is too broad and often fuzzy. Two examples are: the Institute for Trade and Commercial Diplomacy, which defines commercial diplomacy as ‘diplomacy with a commercial twist — diplomacy designed to influence foreign government policy and regulatory decisions that affect global trade and investment’; and Bayne and Woolcock, who point out that ‘economic diplomacy is concerned with international economic issues’.10 More helpful is the definition by Lee and Hudson, who focus on the people involved:

\[\text{[. . .]}\] the work of public officials from foreign ministries and overseas missions and officials from other government departments such as Trade/Commerce as well as private economic actors in support of the business and finance sectors of the economy’.11

Saner and Yiu add concrete tasks such as supplying information about export and investment opportunities and organizing and helping to act as hosts to trade missions from home, as well as being advisers to foreign home companies on economic decisions such as investment plans.12

This article builds on these definitions in order to arrive at a concrete and precise description of the subject. Economic diplomacy is seen as the work of private actors such as (hybrid) trade and support offices, as well as public governmental agencies and departments such as embassies, consulates, ministries of foreign

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12) Saner and Yiu, *Commercial Diplomacy and International Business*. 
affairs and ministries of economic affairs, trade and/or commerce, in supporting
domestic businesses and companies abroad in foreign markets. Economic diplo-
mats assist companies in various ways and may deal with a variety of different
complex international issues, but usually mainly fulfil the following tasks by
exerting political influence:

- Trade promotion (including export and import promotion), as well as the
  promotion of transnational investments (inward and outward);
- Information-gathering and -supplying and advisory tasks;
- Securing property rights;
- Influencing foreign national policy-making in order to further the interests
  of (international) domestic companies.

This summary captures the essence of economic diplomacy and the article will
focus in particular on trade promotion. An empirical problem is that ‘exerting
political influence’ cannot be observed directly and therefore the article will
deal with the loci from which political influence would typically be exercised. To put
it bluntly: if there are no economic diplomats in a country, the exerted influence
is typically zero. Foreign representation is therefore used as the key variable of
interest in this article.

Different Representations for Different Purposes

It is important to consider the different forms of diplomatic representation. The
two most important international formal agreements between nation states that
 stipulate exactly how states can choose to represent themselves in other countries
are: the Vienna Convention on Diplomatic Relations (the international legal frame-
work for embassies, defining diplomatic terms such as ‘head of missions’ or ‘head
of states’ and their functions, codes of conduct, working conditions, legal aspects,
and immunities and privileges), which was signed as a treaty in 1961; and the
Vienna Convention on Consular Relations, which was signed in 1963, provides the
international legal framework for consulates and defines two different types of
consular representation, thus pointing out a potentially important omission in
the economic literature, for example regarding the role of honorary consuls.
Whereas most economic analyses of economic diplomacy follow the approach
introduced by Rose13 and only take into account embassies and career consulates,
the Vienna Convention on Consular Relations clarifies that consular functions con-
sist, among other things, of:

13) A. Rose, ‘The Foreign Service and Foreign Trade: Embassies as Export Promotion’, World Economy,
A relevant issue that has largely been neglected in the recent empirical literature on the impact of foreign representations on trade, tourism and foreign investment is the way in which economic diplomatic representation should be measured. Rose’s seminal study in the field turned diplomatic activity into a quantitative measure, building on three assumptions (that have been followed in most of the subsequent literature):  

- **One embassy and one consulate in the same city is equal to one foreign mission.** At face value this may look like a reasonable assumption, since it would be inefficient on the part of the sending country if both diplomatic representations in the same city fulfilled the same tasks (economic or consular/political affairs). However, it is equally possible that both diplomatic representations in the same city assist and complement each other. There is no overruling reason a priori to treat the number of diplomatic representations in the way that Rose did in his seminal paper. For this reason, in the present analysis, the embassies and consulates that are situated in the same city are not coded as one foreign mission, but are counted as two separate missions.  

- **All foreign missions are equally effective (in promoting trade).** This assumption is quite essential. As Rose states (his emphasis):  

$$\ldots$$ it is only possible to identify the exact number of individuals in a given embassy/consulate that are actively engaged in export promotion for a small number of countries. Since there is no easy way to measure the importance of different foreign missions, I am forced to treat them all as equal.  

Although it is possible to identify these numbers for some countries, it is a very costly and time-consuming exercise, especially when many countries are included in the study, as is the case in this article. Therefore, this article sticks to counting representations for the sake of practical feasibility.  

- **Other (types of) foreign representations are ‘unimportant’.** The available studies only include embassies and career consulates, thus ignoring other forms of diplomatic representations such as honorary consulates, vice-consulates, 

\[\text{Vienna Convention on Consular Relations}, \text{ Article 5 on ‘Consular Functions’, p. 4.}\]

\[\text{The only exception of which we are aware is E.R. Afman and M. Maurel, ‘Diplomatic Relations and Trade Reorientation in Transition Countries’, in P.A.G. van Bergeijk and S. Brakman (eds.), } \text{The Gravity Model in International Trade: Advances and Applications (Cambridge: Cambridge University Press, 2010), pp. 278–295.}\]

\[\text{Rose, ‘The Foreign Service and Foreign Trade’. Note, however, that Rose provides a test for differences between embassies and consulates (on p. 34).}\]

\[\text{The alternative is to limit the number of countries, particularly to those countries for which information is readily available. However, that research strategy carries a clear cost since it will bias the results.}\]
consular agencies and so on. This assumption is a particularly limiting assumption and in a formal sense this article provides an empirical test of the assumption since it will estimate the impact of each of the different types of foreign representation, providing both an indication of the size and the statistical significance. Fortunately, it is possible — although quite laborious — to make a distinction between the different types of diplomatic representations. The remainder of this section will elaborate on the way in which the different types of representation have been classified.

Apart from the embassies that do not come in different ‘types’, there are two main types of consular representations: career consulates; and honorary consulates. The main difference between these two types is that career consuls are paid (national) foreign servants or officers that serve abroad their home country in the (foreign) receiving country, whereas honorary consuls do the work ‘for the honour’, hence the term ‘honorary’. Honorary consuls receive a small reimbursement for the responsibilities that they fulfil; they do not perform their tasks to earn a living, as the career consuls do, but rather fulfil their consular functions alongside their daily work. An honorary consul could be a national of the sending country residing in the receiving country, but also a regular business person of a foreign nationality who is willing to fulfil the consular functions. These different types of representation and their impact on trade relationships have not so far been studied. This article therefore investigates whether honorary consuls are as effective in promoting trade as career consuls, especially since honorary consuls do not retain any political/diplomatic status as the career consuls do.

Furthermore, ‘less diplomatic’ offices can be discerned. Examples are trade offices, embassy branches and other representative offices that may also operate on the same level as the foreign representations that are mentioned above. Permanent representations are not included in this analysis, because these entities do not focus on bilateral trade flows, but rather are active in international organizations and are thus concerned with multilateral relations. The permanent representations of many countries are found in the United States, France and Switzerland, where the most important international organizations are situated (such as the United Nations (UN), the International Monetary Fund (IMF), the World Bank, the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO)). European Union (EU) countries have permanent missions in Belgium.

To construct the database and gather information on foreign representations, an obvious source to consult was www.embassypages.com, but a random triangulation with a selection of websites of ministries of foreign affairs revealed that the embassy pages website was reporting with considerable and differing country-specific delays, so the information did not provide a good description of the status quo at the required moment. More importantly, this source did not provide an
adequately separated classification of career and honorary consulates. Therefore, an alternative strategy was followed and we created our own data set. For each of the 63 countries in the sample, websites of the ministries of foreign affairs were consulted in order to gain an overview of diplomatic representations in the other 62 countries. This was not always an easy process, especially not for those countries whose websites are not available in English.

Since there is *de facto* no difference between each of the four different forms of consular representations within each type (career and honorary) except for their ranking, it is sensible to consider only the difference between career consulates and honorary consulates. Hence, the foreign missions of all 63 countries were categorized into six different groups:

- Embassies;
- Career consulates;
- Honorary consulates;
- Trade offices;
- Embassy branches;
- Other representative offices.

When refining the data, it was noticed that some of the vice-consulates and consular agencies were not specified as either career or honorary, making it hard to classify them. (The problem being that the proper classification could simply not be understood or identified from the websites of the ministry of foreign affairs in question.) We chose to classify these vice-consulates and consular agencies as honorary consulates, since vice-consulates and consular agencies usually tend to be honorary. Moreover, these unspecified vice-consulates and consular agencies only constitute 5 per cent of the total representations, implying that adding these representations to the group of honorary consulates is unlikely to affect the results seriously. A sensitivity analysis on the coding was not performed *per se*, but readers should note that Yakop and Van Bergeijk provide a replication of Rose and thus offer an indication that the general findings are robust with respect to the differences in coding.18 Table 1 summarizes a breakdown of the 10,524 foreign representations that we investigate in this article.

Table 2 provides some indication of the variation of bilateral economic diplomatic representation. On average, a country has 1.29 foreign missions in another country, but that average hides substantial heterogeneity, since the minimum is 0 and the maximum number of foreign representations can be as large as 46 (the high number most of the time occurring in the United States, where economic

---

Table 1. Number of Diplomatic Representations (63 Countries, 2005)

<table>
<thead>
<tr>
<th>Representations</th>
<th>Absolute numbers</th>
<th>As % of grand total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embassies</td>
<td>3,103</td>
<td>29.5%</td>
</tr>
<tr>
<td>Career consulates</td>
<td>1,923</td>
<td>18.3%</td>
</tr>
<tr>
<td><strong>Total career diplomats</strong></td>
<td><strong>5,026</strong></td>
<td><strong>47.8%</strong></td>
</tr>
<tr>
<td>Honorary consulates</td>
<td>4,860</td>
<td>46.2%</td>
</tr>
<tr>
<td>Vice-consulates, unspecified</td>
<td>333</td>
<td>3.2%</td>
</tr>
<tr>
<td>Consular agencies, unspecified</td>
<td>210</td>
<td>2.0%</td>
</tr>
<tr>
<td><strong>Total non-career consulates</strong></td>
<td><strong>5,403</strong></td>
<td><strong>51.3%</strong></td>
</tr>
<tr>
<td>Embassy branches</td>
<td>58</td>
<td>0.6%</td>
</tr>
<tr>
<td>Trade offices</td>
<td>35</td>
<td>0.3%</td>
</tr>
<tr>
<td>Other representative offices</td>
<td>2</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Total non-diplomats</strong></td>
<td><strong>95</strong></td>
<td><strong>0.9%</strong></td>
</tr>
<tr>
<td><strong>Grand total</strong></td>
<td><strong>10,524</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

Table 2. Descriptive Statistics of Foreign Representation per Country (Country Pairs, 63 Countries, 2005)

<table>
<thead>
<tr>
<th>Representation</th>
<th>Mean</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of foreign missions</td>
<td>1.29</td>
<td>46</td>
</tr>
<tr>
<td>Honorary consulates</td>
<td>1.38</td>
<td>58</td>
</tr>
<tr>
<td>Trade offices</td>
<td>0.01</td>
<td>6</td>
</tr>
<tr>
<td>Embassy branches</td>
<td>0.01</td>
<td>10</td>
</tr>
<tr>
<td>Representative offices</td>
<td>0.00</td>
<td>1</td>
</tr>
</tbody>
</table>

diplomatic representation has been organized by some countries at the level of individual states).

**Empirical Evidence**

This section describes the results of an empirical study identifying the impact of different types of foreign representation on international trade. The focus is on interpreting the results in so far as they shed light on the effectiveness of foreign representation. For the full econometric details, see the two listed papers.19

Research Strategy

Our research question was to find out whether foreign missions have a beneficial impact on the intensity of trade between two countries or, in other words, whether there is a systematic association between economic diplomatic representation and the level of bilateral trade. Moreover, in the context of this article, it is important to ensure that causality runs from representation to trade enhancement. Representation could simply reflect that bilateral trade is important, implying a demand effect: if more trade issues exist, more diplomats will be needed to handle these issues. This issue was investigated extensively and interested readers are referred to the accompanying econometrically oriented papers. Two precautions should be pointed out: we collected the data for foreign representation in 2005 and used this as an explanatory variable for bilateral trade in 2006; also, and importantly, the choice between the different forms of representation would not seem to be influenced by trade volumes in any way. The comparison of their relative effectiveness is thus not compromised by any causality issue.

The bilateral component of the data on economic diplomatic representation, as discussed in the previous section (see Tables 1 and 2), was used as one of the explanatory variables in a gravity model that takes a number of more or less standard economic and non-economic factors into account in explaining the amount of observed trade between countries. More specifically, other economic variables — such as GDP, transportation costs, trade agreements, and non-economic factors such as common languages and specific characteristics of the geographical position of countries (for example, landlocked or island economies) — were used as controls, and thereby the added value of the different economic diplomatic representations was distilled. The gravity model is thus used as a tool and not as the goal of the analysis. The gravity model has been proved to be a useful workhorse model for such applications, which provides the ability to control in a sensible way for other determinants of trade and has always performed very well empirically speaking.

The equation to be estimated is:

\[
\ln(X_{ij}) = \beta_0 + \beta_1 \ln(D_{ij}) + \beta_2 \ln(Y_i) + \beta_3 \ln(Y_j) + \beta_4 \ln(\text{Pop}_i) + \beta_5 \ln(\text{Pop}_j) + \beta_6 \text{Lang}_{ij} + \beta_7 \text{Cont}_{ij} + \beta_8 \text{Land}_{ij} + \beta_9 \text{Island}_{ij} + \beta_{10} \ln(\text{Area} \_i \_j) + \beta_{11} \text{Col}_{ij} + \beta_{12} \text{CU}_{ij} + \beta_{13} \text{FTA}_{ij} + \gamma_1 \text{Emb}_{ij} + \gamma_2 \text{CarCon}_{ij} + \gamma_3 \text{HonCon}_{ij} + \gamma_4 \text{TradeOf}_{ij} + \gamma_5 \text{EmbBr}_{ij} + \gamma_6 \text{RepOf}_{ij} + \epsilon_{ij}
\]

Other models and methods have been used that combine economic theory and the theory of political science to examine empirically the effectiveness of diplomacy and politics with respect to economic goals such as trade expansion (see Van Bergeijk, *Economic Diplomacy and the Geography of International Trade*; and J.D. Morrow, R.M. Siverson and T.E. Tavares, ‘The Political Determinants of International Trade: The Major Powers, 1907-1990’, *American Political Science Review*, vol. 92, no. 3, 1998, pp. 649-661.)
where \( i \) denotes the exporter, \( j \) denotes the importer, and the relevant variables are as follows:

- \( X_{ij} \) is merchandise exports in dollars for the year 2006, from \( i \) to \( j \);
- \( Emb_{ij} \) is the number of embassies that \( i \) has in \( j \) for the year 2005;
- \( CarCon_{ij} \) is the number of career consulates that \( i \) has in \( j \) for the year 2005;
- \( HonCon_{ij} \) is the number of honorary consulates that \( i \) has in \( j \) for the year 2005;
- \( TradeOf_{ij} \) is the number of trade offices that \( i \) has in \( j \) for the year 2005;
- \( EmBra_{ij} \) is the number of embassy branches that \( i \) has in \( j \) for the year 2005;
- \( RepOf_{ij} \) is the number of representative offices that \( i \) has in \( j \) for the year 2005;
- \( D_{ij} \) is the geographical distance between \( i \) and \( j \);
- \( Y_{k} \) is GDP per capita in US dollars in 2006, for \( k = \{i, j\} \);
- \( Pop_{k} \) is population size (in millions of people in 2006), for \( k = \{i, j\} \);
- \( Area_{k} \) is the area of the country (in square kilometres) for \( k = \{i, j\} \);

and the following dummy variables are:

- \( Lang_{ij} \) is 1 if \( i \) and \( j \) have a common language, 0 otherwise;
- \( Cont_{ij} \) is 1 if \( i \) and \( j \) share a land border, 0 otherwise;
- \( Col_{ij} \) is 1 if \( i \) and \( j \) are colonies or ever shared a colonial relationship, 0 otherwise;
- \( CU_{ij} \) is 1 if \( i \) and \( j \) use the same currency, 0 otherwise;
- \( FTA_{ij} \) is 1 if \( i \) and \( j \) belong to the same regional trade agreement, 0 otherwise;
- \( Landl_{ij} \) is the number of landlocked countries in the country-pair: 0 if both \( i \) and \( j \) are not landlocked; 1 if either \( i \) or \( j \) is landlocked; and 2 if both \( i \) and \( j \) are landlocked;

and \( \varepsilon_{ij} \) is the error term with the standard properties.

It is important to note that we look at trade, rather than exports (which have received most attention in the literature so far). Explicit attention is thereby also paid to import facilitation, which is the mirror image of export promotion. Neglecting the impact of economic diplomacy on incoming flows of goods and services would simply be a waste of available evidence. To do so, the impact of both home and foreign representation on the observed trade flows was investigated. So exports from country A to country B can both be affected by the representation of country A in country B, as well as by the representation of country B in country A (where the impact of the former can be expected to be largest). Additionally, if import facilitation is found to be statistically significant, this can
be seen as circumstantial evidence in favour of the argument that economic diplomacy is a form of government intervention that fights international rather than national market failures. If import facilitation turns out to be statistically insignificant, this would suggest that market failures are only addressed to the extent that they distort the national costs and benefits rather than that outward economic diplomacy is more effective in fighting market failures than inward economic diplomacy.

**Empirical Findings**

Table 3 sheds light on the impact of the different forms of economic diplomatic representation and in particular their respective contribution to the stimulation of trade (namely, exports and imports).\(^{21}\) Note that column 1 in Table 3 investigates the impact of the representation of an exporting country in an importing country on the level of the exporting country’s export. Column 2 provides a mirror image, replacing the independent variable ‘number of foreign missions of \(i\) in \(j\)’ with the import-facilitating representations ‘number of foreign missions, \(j\) in \(i\)’. Column 3 analyses export promotion and import facilitation in combination.

Highly significant and larger coefficients were found for the impact of embassies on trade than has been reported so far in the literature, irrespective of the trade component considered. Indeed, in all three columns of Table 3 there are coefficients that are statistically significant at the 99 per cent significance level and that are in the range between 0.48 and 0.92. Table 3 also shows that the added value of other types of representations — with the exceptions of career consulates and embassy branches — are statistically insignificant and do not have the expected positive sign. There is a consistent and large difference between the effect of embassies and the effect of career consulates and embassy branches, which may represent the fact that countries typically only have one embassy in another country whereas they can have many more consulates. The coefficient estimates that were obtained for honorary consulates are either insignificant or significantly negative when considering their potential role as a facilitator of imports into their home country. The coefficients for trade offices and representative offices are statistically insignificant. In terms of the tested hypotheses, the null hypothesis (no impact) is refuted for embassies, career consulates and embassy branches with a 95 per cent confidence level and better, but we were unable to do so for other forms of representation. Regarding the measurement issues that were raised earlier, this implies that the measures that have so far been used in the literature miss a significant aspect, since they do not count embassy branches. Also, and relatively, the results show that embassies, career consulates and embassy branches are not equally effective and should thus not be aggregated into one indicator, as has so far been the common practice in the literature.

\(^{21}\) Table 3 basically reports the \(\gamma_i\) of equation 1.
Table 3. Effects of Types of Representation on Trade
(Dependent Variable is Exports from $i$ to $j$ in 2006, N=3730)

<table>
<thead>
<tr>
<th>Model</th>
<th>(1) Export facilitation</th>
<th>(2) Import facilitation</th>
<th>(3) Import and export facilitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embassies</td>
<td>0.92*** (0.09)</td>
<td>0.68*** (0.10)</td>
<td></td>
</tr>
<tr>
<td>Career consulates</td>
<td>0.06*** (0.02)</td>
<td>0.06*** (0.02)</td>
<td></td>
</tr>
<tr>
<td>Honorary consulates</td>
<td>0.01 (0.008)</td>
<td>0.01 (0.008)</td>
<td></td>
</tr>
<tr>
<td>Trade offices</td>
<td>-0.06 (0.15)</td>
<td>-0.05 (0.15)</td>
<td></td>
</tr>
<tr>
<td>Embassy branches</td>
<td>0.31** (0.15)</td>
<td>0.31** (0.15)</td>
<td></td>
</tr>
<tr>
<td>Representative offices</td>
<td>-1.23 (1.18)</td>
<td>-1.03 (1.18)</td>
<td></td>
</tr>
<tr>
<td>Embassies (of $j$ in $i$)</td>
<td>0.79*** (0.09)</td>
<td>0.48*** (0.10)</td>
<td></td>
</tr>
<tr>
<td>Career consulates (of $j$ in $i$)</td>
<td>0.03 (0.02)</td>
<td>0.02 (0.02)</td>
<td></td>
</tr>
<tr>
<td>Honorary consulates (of $j$ in $i$)</td>
<td>-0.02* (0.008)</td>
<td>-0.02* (0.008)</td>
<td></td>
</tr>
<tr>
<td>Trade offices (of $j$ in $i$)</td>
<td>0.08 (0.15)</td>
<td>0.12 (0.15)</td>
<td></td>
</tr>
<tr>
<td>Embassy branches (of $j$ in $i$)</td>
<td>0.05 (0.34)</td>
<td>0.09 (0.34)</td>
<td></td>
</tr>
<tr>
<td>Representative offices (of $j$ in $i$)</td>
<td>-1.57 (1.19)</td>
<td>-1.24 (1.18)</td>
<td></td>
</tr>
<tr>
<td>Goodness of fit ($R^2$)</td>
<td>0.68</td>
<td>0.68</td>
<td>0.69</td>
</tr>
</tbody>
</table>

Notes: ***, ** and * imply significance at 99, 95 and 90 per cent confidence levels, respectively. Standard errors are reported in parentheses. Included in the regression analyses but not reported in the table are the standard explanatory variables of the gravity model — such as GDP, distance, population, common language and border, membership of regional trade agreement, etc. — that were discussed in the main text.

In addition to the effectiveness of the economic diplomatic instruments, the geographical pattern of foreign economic diplomatic representations can be analysed in more detail and foreign services can also be benchmarked against the hypothetical ‘average country’. For this purpose, Fig. 1 reports two different parameters for each country.

First, Fig. 1 reports in black bars the coefficient estimates for economic diplomacy obtained from separate country regressions. These coefficients have thus been estimated in 63 regressions for each of the 63 countries. Each gravity equation describes the geographical trade pattern of a country and its 62 trade partners. These coefficients represent the impact of economic diplomacy on trade for an individual country. Second, Fig. 1 reports in white bars the country-specific
slopes that have been estimated for the whole sample, allowing a comparison against the hypothetical average benchmark country. The first set of coefficients addresses the question of whether a country’s foreign representation is positively (or negatively) associated with its exports to its 62 export markets. Essentially, this addresses their geographical pattern of foreign representations.\textsuperscript{22} A cautious

\textsuperscript{22} Because of the relatively small number of observations, the gravity equation is in this part of the
interpretation of these empirical results is needed, because causality could be an issue: countries might have stronger representations in their major trading partner countries. This caveat, however, does not apply to the second set of calculations estimated using only a limited number of explanatory variables: the log of distance; the log of importer GDP per capita; the log of importer population; and the log of product area.\(^{23}\) Note, however, that Yakop and Van Bergeijk provide extensive econometric tests for causality that show that causality indeed runs from economic diplomacy to trade.

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\(^{23}\) Note, however, that Yakop and Van Bergeijk provide extensive econometric tests for causality that show that causality indeed runs from economic diplomacy to trade.
country-specific dummy variables, which compares the contribution of a country’s pattern of foreign economic diplomatic representations to the benchmark of an ‘average country’ (that is, after controlling for the other relevant economic and non-economic variables). This enables us to identify four country groupings from the perspective of economic diplomacy (see Table 4). In particular we distinguish:

- Countries that are **ineffective on both accounts**, as their foreign representation is negatively associated with their trade pattern (geographical inefficiency) and their diplomatic representations are less effective in generating trade than for the hypothetical average country (economic diplomatic inefficiency). Iran is a clear example in our sample.

- Countries that are **efficient on both accounts**, as their foreign representation is positively associated with their trade pattern (geographical efficiency) and their diplomatic representations are more effective in generating trade than for the hypothetical average country (economic diplomatic efficiency). Clear examples are Austria, Indonesia, Ireland, Israel and the Netherlands.

- Countries that are **geographically inefficient but economic-diplomatic efficient**, such as Chile and South Korea. These countries can improve on their geographical efficiency by shifting their patterns of economic diplomatic representation (by opening foreign missions in trade-relevant markets and closing them in trade-irrelevant countries).

- Countries that are **geographically efficient but economic-diplomatic inefficient**. Here we find many clear-cut examples (in terms of the level of significance), including all G7 countries. Their patterns of international specialization in the network of foreign economic-diplomatic representation reflect their specialization in terms of export markets, but the economic diplomacy of these countries is suboptimal, either because the mix of different representations is suboptimal (for example, embassies versus consulates) or because their foreign economic diplomatic services are not produced as efficiently as for the hypothetical average country.

**Conclusions and Suggestions for Future Research**

*Outward* economic diplomacy and *inward* economic diplomacy are relevant (from a trade-expanding point of view), with outward economic diplomacy being more effective. Positive significant estimates have consistently been obtained for the impact of the number of embassies, career consulates and embassy branches on export flows. Import facilitation, in its turn, has also regularly been estimated positively and significantly, although less in magnitude compared to export promotion. This implies that the contribution of economic diplomacy to import facilitation is smaller than its impact on exports.
Table 4. Country Classification Based on Country-specific Factors

<table>
<thead>
<tr>
<th>Pooled gravity progression with country-specific slope</th>
<th>Country-specific Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>Negative</td>
</tr>
<tr>
<td>Positive</td>
<td>Fully Efficient</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina, Austria, Belarus, Belgium, Bulgaria, China, Czech Republic, Ecuador, Finland, Indonesia, Ireland, Israel, Kenya, New Zealand, Pakistan, Peru, Philippines, Russia, Saudi Arabia, Singapore, South Africa, Sweden, Thailand, Ukraine, Uruguay, Vietnam</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>Geographically Efficient</td>
</tr>
<tr>
<td></td>
<td>Economic–Diplomatic Inefficient</td>
</tr>
<tr>
<td>Algeria, Bangladesh, Canada, Denmark, Dominican Republic, Egypt, France, Germany, Greece, Hungary, India, Italy, Japan, Kuwait, Mexico, Morocco, Nigeria, Poland, Portugal, Romania, Spain, Sudan, Switzerland, Tunisia, Turkey, United Kingdom, United States</td>
<td></td>
</tr>
</tbody>
</table>

Notes: Countries in **bold** have one or two parameters that are significant at the 90 per cent confidence level. Countries in *italics* have two parameters that are significant at the 89 per cent confidence level.
The breakdown of foreign missions into different types of diplomatic representations shows that embassies have a stronger impact on trade than career consulates. This article’s findings illustrate that embassies and career consulates are effective in influencing export flows, whereas honorary consulates do not seem to add additional value for trade. This, in its own right, is an important conclusion, since there is much debate on whether honorary consuls are indeed important for promoting their home economy in terms of trade and investment. Much of the scarce anecdotal evidence that is present within the academic literature claims that honorary consuls are crucial in developing important micro-relations, which in turn impact strongly upon trade and investments. As Stringer puts it, honorary consuls are ‘a critical ingredient for success in adapting to the changes occurring in diplomacy, by enabling better trade, tourism and investment promotion, in order to move their economies up the commercial value chain’, but also that one:

[...] critical point of research to be conducted is to determine if there is a causal relationship between actual increases in FDI, trade, or tourism due to an honorary consul’s efforts. Certainly anecdotal and observable evidence would point towards this, but stronger facts or metrics have not yet been presented.

This study, however, finds that econometrically speaking, honorary consulates on average do not add value to trade promotion.

This article developed an empirical framework to classify the effectiveness of economic diplomatic representation, and Fig. 1 and Table 4 offer a first attempt to apply this framework in the empirically relevant context of the bilateral trade flows of 63 countries in the year 2005. It should, however, be noted that this research provides a snapshot picture at best. In order to provide a better assessment, a data set needs to be developed that covers more years. The temporal dimension may become especially relevant in the context of further integration of the diplomatic functions in Europe. Countries are expected to evaluate whether specific national economic diplomatic activities will also be relevant and thus need to assess the costs and benefits of having individual (often less formal) representations in addition to EU-type embassies and consulates. This process of restructuring the geographical pattern of economic diplomatic representation may speed up as part of the austerity measures that are presently being contemplated on the European continent. Come what may, these developments offer a


versatile perspective for a dynamic analysis of the impact of economic diplomacy. We hope that this article can function as a stepping stone for such investigations.

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Commercial Diplomats in the Context of International Business

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Summary
Drawing on literature from various disciplines that directly address commercial diplomacy (diplomacy, political economy and international marketing) as well as empirical research, this article brings to commercial diplomacy the approach of management and organizational science. Methods used include qualitative case study research from in-depth semi-structured interviews with numerous commercial diplomats and related stakeholders, such as concerned business firms. A large share of the data was gathered in Switzerland. Naray analyses the roles of commercial diplomats by creating a framework composed of three main groups of roles — facilitation (F), advisory (A) and representation (R) — or ‘FAR’. These three roles cut across activity areas such as trade promotion, investments, ‘made-in’ and corporate image, cooperation in science and technology, and the protection of intellectual property. Two key dimensions of factors that shape the nature of commercial diplomacy are identified: organizational (such as arrangements between ministries and trade-promotion organizations, etc.); and individual (education, background and motivation). Implications arising from the organizational dimension concern organizational design, seeking effective arrangements between the commercial diplomat’s organizational unit and the headquarters. The individual dimension implies rethinking recruitment and talent management. If governments are to reorganize their commercial diplomacy, these two dimensions should be considered and acted upon.

Keywords
commercial diplomacy, commercial diplomat, role of commercial diplomats, trade promotion, export promotion, investment promotion (FDI), promotion of international business, trade representation

*) This paper is dedicated to my dear father, Dr Peter Naray, who passed away suddenly on 20 June 2010. A large share of this paper results from joint empirical research, comments and discussions with Prof. Michel Kostecki, University of Neuchâtel, to whom I express my deepest gratitude. I am also especially grateful for Prof. Sam Bili’s input and conceptual insights, which considerably helped the logic and the structure. I also thank Prof. Raymond Saner and Prof. Kishan Rana, who made precious comments on previous papers, as well as Dr Lichia Saner-Yiu for her thorough comments on previous conceptualizations. I thank the following researchers and their organizations: Prof. Adrian Bangerter; Prof. Cédric Dupont; Dr Peter Naray; Dr Thomas Borer; Dr Valéry Bezençon; Dr Reza Sajadi-Etemad; Dr Lassaad Ghachem; Mr Yvan Nieto; Dr Giuseppe Melfi; Mr Alexandre Mercier; Dr Kevin Stringer; and the International Trade Centre, Geneva, Switzerland. I also sincerely thank all of the anonymous participants in our research interviews and questionnaires.
Introduction

Commercial diplomats are state representatives with diplomatic status who are working for business promotion in a broad sense between a home and a host country. Commercial diplomacy aims at encouraging bilateral business through a series of roles that commercial diplomats perform in various activity areas, such as trade promotion, investment promotion, and cooperation in science and technology. This definition focuses on the business-promotion aspect rather than the negotiation of trade policy and its regulatory framework, by drawing on Berridge and Barder’s definition, quoted also by Saner and Yiu: ‘commercial diplomats […] are either civil servants and specially trained diplomats or representatives of chambers of commerce of trading associations seconded to national embassies located in important foreign markets’.1 This article’s main concern is the specialized professional commercial diplomat (CD), and/or the equivalent function, which may also be fulfilled at ambassadorial level. The function rather than the official status is therefore stressed.

Commercial diplomats located abroad undertake activities in the field of promoting (in a broad sense) trade, investment and tourism, cooperation in science and technology (S&T), and the protection of intellectual property rights (IPR). They are usually staff members of a diplomatic mission or heads of a ‘commercial representation’ abroad with a diplomatic status. The term commercial diplomat may cover various denominations, such as commercial counsellor, commercial attaché, trade representative or commercial representative. Certain business-promotion tasks accomplished by CDs may also be assigned simultaneously or separately to other diplomatic institutions, such as consular diplomacy, and in particular to honorary consuls.2 In addition, non-diplomatic institutions such as most trade-promotion organizations (TPOs), chambers of commerce and other trade-support institutions should be considered as the broader context of business support around commercial diplomacy.

Growing Concern

Commercial diplomacy is an issue of growing concern for governments and business alike. According to Porter,3 governments — like business firms — should elaborate strategies and policies to create the best conditions to sustain their

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competitive advantage. In a particular industry these advantages lie in four attributes: (i) factor conditions; (ii) demand conditions; (iii) related and supporting industries; and (iv) firm strategy, structure and rivalry — that is, a nation's investment attractiveness is greater, the greater the intensity of domestic rivalry. In line with these principles, the core mission of commercial diplomacy is to promote the home country's business and economic interests with a view to sustaining the nation's competitive advantages over foreign markets.

Governments encourage home firms to trade, as well as seeking to make the country an attractive destination for foreign direct investment (FDI), research and development (R&D) and knowledge. Simultaneously, the business establishment applies pressure for beneficiary-orientation and more efficiency of government services, such as commercial diplomacy. Moreover, the internet, increased mobility and the emergence of new poles of economic activities call for a rethinking and repositioning of many services offered by commercial diplomacy. For instance, sceptics ask why the French government should support a French company that is willing to expand in Stuttgart (Germany) while it will not help the company back home in Strasbourg. Others put forward that firms might become dependent on this type of government assistance, which would hinder companies in their efforts to learn internationalization by themselves. Still, the fact remains that most, if not all, developed countries — such as the United States, Germany, the United Kingdom and Finland, and not to forget Japan and Singapore — are maintaining modern and well-performing commercial diplomacy business-support services to assist business development and promotion. For instance, international organizations such as the International Trade Centre (ITC) have addressed the issue on a regular basis. A ‘World TPO Conference’, inviting most of the world’s TPOs, gathers every two years to address TPO-related issues, under which commercial diplomacy is naturally included, often under the synonym ‘trade representation’.

Research Objective and Questions

This article’s objective is to:

(i) Review the existing literature’s approaches to commercial diplomacy and commercial diplomats’ roles and activities in the promotion of international business (in a broad sense); and to

(ii) Conceptualize and thus build a framework for analysing commercial diplomacy by drawing on in-depth empirical research (semi-structured in-depth research interviews).

The research questions that the article attempts to answer are thus:

(i) How are commercial diplomacy and commercial diplomats considered in the existing literature?
(ii) What are commercial diplomats’ roles and how are they performed in the broad context of international business?
(iii) How is commercial diplomacy designed from an organizational standpoint and what are the implications?
(iv) Which individual factors matter for recruitment and talent management in order to encourage further success?

The article first details the empirical research methods, and subsequent sections attempt to answer these four questions.

Research Methods

Research Design and Data Collection

Research methods and procedures followed the recommended guidelines for the development of theory in exploratory case-study research based on classics such as those by Eisenhardt and Yin. The unit of analysis is the phenomenon of commercial diplomacy. The key respondent is the commercial diplomat, defined as a senior diplomat or trade representative with diplomatic status in charge of commercial affairs, meaning mainly trade and investment promotion. The data collection involved:

(i) Existing literature, both scientific and from the press;
(ii) A three-day professional conference with practitioners (commercial diplomats, international organizations, government ministry officials and heads of TPOs) and field experts;
(iii) In-depth face-to-face semi-structured interviews;
(iv) In-depth semi-structured telephone interviews;
(v) Reading material distributed by the interviewees.

Progressively structured (semi-structured) in-depth interviews were undertaken following Kvale’s recommendations in interviewing techniques. Observations are based on the individual interviews and the content of panel discussions.

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Sampling and Quality of Design

Theoretical sampling was used with the global objective of covering the major types of commercial diplomacy from home countries with (i) developed, (ii) ‘emerging’, and only a few (iii) developing economies. There was a conscious focus on the commercial diplomacy of Organization for Economic Cooperation and Development (OECD) countries and emerging countries in order to conceptualize the potential differences.

The 46 interviewed units were composed of the following:

- 30 commercial diplomats originating from the following ‘home countries’: Austria; Brazil; Canada; China; Cuba; El Salvador; Finland; France; Hungary; Ireland; Japan; Korea; Moldova; New Zealand; Poland; Portugal; Switzerland; Spain; Sweden; the United Kingdom; and the United States. Most of these were posted in Switzerland as the ‘host country’ at the time of the interviews.
- The 16 business people interviewed represented companies from Austria, Belgium, Switzerland, Moldova, Spain, and two business associations from Austria (Wirtschaftskammer: Aussenhandelsstelle [Economic Chamber of Austria: Trade Commissions]) and Switzerland (OSEC [Business Network Austria]) that are involved in commercial diplomacy.

The other involved experts and relevant stakeholders who contributed were from Canada, Hungary, Switzerland and international organizations. The professional conference referred to the International Trade Centre’s ‘World Trade Promotion Organization Conference’ at The Hague in the Netherlands in October 2008.

The quality of the research design was assured by following Yin’s recommendations on construct validity, internal validity (although this did not play a role in this case since it is not explanatory), external validity and reliability. A potential bias may have arisen because much of the data was gathered in Switzerland as a host country. Still, the interviews focused on the commercial diplomats’ entire career path, including many other postings apart from Switzerland.

Construct validity: data triangulation — with the sources mentioned above — was assured to test the construct validity. In-depth interviews allowed for relating with the CDs’ overall experience and views and not only with challenges in the current target market/host country.

External validity: the relatively large number of observations and other relevant sources (beneficiary companies, TPO experts, experienced retired diplomats) allow inference of some generalized patterns.

Reliability: a larger and independent team was involved in the data collection process, and another team acted as a jury to reconsider various classifications and matrices where necessary. Moreover, a large timeframe (over two years) contributed to reliability. Even if the questions evolved in the iterative process, the newer observations remained comparable with older observations.

8) Yin, Case Study Research, pp. 33-39.
Data Analysis

The interview transcripts were analysed to reveal broader patterns. For Yin and Eisenhardt,9 in the case-study theory-development approach, patterns are expected to emerge from the empirical research. Some ‘quasi propositions’ (in Yin’s definition) emerged out of the existing literature, preliminary interviews and the author’s own professional experience and observations in the field. The quasi-propositions that evolved in the iterative process of the research can be summarized as follows in chronological order:

1. There is a clear distinction between strategic promotion activities (such as S&T cooperation and attracting FDI) and punctual and individual business-support services (such as export support), often for small and medium enterprises (SMEs).
2. There is growing tension between activities relating to foreign trade policies (trade diplomacy) and business-support and service-related activities (typically linked with the home country’s trade-promotion organization, which is here called commercial diplomacy).
3. The CD’s freedom of action and entrepreneurial potential may be seriously limited by institutional and organizational arrangements such as the ministry’s distinction between trade policy and trade promotion.
4. Developed countries’ commercial diplomacy increasingly insists on the promotion of R&D, S&T and pre-business cooperation and includes the promotion of FDI (inward and outward) as opposed to traditional export-promotion tasks such as trade fairs and legal advice on trade barriers, etc.

Given that scientific literature has been relatively scarce on the topic, a priori theory bias could be minimized. In the iterative process, concepts and possible theories were compared and analysed with existing literature via data triangulation in order to strengthen the new conceptualization. The data and the literature enabled the development, inter alia, of a systematic classification of the major roles and activity areas of commercial diplomats (and estimation of their time allocation between the various activities). The Ishikawa framework10 was used to gain insights into the problems raised and to evaluate the relative importance of the various concerns.

10) An Ishikawa diagram (also known as a cause-and-effect diagram, or a fishbone diagram because of its distinctive shape) is a graphical method for finding the most likely causes of an undesired effect, a tool for systematically identifying and presenting all possible causes of a particular problem.
**Multidisciplinary Angles**

Various disciplines have addressed commercial diplomacy and commercial diplomats’ roles, activities and contexts. The various contributions provide a solid basis for further conceptualization. Yet specialized and empirical publications have been scarce in recent years. An introduction to the various approaches helps us to see which are to be integrated.

**International Relations and Diplomacy**

The approach of international relations and diplomacy — taken by Carron de la Carrière,¹¹ Saner and Yiu,¹² Ögütcü and Saner,¹³ Lee,¹⁴ Borer-Fielding,¹⁵ Rana,¹⁶ Kopp,¹⁷ and Kopp and Gillespie¹⁸ — focuses on commercial aspects of diplomacy as relations between states and governments.

Commercial diplomacy is addressed mainly as a part of diplomacy and from a governmental point of view. Saner and Yiu contribute considerably by differentiating among various types of diplomacy — in particular economic diplomacy from commercial diplomacy — and recognize the growing importance of both trade and investment promotion. Rana emphasizes the advantages of the full integration of the ‘commercial service’ — that is, commercial diplomacy into the Foreign Service — as opposed to separating it in favour of the ministry of trade. Lee and Hudson insist¹⁹ on the increasing importance of business-government, private-public partnerships; Lee argues that this aspect has been only marginally addressed. The writings place the topic in the context of international diplomatic relations — that is, the relationship between states and the representation of states’ interests abroad, including diplomats’ commercial work. As such, commercial diplomacy is necessary for the national interest.

¹¹ Carron de la Carrière, *La diplomatie économique*.
The Political Economy of Commercial Diplomacy

This part of the research, which is represented by Rothkopf, Garten et al., Harris and Li, and Bell et al., focuses on the political debate about the funding of ‘programmes’ and the necessity, or not, of commercial diplomacy services as a part of government, addressing fundamental arguments for and against. The multifaceted challenges of commercial diplomacy in regard to the political debate on its public funding and political forces, lobbies and the interest groups behind it are introduced. This dimension of the topic shows that commercial diplomacy is at the crossroads of business, politics and economics. The focus remains on commercial diplomacy’s effectiveness and efficiency aspects of ‘how much bang for the buck’. The debate is often turned into a confrontation of free trade versus mercantilism and is highly politicized, especially in the United States.

International Trade Promotion/International Marketing

The focus here lies in the promotion of trade and investment from the point of view of international business firms and countries’ promotional efforts. Kotler et al. elaborate on the concept of the ‘marketing of nations’, whereby they analyse, inter alia, nations’ trade and investment-promotion policies. Kotler says that governments can manipulate beyond the intrinsic advantages or disadvantages of investing in the country, tax incentives, grants and tariff protections and also promotion: activities that disseminate information about, or attempt to create a favourable appearance of, the country as an investment site. Commercial diplomacy is to be included under the latter.

Most relevant studies by Hibbert, Seringhaus and Rosson, the International Trade Centre, Potter and Rose tackle commercial diplomacy in the context

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of export promotion, which is defined as ‘all public policy measures that actually or potentially enhance exporting activity either from a firm, industry or national perspective’. Rose, as well as Yakop and van Bergeijk, concludes that commercial diplomacy does have an impact on trade figures and that exports do increase with embassies’ and consulates’ efforts. In particular, Yakop and van Bergeijk argue that diplomatic representation is significant in the bilateral relationships of developing countries as opposed to OECD member countries.

These writings help in distinguishing the actual and current activities of CDs mainly in the field of export and FDI promotion. The analytical findings are useful for further conceptualization and typologies with regard to trade representations’ possible ‘business models’, institutional arrangements and country comparisons. However, in spite of various impact studies, it remains difficult to quantify directly the impact of efforts at promoting trade on national export figures or even on business firms’ results, but the empirical and quantitative research material constitutes a good basis for more targeted investigation. Thanks to the insights of the previous literature, some key concepts can already be proposed in order to grasp commercial diplomacy’s origins and underlying rationale.

The Origins of Commercial Diplomacy

Commercial diplomacy is not new, as the very origins of diplomacy often find their roots in commerce and navigation. The origins of diplomacy are deeply, if not exclusively, commercial: the Roman institution of proxenes or European consuls in the Ottoman Empire were essentially merchants protecting their communities’ interests. In the extensive trade that existed in the period 1460-1220 BC among the countries and civilizations of Egypt and West Asia, trade provided the first motivation for inter-state contact and agreements. Another example is the spread of colonialism in Asia, following Vasco da Gama’s journey to India in 1498 and Europe’s discovery of the riches of East Indies: the flag followed trade.

Later, information-gathering and intelligence were at the origin of the creation of modern commercial attachés in the late nineteenth century. Today, the argument of missing markets is put forward to justify the supply of intelligence, since:

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some types of information have the nature of public goods, which markets cannot supply — these include unique, reliable and impartial access to information such as through the global embassy network and other government channels and contacts, which become available through the government's very long-term, and non-commercial, attachment to foreign markets.35

Moreover, diffusion of such information is likely to have a beneficial spillover (externality) through demonstration effects that lead to encouraging the internationalization of business among domestic SMEs.36 With the development of the internet, there has been a shift towards more value-added and tailor-made intelligence that is based on personal contacts and direct observation, since most data are readily available online. Rich countries and developing nations alike consider the mobilization of inward foreign investments (foreign direct investment, or FDI) and export promotion as ‘the essence of advancing interests in foreign countries’.37 In the 1970s and even in the 1980s, however, diplomats pursuing a fast-track career saw commercial diplomacy as ‘a black hole’.38

Fields to Explore Further

The empirical research, which was undertaken via in-depth interviews on a large scale, addressed what has been missing: the research went more in depth by identifying the concrete activity areas and roles (nature of activities), as well as the implications of individual and organizational factors. More specifically, the existing research was added to the following undertakings:

- Elaborate on the roles and activity areas.
- Identify and describe stakeholders (public and private/corporate).
- Elaborate on organizational and individual factors that affect commercial diplomacy.

The following sections of this article enlarge on the above.

Activity Areas and Roles (Nature of Activities)

The business-related functions of diplomatic envoys are clearly recognized under the Vienna Convention on Diplomatic Relations (Vienna Convention 1961 and subsequent amendments), which explicitly refers to diplomatic activities such as: (i) protection within the host state of the interests of the home state and its nationals, including their property and shares in companies; (ii) gathering eco-

35) Harris and Cher Li, Review of the Literature, p. 75.
36) Harris and Cher Li, Review of the Literature, p. 75.
37) Rana, Bilateral Diplomacy, p. 68.
38) Rana, Bilateral Diplomacy, p. 67.
nomic information; and (iii) promotion of economic and scientific relations between the two states, which includes commercial and investment-related issues.39

Trade Promotion

The literature review and various national evaluation papers also make it clear that many firms are discouraged from exporting because of high barrier costs. Governments bring benefits of scale and scope for large amounts of exports. Businesses use and expect help from CDs: quantitative evidence contained in the study by Rose suggests that export development is encouraged by diplomatic representations abroad.40 The shortcomings of export-promotion programmes include bureaucracy, corruption, politicization, rewarding political friends at trade missions, poor service, insufficient budgets and poor understanding of the private sector.41 A commercial diplomat representing Moldova illustrated both product-based activity areas in trade relating to the product as well as framework agreements for trade:

Our task was to research the Swiss market, the products that are demanded, and to elaborate a list of Moldovan products that have a high potential as exports to Switzerland. Another issue was to prepare the agreement regarding the international transportation of goods and passengers, the trade agreement between Moldova and Switzerland [. . .]. Last year’s objective was the foundation of a Moldovan-Swiss mixed chamber of commerce.

The Promotion of ‘Made-in’ Country Origin and Corporate Image

The growing importance of country brands are addressed in general by Olins,42 showing that countries use modern marketing tools to promote strong country brands in exporting, inward investment and tourism promotion alike.

Potter43 focuses on the Canadian experience and emphasizes the added value of commercial diplomacy’s various functions. Furthermore, famous diplomacy theorist Brian Hocking showed in a survey of 200 US Fortune 500 companies that 72 per cent said that the national image was significant to external purchase of goods and services, adding that ‘company brands interact with national identities in concrete ways’.44

40) Rose, The Foreign Service and Foreign Trade.
44) Quoted in Rana, Bilateral Diplomacy, p. 81.
'Made-in' aspects — meaning promoting the country of origin where the product has been made — linked to corporate image constitute an important managerial concern for newcomers to foreign markets, and the CD’s support may be crucial. The issue is particularly important in distant — that is, non-traditional — markets and for small and middle-sized enterprises (SMEs), because the export potential of such newcomers depends on a company’s image, which — unless it is internationally established — may be difficult to achieve without the benefit of a strong and positive ‘made-in’ image, such as a German car, Swiss watch or Italian design. A CD can therefore help by enforcing a country’s business reputation or contributing to the company’s credibility by recommending it to the host country’s businesses and government.

Promotion of Investments

A coordinated and proactive promotion of the country abroad is recommended, with the objective of attracting FDI by large multinational enterprises and also SMEs. The research interviews confirmed the general tendency to include increasingly the promotion of investments in CDs’ mandates. Furthermore, Blili and Sermet recognize the importance of the promotion of the ‘location [the home country] along with the home country’s policies’ and regulatory frameworks regarding inward investments.

The main challenge seems to lie in attracting FDI to the home country in order to develop various aspects of the home economy (according to its level of development), such as new jobs, talents and knowledge, tax revenues, and production in the view of exports from the home country.

A commercial diplomat representing Portugal recalls:

The challenge for Portugal lies in encouraging a multinational company to move from Switzerland to Portugal, also because this company subcontracts more and more with Portuguese firms. This would mean a green-field investment — we are trying to build clusters. It is very difficult to be competitive in this kind of project. The competition might be in Hungary somewhere, [...] therefore we try to strengthen our connections.

Protection of Intellectual Property Rights

Commercial diplomats engage in active, reactive or even proactive protection of intellectual property rights (IPR) concerning the activities of a home country’s business firms in the host country. The protection of IPR is of particular importance when located in critical, often emerging and developing markets where counterfeiting develops quickly — Kostecki reports on IPR issues in a developed

versus developing context. A CD representing China in a Western European country explains:

The host country authorities bring their complaints and the Chinese see what they can do. When a delegation of the host country is about to visit China, our Embassy [of China] will advise on issues. It also recommends to the Chinese government which issues to tackle.

**Cooperation in Science and Technology (Research and Development)**

In today’s knowledge economies, CDs include projects and programmes of cooperation with business firms, government departments, agencies and non-governmental agencies to transfer, sell, exchange experiences or simply to learn about scientific and technological developments. A commercial diplomat representing Hungary explained: ‘We are to bring together the potential partners: Hungarian scientific institutes together with University of Lausanne, for instance. It’s about pre-business cooperation’.

**The Role of Commercial Diplomats: The ‘FAR’ Framework**

The following roles are typically carried out by CDs and their weight and aspects are thus often different from other trade-support institutions (TSIs).

Drawing on Mintzberg’s approach of identifying and categorizing managers’ roles, this article builds on the research interviews and conceptualizes and regroups the roles (nature of activities) of commercial diplomats under various themes. This process has been supported by previous research by Kostecki and Naray, and Naray. The starting point is the definition of a role used by Mintzberg, quoting Sarbin and Allen: ‘[a role is] an organized set of behaviours belonging to an identifiable office or position’. Role in the CD’s context means the underlying nature of the activity carried out in various areas (such as trade promotion, protection of IPR, etc.). A commercial diplomat representing Hungary in a Western European country summed up various classical roles:

The role and also added value of the commercial diplomat reside in personal contacts and the special information gathered in the host country. For instance, for European Union project procurement, there might be three countries in the race: Hungary; Spain; and Sweden. Attracting the project to

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Budapest is typically a CD job: convince the authorities; transfer the right information; find support for our position; find mutual interest for cooperation.

A framework was devised (see matrix 1) that emerged out of field observation (the author’s work experience in an embassy), research interviews and the literature. Areas covered comprise trade promotion in goods and services (including tourism), protection of intellectual property rights (such as trademarks, copyright patents, denomination of origin), promotion of the ‘made-in’ brand and the corporate image of home country companies and the promotion of inward and outward FDI. The variety of the activities’ natures was reduced to six essential categories: intelligence; communication; referral; advocacy; coordination; and logistics.

Conceptualizing the roles under facilitation (F), advisory (A) and representation (R) — the ‘FAR’ framework — is suggested. These roles cut across the various activity areas. Facilitation includes particular roles relating to referral, coordination and logistics; advisory comprises intelligence-gathering and internal communication; and representation includes advocacy and external communication. Matrix 1’s ‘roles and activity areas’ illustrate each role.

Facilitation Roles

Facilitation infers that the CD takes no part in the business transaction and only refers, coordinates and provides logistics to encourage the transaction and/or its preparation.

Referral covers recommending companies to prospective clients and partners and vice versa, and other forms of facilitating direct contacts. A Swiss multinational SME in the scissors’ industry expressed a typical business point of view:

The commercial diplomat is only facilitator, but on the spot he/she visits the potential clients! I also went down there (the host country). The CD comes back, for instance, saying that he has five companies interested in our products and as such we continue by ourselves. The CD’s local employees play an important part too. We (as Swiss) would think we know China, Japan or India but we don’t. A consultant in the same job (as the CD) would ask for a…hmm…crazy price!

A commercial diplomat representing Portugal who was posted to Switzerland, illustrated referral in terms of a two-way street. It is not defined that companies have to address the CD; the opposite may happen too:

We have to introduce ourselves, for instance, to companies in the micro-electronic sector, which did not know anything about Portugal and that we [Portugal] had interesting potential partner companies. We pass on the information to multinationals — they come to us or we go to them.

The same CD points out the importance of referral as a first step in informing the multinational company (in the host country) that would invest in Portugal:
Matrix 1: Roles and Activity Areas

<table>
<thead>
<tr>
<th>ACTIVITY AREA</th>
<th>Promotion of Trade in Goods and Services</th>
<th>Protection of Intellectual Property Rights (IPR)</th>
<th>Cooperation in Science and Technology</th>
<th>Promotion of ‘Made-in’ and Corporate Image</th>
<th>Promotion of Foreign Direct Investment (FDI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facilitation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Referral</td>
<td>Introducing potential exporters</td>
<td>Search for reliable IP lawyers</td>
<td>Facilitation of contacts between high-technology labs</td>
<td>PR for large contracts where national image counts</td>
<td>Approaching CEOs with investment proposals</td>
</tr>
<tr>
<td>Coordination</td>
<td>Organization of prospect meetings</td>
<td>Coordination of legal action</td>
<td>Introducing parties to initiate R&amp;D joint ventures</td>
<td>Coordination of ‘made-in’ campaigns</td>
<td>Organizing minister’s participation in private investors’ forum</td>
</tr>
<tr>
<td>Logistics</td>
<td>Embassy’s secretariat is servicing a trade promotion conference</td>
<td>Training material for awareness campaigns is printed and distributed by the Embassy</td>
<td>Ambassador or CD hosts a conference on promotion of scientific cooperation</td>
<td>Translation of the campaign’s material is done by the CD unit’s staff.</td>
<td>Members of an investment promotion mission use office facilities at the Embassy.</td>
</tr>
<tr>
<td>Advisory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intelligence-gathering and analysis</td>
<td>Gathering export marketing data</td>
<td>Supervision of violations of IPRs</td>
<td>Monitoring research achievements</td>
<td>Image studies</td>
<td>Identifying potential investors</td>
</tr>
<tr>
<td>Internal Communication</td>
<td>Report to HQ about emerging exporting product niche in host country</td>
<td>Spotting of counterfeiting cases and reporting back to HQ with advice for action</td>
<td>Advising on participation of experts from home ministries in a multi-stakeholder joint venture project</td>
<td>Reporting internally on the success of the last ‘made-in’ campaign</td>
<td>Inform HQ about international tender, including possibilities for large investors from home</td>
</tr>
<tr>
<td>Representation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advocacy</td>
<td>Support firms in dispute settlement procedures</td>
<td>Pressure for improved protection of home country’s IPRs</td>
<td>PR in favour of joint scientific projects</td>
<td>Defence of national companies singled out by host country authorities</td>
<td>Protection of home country investors in the host country</td>
</tr>
<tr>
<td>External Communication</td>
<td>Tourism promotion conference</td>
<td>Presentations during awareness campaigns</td>
<td>Preparation of press articles on scientific achievements</td>
<td>Contribution to ‘made-in’ promotion events</td>
<td>Briefings for potential investors</td>
</tr>
</tbody>
</table>

Source: Common empirical research and insights with Prof. M. Kostecki and the literature review.
Once we have done our job of informing, the multinationals check on the spot, engage consultants, etc., to study the market and the conditions in more depth. At the beginning these Americans did not know anything about Portugal; at the end they knew too much!

Another element of facilitation is coordination, which means encouraging social interaction between partners (businesses and/or state authorities) where various processes are considered simultaneously and their evolution is arranged for the benefit of all parties. Typically, the organization of meetings and networking sessions belong to this category of activity.

Empirical evidence attests to the importance of visits for the enhancement of international trade, as suggested by Nitsch, who examined the effect of state visits on international trade. Nitsch concludes that state and official visits are ‘indeed positively correlated with exports’.

Ambassadors with commercial diplomats and embassy staff actively support and prepare home-government visits and provide input into trade negotiations with the host country — especially as far as their business-relevant aspects are concerned (for example, dealing with problem areas that are signalled by managers and bringing them to the attention of bilateral trade consultative bodies). Commercial diplomats also assist in organizing trade missions and business visits. ‘Scrupulous programming and pre-arrival arrangements to identify serious interests among business communities’, on both sides, are typically accomplished by CDs. A commercial diplomat representing China in Switzerland expounded further on the delegations:

> It’s about business or government, official talks, government-to-government dialogue on trade. IP is a great issue concerning counterfeiting; the Swiss authorities bring their complaints and the Chinese see what they can do. Swiss delegations — cantonal as well as federal — are supported by the Embassy. It also recommends to the Chinese government which issues to tackle.

Last but not least, a perhaps more tangible part of the facilitation role is providing logistical support when demanded. Logistics refers to roles that deal with all aspects of technical and facility support for the actually or potentially involved parties. A CD from South America, referring to the physical premises of the embassy, said that ‘our exporters of meat and poultry use our embassy in their dealings with the local sanitary authorities or to initiate a new business project’. A CD from Hungary provides various facilities for business negotiations: ‘we provide rooms and translators for contract negotiations between home and host businesses and firms’. Furthermore, a businessman (consortium) working for a Moldovan company insists on the relatively ‘hands-off’ aspect of logistical support provided by CDs:

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We collaborated with the commercial diplomats of Moldova in Russia. They organized a meeting for us with the government representatives and GAZPROM representatives in order to negotiate the price of natural gas for the Moldovan market. But commercial diplomats helped only with logistics: they rented the conference room for us, and called the participants.

Advisory Roles

Roles that refer to gathering and analysing intelligence and information with a view to advising, either internally or externally, are referred to as advisory roles. The project distinguished between intelligence-gathering and analysis that is often directed towards outside stakeholders and internal communication that is directed towards internal entities.

Intelligence gathering and analysis is referred to by most studies on commercial diplomacy in one way or another that comprises both data collection and analysis for the home-country business community and — to a lesser extent — foreign investors and traders. Harris and Li⁵⁴ maintain that the critical factor determining internationalization is ‘the core and essential role of knowledge generation and acquisition both within the firm and its external environment’. Commercial diplomats tend to guarantee that the information is both reliable and neutral. Lee⁵⁵ points out as well that one of the main activities includes ‘the gathering and disseminating of commercial information and market research’. A French study group led by Martre⁵⁶ recognized the particular role of commercial diplomacy as a determinant of competitive intelligence-gathering. The study emphasized the necessity of collaboration, cooperation and coordination among all actors (private and public) involved in the gathering and diffusing of such ‘competitive intelligence’. A commercial diplomat representing Japan points out that intelligence-gathering and analysis occur in various aspects, such as the provision of databases of potential partner companies or simply rules and regulations: ‘We have to find projects, including distributors (companies), provide information on Switzerland concerning authorizations, etc. For more specific and detailed studies, such as market research, we charge’.

The process of intelligence-gathering may be anything but easy, especially for a freshly posted commercial diplomat. A representative of Hungary expressed how challenging the process of intelligence-gathering can be:

First he/she [the commercial diplomat] has to read everything about the sector in question (in the host country). He/she finds on the internet and here and there, goes perhaps to the local administration to talk to the responsible people who will tell him implicitly: ‘here is what you have to

⁵⁴) Harris and Li, Review of the Literature.
read, read it, go and formulate your questions, and come back in a month until you become a partner for discussion’.

One notices that intelligence-gathering and analysis constitute an iterative process drawing on very diverse sources and have a ‘country competition’ aspect:

We should become proactive in contact-building, development, with business circles — in Switzerland this means the mechanics industry, the watch industry and other relevant industries, potential branches, science and technology cooperation. Work in advance, prepare, what are the future’s potential growth sectors? What is competition doing? Why? What is the British Know-How Fund doing? They might be more intelligent than we are . . .

Another advisory element is *internal communication*, which includes reporting to the home ministry and communication within the CD’s office and the embassy. Other internal and G2G (government-to-government) communication activities are also included, such as reporting the information of government counterparts in the host country to the home ministry. A CD representing China in a Western European country gives an example:

I have to write an in-depth report about the host country every two or three months. For instance, a current banking issue takes 30 pages in trying to understand ‘why’ and to see whether there could be an idea for China, and how to apply it, etc. Reports cover typical sectors such as pharmaceutical, medical devices, beauty care and related technology.

**Representation Roles**

Commercial diplomats represent their home country’s economic and business interests and thus have a role in communicating and advocating positions and interests in the host country before various stakeholders.

*External communication* consists of CDs’ presentations, participation in conferences, preparation of business briefings, press articles, direct involvement in event marketing, etc. Every country would like to benefit from favourable associations and reputation. CDs should provide visibility for their country as a name and a brand name as well. The argument is particularly significant for the promotion of ‘made-in’ products by diplomatic missions. Diplomats — especially an ambassador or a politician — usually attract greater attention from journalists and the public at large than a business person. This role of commercial diplomacy is likely to intensify with the growing role of online media and the constant search for ‘news’. So-called ‘public diplomacy’ is part of this category. An experienced South American diplomat says that it is important to:

[…] describe and analyse a country’s current situation, create a climate of confidence. If the Swiss business people have good contact with ours, it’s better for both parties in order to arouse interest. The internet does not replace the diplomat’s personal contact. The diplomat is the face of his/her country; the impression is different when one talks to a person representing the host institution compared to an email.
A commercial diplomat representing Portugal expounds in a similar direction:

We argue about the durability of trade relations and the quality of our products with department stores such as department store ‘A’ [name kept confidential] and department store ‘B’, for instance. If we say that ICEP [the TPO of Portugal] pays for and organizes the promotion of Portuguese wine, they are immediately interested.

Advocacy, meanwhile, consists of systematic and planned efforts to defend the home country’s business interests in dealings with home-country governments and major publics with the objective of improving the regulatory environment.\(^\text{57}\) It also comprises the CD’s assistance in conflict resolution and dispute settlement involving home-country firms.

Commercial diplomats are involved in business conciliation and dispute settlement. CDs may be of direct help for firms experiencing business disputes and non-payments, etc., in the host country.\(^\text{58}\) Most of the time, CDs help in order to avoid the judicial path and to encourage out-of-court solutions. A mission or embassy can help at the initial or informal phase in offering ‘good offices’ and informal mediation, and urging a reasonable settlement. It is important for diplomats to maintain credibility and to be able to help home enterprises. Commercial diplomats also act as advisers in contract negotiations, provide support for problem-solving in business or in corporate-government relations, and become involved in dispute-settlement cases. The problem-solving activities frequently refer to the protection of intellectual property rights, tax issues, and assistance to national companies that have suffered losses and wish to obtain compensation, as well as various forms of support provided as diplomatic protection. Many of these kinds of problems are discussed during periodic bilateral consultations with host-country governments. To illustrate a case, a CD representing an Asian country describes: ‘When a food product suffered from an export ban to Europe’s market, CDs also assist in the finding of a “friendly” solution without judicial procedures when business conflicts arise’. Another CD representing the People’s Republic of China adds about problem-solving:

Questions deal with trials, which court to use, etc., and they concern mainly SMEs. The CD can solve about 80 per cent of the questions; for the rest he recommends consultants and law firms. There are numerous payment problems. CDs recommend law firms and lawyer advocates that speak the host country’s language and English. Firms ask for more protection and guarantees for payment. This is not the role of the government but private insurance or the import-export bank. The CD does not issue visas, and does not legalize documents in any way, since this is forbidden by the government.

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\(^{58}\) Kopp, *Commercial Diplomacy and the National Interest*. 

The described roles performed by commercial diplomats evolve in complex organizational and individual contexts. These two dimensions seem crucial for the further understanding of commercial diplomacy's design, improvement and management.

**Organizational Factors**

Organizational arrangements matter and stem from a country’s institutional traditions, culture and current trends in public-sector reforms. The CD’s unit position is at the centre of organizational concerns. Governments play a major part, yet the private sector and semi-public entities are also involved in commercial diplomatic activities. Various partners and stakeholders are involved beyond the government ministry, as Fig. 1 attempts to capture. First, the business firms are to be made aware. They discover the services, networks and information that may be accessed through a commercial diplomat at an event given by the national trade-promotion organization, which presents the actual existence of commercial diplomatic networks before a business association or chamber of commerce. Businesses then contact CDs from the home or the host country; electronic communication facilitates the process nowadays. Commercial diplomats who are posted abroad report directly to the responsible ministry and national trade-promotion organization, depending on the country’s system — if the CD is located outside the embassy, he/she sometimes has a more or less close relationship with it. Collaboration, networking and advocacy take place, generally coordinated with the bi-national (home-host) chamber of commerce, while special services such as specific market research or even public relations campaigns are often prepared with the help of private consultants/subcontractors.

**Organizational Arrangement Types**

There are substantial differences between (national) commercial diplomacy systems with respect to organizational and institutional arrangements, including trade-support institutions such as chambers of commerce and others participating in business-promotion efforts. Additional research might be needed to reflect the multiplicity of export-promotion agencies, including both the public and private sectors and how these co-exist, cooperate and compete in the same national context.

The various types of distinguishable arrangements serve as a basis to elaborate the criteria concerning organizational arrangements. Six types of arrangements

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are suggested, in a specific order from 1 to 6 corresponding to the ‘scale’, qualitatively measuring the degree of the CD’s independence towards traditional, governmental, ministry of foreign affairs (MFA) structures. Criteria such as the TPO’s relative independence — that is, decentralization — from ministries, its position in the trade-promotion structure and the responsible ministry are among the most important aspects for commercial diplomacy. Government structures in terms of responsible ministries seem particularly complex — that is, MFA or/and ministry of trade (MT) and promotion agencies (TPOs most of the time). There are different possible configurations: in some cases the MFA dominates; in others the MT; and sometimes even joint structures exist (as in the United Kingdom, for example). There is also a difference in the TPO’s position in the structure and its relationship with the CD. Table 1, below, summarizes the major tendencies found.

The following detailed findings are based on the quoted literature and 30 research interviews that were held with commercial diplomats and TPO managers from the respective countries.
Arrangement 1: The Corporatist Type — Independent Trade-Promotion Structures

Commercial diplomacy is essentially delegated to public or semi-private/subsidized agencies. These have no hierarchical subordination to the embassy and work independently. The embassy only tackles political affairs and the political dimension of trade. For instance, Germany delegates its main trade-promotion activities to the network of bi-national chambers of commerce. Japan (through the Japan External Trade Organization, JETRO) and South Korea (through the Korea Trade-Investment Promotion Agency, KOTRA) have at their disposal very solid, relatively independent structures that practise de facto commercial diplomacy; this is also the case for Italy (with the Italian Institute for Foreign Trade).

Arrangement 2: The Pragmatist Type — Coordination Mechanisms

UK Trade and Investment (UKTI) is subordinate to both the British Foreign Office and the Department of Trade and Industry. The structure is centralized. The UK CDs are career diplomats but commercial activities take by far most of the UK’s diplomatic resources and three-quarters of the staff are recruited locally in the target market. Rana\(^{60}\) mentions a matrix of ‘part unification’, since the two ministries have created two special units in the Foreign Office to handle trade and investments by a unified diplomatic service. Since 1997, the UK has practised (not without controversy) ‘cross-fertilization’ by hiring business people for specific diplomatic assignments.\(^{61}\) Switzerland is special because it works with a coordination mechanism in priority markets (Swiss Business Hubs); otherwise the Swiss MFA is responsible for commercial diplomacy.

Arrangement 3: The Northern Europe Type; and Arrangement 4: The Commonwealth Type — Combination of Foreign Affairs and Trade

Australia, Canada and New Zealand separate trade policy and trade promotion. Scandinavian countries include trade promotion, but all of these countries combine foreign affairs and trade in a single ministry. They maintain a separate representation that is distinct from their diplomatic service, although the heads of the diplomatic missions are responsible for both activities.

Arrangement 5: The Classical Type — Trade Promotion as Part of Trade Policy and Ministry of Trade

The Chinese MFA is not directly involved in commercial diplomacy and China keeps a ‘commercial service’ collaborating with the embassy. The US ‘commercial service’, which deals exclusively with business-support issues, is a part of the US Department of Commerce but it also lies under the authority of the ambassador and, through the ambassador, of the US Department of State. Another example

\(^{60}\) Rana, *Inside Diplomacy*.

is the Republic of South Africa, where tasks include export promotion, attracting FDI, encouraging technology transfer, and improving bilateral relations. The South African Ministry of Trade decides where trade offices will be. The CD formally falls under the authority of the head of mission (ambassador). Problem areas that are addressed are coordination, communication and specialization.

**Arrangement 6: The Developing Country Type — Trade Promotion in the MFA**

The MFA constitutes the only responsible organ and there is no combination of foreign affairs and trade. The weight of institutions may be considerable and reforms may thus be difficult to implement. In addition, rivalry may arise between the MFA and MT; this is typically the case of large or medium-sized developing countries.

Table 1 summarizes the six organizational arrangements. The focus is on the CD’s position within organizational complexity and implications in terms of commercial diplomacy’s overall positioning and challenges.

**Individual Factors**

**The Importance of the Individual**

Ministries’ and TPOs’ definitions of the commercial diplomat’s individual job description (his/her terms of reference within the contract) and boundaries in the activity areas (such as trade, intellectual property (IP) and FDI) and roles will play an important part in further designing the system with regard to recruitment profiles and motivation policies. Carron de la Carrière\(^62\) argues that business support is no job for traditional diplomats; rather, the job finds its roots and challenges in marketing, market knowledge, and commercial and financial techniques that are in general not expected from traditional career diplomats. The question of ‘what do high-level government negotiations (at a legal framework level) and country positions at the International Monetary Fund and the World Trade Organization have to do directly with the promotion of business deals and the marketing plan of an SME?’ is legitimate. The CEO of a Swiss multinational SME sums it up: ‘we need people [commercial diplomats] who understand international SMEs and explain things well and fast’.

Lee\(^63\) and Mercier\(^64\) refer to ‘cross-fertilization’ between public and private sectors, yet this is not practised enough, and it constitutes a necessary exchange of competencies between the public and private sectors. The export manager of

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\(^{62}\) Carron de la Carrière, *La diplomatie économique*.


\(^{64}\) Mercier, ‘Commercial Diplomacy in Advanced Industrial States’.
<table>
<thead>
<tr>
<th>Arrangement Type</th>
<th>Implications from an organizational standpoint: positioning of commercial diplomacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 CD runs TPO branch separately, <em>independently</em> from the embassy. The embassy is only involved in policy issues. There is no CD in the embassy for business promotion. Germany is a special case.</td>
<td>If the CD’s organizational unit (the ‘trade representation’) becomes obviously too independent from a government’s administration yet still funded by it, then the advantages of privatization should be weighed against the status quo. To what extent diplomatic status is actually given and used is to be examined.</td>
</tr>
<tr>
<td><strong>Corporatist Type</strong> Japan, Korea, Italy, Germany, Austria.</td>
<td>Promotion of the country and location is to be included, if the service is to remain government-funded. Possible further subcontracting is to be considered with the private sector’s competitive consultants or privatization with minority membership of the government in the board of directors.</td>
</tr>
<tr>
<td>2 Trade promotion entrusted to a dedicated agency. <strong>Pragmatist Type</strong> UK, Singapore, (Switzerland).</td>
<td>Oversight may become too complicated between TPO, MT and MFA. A simple message and organizational identity has to be communicated outwards. Examine what can possibly stand on its own feet within the TPO and subcontract by privatizing where possible, submitting to public tender. Potential conflict between MFA and MT regarding division of labour and identity.</td>
</tr>
<tr>
<td>3 CD coordinates the TPO branch, which is integrated with the MFA or MT. <strong>Northern Europe (Scandinavian) Type</strong> Sweden, Norway, Denmark, Finland, Iceland, (Ireland).</td>
<td>Trade promotion integrated in MFA-MT and MFA work is <em>harmonized</em> Ministry of Foreign Affairs (MFA) To what extent diplomatic status is actually given and used is to be examined. Communication and relationship with the embassy (trade policy) is to be examined regarding firms’ enquiries and other issues that might arise in outwards communication and participation in trade/investment events. Does the CD understand location and country marketing issues versus classical export promotion and export development?</td>
</tr>
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Table 1 (cont.)

<table>
<thead>
<tr>
<th>Arrangement Type</th>
<th>Arrangement between Ministry of Trade and Ministry of Foreign Affairs</th>
<th>Implications from an organizational standpoint: positioning of commercial diplomacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 CD coordinates the TPO branch. Trade promotion handled by separate agency (TPO).</td>
<td>Separation of trade promotion activity and trade policy (MT excluded)</td>
<td>Relationship with the ministry of trade/industry has to be clear regarding division of labour.</td>
</tr>
<tr>
<td><strong>‘Commonwealth’ Type</strong></td>
<td>Ministry of Foreign Affairs (MFA)</td>
<td>Watch the impact of possible politicization of the TPO; re-examine the advantages of MFA supervision.</td>
</tr>
<tr>
<td>Australia, New Zealand, Canada.</td>
<td></td>
<td>Identity issue and task overload (in diversity) might arise because of the ambiguous identity of the two poles of business development and hands-off facilitation.</td>
</tr>
<tr>
<td>5 CD works with the TPO branch, which is frequently in the perimeter of the embassy. CDs may also report to the ambassador.</td>
<td>Trade promotion is part of trade policy. MT and MFA work separately</td>
<td>Is a behavioural effort in trade and investment promotion possible and to be expected while trade-policy issues probably also take considerable time?</td>
</tr>
<tr>
<td><strong>Classical Type</strong></td>
<td>Ministry of Trade (MT)</td>
<td>Delegate specialized trade promotion to the private sector and recommend firms to use them.</td>
</tr>
<tr>
<td>USA, China, (Taiwan), Poland, France, Russia, Spain, Hungary.</td>
<td></td>
<td>Redefine realistic objectives, including trade policy and promotion.</td>
</tr>
<tr>
<td>6 CD is mainly a generalist and deals with both economic and political issues. If an agency, it is integrated with MFA and embassy.</td>
<td>Separation of foreign affairs and trade. Ministries work separately</td>
<td>Efforts may concentrate on the promotion of country image and location to obtain the best possible press and professionalization in important host markets through mandating public relations and public affairs firms for advice.</td>
</tr>
<tr>
<td><strong>Developing Country Type</strong></td>
<td>Ministry of Foreign Affairs (MFA)</td>
<td>Concentrate on business advocacy in host markets for the few competitive firms and influence trade regulations.</td>
</tr>
</tbody>
</table>

another SME in the scissors’ industry likens expectations of a CD’s support for export development to an investment decision:

We think in terms of marketing research and in economic terms and it is an advantage to work with commercial diplomats and their teams who also have had a background in management and marketing. We look for partners in foreign markets, for distributors of our products; it’s not typically a diplomatic job. […] If it’s about industrial investment (and opening a subsidiary), then of course we would need much more the diplomat who would help us with political contacts.
Recruiting the Commercial Diplomats and Talent Management

Since business-promotion tasks have often been delegated to ‘less prestigious’ positions and local assistants (within an embassy or TPO) or consular staff,65 ‘selling socks for Britain’ — as reforms in the UK became known — might shock the traditional non-commercial view of diplomacy. Prestige ought to be built up in both the career diplomats’ and new commercial diplomats’ circles by offering attractive working conditions. It is a challenge for governments to recruit potentially professional commercial diplomats who are in an ascending career phase, given a system where commercial diplomacy is not limited to classical career diplomats. The private sector obviously offers better material conditions (in terms of salaries and stock options, etc.) for senior managers, yet diplomacy remains attractive for other benefits, such as good working conditions abroad, tax-free salaries, job security, high prestige and contacts. A trade representative representing Sweden illustrates: ‘We have a very business-like structure and staff; the CD is hired only for the assignment, usually four years. STC [the Swedish Trade Council] is the third most popular employer in Sweden overall, in both public and private sectors (after IKEA and H&M).’

The research here identifies two elements — even though not necessarily exhaustive — that seem critical for future recruitment: (i) business knowledge, mainly in international marketing; and (ii) business experience. In Ireland and Sweden, for instance, the most successful CDs are those with a business background and at least five years experience in senior management, if possible in marketing. It has also been suggested that after several years of diplomatic service, CDs should return to the private sector so as not to lose touch with the business world. A Swedish CD illustrates:

Most CDs are recruited from the private sector and go back to the private sector — mostly Swedish MNEs [multinational enterprises]. Some trade representatives do not even have to be from Sweden, as it is knowledge of the target market that counts; yet in host countries where we work with diplomatic status, Swedish citizenship is a must.

The newly recruited profiles should ideally combine strengths in international experience and business, preferably in senior marketing, and have a solid understanding of the involved institutions. Various models and priorities may be chosen; there is no single winning formula. It is crucial to be at ease with a variety of counterparts and to remain a credible and trustworthy partner for both business executives and public authorities. This touches upon the issues of credibility, trust and durability in relations between the business world and government representatives.66

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66) Naray, ‘Was ein guter Wirtschaftsdiplomat Alles können muss’, pp. 31-34.
Whatever model is chosen, the most important factor is that the commercial representatives have natural access to international business and marketing issues while understanding the broader context of bilateral relationships between two countries. Cross-fertilization with the private sector could be encouraged: multinationals constitute a reservoir of great international talent to be recruited, even if initially only for limited assignments.

Conclusions

This article reviewed the existing literature on commercial diplomacy in the wider context of trade and investment promotion and business promotion. These sources were backed by empirical research based on in-depth interviews and field observations in order to conceptualize further the roles and activity areas of commercial diplomacy. The identified main groups of roles, which cut across the activity areas (that is, trade promotion, investments, cooperation in science and technology, and protection of IPR) are facilitation, the advisory role and representation — ‘FAR’. Various types of organizational arrangements were then identified, going from a private-sector-like service for companies to a traditional ministry-dominated structure. It seems that the commercial diplomat’s position and distance from government and business institutions, as well as individual factors such as professional background, are to be considered in order to improve the design and management of commercial diplomacy. For governments and responsible trade-promotion institutions, clear positioning of the commercial diplomat’s roles and fundamental mission may be the first step towards working on the two adaptable dimensions of organizational (structure should follow strategy) and individual factors (motivation, recruitment and talent management).

Contribution and Further Research

This article’s conceptualizations and framework-building have considerably opened the emerging research field of commercial diplomacy and commercial diplomats’ roles, activity areas, organizational design, and personnel recruitment and management. Further in-depth research of the two dimensions that affect effectiveness is necessary in order to understand better the concrete room for manoeuvre for possible structural and individual reorganization. New research questions may be formulated on the basis of this article. The article leaves us with implications and possible suggestions for adapting commercial diplomacy and, if necessary, reorganizing it according to home and host countries. One could also investigate how one could measure the extent to which governmental objectives and beneficiary (business) satisfaction have been reached and thus address commercial diplomats’ effectiveness. Further research is needed to refine and build on
these concepts with quantitative methods, as well as qualitative case-study data, in order to formulate tangible and also quantitative-based recommendations to governments and business firms.

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Any Ties that Bind? Economic Diplomacy on the South Asian Subcontinent

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Summary
The ‘liberal peace’ model emphasizes the importance of commercial ties and shared norms for peaceful inter-state relations. In view of that, economic diplomacy promotes cross-border economic activities not only for direct economic gains but also for the indirect benefits of stable political relations. Ever since the creation of India and Pakistan in 1947, political relations between the two states have been tense and have witnessed six military confrontations. The enduring rivalry has undoubtedly limited contacts between the two countries. The political elites have only intermittently supported direct diplomatic engagement, and there are severe restrictions on trade and travel between the countries for ordinary citizens. Furthermore, India is generally seen as a successful democracy in a developing country, while Pakistan has been an autocracy for large parts of its history. India-Pakistan can therefore be considered as a worst-case scenario for the liberal peace model, with continued high levels of hostility likely.

This article argues that economic diplomacy continues to matter, because it has increasingly involved India and Pakistan with the world community. It provides evidence suggesting that these indirect links can be seen to have functioned as (partial) substitutes for direct ties. Furthermore, the article analyses the relevance of indirect ties for diplomatic efforts to address three conflict issues: the Kashmir conflict; the Indus water basin; and the nuclear programmes.

Keywords
economic diplomacy, crisis diplomacy, South Asian subcontinent, Kashmir conflict, Indus water basin

Introduction
The hostility between India and Pakistan is arguably one of the most prominent inter-state conflicts extant, whose saliency is highlighted by the presence of nuclear weapons on both sides. Conflict reduction is also necessary if the region is to release resources from military expenditure for poverty reduction. The
enduring rivalry between India and Pakistan has limited direct contact between the two countries. Political elites only support direct diplomatic engagement intermittently, and there are severe restrictions on trade and cross-border travel by ordinary citizens.

The liberal peace model emphasizes the importance of commercial ties and shared norms — of which shared democratic institutions have received most attention — for peaceful inter-state relations. Liberal peace and economic diplomacy are thus closely related. Following Nicholas Bayne and Stephen Woolcock, and Peter van Bergeijk, this article defines economic diplomacy as a set of activities involving state and non-state actors that are related to cross-border economic activities such as trade, investment, lending, aid and migration. Economic diplomacy promotes economic interactions not only for their direct economic gains but also for the indirect benefits of stable political relations. An important element of economic diplomacy is the ‘[t]he use of economic assets and relationships to increase the cost of conflict and to strengthen the mutual benefits of cooperation and political stable relationships’. The study of economic diplomacy shares further with liberal peace their attention to the role of non-state actors, in particular intergovernmental organization (IGO), for stable inter-state relations.

From the perspective of liberal peace, India-Pakistan can be considered as a worst-case scenario in which there are only limited opportunities for economic diplomacy and continued high levels of hostility are likely. First, India is generally seen as a successful democracy in a developing country, while for large parts of its history Pakistan has been an autocracy. Second, direct bilateral cross-border economic activities are limited. It is noteworthy, however, that over the same period India and Pakistan have become increasingly involved with the world community, as shown by increased economic as well as diplomatic linkages. Can the latter substitute for direct ties? If so, how have global concerns about stability on the South Asian continent spurred diplomatic initiatives? In particular, is there evidence that these diplomatic efforts have made a difference to three salient issues in India-Pakistan relations: the Indus water basin and the Kashmir conflict, both now under the shadow of their nuclear competition? This article argues that since trade between India and Pakistan is very limited, bilateral commercial ties cannot explain any management of conflict. However, economic diplomacy has

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mattered, because indirect links via IGO and trade networks have become increas-
ingly well developed and may have prevented things from becoming even more
conflictual. This is a modified version of the Kantian peace theory, relative to what
could have happened.

Setting the Stage

India and Pakistan emerged as separate nation-states in August 1947, when Brit-
ish India was partitioned following independence from colonial rule. In 1971 the
eastern wing of Pakistan separated to become Bangladesh. In many ways, India
and Pakistan share a common heritage, including overlapping languages and eth-
nicities, as two major provinces of British India were split up during the partition
process (Punjab and Bengal). The ostensibly differentiating factor is religion;
although Pakistan is predominantly Muslim, up to 13 per cent of India’s popula-
tion continues to be Muslim. The hostility between India and Pakistan dates back
to the very inception of these countries as independent states. Fig. 1 charts the
hostility levels of the two states on a scale of 0 to 6. Every hostility levels have usually
been at a high level of 4, indicating belligerency short of outright war. India and
Pakistan have fought six wars or fatal conflicts: three over the disputed territory
of Kashmir in 1947-1948, 1965 and 1999; the Rann of Kutch War in 1965; the
secession of Bangladesh in 1971; and sporadic fighting over the uncharted Sia-
chen Glacier in the 1980s.

Fig. 1. Hostility levels in Pakistan and India.

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As a further illustration of the high level of hostility, Fig. 2 graphs the large military expenditures of India and Pakistan, showing clearly the greater military burden for the smaller country, Pakistan, indicating its efforts to balance the military might of India. The World Bank reports that the two countries have some of the highest military burdens in the world outside the Middle East.5

India and Pakistan established formal diplomatic relations quickly following their independence, but the relations have remained ‘difficult and volatile’.6 Diplomatic relations were interrupted following the 1971 India-Pakistan war until 1976. Since then periods of reduced tensions with high-level bilateral meetings have alternated with periods of strained relations. Territorial disputes — in particular focused on Kashmir and East Pakistan/Bangladesh — triggered deterioration of relations. More recently, religious tensions — such as the destruction of the Ayodhya mosque by Hindu extremists in December 1992 and terrorist attacks in Mumbai in 1993 and 2008, as well as the 2001 attack on India’s parliament — seriously damaged diplomatic relations. For example, the process of Composite Dialogues that were agreed by India and Pakistan in 2004 was halted after the 2008 Mumbai attacks and is yet to resume, even though it was agreed in principle to resume the process in April 2010. Yet after reviewing the historical record of bilateral diplomacy, Peter Lyon concludes that:

[...] the conversations and negotiations between India and Pakistan have been much more continuous and frequent than is often popularly believed. True, there is generally an acute disproportion between the number of these contacts and their rather slender accomplishments. But for both countries their bilateral encounters constitute a major aspect of their external relationships.7

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7) Peter Lyon, *Conflict between India and Pakistan: An Encyclopedia* (Santa Barbara CA: ABC-CLIO,
It is noteworthy that diplomatic engagement has recently been initiated in the sidelines of multilateral meetings, such as of the South Asian Association for Regional Cooperation (SAARC) in 2004 and 2010, or the Non-Aligned Movement in 2006. Pakistan has consistently striven for good diplomatic relations with the United States and China, as well as the Gulf States and Europe. During the Cold War, India promoted itself as one of the leaders of the Non-Aligned Movement. In recent years, India has broadened its diplomatic portfolio and strengthened its relations with the United States, Japan, the European Union, the Association of South-East Asian Nations (ASEAN), Iran and China. It is also very active in other multilateral organizations, such as SAARC and the UN. Economic interests often motivate India and Pakistan to get involved in international organizations, and it also reflects the growing economic importance of India in particular.

Contacts between ordinary citizens are even more limited than elite interaction. There are important historical and cultural factors that have made the people of these two countries grow apart. First, there is the trauma of partition in 1947. Both the Indian and Pakistani Punjab were ethnically cleansed; some six million refugees were forced to flee the Indian Punjab to Pakistan and similarly four million people moved from Pakistan to India. At least half a million (but more likely one million) died in the violence associated with the partition of Punjab province alone, something that has prompted many writers, including Stanley Wolpert, to describe it as an act of stupendous mismanagement by the colonial administration. Second, since the late nineteenth century, the language that was common to all communities in northern India has grown apart. What used to be Hindustani has gradually metamorphosed into Urdu for Muslims and Hindi for non-Muslims. Prior to the advent of satellite television, films or music in common or commonly understood languages could not be viewed in the other country except through clandestine means. Finally, the draconian consular practices of the two countries inhibit travel and cultural exchange, despite the much vaunted cricket tours. Rail and air links between the two countries remain limited and subject to restrictions. As will be discussed more extensively below, trade between India and Pakistan declined sharply between 1947 and 1965, and has only

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12 Beena Serwar, ‘India and Pakistan are Stronger Together’, 5 October 2010, available online at guardian.co.uk.
partially recovered since then. Interestingly, throughout this period the economies of both India and Pakistan have become increasingly more open; as can be seen in Fig. 3. Historically, Pakistan is more trade dependent. What, if any, are the consequences of these diverging trends — between limited bilateral contacts and increasing regional and global interaction — for crisis diplomacy in South Asia?

Fig. 3. Trade openness for Pakistan and India.
Liberal Peace and the ‘Ties That Bind’

States are often regarded as existing in a state of non-contractual anarchy *vis-à-vis* each other, making the exercise of power or the gathering of power by war an opportunistic act. Yet liberals have long held that common values and/or inter-state commerce can moderate these war-like tendencies.\(^\text{13}\) According to the concept of liberal peace, conflict between any two states becomes less likely if they are both democracies, economically interdependent and co-members of a large number of IGOs. Liberal peace may be sub-divided into two types of theories: one set emphasizing common norms (with democracy at the kernel of these shared beliefs); and another highlighting that conflicts seriously disrupt trade, thereby reducing the gains from trade and thus inducing a rational leadership to eschew war. The former notion is more idealistic, and the latter idea is predicated upon a rational calculus of the opportunity costs of lost trade. Economic diplomacy is particularly relevant for the second set of arguments, since it promotes and regulates cross-border economic activities as well as the participation of state and societal actors in international commercial institutions.

The idealist version of liberal peace can be traced back to Immanuel Kant — so it is also known as the ‘Kantian peace’. In his essay on the *Perpetual Peace* (1795),\(^\text{14}\) Kant argues that although war is the natural state of man, peace can be established through deliberate design. He emphasizes the importance of international law facilitating peaceful relations for the envisioned loose ‘federation’ of sovereign republics. The adoption of a *republican* constitution by all states would, *inter alia*, check the war-like tendencies of monarchs; the cosmopolitanism that would emerge among the community of states would preclude war. Additionally, commerce between nations would grease the machinery that keeps the peace. David Bearce\(^\text{15}\) suggests three arguments why international commercial institutions matter for peace: they increase state leaders’ expectations about the future gains from trade; they allow for security coordination and provide information about economic and military capabilities; and they bring together high-level state leaders on a regular basis.

In their empirical evaluation of these arguments, Bruce Russett and John Oneal\(^\text{16}\) find indeed that war is less likely between states that are both democratic

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\(^{15}\) Bearce, ‘Grasping the Commercial Institutional Peace’, p. 352.

and share more memberships in IGOs, preferably with predominantly democratic member states. Historically, India has always had one of the highest democracy scores in the developing world (scoring 7-9 out of 10), whereas military coups — in 1958, 1969, 1977 and 1999 — have interrupted Pakistan’s experience with democracy. Pakistan’s incomplete and intermittent process of democratization is particularly problematic in the light of Edward Mansfield and Jack Snyder’s observation that the road to democracy contributes to the risk of conflict for countries at an early stage in the democratization process. They argue that national sentiments rise to the fore in the presence of weak institutions. This may apply to Pakistan, and even to India given its widespread poverty. Clearly, India and Pakistan cannot rely on a shared democratic polity to mitigate conflict.

Erik Gartzke emphasizes that common foreign policy goals reflected in the membership of IGOs also promote peace. Han Dorussen and Hugh Ward make a similar point, except that they emphasize indirect network links. They argue that participation in an IGO network enables not only intergovernmental organizations but also third countries to mediate more effectively. It also minimizes any lack of information over preferences, intentions and capabilities, even when there is no direct dialogue between the antagonists, as with India and Pakistan. It is thus encouraging that India and Pakistan have both engaged consistently and progressively with the international community, as witnessed by their membership of IGOs. Fig. 4 graphs the joint IGO membership of India and Pakistan, which increased from 26 up to 66 between 1947 and 2000. This is contrasted with the average joint IGO membership for all pairs of states in the world, which has increased from approximately 17 to 39. Throughout this period, the number of IGO co-memberships of India and Pakistan has been above average. This trend also appears to have been largely unaffected by the many crises in the Indo-Pakistan history.

There is also less foreign policy divergence now when compared to the past. India under Nehru (from 1947-1964) championed the non-aligned movement, and was closer to the Soviet Union in the 1960s, 1970s and 1980s, from whom it obtained concessionary military assistance. Pakistan, in contrast, was a member of long-defunct military pacts such as the Baghdad Pact or CENTO (Central Treaty Organization) and SEATO (South-East Asian Treaty Organization) during the height of the Cold War. The United States showed some favour to Pakistan and gave it military aid during the late 1950s, early 1960s and 1980s.

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19) The global mean is measured as the average for all politically relevant dyads, where the latter are defined as all states that share a common border as well as pairs of states involving the ‘major powers’; for this period, the permanent members of the UN Security Council.
However, the United States suspended military aid to Pakistan (and India) after the 1965 war, and did not resume it until the Soviet invasion of Afghanistan in 1979 and the Reagan presidency in 1981. Pakistan moved closer to its enemy’s enemy — China — in the mid-1960s, after India’s border disputes with China led to war in 1962. Indeed, Pakistan became increasingly reliant on China, rather than the United States, for the transfer of military hardware and technology.

With the end of the Cold War, the strategic interests of the major powers in South Asia were transformed. With the Soviet Union long gone, Russia’s influence in the region has declined. There has been a rapprochement between India and China, and the United States views both Pakistan and India as allies in its global war on terror.

The second liberal view that trade between nations directly contributes to peace can be related to Baron de Montesquieu’s *Spirit of the Laws* (1748), where he states that commerce tends to promote peace between nations because mutual self-interest precludes war. Considerable debate remains, however, on whether any opportunity costs of lost gains from trade deter inter-state conflict. While all analysts agree that war impedes trade, the ‘realist’ view is that countries may choose to disrupt their potential enemy’s gains from trade by ceasing to trade with them, even if this means hostilities. Katherine Barbieri and Jack Levy, using an interrupted time-series framework, found little impact of war on trading relationships for seven dyads from 1870. They argue that any disruption to bilateral trade caused by war is, in many instances, remedied after peace emerges. Both trade and war produce winners and losers. Even if there are losses to the aggregate

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economy from war or diminished trade, some groups may gain, and these groups may be the more politically influential. Charles Anderton and John Carter, however, dispute these results.\textsuperscript{21}

Solomon Polachek and Carlos Seiglie maintain that wars and disputes between geographically contiguous states involve substantial losses, as more efficient geographically proximate trade is displaced.\textsuperscript{22} At the same time, the absence of trade between neighbours also increases the probability of conflict. Polachek, in collaborative research with John Robst and Yuan-Ching Chang, demonstrates that geographical proximity has a greater conflict-enhancing effect when two nations fail to realize opportunities for trade.\textsuperscript{23} Both findings have worrisome implications for India and Pakistan. Fig. 5 shows that India-Pakistan official trade (as a proportion of Pakistan's total international trade) steadily declined from nearly 20 per cent in the early 1950s, plummeting to almost zero after their war in 1965, and has shown some signs of recovery in the 1990s but is still below the levels of the 1950s.

The pattern of trade also strongly suggests that the various disputes have had a negative impact on trade between India and Pakistan. The simultaneity problem or reverse causality between economic interdependence and conflict has received much attention lately. Studies by Hyung Min Kim and David Rousseau, as well as Omar Keshk, Brian Pollins and Rafael Reuveny, report that after controlling for simultaneity, conflict diminishes economic interdependence, but not the other way around. Håvard Hegre, in collaborative research with Oneal and Russett, however, finds that even controlling for reverse causality, trade still reduces the probability of conflict. Interestingly, they fault earlier studies for failing to control for geographic distance or relative capability. Arguably, both factors would be salient for India and Pakistan.\textsuperscript{24}


Han Dorussen and Hugh Ward argue that in the classical-liberal tradition, ‘trade is important not only because it creates an economic interest in peace but also because trade generates “connections” between people that promote communication and mutual understanding.’ Patrick McDonald argues further that it is not just the intensity of trade between nations, but a commitment to the policy of free trade, that may promote liberal peace as it serves to dampen domestic protectionist and pro-war interests. Edward Mansfield, Jon Pevehouse and David Bearce find that joint membership in a preferential trade institution makes militarized conflict between neighbouring states less likely. The nature of advanced capitalism leads to fewer territorial disputes, which are mainly contests over resources, as market mechanisms allow for easier access to resources. The output of more sophisticated goods and services is increasingly reliant on ‘ideas’ that are research and development intensive and skilled personnel who can be acquired through more open global labour markets. Moreover, fear of disruption to integrated financial markets decreases the likelihood of war between countries that are caught up in that web of interdependence. The fragmented nature of production, with components produced in different international locations, can also be added to this list. Much of world trade is trade in components between the same multinational firms across national borders. Accordingly, Gartzke proposes the

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notion of the capitalist peace in which the saliency of international trade in goods and services is minimized. In fact, he argues that the intensity of trade is the least important feature in the peace engendered by modern capitalism. Unfortunately, there is also little in terms of financial and investment flows between India and Pakistan limiting the immediate relevance of the capitalist peace.

Dorussen and Ward rehabilitate the pacifying role of trade through a novel channel. They argue that trade has important indirect effects over and above the interdependence that is induced by bilateral trade. Increased trade generally may do little to mollify war-like tendencies between a pair of countries, but if each of these countries interacts considerably with third countries, it will not be in their interests to go to war with each other, as it disrupts other links and networks. Because indirect ties by means of trade are economically valuable, they will also encourage mediation. In other words, any two countries are less likely to go to war with each other if their trade with the rest of the world is substantial, even when their bilateral trade dependence is low. Fig. 6 contrasts the trend of India-Pakistan connections by means of trade with the global trend. Until the second Kashmir war in 1965, trade connections between India and Pakistan were close to the global mean. Since then, and contrary to the trend in IGO engagement, the third-country trade connections have remained significantly below the global average for the whole period. More promising is that, at least since the early 1980s, India and Pakistan again follow the trend of increased global interdependence.

Syed Mansoob Murshed and Dawood Mamoon find that conflict between India and Pakistan has significantly hampered bilateral trade between the two nations. However, they also find that the converse holds; more trade between India and Pakistan decreases conflict and any measures to improve bilateral trade would be a significant confidence-building measure. Currently, however, Pakistan’s and India’s general degree of openness to world (instead of bilateral) trade has to be the dominant economic factor in conflict resolution. These results echo McDonald’s finding that generally freer trade, not just trade interdependence, facilitates peace, as well as the suggestion of Dorussen and Ward that increased multilateral trade increases the trade costs of hostility.

To summarize, from the perspective of liberal peace, the limited direct interaction between India and Pakistan remains worrisome. Weak and regularly undemocratic political institutions (particularly in the case of Pakistan) and limited economic interdependence characterize their history. More promising is their
increased interaction with the outside world; India and Pakistan have an above average number of common memberships of international organizations, which shows their consistent and progressive engagement with the world community. Economic diplomacy has been the main driver behind their increased involvement with international organizations. Economic connections with ‘third countries’ have also increased markedly, even though they still lag behind the global mean. Both developments suggest that India and Pakistan have developed ties that bring with them a vested interest in avoiding escalation of the often tense political situation. This article will now explore whether further evidence can be found that these ties via third countries and IGOs have indeed been valuable.

The Role of Third Parties in Crisis Diplomacy

It is obviously impossible here to do full justice to the diplomatic history of India and Pakistan over the last 60 years, or even to evaluate fully how diplomacy may have lessened, or possibly exacerbated, tensions. Instead, the aim of the three brief case studies below is to suggest how indirect links — in particular via IGOs but more recently also by way of commercial connections — may have prevented the record being even more conflictual. IGOs have been relevant because they have mediated and, more commonly, facilitated by providing a venue for both sides to

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meet during crises. IGO meetings have also provided third countries with an opportunity to mediate or facilitate, and — more tenuously — commercial ties may have motivated them to do so. Finally, IGOs have promoted dyadic cooperation more generally, with a potential to reduce tension.

**Kashmir**

Any search for the seeds of conflict between India and Pakistan has to acknowledge the salience of the Kashmir territorial dispute. Kashmir was not directly ruled by the British, but was a quasi-autonomous princely state with a Hindu prince ruling over a predominantly Muslim population. The partition plan allowed princely states to remain independent or to opt for either India or Pakistan. While not a single princely state with a Hindu majority was permitted to join Pakistan, the Hindu ruler of Kashmir was persuaded to accede to India. This angered many, including tribesmen in Pakistan’s North-West Frontier Province along the border with Afghanistan. The tribal incursion into Kashmir led to a response by the regular Indian army, and irregular and regular Pakistani forces were drawn into the fray. The majority of Kashmir is in India (including the Kashmir Valley) and Pakistan controls the smaller and more rugged mountainous part of Kashmir. The disputed territory of Kashmir triggered direct military confrontation between India and Pakistan in 1947-1948, 1965 and 1999. Even when they are not engaged in outright war, Indian and Pakistani troops confront each other every day, with fingers literally on the trigger, along the ceasefire line or line of control that was established on 1 January 1949. India and Pakistan amassed troops along the border in 1951 and 2002. Moreover, India has regularly accused Pakistan of fermenting, aiding and abetting the insurgency in Indian Kashmir since 1989 and of related wider acts of terrorism inside India. In Indian-administered Kashmir, an armed insurgency combined with public protest has gradually grown, along with demands for full ‘independence’. Unlike in the past, the protests at this juncture in Indian-held Kashmir seem mostly home grown in nature. Indian Kashmir is heavily militarized with 700,000 Indian military, paramilitary and police personnel dealing with insurgency, as well as facing Pakistan’s army. There are widespread allegations of human rights abuses, including the extra-judicial ‘disappearance’ of suspected insurgents. Indian Kashmir is also subjected to emergency legislation granting immunity to the activities of the security forces.

With initial encouragement from India, the United Nations has attempted to mediate in the dispute between India and Pakistan since January 1948, almost immediately following independence. The UN brokered a ceasefire in 1949 and deployed the United Nations Military Observer Group (UNMOGIP), one of the

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first and longest running UN peacekeeping missions, to monitor the ceasefire line. In 1972, India and Pakistan formally defined the line of control in Kashmir, which followed the 1948 ceasefire line with only minor alterations.\textsuperscript{32} India maintains that UNMOGIP’s mandate lapsed with the 1972 Simla Agreement; a position that Pakistan does not accept. The position of the UN Secretary-General has been that, in these circumstances, a decision from the UN Security Council is needed to terminate UNMOGIP. As a consequence, India and Pakistan vary in their level of cooperation with UNMOGIP. Only Pakistan continues to lodge complaints about ceasefire violations, while India has restricted the UN observers’ activities on Indian territory. India has not, however, severed its ties with UNMOGIP completely and still provides accommodation, transport and other facilities.

The 1949 ceasefire envisaged a plebiscite to determine the fate of Kashmir, but it has never been implemented because of Indian reservations. Moreover, following the Simla accords, India has advocated bilateral talks as a conflict-resolution mechanism and has been adverse to any international debate on the issue. Bilateral talks have been relatively regular since the mid-1980s, but have failed to resolve the Kashmir issue and occasionally have even contributed to tensions.\textsuperscript{33} During the Cold War, the major powers were similarly unable, and possibly even unwilling, to resolve the conflict. Robert Wirsing holds that the:

[India-Pakistan] rivalry offered all three of these powers [the United States, Russia and China] tempting opportunities for alliance, for arms sales, and for much else; at the same time it continued to impose severe limitations on the policy options open to them. [...] [T]he stubborn persistence of the Indo-Pakistan rivalry exerts, for the most part, a profoundly conservative influence on these policies, breeding in them at least as much continuity as discontinuity and, in particular, discouraging changes in policy that would promote greater regional stability and cooperation.\textsuperscript{34}

In his analysis of major power involvement and the persistence of the India-Pakistan conflict, Ashok Kapur similarly argues:

[...] that the resolution of the India-Pakistan conflict has not been the primary motive in the policies of major powers that have been heavily involved in the area. The interventionist character of their diplomatic and military postures was driven by a desire to maintain a situation of manageable instability.\textsuperscript{35}

\textsuperscript{32} See online at http://www.un.org/en/peacekeeping/missions/unmogip/. UN Security Council Resolutions 39 and 47 (1948); of further relevance is Resolution 91 (1951). With Resolution 307 (1971), the UN Security Council supported the de facto ceasefire ending the 1970 war, during which the UN had been largely ineffectual.

\textsuperscript{33} Lyon, Conflict Between India and Pakistan; Dixit, India-Pakistan in War and Peace, recounts the failure of bilateral talks leading up to the Kargil crisis in 1999.


'Manageable instability', however, still meant that the major powers had an interest in preventing outbreaks of war and in securing ceasefire in case of war. Sumit Ganguly recounts how during the crises in 1987 and again in 1990, the United States counselled restraint and direct dialogue between India and Pakistan. Illustrating the changed mood following the end of the Cold War and shared concerns about possible war, US President George H.W. Bush and Soviet President Mikhail Gorbachev issued a joint statement urging restraint over Kashmir in 1990.

**Indus Water Basin**

The United Nations Environment Programme (UNEP) lists the Indus River system as one of the world’s potential water conflicts. The population and per capita demands for water are growing rapidly in the Indus basin on both sides of the border, while water resources are limited. The pressures of water scarcity particularly affect Pakistan; by some accounts, the flow of water in Pakistani-controlled rivers has been falling by 7 per cent per annum over recent years. The pumping of groundwater is leading to salinization of the aquifers used to provide water for rapidly growing urban areas in Pakistan, as well as increasing demands from agricultural production in Pakistan and Indian-controlled Punjab. The 2010 Pakistan floods heightened concerns about the possible, highly unpredictable, effects of climate change, which may affect seasonal monsoon rain patterns and reduce rainfall in the headwaters of the river system in Kashmir and Tibet.

The border between Pakistan and India divided a large-scale canal irrigation system, engineered by the British in the nineteenth century, which had contributed to the massive development of grain and cotton production in the Punjab. The 1947 partition allocated most of the area of irrigated land to Pakistan, but left India with upstream control of the water resources, since the Indus flows through Indian-controlled Kashmir, and several of its major tributaries also flow through or originate in Indian-controlled territory. Pakistan was left in a vulnerable position as a downstream state in relation to a potentially hostile neighbour. On 1 April 1948, India indeed shut off the water flowing into Pakistan’s canals, affecting 8 per cent of Pakistan’s cultivable land as well as the city of Lahore. While India claimed that this was an accident, Pakistan viewed it as a hostile act. Although the water started to flow again by May 1948, tensions remained high.

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From 1952, India and Pakistan negotiated the issue under the auspices of the World Bank. The dialogue was initiated by World Bank President Eugene R. Black, and had as its initial objective to manage the basin as a shared resource. After talks collapsed in 1954, the World Bank proposed dividing the river basin with exclusive use of the waters. India got the three eastern rivers — the Ravi, Beas and Sutlej — while Pakistan was awarded the three western flows: the Indus, Jhelum and Chenab. Besides getting 80 per cent of the available water, Pakistan was compensated by being allowed to build upstream dams and was guaranteed supply of water from India for a ten-year transition period. The World Bank further organized a consortium of donors, which raised US$ 900 million in addition to the US$ 174 million that was promised by India. Membership of the consortium — the United States, Canada, the United Kingdom, West Germany, Australia and New Zealand — reflected the US dominance of the World Bank and its strategic interests, which at the time clearly favoured Pakistan. The Indus Waters Treaty was signed in Karachi, Pakistan, on 19 September 1960.

The Indus Water Treaty has proven to be resilient to major crises, even wars, in India-Pakistan history. As Graham Chapman concludes ‘[t]here are conflicts — over shifting river courses on the border and the consequent river-training works, over drainage and local floods — but these are not of major international significance’. The Trans-boundary Freshwater Dispute Database makes further mention of 35 cooperative events, including three treaties, eleven non-military economic, technological or industrial agreements and eight cultural or scientific agreements. The most serious dispute so far concerned the Baglihar Dam on the River Chenab, which Pakistan claimed violated the Treaty. After the failure of bilateral talks on the issue between 1999 and 2004, Pakistan raised the issue to the World Bank, whose final verdict — delivered on 12 February 2007 — was accepted by both sides. The verdict only resulted in fairly modest reductions to Indian design. The further issue relating to the initial filling of Baglihar Dam was resolved on 1 June 2010.

Nuclear Competition

India detonated a nuclear device in 1974. About the same time, Pakistan embarked on an effort to develop nuclear weapons, for which the Indian test provided additional impetus. Subsequently, the US Carter administration instituted some sanctions against India and Pakistan over their nuclear programmes. In 1998, Pakistan conducted nuclear tests following Indian nuclear tests in the same year.

41) UNEP, Hydro-political Resilience and Vulnerability along International Waters: Asia, pp. 44-45; and Aaron Wolf, Transboundary Freshwater Dispute Database, a project of the Oregon State University Geoscience Department, 2003, available online at http://www.transboundarywaters.orst.edu/.
making the nuclear capabilities of both sides explicit. The effects, if any, of these
developments for stability in South Asia remain unclear. Sumit Ganguly, Devin T. Hagerty and Saira Khan all argue that the recognition of each other’s nuclear
capabilities may well have moderated the policies of India and Pakistan during
crises.43 The overt nuclearization clearly did not stop both sides from initiating
crises. Pakistan still supported the intrusion of insurgents into the Kargil area of
Kashmir, prompting a military response from India. Interestingly, the response
was limited to the Kargil area and India avoided crossing the line of control. Fol-
lowing 9/11 and in the wake of the Muslim extremists’ attack on the Indian
parliament, India threatened a limited conventional war against terrorist bases
inside Pakistan’s Kashmir, but eventually decided to back away, possibly fearing
nuclear escalation.

The possibility of a nuclear confrontation also appears to have raised the inter-
est of third parties in mediating, or at least facilitating, peaceful dialogue between
India and Pakistan. Ganguly argues that it motivated the efforts of the United
States to temper Pakistan’s policies in 1987 and 1990.44 Gaurav Kampani argues
that in response to India’s more assertive coercive diplomacy under the nuclear
shield, the United States pressured Pakistan’s Musharraf regime to crack down on
some of the fundamentalist Islamic groups that were active in Kashmir in 2002.45
Rajesh Basrur, in his analysis of the crisis following the attack on India’s parlia-
ment on 13 December 2001, notes that ‘since the advent of nuclear weapons,
the US has felt compelled to intervene whenever the regional barometer has
gone up’.46 Thomas L. Friedman claims that Indian business leaders responded to
the US State Department’s travel advisory and its threat to India-US business
relations by successfully pressing their case for de-escalation of the conflict.47

On occasion, IGOs have also played a role in reducing tensions. The 2002
regional Conference for Interaction and Confidence-building Measures in Asia
(CICA) meeting can serve to illustrate how the exchange of information and
mediation outside the formal context of the IGO business can still matter. CICA’s
first summit meeting became a venue for intensive international mediation in
Indian-Pakistani relations during the height of the 2002 Kashmir crisis, even
though CICA is relatively weakly institutionalized and India’s Prime Minister

44) Ganguly, Conflict Unending, pp. 79-100.
Vajpayee and Pakistan’s President Musharraf refused to engage in direct dialogue at the meetings. There were, however, significant bilateral talks between China and Russia on one hand and India and Pakistan on the other. Significantly, CICA was not the main mediator, but it nevertheless had a clear latent function in relation to the conflict.

The SAARC meetings have proven to be even more significant. The decision of Vajpayee to attend the 12th SAARC summit in Islamabad in 2004 allowed for a further reduction of tensions. Vajpayee and Musharraf agreed to re-establish the Composite Dialogue to resolve their bilateral disputes. The Composite Dialogue would encompass territorial disputes as well as promotion of friendly exchanges, terrorism and drug trafficking, and economic and commercial cooperation. The first round in this renewed Composite Dialogue was held in New Delhi from 27-28 June 2004. The July 2008 bombing of the Indian Embassy in Kabul, followed in November 2008 by terrorist attacks in Mumbai, brought the process to a halt. In 2010 the 16th SAARC summit provided yet another opportunity to restart the dialogue, when Indian Prime Minister Manmohan Singh and Pakistani Prime Minister Yousuf Raza Gilani met on the sidelines of the meeting and signalled that they would work towards resuming dialogue.

Conclusions

The case studies provide some evidence for our proposed modified version of the Kantian or liberal peace: given limited and tenuous direct contacts between rival states, indirect connections can provide ties — however weak by themselves — that may prove to be essential in crisis situations. It is worth repeating that such indirect ties are generally motivated by economic and developmental needs and are the result of economic diplomacy. Moreover, an essential element of economic diplomacy is to promote a stable international environment.

In this respect, SAARC seems to be the most promising IGO, while the United States is the most promising third-party mediator. SAARC is the main regional organization promoting economic, scientific, technological and cultural cooperation in South Asia. Its origins date back to 1985 when it was formed by seven states, including India and Pakistan. At that point bilateral relations between

49) US Department of State, *Background Note: Pakistan*.
52) The others were Sri Lanka, Bangladesh, Nepal, Bhutan and the Maldives. Afghanistan joined in 2007.
India and Pakistan were at their most promising since the 1950s. The development of SAARC’s institutions and programmes has been gradual and generally seen as failing to live up to expectations and its potential. In 1995, the seven member states ratified the South Asian Preferential Trading Association (SAPTA). Notably, preferential trade agreements are the weakest form of regional trade agreements, as the concessions granted can be fragmentary, piecemeal and not general. Protectionism can continue, especially in the presence of confounding rules of origin and complex non-tariff trade barriers. Suresh Moktan’s evaluation of SAPTA using gravity models suggests that the trade-creating role of SAPTA (a multilateral agreement) would require reinforcing bilateral trade agreements. This suggests a major role for economic diplomacy. It is also noteworthy that bilateral agreements do not exist between India and Pakistan, but do exist between other South Asian states except Pakistan and Bangladesh. A South Asian Free-Trade Area (SAFTA) was established in 2006 and envisages a 20-30 per cent tariff reduction, except for items on a sensitive list. Progress on its implementation is, however, slow and fraught with difficulties.

These commercial institutions, although admittedly imperfect and institutionally weak, already provide important incentives for peace. In particular, they have increased expectations about future gains from trade and the concurrent risks of conflict for these gains, and they have provided a forum for regular meetings of high-level state leaders. Rajiv Sikri emphasizes that ‘[i]n dealing with most countries beyond India’s immediate and strategic neighbourhood, India’s foreign policy goals are primarily economic’ (emphasis added). This shows that economic diplomacy is essential to India’s foreign policy, and that it is still seen as secondary in its dealings with India’s immediate neighbours. This article has argued here that in fact the distinctions between India’s strategic and global environment, and hence between its economic and ‘classic’ diplomacy, have become increasingly blurred.

Regarding the significance of ‘third countries’, Wirsing points out that Russia, China and the United States share a major interest in the stability of relations between India and Pakistan, and

56) Sikri, Challenges and Strategy, p. 220. It is telling that Pakistan is not mentioned once in his survey of India’s economic diplomacy.
India and Pakistan is, of course, the United States. Arguably, the United States alone has the resources and capabilities to convert its parallel and positive bilateral relationships with these two states into a sustained project of regional conflict resolution.57

The United States has developed significant trade relations with both Pakistan and — particularly since the mid-1980s — with India. The United States is the leading trading partner for Pakistan as well as India, and is the largest investment partner for India. There are also large numbers of immigrants from both countries to the United States; between 1999 and 2009, 166,700 new legal residents arrived from Pakistan and 665,400 from India.58 Lacking reliable direct bonds that are resilient to recurring crises, indirect ties (via IGOs such as SAARC and the World Bank and third countries like the United States and the former colonial ‘master’ the United Kingdom) therefore appear to be the best option available to contain the India-Pakistan rivalry.

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58) Over this period, Pakistanis made up 1.5 per cent and Indians 6 per cent of all new legal residents in the United States; the data are from the Migration Policy Institute, available online at http://www.migrationpolicy.org/.
Economic Diplomacy in a Changing World

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Summary
This article stresses the importance of economic diplomacy in international policy-making. It elaborates on the global challenges that we face in the coming years. Solving these challenges has become complicated as a result of the rebalancing act from the West towards the East. The challenges touched upon here are issues such as the aftermath of the 2008-2009 global financial crisis, guarding the multilateral system, the decreasing power of the Netherlands, and securing food and raw materials. Solutions to these challenges can be found in increasing our understanding of our new partners and using economic diplomacy more frequently in an intelligent way.

Keywords
economic diplomacy, power shifts, global challenges, economic rebalancing, multilateralism, bilateralism

The Importance of Economic Diplomacy

Economic diplomacy is one of the spearheads of the Dutch cabinet and Dutch trade and investment policy. Given the long tradition of the Netherlands as a trading nation, everyone is well aware of the fact that political contact is the oil in the international economy. The Netherlands is a small country, with an open medium-sized economy. Trade and investment are of vital importance to the Dutch economy. Exports, imports and foreign direct investment (FDI) generate welfare directly. Substantial research also shows that international trade and investment enable firms to raise wages, increase the quality of products, lower prices, have Research and Development (R&D) spillover effects and increase productivity levels.\textsuperscript{1}

The importance of the role of economic diplomacy in international policy is increasing. The world is currently moving towards a ‘new normal’, whereby we are confronted with major challenges because of the fragile international economic environment. We are presently in the middle of a rebalancing act economically (so are thus handling geo-economic shifts), but this also reflects a rebalancing of political power (so a geopolitical shift). The most obvious causes are the 2008-2009 global financial crisis and the rise of the BRICs (Brazil, Russia, India and China). Being aware and prepared is crucial to maintaining a strong, open economy.

This article will elaborate on these challenges and the important role that we see here for economic diplomacy. The first section will start by defining economic diplomacy in our work; the second section will discuss the main changes in the environment in which economic diplomacy is conducted; the third section will describe the challenges for economic diplomats; and the final section will give our conclusions.

**Defining Economic Diplomacy**

The Netherlands is a small country but we have an open economy, a unique geographical location and an excellent trade-facilitating infrastructure. The Netherlands holds only two per cent of the world’s population and is of limited size. It is, however, the world’s sixteenth biggest economy, the fifth exporter, seventh importer, the fifth investor, and eighth global destination of FDI. The Netherlands has strong well-known companies operating abroad, and it is home to fourteen global headquarters of Fortune 500 companies. Nearly 8,000 foreign companies have established operations in the Netherlands. These include European distribution centres, R&D facilities, production plants and European headquarters. In total they generate 700,000 jobs, or 15 per cent of total employ-
Economic diplomacy in a changing world

Dutch government policy recognizes the potential benefits of openness to international trade and investment, both through active participation in international policy forums and through pursuing a supportive policy environment within the Netherlands, at both macroeconomic and microeconomic levels.

Economic diplomacy is one of the major tools by which the Dutch government can facilitate openness to international trade and investment and its benefits. Economic diplomacy is a government activity that supports economic transactions and trade by negotiating with governments, international bodies or in multilateral organizations. These negotiations are typically aimed at troubleshooting, improving market access and improving the functioning of markets. Economic diplomacy can be used bilaterally, multilaterally, or as a mix of the two. There is a growing body of evidence that economic diplomacy is highly effective.

Main Changes in the Environment of Economic Diplomacy

Economic strength has always been a main driver of political influence in the long run. We have seen remarkable growth in emerging economies throughout the 1990s, with growth rates of up to 6 per cent (except for 1998-1999 during the Asian crisis), and during the first decade of this century of up to almost 9 per cent (see Fig. 1).

For many developing countries the effect of the crisis has been much less severe than for the developed world. Although the world has begun to recover from the crisis, growth figures differ greatly among countries (see Fig. 2). Most industrial countries remain well below pre-crisis levels for GDP, wealth and employment, while emerging economies have out-performed industrial countries, with stunning growth that has spread well beyond China.

The West Will No Longer Dominate

In the early twenty-first century, industrialized countries produced nearly 80 per cent of the world’s GDP, while only 15 per cent of the global population lived there. This, however, is changing. Emerging markets are driving global recovery. The crisis has accelerated the economic shift towards the East. China has become

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% Year mutation

Emerging and developing markets (1)

Developed economies (2)


Developed economies (2)

Source: IMF (2010).

Fig. 1. Real GDP growth.

Constant 2009 prices, US$ in billions

Source: calculations based on IMF (2010).

Fig. 2. World’s largest economies.
the world’s second economy,12 is the largest exporter and the third-largest importer.13 India, a high potential economy because of its large and young population and upcoming middle class, is about to enter the list of ten largest economies in the world.14

The United States is no longer the engine of growth. Asia’s trade is expected to rise to no less than 36 per cent of world trade in 2025. At the same time, the EU will see its share of world trade shrink from 40 per cent in 2004 to 23 per cent in 2025. Now the rest of the world, whether it is the BRICs or CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) or other future tigers, will begin to dominate.

Worldwide, economic diplomacy is gaining in importance. With the world’s centre of gravity shifting eastwards, we see a movement towards more emphasis on trade missions and state visits between Western countries and emerging markets. China, in particular, has been the centre of attention. Germany’s leaders actively support the interests of their exporters at the highest diplomatic levels. German Chancellor Angela Merkel has led four trade missions to China in the past five years, bringing German business leaders for face-to-face meetings with China’s rulers and helping to secure billions in contracts for German exporters. French President Nicolas Sarkozy closed €15 billion in business deals with China by bringing French business leaders face-to-face with Chinese President Hu Jintao during his state visit to France. This was followed by a trade mission by UK Prime Minister David Cameron to China, with calls for closer trading ties between the United Kingdom and China.

The Netherlands, too, realizes that its economic diplomatic standing deserves special attention in countries such as China, India, Brazil, Russia and other emerging economies. The past decade has shown a shift in Dutch trade missions from the developed world towards emerging markets (see Fig. 3). Yet the Netherlands currently exports 75 per cent to its European partner countries, with only 4 per cent of its trade going to the BRIC countries (see Fig. 4A). The same can be found for investment (see Fig. 4B). In order to make optimal use of the growth markets, the role of state visits and trade missions to the emerging markets will increase even more.

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14) IMF, World Economic Outlook October 2010.
Fig. 3. Destination of Dutch trade missions, 2002-2010.

Source: Dutch Ministry of Economic Affairs, Agriculture and Innovation (2010).

Fig. 4A. Dutch exports by country of destination.

Source: CBS (2010).  

Informal Market Barriers Grow in Importance

With the rise of the emerging markets there is also a shift towards more government influence in the market. Even though former communist countries have come a long way in terms of market orientation, Dutch companies’ counterparts are often still linked to their government. Without political help from the Dutch government, Dutch companies may be unable to enter these markets. With growth currently mostly in emerging markets, more Dutch businesses will move towards the East. This means more need for government support, meaning more cooperation between government and businesses.

And it is not only direct government-to-government issues that have increased. Informal barriers have also become more important. These include differences in culture, institutions and language. The top three bottlenecks in the cross-border activities of small and medium enterprises (SMEs) are all related to informal and cultural barriers.\(^{17}\) This puts extra pressure on the economic diplomats in the Dutch government’s extensive network of embassies, consulates, investment-promotion agencies and business-support offices. Helping Dutch companies to move to growth markets and successfully dealing with informal barriers will become an important competitive factor in the coming years of low growth in the West.

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New Investors in Dutch Markets

As emerging markets grow, so will we see their companies expand across the globe. Chinese, Indian and Brazilian companies are currently only small investors internationally. For example, total Chinese investment in the Netherlands was only € 64 million in 2009. Compare that to the € 16 billion that Swedish companies have invested in the Netherlands, or the € 84 billion by US companies. It is very likely that this picture will change drastically, however, during the coming years. McKinsey’s analysis shows that a number of large companies from emerging markets are at the start of their internationalization process. The Netherlands may profit from these new investment flows and increase its connectedness to the emerging markets by attracting these companies to Dutch markets. This may be done by targeted strategies from the Dutch government’s foreign direct investment office. Political contact may help the process for some of these companies, as it will be a sign of goodwill towards the investors.

Challenges for the Economic Diplomats

The world is constantly driven by a changing political and economic environment. However, the challenges that we face now are more profound than usual. New countries have entered the world stage and are increasingly vocal in multilateral institutions. To deal with new partners, we need to understand their culture and values and to use economic diplomacy more and more intelligently.

Getting Beyond the 2008-2009 Crisis

The world in which we live has changed enormously from an economic point of view. Underlying trends that already existed came to the surface, the impact of which took some by surprise. The recent international changes cannot be understood without looking at the recent economic crisis. This 2008-2009 crisis has had a huge impact on the global economy and political relations. Governments in the industrialized world stepped into the ‘free markets’ with major bail-outs and stimulus measures. This prevented a total collapse of the financial system and the global economy, but gave a severe blow to the self-perceived supremacy of the Western economic model. Emerging economies suffered much less during the crisis or recovered a lot faster. Although economic recovery in the industrialized countries has also slowly begun, the political power shift — most eminently seen in the exit of the G7 and the rise of the G20 — remains.

The crisis has also set the agenda for the coming years, as important risks because of the remaining global imbalances need to be tackled. Protectionism has

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so far been contained, but tensions remain. The euro has proved to be less robust than thought. Important questions surrounding the financial system need to be addressed. Monetary policy is leading to frowned eyebrows. These issues need international solutions, but the infrastructure for successful coordination is lacking and has seen a setback after the hopeful first crisis response by the G20 in 2008-2009. The global economy and economic agenda are still very much dominated by offsetting the crisis, the effects of the crisis and the needed exit strategies of crisis measures.

Preventing Protectionism

The crisis has put protectionism back on the international political agenda. As global trade dropped in 2008 and 2009, fears grew internationally of a trade war similar to the tit-for-tat tariff increases and import quotas during the Great Depression of the 1930s. Countries have taken some measures. Fears of a trade war, however, have not been borne out. Nonetheless, tensions remain and symptoms take on subtler forms than crude tariff barriers. The Dutch government is especially worried by the tension between the United States and China. With Chinese growth rates above 9 per cent, the United States accuses China of failing to meet its commitments to the World Trade Organization (WTO) by holding its renminbi currency artificially low against the US dollar, resulting in fewer jobs in the United States.

These developments could lead to a trade war between the United States and China, one that could do considerable damage to more than only these two countries. The United States threatens to impose tariffs on Chinese imports if China does not let go of the peg. The US House of Representatives has already adopted a bill that allows the United States to levy tariffs on Chinese imports. If this escalates any further, there will be serious repercussions.

In the meantime, the US Federal Reserve (the Fed) has introduced Quantitative Easing II (QE2) to stimulate the US economy and create jobs. QE2 has some international facets as well. First, it raises fears in the emerging markets of cheap money floating into their economies, resulting in ‘asset bubbles’. Emerging markets have therefore threatened to introduce restrictions on foreign capital. Second, QE2 may push the dollar down, thus improving the Unite States’ competitive position in the international market. With the perceived undervaluation of Chinese and US currencies, other countries are also considering devaluation. By using devaluation as an instrument to boost exports, the danger of retaliation and counter-retaliation increases, eventually leading to a trade and/or currency war. This would prove to be a major setback for the global economy and much-needed international economic cooperation.

To solve this issue, we see an increasing role for economic diplomacy. Domestic policy influences the economies of trading partners, which should remind us that all countries are in this together and therefore need to work jointly to find a solution in the G20, International Monetary Fund (IMF), EU or any other multilateral framework that offers the opportunity to ensure strong, balanced and sustainable growth.  

Preserving Trust in the Euro

Today, the euro-dollar exchange rate is still near its highest value since the introduction of the euro currency. The crisis has, however, created tensions within the euro area relating to the sustainability of debt by some euro member states. A solution has been found for the short term, by means of a joint European-IMF bail-out fund. Turmoil in the market has so far been tempered. The measures, however, do not address longer-term solvency concerns arising from the high debt burdens of some Euro-area governments. Every time the peripheral countries need to sell new bonds, fears surface of a country defaulting. This demands the special attention of economic diplomacy. With countries that are economically very different from each other, however, needs diverge. Solving the issue will become a real challenge.

Arranging an Orderly Fiscal Consolidation

The expansionary fiscal policy during the global financial crisis has left many governments worldwide in great debt (see Fig. 5). Most European Union countries, including the Netherlands, have begun to follow a track of fiscal consolidation to deal with this debt. With private demand not fully back to full speed, less government spending will have short- and medium-term consequences for the economy. Budget cuts will mostly hit social security and subsidies, affecting demand and business activity in the euro area. In the short term, lower growth and a brake on international trade will result for the Netherlands if we do not tap into new markets where growth is still dynamic. Here we see an increasing role for economic diplomacy. As the meta-analysis by Van Bergeijk and Moons shows, economic diplomacy is an important and significant driver for international trade. More personal contact with our trading partners or match-making support between companies can be examples of increased efforts. However, fiscal consoli-

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This demands a more critical view on how a government spends these means.


Fig. 5. World government debt.\textsuperscript{22}
Challenges for the Multilateral System

As the Netherlands is an open country, multilateral agreements have always been of high importance to the Dutch international business environment, not only to provide transparency to do business, but also to solve trade, financial, social and environmental issues.

The Netherlands faces global challenges in the areas of natural resources, climate change, energy supplies, migration, human rights, non-proliferation and counter-terrorism, which must be met. We still feel and know that multilateral agreements offer the best (global) solution. The power shift to the East, however, has changed the balance of this international framework. Aside from the fact that the emerging powers are underrepresented in institutions such as the IMF and World Bank, and are not members of the Organization for Economic Cooperation and Development (OECD), they also differ from traditional Western views.

Evidence from the past already shows that agreements on a multilateral level appear more difficult and time-consuming than they used to be (see Fig. 6). An important challenge for economic diplomacy is hence to improve the strength of the multilateral system. Participation by the emerging economies in multilateral forums is important in guarding this strength. We are therefore in a quest for a new balance between the industrialized West and emerging markets in the multilateral forums.

Fig. 6. More time-consuming trade rounds.
In the meantime, bilateral negotiations have gained in importance. To circumvent the multilateral problems, and yet to achieve access to new markets, recent years have shown that nations, as well as the EU, have started to focus more on Free-Trade Agreements and Bilateral Investment Treaties. We believe in the multilateral system; bilateral negotiations are therefore a second-best solution. However, in the current climate, bilateral agreements seem to be the only way to achieve improved market access quickly.

**Creating a Well-functioning EU Diplomatic Service**

With the Netherlands as a medium-sized economy that is losing relative strength, a strong Europe is essential. With the start of the Lisbon Treaty, the new European diplomatic service — the European External Action Service (EEAS) — is set to enable the EU to take joint action to safeguard its interests when dealing with the great powers, also on trade. The necessary cohesion and focus of joint action demands more effort by the Dutch government to strengthen the EEAS, because a strong European diplomatic service can strengthen Dutch interests in the world and also increase efficiency in times of fiscal consolidation.

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Food and Raw Materials

The demand for raw materials — including so-called ‘rare earths’ and food — has increased, resulting in increasing commodity prices (see Fig. 7). Recent years have been marked by fluctuations in oil prices, commodity price spikes, food security fears and resultant trade restrictions. The 2008-2009 financial crisis relieved some of this pressure, but since 2010 the economic turmoil has eased and commodity prices have increased again from their 2009 levels. With an expected global population growth of 2.3 billion people between 2009 and 2050, this tension on prices — according to the OECD and FAO — will most likely remain in coming years.

The challenge with respect to food is to feed a growing, more urban and, on average, richer population, while adopting more efficient and sustainable production methods and adapting to climate change. It is estimated that feeding a population of 9 billion requires a 70 per cent increase in global food production between 2005-2007 and 2050. This, in turn, means that production in the developing countries would need to almost double. The highly productive agricultural sector in the Netherlands can offer an opportunity in targeting this challenge. By means of economic diplomacy, Dutch knowledge can be shared on an international level to help feed the growing population and to improve productivity in the agricultural sector.

As well as food, securing raw materials has become a critical focus for many resource-dependent countries all over the world, especially ‘rare earths’. Industrialized regions such as the EU, North America and Japan have explicitly recognized the challenges that the availability of certain raw materials may pose for the functioning of their economies.

It is important to get a good view of the urgency of the problem. Although China currently supplies 97 per cent of the world’s demand for rare earths, other countries hold considerable reserves as well. With rising prices, it again becomes beneficial for other companies to re-enter the market and to reopen mines in other parts of the world than China. Alternatives will be developed. In the meantime, we just need to remain alert and recognize an important role for economic diplomacy in guiding this tension along the right tracks.

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Conclusions

The challenges faced in the Dutch economy may be solved through better linkages with the emerging economies (market access). Economic diplomacy can play an important role here in arranging market access. Analyses show that trade missions, embassies and consulates contribute positively to trade. Analysis by Van den Berg et al. shows a yearly positive net welfare effect of €100 to €200 million for the Netherlands. Bilateral economic diplomacy to create market access, combined with efforts to open up markets via the EU and WTO, is thus the way forward to improve Dutch linkages with fast-growing emerging markets.

The prevention of protectionism, the orderly unwinding of global imbalances and coordinated fiscal consolidation depend on international cooperation and the functioning of international capital markets (improved functioning of markets). There is a role to play here for the world’s multilateral institutions, such as the WTO and the IMF (and perhaps the G20). Dialogue is crucial to ensure that the problems currently faced do not escalate. The positive momentum of the G20 will hopefully return in the near future. Some progress has been made via the G20 in providing better representation for the emerging economies. We need them on board when we start dealing with imbalances in the world’s economy and global financial system.

Regarding the tensions related to raw materials and ‘rare earths’, there is a role for trouble-shooting and improved functioning of the markets. Bilateral actions and multilateral arrangements to improve the functioning of markets probably go hand in hand in resolving this problem.

The world in which economic diplomats live has changed greatly in recent years. New countries have entered the world stage and are there to stay. This article shows that economic diplomacy is an important instrument in the balancing act currently seen in both the global and Dutch economy. Dutch government policy recognizes the benefits of openness for international trade and investment. With fewer financial resources at hand and more challenges to face, the use of economic diplomacy will increase in importance. Because of the many issues that are a result of the economic power shift, emerging markets will receive special attention in the Dutch government’s focus area.

The economic prospects are not gloomy. With the necessary change and focus we will maximize the benefits of our open economy, promote a level playing field for Dutch businesses, and at the same time work towards better functioning of markets.

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The Diplomacy of the Financial Crisis in Context

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Summary
Until the 1980s, financial crises were caused by governments. But thereafter the private sector became the main culprit. The reforms introduced after the Asian crisis of the late 1990s were not properly implemented. Responsibility for financial stability became fragmented and the normal practices of economic diplomacy were abandoned. The crisis of 2007 thus caught governments unawares and obliged them to adopt extreme measures to avoid catastrophe. The decision-making that was associated with these measures gave more power to emerging markets through the G20. It ended the fragmentation of authority and achieved reasonable consistency of national, European and international financial reforms. It introduced stringent new rules in place of regulatory capture. But this progress was fragile: G7 members still tried to control the G20; the new reforms depended on national enforcement; and governments still needed too much from the banks to be able to discipline them completely. This crisis might be over, but it has left the seeds of the next one.

Keywords
financial crisis, fragmentation of authority, finance ministries, central banks, regulators, G20 summit, IMF, Financial Stability Board, future of banks

Introduction
Economic diplomacy has hitherto paid more attention to international trade than to issues of money and finance, as the contents of this special issue of The Hague Journal of Diplomacy show. There are various reasons for this. Export promotion is an integral part of diplomacy for many countries. International trade negotiations happen all the time, at bilateral, regional and multilateral levels, and involve all countries of the world. In money and finance, however, the multilateral level predominates, except within the European Union. The International Monetary Fund (IMF) in Washington and the Bank for International Settlements (BIS) in Basel are the main institutions concerned. Their decision-making has been dominated by mature industrial states, especially the United States. But the decisions taken have not directly affected these economies, but have concentrated instead on developing countries that are in need of debt relief or balance-of-payments'
financing. Financial diplomacy, at least after the 1970s, thus became limited to a narrow focus, which affected countries unequally.

The current financial crisis, which began in August 2007, abruptly changed the picture. It became the dominant issue in economic diplomacy today. This article therefore looks back at how financial diplomacy worked in the recent past and then considers present performance and future prospects. The focus is on the process of decision-making and negotiation, rather than the content of policy. The main findings are that financial crises were caused by governments until the 1980s, but that as the twentieth century gave way to the twenty-first, the private sector became the main culprit. Governments reformed the international system in response to the Asian crisis of the late 1990s, but had neglected to implement the reforms. Responsibility for financial stability became fragmented and the normal practices of economic diplomacy were abandoned. The crisis of 2007 onwards therefore caught governments unawares and obliged them to adopt extreme measures to avoid catastrophe. The decision-making involved with these measures reconciled politics and economics by giving more power to emerging markets through the G20. It reconciled external and domestic pressures by ending the fragmentation of authority and achieving reasonable consistency among national, European and international financial reforms. It reconciled governments with the banks — as key non-state actors — through stringent new rules in place of regulatory capture. But this progress was fragile: G7 members still tried to control the G20; the new reforms depended on national enforcement; and governments still needed too much from the banks to discipline them completely. This financial crisis might be over, but it has left the seeds of the next one.

The Last Financial Crises of the Twentieth Century

The debt crisis that erupted during the summer of […] posed the greatest challenge to international economic stability that the world had faced since the Great Depression. At the time, many observers viewed the international financial system as a house of cards, ready to be blown down at any instant.¹

This quotation reads like a comment on today’s financial crisis. But in fact the missing date in this passage is 1982, when the last systemic crisis broke out in international finance. Today the financial crisis provoked the economic recession; back then it was the other way round. The trouble then started with the tripling of world oil prices at the end of 1973, which drove oil-importing countries into recession, inflation and external deficit. Industrial economies could adjust to this crisis fairly well, but developing countries were much more vulnerable. Meanwhile,

the members of the Organization of Petroleum Exporting Countries (OPEC) earned large surpluses, which they deposited with banks in the United States and Europe. Western governments and the IMF under its Dutch head, Johannes Witteveen, persuaded the reluctant banks to ‘recycle’ these OPEC surpluses to developing countries, in the form of syndicated loans.

This recycling worked well at first. Developing countries maintained their growth and could service their debt from their export earnings. But in 1979 oil prices surged again. Industrial states responded with severe anti-inflation policies, reducing imports and raising interest rates. By 1982 the biggest borrowers among developing countries could no longer service their debts and threatened to default. Many banks had advanced loans in excess of their capital, so that default would have made them technically insolvent. The financial system itself entered a severe crisis, which had been caused by governments, both creditors and debtors; the banks, this time, were largely victims. Western governments and the IMF intervened promptly to check the crisis and eventually to resolve it. This took seven years, during which the IMF made its loans conditional on strict fiscal and monetary policies. To prevent a recurrence, the Basel Committee on Banking Supervision drew up capital adequacy rules, called Basel I. Throughout the crisis, the Western powers were more concerned about the health of their banks than about the hardship suffered by populations in the debtor countries.

The next milestone in financial diplomacy was the Asian crisis that began in 1997 and later spread to Brazil, Russia and a major US hedge fund. This time the crisis was caused by the private sector. Both foreign and local banks in fast-growing East Asian countries found it profitable to finance deals in foreign currency, as the US dollar was falling. When the dollar started to strengthen, the deals turned sour and there was a mad outrush of capital. The Asian governments had been pursuing prudent fiscal and monetary policies; their weakness lay in financial regulation. But the IMF imposed its usual austere macroeconomic prescription as the price of its rescue. The Western powers supported this, as a means of rescuing their banks from their imprudent operations. The IMF, in fact, knew very little about financial regulation, which led to friction with the World Bank, which knew a lot. It was then said that a country in financial trouble had a choice: it could go to the IMF, which would very promptly provide the wrong advice; or to the World Bank, which would provide the right advice but too late to be of any use. The IMF’s strategy was widely criticized and the Asian countries resented it.

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4) In the 1990s and 2000s, Western countries took a rather more generous approach to relieving the debts of poor countries. But these were no threat to the financial system.
5) I heard this joke told by Robert Chote, then at the Financial Times, at an LSE seminar in 1999.
They took precautions against never having to call in the IMF in the future, thus piling up the massive reserves that have contributed to today’s financial crisis.⁶

After the Asian crisis, the Fund and Bank agreed upon a ‘new international financial architecture’, to strengthen the system and to deter future upheavals. There were several key innovations.⁷ The G20 finance ministers associated ‘systemically important’ emerging markets — such as Brazil, China and India — with the mature economies of the G7. Governments, central banks and regulators from the G7 and a few other centres, including the Netherlands, met as the new Financial Stability Forum (FSF), and produced reports on hedge funds and tax havens. The IMF launched a Financial Sector Assessment Programme (FSAP), which by 2005 had conducted reviews of 111 countries, although not of the United States or China. Lengthy negotiations began on updated capital adequacy rules, called Basel II. These were wide-ranging measures, but even so they failed to prevent the worst financial crisis since the 1930s.

The First Financial Crisis of the Twenty-first Century

The financial upheaval of the late 2000s, like the Asian crisis ten years before, was caused by the private sector. In short, banks convinced themselves and their clients that debt was safe. This was not primarily because of greed, but because of incompetence. The banks made mistakes, without realizing the implications of what they were doing. But why did the authorities accept the banks’ assurances that all was well and allow the crisis to happen? One answer lies in the fragmentation of authority, between governments, central banks and supervisory agencies.

Fragmentation of Authority

During the 2000s, governments increasingly delegated issues of financial stability to other agencies. These were either independent central banks or, more often, autonomous regulatory bodies. The rationale was that, like monetary policy, these activities were best divorced from politics. Domestically, finance ministries turned their attention to other things. Once the new architecture was in place, they did not check on its implementation. They were happy to see the banks earning large profits and paying high taxes, and saw no cause to intervene. Internationally, the IMF’s reputation took time to recover from the attacks on its Asian strategy. The Financial Sector Assessment Programme was of limited use to IMF member countries, although the IMF itself learnt a lot.⁸

Independent central banks saw their main aim as checking inflation and their main instrument was monetary policy. They gave less priority to financial stability, which had often ceased to be their direct responsibility. The Bank for International Settlements (BIS) regularly warned in its annual reports of the dangers of mounting debt, but these warnings were ignored until it was too late.9 The Financial Stability Forum could not follow up on its initial burst of activity: the United States discouraged further original work; and the other members did not resist.10

The financial regulators, as the newest to arrive, were often the weakest pillar in the structure. They were keen to establish their autonomy and thus did not welcome outside intervention. But they struggled to understand the complex financial instruments that were being developed in the market by banks with vastly greater resources than they had. So they ended up believing what the operators told them, as even Chairman of the US Federal Reserve (from 1987-2006) Alan Greenspan has admitted. Internationally, the revision of capital adequacy rules (Basel II) was increasingly shaped by input from the banks, channelled through the International Institute for Finance.11

In the twenty years since the end of the Cold War, four principal strategies had been developed to meet the new challenges to economic diplomacy that were created by the advance of globalization. These were: involving ministers alongside bureaucrats; bringing non-state actors into the process in order to share the burden; improving transparency; and using international institutions to advance domestic objectives.12 But in financial stability, these strategies were either mismanaged or stood on their head. Ministers chose to do less, rather than more, passing the responsibility to others. Non-state actors — that is, the banks — were brought so deeply into the process that in fact they captured it, and the public authorities proved no match for them. Transparency became worse, rather than better, as the banks invented opaque new instruments that they did not even understand themselves. International institutions such as the IMF and FSF were sidelined or were captured, like the Basel process. These departures from accepted practice led inexorably to disaster.

The Year of the Central Banks

The crisis began with a sudden credit crunch in summer 2007. On 9 August 2007, the European Central Bank (ECB) had to provide 128 billion euros in liquidity to unfreeze the European inter-bank market. Yet for over a year thereafter, until September 2008, the fragmentation of authority persisted. The central

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9) The BIS Annual Reports for the 2000s are all available online at www.bis.org.
banks, especially the ECB, the US Federal Reserve and the Bank of England, saw that they had to act, but they battled the crisis almost single-handedly. They poured in liquidity in ever-growing amounts, using innovative techniques and sometimes acting in unison. They cut interest rates, with the Fed acting most aggressively. They provided funds to rescue banks threatened with collapse, such as Northern Rock in the United Kingdom and Bear Stearns in the United States. Regulatory agencies, such as the American Securities and Exchange Commission and the British Financial Services Authority, gave what support they could and tried to stiffen their disciplines, but they largely carried the blame for the crisis and remained in the shadow of the central banks.13

In contrast to the activity of central banks, finance ministries stood back and were reluctant to intervene. The British government hesitated for five months before finally taking over Northern Rock in February 2008. The US Treasury tried to encourage market responses to the crisis, but to no avail. It backed the takeover of Bear Stearns, but the money came from the Fed. Finance ministries began drafting legislation for future regulatory reform, including in the European Union, but this only contrasted with their inactivity in the current crisis.

Internationally, the same pattern prevailed. The Financial Stability Forum, led by central banks, found a new lease of life. As early as April 2008 it had prepared detailed recommendations for regulatory reforms. But despite the urging of its new head, Dominique Strauss-Kahn, the finance ministries assembled at the IMF took no decisions, apart from encouraging the Financial Stability Forum and endorsing its proposals. Likewise, the G8 heads of government at the Hokkaido summit of June 2008 barely noticed the crisis. In retrospect, this year of government inactivity was fatal. The imminence of the US presidential election discouraged American initiative, while the strict independence of the ECB was a deterrent to action in Europe. If finance ministries had realized sooner the gravity of the crisis, the worst of the consequences might have been avoided.

The Return of Governments and the Revival of Summity

The heroic efforts of the central banks were eventually overwhelmed by the disasters that struck in September 2008. In the United States, Fannie Mae and Freddie Mac, Merrill Lynch, Lehman Brothers and the American International Group (AIG) all came to the brink of failure and had to be rescued, except for Lehman Brothers, which proved beyond saving.14 There were parallel collapses in Europe, including banks in the United Kingdom, Germany and the Netherlands. These disasters provoked government intervention without parallel outside wartime.


14) Fannie Mae and Freddy Mac are the acronyms of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, both US government-sponsored enterprises.
Governments poured money into financial institutions, nationalized major banks, guaranteed depositors and acted to neutralize toxic assets. Central banks backed this up with measures to ease monetary policy yet further and to get banks lending again. By spring 2009 these heroic measures had brought the financial system back from the brink. Governments now had to turn their attention to counteracting the recession that had been provoked by the collapse of the banking system, providing massive fiscal stimulus and other measures to revive their economies.

The financial and economic crisis stimulated the personal intervention of heads of government to revive international cooperation. This took place in two innovative formations:

- French President Nicolas Sarkozy called the first ever eurozone summit on 12 October 2008, as panic was spreading on both sides of the Atlantic. British Prime Minister Gordon Brown was invited to attend and he expounded upon the rescue plan just introduced to save the British banks, which was based on massive capital injections. Similar plans were adopted throughout the eurozone and the rest of the EU. The United States decided to use the funds that had just been agreed by Congress to replenish capital rather than to buy up toxic assets. The panic started to recede.
- The first G20 summit met in Washington on 15 November 2008. This produced broad international agreement on the principles that should guide economic stimulus and financial regulation. This format proved so effective that the G20 summit rapidly became an established institution, meeting twice in 2009 and in 2010, before settling on an annual rhythm from 2011.

Most of the emergency measures taken in 2008 and early 2009 worked their way through the system over the next two years. New measures were needed in 2010 to preserve the weaker economies of the eurozone such as Greece and Ireland. Governments turned their attention to correcting their budget deficits, which had been swollen by the measures taken to mitigate the recession. But economic recovery set in slowly in Western economies and new crises could yet lurk beneath the surface.

The New Shape of Financial Diplomacy

This article now looks not at the measures adopted, but at the new processes of decision-making and negotiation that emerged from the financial crisis. It focuses on financial issues, leaving aside other areas such as macroeconomic policy, trade negotiations, help for poor countries or climate change. It examines these processes using an analytical framework that sees governments, in their economic
diplomacy, as trying to reconcile various tensions so that policies reinforce each other rather than conflict. Three such tensions are identified: between economics and politics; between domestic and external pressures; and between government and other forces.¹⁵

Reconciling Economics and Politics: The G20 and the IMF

For many years the key issue in the tension between economics and politics had been how to create a better balance of power in the international economic system. Major emerging countries — led by Brazil, China and India — advanced steadily economically, but this was not reflected in the political weight that they were able to exercise. As long ago as 1993, The Economist was arguing that major emerging countries should join the G7 summit,¹⁶ but the G7 fought a determined rearguard action. Despite the formation of the G20 meeting of finance ministers after the Asian crisis, the G7 managed to keep the central economic and financial issues under their own control. Attempts to reform the IMF’s voting structure produced very little.

The recent crisis made this rebalancing of power indispensable. The old industrial states were crippled by the financial disasters and went into deep recession. Most emerging powers, however, avoided financial adventures and suffered only a brief setback to their growth, although Russia was an exception. The G20, which met now at head-of-government level, was finally able to build up momentum and take the lead. The Pittsburgh summit of September 2009 ‘designated the G20 as the premier forum for our economic cooperation’ and agreed the plans for future summits in 2010 and 2011.¹⁷ The leaders had earlier decided that all G20 countries should have seats on what was renamed the Financial Stability Board, alongside the original G7-based members.

But this embrace of emerging markets by the G7 remained superficial. Of the first four G20 summits, two were held in the United States, one in the United Kingdom and one in Canada, with the host country in charge of preparations. The opportunity for a non-G7 country to host a summit did not come until South Korea, the 2010 chair of the G20 finance ministers, held a summit in November 2010. In 2011 the chair has moved back to the G7, with France taking its turn as host. The early G20 summits were dominated by ideas emanating from the United States, the United Kingdom and other Europeans, not by proposals from China and others, who kept a low profile. It was not clear whether non-G7 countries yet felt that they had ‘ownership’ of the G20 process and how they

¹⁵ This analytical framework is expounded in Bayne and Woolcock, The New Economic Diplomacy, pp. 7-10.

¹⁶ See The Economist, 10 July 1993, p. 67. The article drew on evidence from the World Development Report 1993, which documented the growing weight of major emerging countries.

¹⁷ The summit declaration is accessible at www.g20.utoronto.ca/2009/2009communique0925.html. The references are to paragraphs 19 and 31.
would operate when they did. China announced a change in the management of its renminbi just before the G20 Toronto summit in June 2010, to avoid being put under pressure at the summit itself, especially by the United States. But tension was later revived between China and the United States, which suggested that China could prove an uncomfortable negotiating partner.

The rebalancing of power had institutional consequences, especially in the IMF. From 2008 the Fund rediscovered its original role in providing and mobilizing finance for countries in difficulty. The Fund not only helped developing countries, such as Pakistan, but even European countries, including Hungary, Latvia, Greece and Ireland, working closely with the EU. The London G20 summit of April 2009 agreed a very substantial replenishment of the IMF’s resources for this purpose. But emerging countries, especially in Asia, still mistrusted the IMF because of their unhappy experience a decade earlier. They would not give the IMF their full support unless they had more control over the Fund’s decision-making. This meant changes in quotas, which determined votes, and in seats on the Executive Board. The G20 leaders at Pittsburgh agreed on a shift in quota shares of at least 5 per cent in favour of dynamic emerging countries, to be agreed by the end of 2010. This might well prove not to be enough, requiring further shifts in the future, but in any case it put the pressure squarely on the Europeans.

The United States had the largest quota share, at 17 per cent, but only one seat on the Executive Board. Nevertheless, the United States had been the dominant influence on the IMF ever since its creation. In principle the European Union should be twice as powerful as the United States, as in 2010 EU members held 30 per cent of the total quotas. They occupied eight seats on the Board — one-third of the total — plus had the ECB as an observer. But in practice the EU got the worst of all worlds. It was persistently criticized for having too many seats and too generous quotas. Yet European influence was negligible, because the mechanism for agreeing joint EU positions was inadequate. There was no record of European initiatives in the IMF: individual EU members might launch ideas, but others often opposed them. The EU’s position in the Fund would in fact be stronger if it gave up both quotas and seats, in return for speaking as one. This would mean unscrambling those constituencies that combined EU and non-EU members, but that would only improve the coherence of the Fund’s decision-making.18

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Reconciling Domestic and External Pressures: The G20, Basel III and the FSB

The record shows that when states are successfully reconciling external and domestic pressures (the second tension), they are prepared to adopt rule-based international regimes and to rely on formal international institutions. When the tension is unresolved, states are reluctant to go beyond voluntary cooperation, from which they can withdraw if domestic pressures are too strong. For example, this tension was well reconciled after the end of the Cold War, leading to new rule-based regimes and new institutions in trade and the global environment. But this progress was not sustained into the 2000s.¹⁹

Economic summits themselves never go beyond voluntary cooperation. At their best, they can give impulses to rule-making and institution-building elsewhere; but at their worst, they make high-sounding declarations that are not put into effect. This was a sign of the decline of the G8 summit, which was rightly criticized for not keeping its promises. There were two initial reasons for expecting the G20 summit to do better. The first was that the summit was firmly plugged into the existing network of G20 finance ministers, who could provide continuity. By contrast, the G8 summit drifted apart from its finance ministers and ceased to receive reports from them after 2002. The second reason lay in the close links between the G20 and the IMF. This gave access to an experienced technical staff. It also offered a means for countries outside the G20 to feed in their views, since the staff could speak up on their behalf. The G20’s Pittsburgh summit made the IMF directly responsible for operating the new framework for economic policy coordination. This was further evidence of the Fund’s revival, following the resumption of its financial support operations. These two advantages, however, only applied where the G20 focused on the macroeconomic and financial issues that were the responsibility of finance ministers. Once the G20 leaders moved to other issues — such as international trade, development or climate change — these advantages evaporated. Here there was a greater risk that promises would not be kept, as happened with the pledges to complete the Doha Development Agenda of the World Trade Organization (WTO).

The G20 summits strongly encouraged reform of financial regulations in the Financial Stability Board (FSB) and in the Basel Committee on Banking Supervision, called ‘Basel III’. New rules were called for on levels of capital, leverage, liquidity, asset-backed securities, short-term borrowing, bankers’ pay and bonuses and plans to wind up troubled financial institutions. Regulation should be extended to become ‘macro-prudential’, so that it looks at the whole system, and should also embrace hedge funds, credit derivatives, rating agencies and tax havens. Although the issues were highly technical and many were controversial, there was a strong drive to put in place tight new rules to deter such a disaster

from happening again. By the second anniversary in September 2010 of Lehman
Brothers’ collapse, the Basel Committee had agreed new rules on capital adequacy,
leverage and liquidity.20 These were tougher than before, although banks would
have nearly a decade in which to put the rules into effect. The FSB was preparing
rules for handling institutions that were ‘too big to fail’ or whose operations
crossed the borders of several states, and also for bringing greater transparency
into derivatives markets.21 The work of both the FSB and the Basel Committee
was endorsed by the G20 summit in November 2010.

In parallel with the international activity in the Basel Committee and the FSB,
national governments pressed ahead with their own reforms aimed at restoring
financial stability. The United States Congress adopted a major reshaping of the
American regulatory regime. The new coalition government in the United King-
dom began a similar process. The European Union agreed to create new supervi-
sory institutions, as recommended in the Larosière Report of 2009: a European
Systemic Risk Council would work alongside separate bodies overseeing Euro-
pean banks, insurers and securities markets. The debate continued in the EU on
the regime for hedge funds, derivatives and short selling. There was much special
pleading, notably from the United Kingdom, France and Germany, as they sought
to protect cherished national regimes. Nevertheless, every EU member state
accepted the need for tighter European arrangements.22

One common aim of these reforms was to prevent the fragmentation of respon-
sibility for financial stability that had prevailed before. The US legislation gave
authorities the capacity to intervene with non-banking financial institutions, as
well as banks. The United Kingdom took power away from the Financial Services
Authority and restored it to the Bank of England. In the European Union, the
President of the ECB would initially chair the new Systemic Risk Council, giving
the ECB formal responsibility for financial stability for the first time. The reforms
were driven by domestic pressures in the countries concerned, without any formal
consultation with other states. Nevertheless, they all pointed in the same direc-
tion. There was reasonable consistency between the different approaches and
there were no complaints about the unilateral actions, except when Germany
announced a ban on short selling without any warning. This contrasted with
what was happening in exchange-rate policy.

But this reconciliation of domestic and external pressures owed much to the
chastening experience of the upheavals of 2008. The effectiveness of the national
and European reforms would depend on the determination of the regulatory
authorities to enforce them. Similarly, while the content of the international rules

20 For details, see online at www.bis.org/bcbs/basel3.htm.
21 Mario Draghi [Chairman of the FSB], ‘Next Steps on the Road to Financial Stability’, Financial
Times, 17 September 2010, p. 13. See also the FSB’s website: www.financialstabilityboard.org.
22 Financial diplomacy in the European Union is covered in Stephen Woolcock’s contribution to this
special issue of The Hague Journal of Diplomacy.
and guidelines was agreed collectively, their application would take place nationally, being subject to domestic pressures. Although the Financial Stability Board was now called the fourth pillar of the international system — with the IMF, World Bank and WTO — it had no powers to enforce compliance with its recommendations, beyond the gentle pressure of peer reviews. Both the FSB and the Basel Committee were very lightly staffed and resourced compared with the Fund and the Bank.23 Governments were reluctant to surrender national control over regulating their financial sector, even within the European Union. All governments accepted that finance generally needed new rules, but they argued that their own banking sector required special treatment. So there must be doubt over how far the new rules will constrain national behaviour once today’s panic recedes from people’s memory. Much will depend on the attitude that governments take towards the banks, the key issue in the third tension.

Reconciling Government and Other Forces: What Future for the Banks?

In the economic diplomacy of the last two decades, non-state actors — including private business and the NGOs collectively called ‘civil society’ — increased their power at the expense of governments. In consequence, governments sought to engage them in decision-making processes, so that they would share more of their burdens, and reconciled the third tension in this way. In most areas of economic diplomacy, such as trade, development and the environment, NGOs made the most visible advances, rather than business. But in finance, the process was different. While protesters would demonstrate against the IMF, there was no body of well-informed NGOs lobbying for alternative financial systems. On the other hand, the influence of business — that is, the banks and other financial operators — became all-pervasive. Governments hesitated to go against the wishes of the private financial sector, for fear of being penalized in the markets, and thus framed their policies accordingly.

All that went abruptly into reverse during the financial crisis. The banks’ mistakes were cruelly exposed and their reputations were discredited. To keep the financial system from total collapse, governments and central banks had to pour huge sums of money into the banks, imposing conditions in the process. In some countries, such as the United Kingdom, the government became a major shareholder in several of the largest banks and other financial institutions. All governments prepared to impose much tighter regulations on the financial sector. Existing regulations were applied more stringently, so that Goldman Sachs, which had hitherto been untouchable, had to pay large fines in both the United Kingdom and the United States. Governments thus re-established their power in no

uncertain terms. But would this be a permanent shift? The chances are strongly against it, at least in Western economies.

The private banking sector, having been through a Darwinian process, has emerged stronger than before in some respects. The surviving banks faced less competition and many had consolidated into larger groups. They knew that governments could not allow them to fail so soon after the trauma of the Lehman Brothers’ collapse. The problem of their holdings of toxic assets, which had provoked the original credit crunch, was quietly forgotten. Governments were reluctant to spend more on this and thought that the banks should bear the cost of cleaning up their balance sheets. But the banks had no incentive to reveal their true incompetence if they could avoid it.24 They lobbied vigorously to mitigate the impact of the new regulations, with some success.

Governments, meanwhile, had conflicting objectives. Banks in the United States and Europe were highly unpopular with national electorates, which wanted to see them cut down to size. But the idea of a worldwide punitive levy on banks was vetoed in the G20 by a group led by Canada, whose banks had done nothing wrong, and including most of the non-G7 members. Governments wanted banks to make more loans to business to promote economic recovery, but they could hardly complain if banks instead gave priority to correcting their over-leveraged balance sheets that had provoked the crisis. Those governments that partly owned banks, such as the United Kingdom, wanted them to become profitable again so that they could dispose of them, ideally making a profitable return for the taxpayer. The British government also did not want to see the financial centre of the City of London shrink, as that would mean lower growth, fewer jobs and less tax revenue.

Above all, governments needed to get private financial markets working effectively again. This was not only to underpin recovery from recession by the rest of the private sector; it was especially so that governments could finance the staggering levels of debt, unprecedented in peacetime, which they had accumulated. Many governments were at the limit of their resources and could not contemplate further demands to prop up their banks. This explained why the European Union went to exceptional lengths to set up a Financial Stability Facility with the IMF, to enable Greece and other vulnerable eurozone governments to continue servicing their debts, even at the cost of painful austerity for their people. If the Greek government, for example, had defaulted, most of the debt at risk was held by other European banks. As in 1982 and 1997, creditor banks were saved at the expense of debtor populations.

Traditionally, banks earn profits from the process of using the money of others to enrich the entire economy. But in the 2000s, banks developed financial innovations whereby they used the money of others mainly to enrich themselves.

24 This proved impossible in Ireland.
Although the banks will operate in a much tougher regulatory environment in future, this alone will hardly be enough to restrain them in the longer term. They will have every incentive to look for new techniques that keep within the rules but that still yield the generous profits to which they are accustomed. A gradual return by the banks to their position of power looks all too likely, carrying with it the risk of further financial crises.

Conclusions

The recent record of financial diplomacy has not been brilliant:

- Western governments encouraged the recycling of Organization of Petroleum-Exporting Countries (OPEC) surpluses in the 1970s. But in the 1980s they adopted policies that threatened developing countries with default and banks with insolvency. The crisis was only resolved at the cost of austerity imposed on the debtors.
- After the private sector caused the Asian crisis in the 1990s, the IMF chose the wrong policies in response. These again favoured Western creditor banks, but alienated the countries affected. The ‘new architecture’ contained some valuable innovations, but these were not properly implemented.
- Fragmentation of authority between finance ministries, central banks and regulators allowed dangerous levels of debt to build up in the early 2000s. When the current financial crisis began, governments misjudged its gravity, leaving the central banks to fight it alone.

The measures taken after Lehman Brothers’ failure created a new vision of financial diplomacy, which held great promise:

- The full emergence of the G20 offered new powers such as Brazil and China the place in the system that their economic success deserved;
- The new G20 summit was much better integrated than the G8 into their supporting finance ministers and helped to revive the IMF as an institution;
- Rule-making was revived with the reform of financial regulation, articulated in part through a new ‘pillar’ of the system, the Financial Stability Board.

But this was only a vision and is far from fully realized. The industrial countries still contrive to steer the G20 and cling to their positions in the IMF; the non-G7 members have yet to show their full hand and do not fully trust the Fund. The G20 summits’ achievements are so far limited to macroeconomics and finance. There was a strong will to agree new rules for banks internationally, but enforcing the rules remains a national process. Meanwhile, the banks that have survived are
recovering their confidence and governments are once again becoming dependent on them.

Two years after the financial panic of 2008, the world economy has reached a convalescent condition. Yet banks could still be nursing toxic assets or face further losses from the recession. Economic recovery in Europe and the United States is taking place slower than governments had hoped. Governments are relying on banks and other financial institutions to support a smooth transition from public support for economic growth to a healthy economy that is based on private-sector activity. New issues in financial diplomacy thus keep appearing over the horizon, even as the current issues are being resolved.

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Development Cooperation as Economic Diplomacy?

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Summary
This article explores the role of international development cooperation — or aid — in foreign policy and diplomacy. Based on his experience as a practitioner, Arjan de Haan makes the observation that the development debate, and in particular the search for effective aid, has neglected the political role of aid. Moreover, the high political symbolism that aid has obtained, particularly in the last decade, has received relatively little attention. A political perspective on aid is now rapidly becoming more important, especially because of the enhanced importance of global security in setting an aid agenda, and because the old ways of working are — or seem to be — challenged by the rise of China and other countries that were recently (and still are) recipients of aid. An understanding of the diverse political motives behind aid should inform the way that aid effectiveness is measured. The changing politics in which aid is embedded are illustrated with reference to the Netherlands, which used to have one of the most respected aid programmes because of its multilateral emphasis and ‘untying’ of aid, and because Dutch strategic interests have now been made one of the cornerstones of the Netherlands’ new policy. The article hypothesizes that reinforcing progressive principles around international development can be a supportive element of a strengthened diplomacy in the globalized world beyond 2010.

Keywords
economic diplomacy, foreign aid, untied aid, China

Introduction
Aid — or international development assistance or cooperation — is big business. Total global aid flows from North to South are probably worth over US$ 150 billion annually, one-third of which goes to Africa. The need to maintain levels of aid after the financial crisis of 2008-2009 was an important part of the discussions among G8 and G20 leaders, and the debates at the G20 meeting in South Korea in November 2010 brought to the table a new Asian development model, thus reflecting the shift of power from West to East but with a continued interest in aid. China and India are rapidly entering the field as aid providers, following

*) The author would like to thank Peter van Bergeijk and Maaike Okano-Heijmans for their patient encouragement in writing this article, and Ward Warmerdam for excellent research assistance.
the emergence of Japan, South Korea and others, and simultaneous to a re-emergence of US interest in aid under the administration of (former) US President George Bush. While an ever-increasing number of celebrities and former presidents provide support to international development issues, private philanthropists have also become significant, with the resources of the Bill and Melinda Gates Foundation, for example, outstripping the annual budget of major official donors such as the World Health Organization (WHO), and donations by private medical companies adding significantly to the overall aid flows.

This popularity on the international stage — once again demonstrated in commitments not to reduce aid after the global financial crisis — is, however, far from always obvious. At national levels, support for development is not a constant. Although a large proportion of the population in the Netherlands and other European countries have for decades favoured development aid, there are also large groups that do not accept its importance, and many believe that a lot of investment is wasted — an argument that is often used in political battles.\(^1\) The aid industry has usually responded proactively to the critique, by enhancing visibility and strengthening information or evidence on what aid has achieved. In my own experience, this happened particularly under political pressure, but without much explicit reflection about how increased political pressure changes the nature of aid and how it should be assessed.

It is also far from clear that aid has been a big success, and important publications have proclaimed for decades that development aid does not work or can even do more harm than good. This view was recently forcefully expressed by Damisa Moyo, and she has found much support among African leaders such as Rwanda’s President Paul Kagame. The fact that Moyo is a Zambian-born woman has brought even more fire to an already heated debate.\(^2\)

The problem of aid dependency continues to feature strongly, and after a period when debt relief and planning for poverty reduction formed the focus of the debate, economic growth, economic independence and the role of the private sector now feature more prominently. These various objectives are not mutually exclusive, of course, but as the aid industry thrives on ‘buzzwords’ and ever-changing trends and approaches, changes in directions — while usually implying relatively small differences in emphasis — can easily be construed as ‘crises’.

Recent political changes in Europe are contributing to the decline in popularity of aid, with the United Kingdom, for example, trying to ‘ring-fence’ the aid

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\(^1\) The share of Europeans who considered aid ‘very important’ declined from 53 per cent in 2004 to 39 per cent in 2009; see Special Eurobarometer, no. 352, ‘Europeans, Development Aid and the MDGs’, available online at http://ec.europa.eu/public_opinion/archives/ebs/ebs_352_en.pdf.

budget, although this may have led to a backlash in the face of severe domestic budget cuts. In the Netherlands, voices have gained strength to reduce the aid budget and to make it much more instrumental for Dutch commercial interests, and recent announcements implied both a cut in the aid budget and a substantive change in approaches (discussed later in this article), reinforced by the influential critique of Dutch development aid in the report of the Dutch Scientific Council.3

The debate over aid effectiveness is not the subject of this article, but aid effectiveness is not irrelevant for the argument here, as the political debate over aid — encapsulated in the question of the role of aid in economic diplomacy4 — is at the centre of attention here. This article’s main contention in the aid debate is that aid effectiveness does indeed need improvement, and that in particular aid needs to contribute to enhancing accountability — or the social contract between recipient governments and citizens — and that the primary channel of accountability vis-à-vis donors and their taxpayers (and its critique) needs to become instrumental to this objective. A better understanding of the politics of aid is critical for enhancing the main (moral) goal of aid, which is to support development and poverty reduction.5

This article about development cooperation and diplomacy is written primarily from the perspective of a practitioner in the ‘aid industry’ who has worked for the UK Department for International Development (DfID) and has been based in the United Kingdom, India and most recently China. The article emphasizes recent changes, including the rise of emerging powers (most notably, but not only, China) on the aid industry’s stage, and how this contributes to challenges for what we may label an ‘MDG agenda’ (that is, considering the Millennium Development Goals) — the emphasis on ensuring that aid is (directly linked) to improvements in well-being. In an attempt to understand the link between aid and foreign policy, the article asks the question ‘why is aid given?, an old question but with relatively little recent empirical analysis. This then brings us in the article’s third section to the question about the links between development cooperation and foreign policy. Finally, the conclusion speculates that reinforcing the progressive principles can be a supportive element of a strengthened diplomacy in

3) Wetenschappelijke Raad voor het Regeringsbeleid (WRR) [Dutch Scientific Council], Minder pretentie, meer ambitie: Ontwikkelingshulp die verschil maakt, WRR report no. 84 (Amsterdam: Amsterdam University Press, 2010), now also available in English.
4) Maaike Okano-Heijmans describes the different approaches to the concept of economic diplomacy, and loosely describes it as a ‘foreign policy practice and strategy that is based on the premise that economic/commercial interests and political interests reinforce one another, and should thus be seen in tandem’; see Maaike Okano-Heijmans, ‘Conceptualizing Economic Diplomacy: The Crossroads of International Relations, Economics, IPE, and Diplomatic Study’, The Hague Journal of Diplomacy, vol. 6, nos. 1-2, 2011, pp. 7-36, this issue.
the globalized world beyond 2010, but also asserts that better understanding of
the politics of aid is required, and that the concept of economic diplomacy can
play a role in furthering this debate.

**What is the Aid Industry and How is it Changing?**

As mentioned above, international development is big business; hence the reason
to call it an industry, not as a critique of a possible watering down of ‘original’
humanitarian motives, but because a large part of international development is,
and should be, run like an industry. Development cooperation has grown, with
an ever-increasing number of organizations, and has become increasingly profes-
sional and confronted with questions of the efficiency and efficacy of its spending
(and rightly so, although it has enhanced the tendency to focus on low-hanging
fruit). In my experience, people in the aid industry are as committed and hard
working as in any other branch of government or the private sector, with long
careers in administration or technical advice and support. And when ‘aid workers’
are confronted with political motives and possible trade-offs, they can — from
my experience working for the Beijing office of the UK Department for Interna-
tional Development — be diplomats and smart political actors too.

International development cooperation emerged directly from the period and
institutions of colonialism, the politically and economically successful US Mar-
shall Plan, and the international agreements during and after the Second World
War. The structure of the industry has largely remained the same. The commit-
ment by Organization for Economic Cooperation and Development (OECD)
nations to spend 0.7 per cent of their national income on aid is regularly con-
firmed (although only six countries actually achieve this), there is a commonly
agreed norm regarding what constitutes ‘aid’, and national ministries continue to
administer aid programmes. Alongside the United Nations (UN) and its many
technical agencies, the International Monetary Fund (IMF) and the World Bank
remain important. Although protests against the international financial institu-
tions have become a regular part of the international stage, recently emerging
economies are rapidly enhancing their stake in those institutions. The number of
organizations — public, private, and private-public — has continued to grow, as
mentioned earlier, despite strong calls for rationalization of, and coordination
among, these agencies.

The 1980s and 1990s saw a period of ‘aid fatigue’, with declining aid flows,
probably particularly to the poorest countries and to Africa. Significantly, the aid
fatigue was the result of both the disappointments about, and heated debates
around, structural adjustment, involving the deep unpopularity of the World

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Bank, and the end of the Cold War, which had accompanied or led much of the
global powers’ aid commitments (indeed, at the time many suggested that aid
might not outlive the end of the Cold War). As always, there continued to be
much diversity within the aid industry, with the like-minded Northern European
donors continuing to emphasize the need to focus aid on poverty reduction and
to ‘untie’ aid from countries’ own economic interests.

In the mid-1990s, aid pessimism turned to optimism, and development aid
entered a period of enhanced symbolic value in both internal and global politics.
The debt relief movement brought hundreds of thousands of people to the streets.
The United Kingdom joined the club of like-minded donors, with the election of
New Labour and arrival of Clare Short as UK Secretary of State for International
Development (and on the back of a scandal on the improper use of aid in Malay-
sia), culminating in the International Development Act of 2002, which provided
a legal provision for UK aid to be solely for the purpose of poverty reduction.\(^7\)
Internationally, during the same period the focus of aid on poverty reduction
became enshrined in the language of the Millennium Development Goals, which
became an almost undisputed framework for the international community, mar-
rying human development objectives with ‘results-based management’,\(^8\) and
incorporating a response to the criticism of neglecting social sectors during the
period of structural adjustment. The ‘Poverty Reduction Strategy Papers’ became
a widely used instrument to promote better use of aid, focusing on poverty reduc-
tion. Subsequent aid-effectiveness discussions emphasized the need for donors’
priorities and working methods that give precedence to the needs and systems of
developing countries (the ‘Paris Agenda’). Many of these discussions were not just
about aid, but about making all policies of donor governments instrumental
for — or at least not hindering — the development of poorer nations.\(^9\) In the case
of the United Kingdom, the ‘humanitarian’ emphasis of aid was seen as an inte-
gral part of the broader foreign policy, alongside strategic and commercial inter-
ests. As one senior official once highlighted to DfID staff, possible trade-offs
(such as between a need to focus on accessible primary healthcare and access for
UK companies to developing countries’ healthcare markets) exist ‘only in the
short term’.

Over the last decade, two main forces have been changing this relatively ‘apo-
political’ face of the aid industry of the 1990s (a third major change may be the rise
of the climate change agenda, but this seems less relevant for this article). First,

\(^8\) David Hulme, ‘The Making of the Millennium Development Goals: Human Development Meets
Results-based Management in an Imperfect World’, Brooks World Poverty Institute Working Paper
no. 16 (Manchester: University of Manchester, 2008).
\(^9\) How well OECD countries perform in this broader perspective is analysed in the Commitment for
Development Index of the Center for Global Development in Washington, available online at http://
www.cgdev.org/section/initiatives/_active/cdi/.
since the late 1990s,\textsuperscript{10} and since 9/11 in particular, the global security agenda has simultaneously led to an increased interest in development, particularly in the United States, and a redefinition of the objectives of at least part of that assistance.\textsuperscript{11} Whereas earlier aid was progressively untied from a nation’s own (commercial) objectives, the establishment of a secure world and the fight against potential sources of conflict have increasingly become central objectives of aid — in the Netherlands, for example, through the ‘3D’ approach to defence, diplomacy and development,\textsuperscript{12} and in my own experience through a concerted effort to ensure that aid practices were made suitable for conditions of conflict and potential conflict. The emphasis on fragile states was also part of this global security agenda: while on the one hand the poorest people (‘bottom billion’) are increasingly concentrated in fragile states, these same conditions for lack of a functioning state are considered potential sources of global terrorism. The emphasis on strategic (post-Cold War) interests as drivers of aid was stronger in the United States than in Europe; in fact, former USAID administrator Andrew Natsios criticized European aid programmes for their failure to align aid to foreign policy concerns,\textsuperscript{13} but over time there seems to have been a fair amount of convergence, reinforced by an electoral turn to the right in Europe in 2010.

The second major change has been the increased visibility of emerging economies in the aid industry. China is only one of them, but arguably has the largest impact, which has led to a polarized debate in many circles, with some highlighting the new alternatives and opportunities presented by China, while others emphasize the ‘tsunami’ of Chinese imports and the ‘neo-colonialism’ of China’s foreign political and economic strategy — a critique that China has forcefully rejected, of course, while it is simultaneously trying to change the way in which China is perceived. China’s impact is felt very strongly, as it is such a large country, which became isolated from global economics and global politics after the Second World War (although with strong involvement in Cold War politics of course, including very importantly in Africa). Its economy has been growing rapidly for over three decades, including through the economic upheavals of the late 1990s and late 2000s, and its external sector in particular has expanded very suddenly since the 1990s.\textsuperscript{14} China’s growing global role is deeply intertwined with its

\textsuperscript{11} N. Woods, ‘The Shifting Politics of Foreign Aid’, \textit{International Affairs}, vol. 81, no. 2, 2005, pp. 393-411, which interestingly draws on work commissioned by the UK’s DfID.
\textsuperscript{12} The new Dutch government reinforces the integration of development cooperation within foreign affairs, and has also announced that Dutch development aid will involve the Dutch private sector much more than before (see ‘Basisbrief Ontwikkelingsamenuwerking’).
\textsuperscript{14} Arjan de Haan, ‘Will China Change International Development as We Know It?’, \textit{Journal of International Development}, vol. 22 (‘early view’ publication).
internal dramatic transformations under the continued leadership of the Chinese Communist Party, a dialectic that has become even more pertinent with the latest financial crisis.\textsuperscript{15}

In terms of international diplomacy, China’s proactive and significant role is by no means new, as it has successfully set its course in the United Nations since the early 1970s, and the Chinese people’s perception is that China is reclaiming a position lost 150 years ago rather than experiencing a mere ‘rise’. However, China’s foreign policy objectives have evolved rapidly, and have increasingly become led by its economic objectives following the 1978 economic reforms, particularly in ensuring access to natural resources and export markets, and with growing assertiveness in the debates on the global financial crisis, reserves and currency. While China’s foreign policy has always emphasized peaceful coexistence (in current terms it wants to be seen as a ‘responsible global actor’), more recently it has added the vocabulary of ‘soft power’ (ruan shili), highlighting its efforts to improve appreciation of Chinese culture and society, such as by opening Confucius Institutes around the world.\textsuperscript{16} China is trying to ensure an increasingly visible presence in global institutions (and for example through events like the Beijing Olympics, which was celebrated as the great renaissance of the Chinese nation), while paradoxically it simultaneously emphasizes that China is still a developing country.

As part of this broader foreign policy, and in China’s own words with a great deal of continuity \textit{vis-à-vis} its policies during Mao’s period, China expanded its aid efforts during the early 2000s and formulated an explicit strategy, particularly towards Africa.\textsuperscript{17} It is by no means easy to assess exactly what this new strategy implies, partly because it is evolving rapidly and with expanding capacity, partly because of the often heated debates and controversies,\textsuperscript{18} and partly because China has not distinguished ‘aid’ as clearly from other forms of collaboration as is common in the OECD’s context. China’s strategy is pragmatic, and sometimes paradoxical.

On the other hand, China asserts its distinctiveness, which is visible for example in the emphasis on its investment in infrastructure in Africa (an East Asian emphasis that is reflected upon in the November 2010 G20 communiqué) and in

\begin{itemize}
\item \textsuperscript{17} Deborah Bräutigam, \textit{The Dragon’s Gift: The Real Story of China in Africa} (Oxford: Oxford University Press, 2009).
\item \textsuperscript{18} Arjan de Haan, ‘Will Emerging Powers Change International Cooperation? Implications of China’s Foreign Aid for Dutch and Other Donors’, MqVU Working Paper no. 4 [MqVU is a team from Macquarie University in Sydney, Australia, and the Free University in Amsterdam that researches China’s development projects around the world], available online at http://mqvu.wordpress.com/working-papers/.
\end{itemize}
donor debates with an emphasis on practical approaches, juxtaposing this with the lofty yet more abstract debates on aid effectiveness. China has also kept many of the ‘old’ agencies at a distance, probably for internal political reasons, but probably also because of a lack of capacity within the institutions responsible for the aid programme.

On the other hand, and in line with the pragmatic international collaboration promoted particularly since Deng Xiaoping, China’s aid agencies work together with ‘old’ development agencies. This happens when China finds clear reasons to do so, and where it has established relationships. For example, this has led to collaboration with the World Bank on various fronts, based on the many projects that the World Bank has had over the last three decades. China has become an increasingly active participant in UN development-related forums at various levels, for example through the establishment of the International Poverty Reduction Center in China, which was mandated by the Chinese government to collaborate on international development (and in particular to share lessons from China’s development success), and was supported by a wide range of ‘old’ donors that are keen to engage with China on its international development role. Finally, the number of Chinese scholars and officials in international organizations has been rising, most recently with Justin Lin Yifu as Chief Economist at the World Bank, who was celebrated as the first scholar from a developing country to take that position and moreover is somebody who had defected from Taiwan.

The reasons that make it difficult to assess China’s ‘aid’ may also form one of the biggest potential changes to aid practices. Unlike the European consensus that has emphasized the need to ring-fence aid against commercial motives, and with a post-structural adjustment focus on social sectors, China explicitly does not distinguish aid from commercial collaboration. It maintains this stance on practical grounds, but also ideologically, as it is commonly argued that mutual interest is the key to sustainable collaboration and development, and with scepticism over Western arguments around untied aid. China may feel pressed, over time, to report aid under OECD-DAC [Development Assistance Committee] norms, as the international community is keen to make China and other new donors part of the club of old donors. China can be expected to continue to assert its distinctiveness, while also joining the OECD debates and possibly showing efforts to adjust its reporting procedures (so that it is seen to be a responsible global actor). At the same time, Western nations may be moving away from established norms, particularly if countries’ own commercial interests are again becoming more important in their aid practices, as in the case of the Netherlands.

19) See, for example, online at http://info.worldbank.org/etools/ChinaAfricaKS/index.htm. Reportedly, practices that World Bank projects have introduced and built capacity for, such as bidding procedures, are now effectively used by Chinese agencies in Africa.

These two changes are very significant for established practices of international development collaboration, and with the recent political shifts are likely to have a big and — by and large — unknown impact on the aid industry and how this is embedded in broader foreign and global policies. This article will return later to the role of aid in economic diplomacy, but first turns to the available evidence on why aid is given.

Why Does Aid Exist?

The question of why aid exists has received relatively little attention in the debate on development studies.21 In the international debate — with much disagreement about the modalities of aid and whether commitments are being achieved — a great deal of consensus exists that richer countries should provide grants or conditional financing to assist the development objectives of poorer countries. At the same time, as indicated earlier, aid has also been heavily criticized, perhaps more than any other form of use of taxpayer’s money. In the Netherlands, aid was recently labelled a ‘hobby of the left’, without reflection on the complexity that leads to the formation of national aid priorities and institutions. Within development studies, most debates have tended to neglect the broader politics in which development is situated (hence the surprise in the observation of China’s aid as part of its ‘soft power’). There has been much attention to the question of whether aid ‘works’, and critique that it does not, without acknowledgement that aid money is often used for diverse purposes. In effect, arguably, the yardstick with which aid effectiveness is measured — also in the fierce critique of Dambisa Moyo, who seems to criticize that aid did not work particularly in the contexts where it was used for Cold War purposes — may thus be inappropriate.

What does the literature tell us about the diverse motives for providing aid?22 The critical (Southern) analysis tends to focus on the impact on the global South, but with little attention to the specific national histories and diversity within the aid industry. For instance, the journal *Third World Quarterly* recently emphasized the neo-liberal approach to governance within EU development policy, without much attention to the origins of this within Europe, which *a priori* could be expected to reflect more diverse characteristics.23 Carol Lancaster’s work on how aid agencies’ reflect national histories and institutions is an in-depth political

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analysis of aid, illustrating for instance that the differences in views and practices cannot be simply conceptualized as a left-versus-right opposition. This kind of detailed political and institutional analysis receives very little attention in the circles that debate development policy, which instead focus on the policies within recipient countries and give little attention to the structures of the Northern countries’ development policy, at best highlighting different emphases under different development ministers.

An often-quoted quantitative but now slightly outdated cross-country analysis by Alesina and Dollar shows convincingly that besides economic need and quality of governance, foreign policy and strategic consideration play a role in the allocation of (bilateral) aid. One would expect strategic considerations to have become even more important since 9/11, although there is also evidence of more ‘selectivity’ in favour of recipient countries with good governance, at least with respect to multilateral aid. Kuziemko and Werker build on Alesina and Dollar’s analysis and show that presence in the UN Security Council enhances the likelihood that a country will receive aid from the United States. Berthélemy confirms the economic self-interest and role of rent-seeking (and incentives to maintain dependency on aid) within donor countries’ aid allocations. Diversity among donor countries is explained by Chong and Gradstein, who use World Values Survey data that indicate that individual willingness to provide aid is related to individual relative income as well as one’s own government’s performance or inefficiency.

One aspect that has remained invisible in academic analysis (including in debates on economic diplomacy) is the symbolic significance for donor countries’ leaders to give aid commitments at global forums. On a bilateral level, it is not difficult to see how aid commitments can cement bilateral links, such as when the prime ministers of the United Kingdom and India agreed to increase aid to GBP 300 million in 2002. Less obvious is why the same UK prime minister put enor-

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mous efforts into a Commission for Africa, except for Africa providing political leaders with an opportunity to connect with a ‘good and noble cause’, or why US President Bush suddenly wanted to present a big announcement at the 2002 Financing for Development Conference in Monterrey. The participation of the Chinese premier at the UN high-level meeting on the MDGs was at the time somewhat surprising, but it is now clear that the leaders of emerging economies do want to be members of the clubs of ‘old donors’ (even though China still presents itself as a developing country, although one that in Chinese premier Wen Jiabao’s words was responsible for two-thirds of global progress towards Millennium Development Goal number 1: to reduce poverty in half by 2015).

Even though academic analysis on the motives for giving aid is somewhat limited, it is clear that the ‘aid industry’ is about much more than humanitarian motives, and that different motives are more or less important in different contexts. Development aid has been a core and important symbolic component of global politics since the Second World War, and while emerging economies contest the modalities of aid, they do not appear to deny or undermine its symbolic importance. This then brings us to the question of whether aid is, and should be, part of what this volume calls economic diplomacy.

**Aid: Whose Diplomacy?**

Better academic understanding of why countries give aid is thus required if we are interested in enhancing the effectiveness of aid. The motives for giving aid are diverse, and their relative importance changes over time, as described above about the influence of the global security agenda and the emerging economies. To perceive the emerging economies as a ‘threat’ to the aid industry would neglect the deeply political nature of aid throughout its history: as a manifestation of the post-Second World War global system; as humanitarian commitment to supporting development efforts; and most recently as a move towards the US model of making aid central to broader diplomacy efforts.

What, then, of the role of aid in economic diplomacy, which is broadly defined as a foreign policy practice that regards economic and political interests as mutually reinforcing? Can aid legitimately be part of economic diplomacy? For the aid industry, this question is particularly important, because the consensus since the late 1990s has emphasized the relative autonomy of the operation of aid, making it increasingly independent of national economic motives. This is now challenged, however, first by the security agenda, and more recently by the combined forces

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of increased emphasis on domestic interests and the operating modes of emerging economies in the field of aid.

On the one hand, while supporters of the untying of aid rightly justify their position from a humanitarian objective, they too may have to grant that this has moved aid too far into the sphere of charity, neglecting the role of self-interest in their enlightened efforts. Ultimately, despite the high-level political commitments, the provision of aid has never obtained a legally binding footing (which is, for example, manifested in the variability of aid flows, with very negative developmental consequences). The current East Asian emphasis on commercial collaboration and partnerships, which are promoted by national authorities, may lead to more sustained economic development. The post-structural adjustment emphasis on social sectors, while also defensible from the humanitarian point of view that stresses how little money is available for healthcare in Africa, can also be criticized from the point of view of sustainable development.

On the other hand, there are important arguments warning against subsuming aid as a simple instrument of economic diplomacy. For a development perspective, economic history suggests that public goods — including regulation — remain under-provided, with too strong an emphasis on markets. One might also argue that the European emphasis on social sectors (which typically require a larger role from public authorities as providers and for subsidies) could very well complement the emphasis of China and others on economic infrastructure. Finally, from a broad diplomacy perspective, one might argue that there appears to be an important symbolic function of being seen to be a charitable aid donor, in the way that we now often observe emerging powers such as China wanting to be seen as a ‘responsible’ global actor, and in line with empirical knowledge about the function of economic diplomacy.

However, understanding of the changing ways in which aid is situated in economic (and other) diplomacy also needs to be embedded in analysis of the donors’ domestic politics. In the Netherlands, the apparent aid fatigue appears to be directly linked to the widely perceived crisis in trust of government, and the rise of populist politics, which has also expressed itself in resistance against official policies vis-à-vis Europe and regarding immigration and integration, infused with an urge to reassert a Dutch identity. The aid fatigue is also accompanied by a rise of philanthropic activity and a ‘do-it-yourself’ mentality of providing aid: not necessarily less international solidarity but a different way of expressing it.

While this article was being written, the Dutch government’s new approach is being witnessed, which is important not only for the Netherlands, but arguably also for the broader development community, because the Netherlands has long been at the forefront of promoting the poverty-focused approach that dominated the aid agenda until recently. As already mentioned, political changes in Europe

have contributed to a declining popularity of aid. In the Netherlands over the last few years, voices gained strength to reduce the aid budget and to make it much more instrumental for Dutch commercial interests, emphasizing the areas where the Netherlands has comparative advantage (such as water and food security), and reducing investment in areas where it is thought to have less comparative strength.34 The new Dutch government announced the new policy direction in November 2010, with a 10 per cent cut in the budget, including items previously not included as ‘aid’ (such as peacekeeping operations and the costs of refugees), proportionally larger cuts in spending on education and for Dutch NGOs, and prioritizing economic growth and sectors of Dutch comparative advantage to enhance aid effectiveness. Departing from the previous emphasis on untied aid, the government now makes Dutch strategic interests a key criterion for the selection of themes and investments.35

These changes, witnessed by foreign observers as radical for the Netherlands, are happening in the context of the increasing external pressure of globalization — even though they are not directly perceived as such. The pressure of emerging economies is critical in this changing context, and the move to make aid instrumental to commercial interests can be regarded as part of an increased protectionism, in which the imperative for a ‘corporate focus’ on national interests is felt increasingly strongly, often with reference to the fact that countries such as China are better at looking out for their national interests than ‘old Europe’, including in the way that China uses aid to promote its diplomatic interests and uses its companies and labour for development projects. The irony (or paradox) seems to present itself that as China and others are emphasizing their soft power, the European consensus seems to be giving way — starting before the financial crisis but of course reinforced since — to an emphasis on focusing more on European countries’ own interests, and thus reducing charitable (untied) forms of aid.

Such competition between global powers is not unique: it is common between OECD powers, and they have been challenged by Japan and South Korea before, but the current wave of changes appears different, perhaps mostly because of the size of the emerging economies. It is perhaps inevitable that there is a backlash against the loss of global status, marked for example by the Netherlands’ non-inclusion in the group of G20 countries and resulting in the nationalism that European countries are now witnessing. The political responses to this new global

34) As already mentioned, the report of the Dutch Scientific Council provided a forceful critique; see Wetenschappelijke Raad voor het Regeringsbeleid (WRR), Minder pretentie, meer ambitie [Less Pretence, More Ambition]. This WRR report on aid was followed by the WRR report (led by Ben Knapen who subsequently became responsible for development cooperation within the Ministry of Foreign Affairs) about the changing Dutch foreign policy (Wetenschappelijke Raad voor het Regeringsbeleid (WRR), Aan het buitenland gehecht: Over verankering en strategie van Nederlands buitenlandbeleid (Amsterdam: Amsterdam University Press, 2010).
playing field may have long-term consequences. The Netherlands, for example, still has the image of an open progressive country with an international agenda (arguably this is the soft power of small European countries); nationalistic responses — including in the field of aid — may damage this image and any short-term gains may be off-set by longer-term losses. As mentioned earlier, too little is known about the gains for a country’s global image, which political leaders seem to perceive intuitively.

Conclusions

Considering the role of aid — or development cooperation — in economic diplomacy may seem to some a digression of the ‘real’ questions about aid — that is, how to make it work (better). I share the worry about this, and do so even more in the Netherlands’ current political climate, where the government is reducing allocations to development aid and is ensuring that the remaining aid will be beneficial to the Dutch national economy, despite well-documented concerns of the inefficiencies brought by such tying of aid. To others, the question may seem like mere semantics, and it may be merely a question of defining whether aid should be regarded as part of this.

My motive for asking the question is that better understanding of the politics of aid is essential for understanding (and properly assessing) what aid can achieve. Development cooperation has been an integral part of global politics since the Second World War, with a constantly changing position that is probably responsible for the malleability that has marked the aid industry since its late-colonial inception. Aid moved from being an integral part of Cold War objectives, via aid fatigue, to a visible Millennium Development Goal framework, which is now partly dominated by global security concerns and to a lesser extent by increased protectionism, and joined — but also partly challenged — by emerging economies.

Political science can help to provide a better understanding of the various roles that aid has played in different contexts and different periods of time, and how this is now changing with the entry of new players. The literature on economic diplomacy can be of help, although I believe that there needs to be better understanding of the role of being seen to be a responsible player in this. Development studies need to enhance political awareness; in particular, new ways need to be found to infuse progressive and humanitarian democratic ideals into the practices of international development, at a period when the effectiveness of aid is in doubt and aid’s post-war assumptions back at home are radically questioned. Arguably, reinforcing progressive principles around international development can be a supportive element of a strengthened diplomacy in the globalized world beyond 2010, thus counter-acting the increasingly nationalistic and probably
short-term and defensive responses to the new global circumstances of the twenty-first century.

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