The geography of conflicts and free trade agreements[*]

Philippe Martin[†]   Thierry Mayer[‡]   Mathias Thoenig[§]

June 2, 2010

Abstract

We analyze the interaction of economic and political determinants of free trade agreements (FTA). In addition to standard trade gains, FTAs can promote peaceful relations by offering a political forum and by increasing the opportunity cost of conflicts that disrupt trade. If policy makers believe in such pacifying effects of FTAs, country pairs with large trade gains from FTAs **and** a high probability of conflict are more likely to sign a FTA. Using data on the 1950-2000 period, we show that this complementarity between economic and political gains is at work in the geography of FTAs. Country pairs characterized by a high frequency of old wars - which we use as a proxy of the latent probability of conflict - are shown to be more likely to sign FTAs, the more so the higher the trade gains from a FTA. These trade gains are estimated by a theory-driven empirical strategy to disentangle them from the political factors. We also show that, contrary to old wars, recent wars make it more difficult to negotiate a FTA. This suggests the existence of windows of opportunity to lock in FTAs and peace. Finally, multilateral trade openness, because it reduces the opportunity cost of bilateral conflict, increases the political incentive to sign FTAs.

JEL classification: F12, F15 Keywords: free trading arrangements, Trade, War.

1 Introduction

Free trade agreements (FTAs) have a bad press among a number of economists. Many scholars argue that they constitute a threat to the carefully constructed postwar multilateral trade system. Whereas multilateral trade liberalization has stalled, the number of FTAs has massively expanded during the last two decades and now stands at well over 300. The well known economic problem with these bilateral and regional agreements is that, although they create trade, by excluding countries, they also generate distortions.[1]

Much less attention has been paid (by economists) to the political and strategic motivations for regional integration, even though these motivations may have been key historically.[2] In fact, the debate among economists and political scientists often interprets economic and political rationales for FTAs as substitutes. In this paper, we revisit the case for trade agreements by explicitly linking the economic and political rationales and show, both theoretically and empirically, that the two are complement.

An important political argument in favor of FTAs is the so called Liberal Peace argument, which states that bilateral trade flows reduce the probability of a bilateral war, a mechanism that has been analyzed theoretically and on which some empirical evidence exists.[3] Hence, FTAs, if they create trade, should reduce the probability of wars between countries. This proposition is however difficult to test because establishing the direction of causality is a challenging task: FTAs may reduce conflict but peace, or expected peace, may facilitate FTA negotiations. Because most FTAs were signed in the late 1990s and 2000s, the lack of historical perspective *following* FTA formation also makes identification difficult in the panel dimension.[4] We choose a different route by asking the following question: is the geography of FTAs consistent with a model in which policy makers believe that FTAs are pacifying? This empirical strategy allows us to exploit the period *preceding* FTA formation for identifying the relevant effects.

We first provide a simple cost/benefit analysis to illustrate the economic and political mechanisms

---

[1]The most recent evidence (Baier and Bergstrand, 2007 using gravity equations) on trade creation finds a relatively large effect: FTAs are on average responsible for a doubling of trade between two members after 10 years. Baier and Bergstrand (2008) use matching techniques and confirm this large effect of FTAs on trade between members.

[2]In the case of Europe, political scientists and historians have insisted on the fact that economic integration was viewed as an intermediate objective while its final objective was to prevent the killing and destruction of the two World Wars from ever happening again. Even the recent creation of the euro, often interpreted by economists as a logical step towards more economic integration, has been discussed in these terms. Indeed, Jacques Delors (former president of the European Commission) declared: "...people forget too often about the political objectives of the European constitution. The argument in favor of the single currency should be based on the desire to live together in peace". Before that, the 1860 Anglo-French commercial Treaty was signed to defuse tensions between the two countries. Outside Europe, MERCOSUR was created in 1991 in part to curtail the military power in Argentina and Brazil, then two recent and fragile democracies with potential conflicts over natural resources.

[3]see Oneal and Russett (1999), Polachek (1980), Martin, Mayer and Thoenig (2008), Spolaore and Wacziarg (2009).

[4] Mansfield and Pevehouse (2000) find that country pairs in FTAs are less likely to be in conflict than others. However, their cross-sectional evidence does not allow to conclude on the direction of causality.

at work in the decision whether to sign or not a FTA. In addition to standard trade gains, leaders consider that FTAs provide peace-promoting security gains (i) by offering a political forum which facilitates settlement of future disputes; and (ii) by increasing the opportunity cost of future and potentially trade-disrupting wars (the Liberal Peace argument). This simple framework allows us to derive several testable implications. First, FTA formation is more likely for country pairs with larger expected trade gains. Second a higher *probability* of war between two countries makes FTA formation more likely because of the political forum channel. Third, trade gains and the probability of war have a positive and complementary impact on FTA formation. The complementarity stems from the opportunity cost channel: the larger the trade gains, the larger the opportunity cost of war and therefore the more useful a FTA is to secure peace which is more valuable to countries that have a higher probability of war. Finally, recent *realizations* of war reduce the gain from a FTA because outbreaks of war increase the political costs of FTA negotiation.

Our empirical analysis estimates a model of FTA formation at the country-pair level over the 1950-2000 period to analyze whether the evolving geography of FTAs is consistent with the economic and political factors identified in the theoretical section. From the perspective of the identification strategy, a first concern is that many empirical determinants of wars and of the FTA-related trade gains are confounded: the gravity covariates, such as geographical distance, economic size, contiguity, cultural distance, etc., affect the propensity to fight as well as the propensity to trade. This problem explains why the existing empirical literature on FTA formation has not been able to disentangle economic from political factors, what we attempt to do in this paper. To this purpose we rely on a theory-driven estimation procedure to quantify directly the potential trade gains generated by FTAs. To our knowledge our paper is the first to adopt such a strategy. A second, and related, identification issue is that we need to differentiate between the latent probability of war, which increases the likelihood of a FTA, and recent outbreaks of war, which reduce it. Our identifying assumption is that recent outbreaks are captured by the country-pair frequency of wars during the last 20 years, while the latent probability can be measured by the country-pair frequency of old conflicts (over the period 1870-1945), a view which is consistent with existing evidence on the time-series autocorrelation of the war process. Finally we address endogeneity issues by controlling for the main codeterminants of political affinity, conflicts and trade; by including country, country-pair, and year fixed-effects; and by instrumenting trade gains. Our results are robust to these different estimation strategies. We also check that the results are not driven by the European integration process, although the mechanisms we focus on are particularly strong for European country pairs.

Our empirical results, both in the cross section and in the panel dimension, support our theoretical predictions. We find that trade gains and the frequency of old wars have a high explanatory power and

both increase the likelihood of FTA formation. Their interaction term also has a positive impact and this confirms complementarity between economic and political factors. By contrast, recent war frequency decreases the occurrence of FTA formation, suggesting the presence of windows of opportunity to lock in FTAs: periods of interrupted conflict between old enemies may help them to form a FTA in order to settle a more peaceful bilateral relation. Finally we find that country pairs characterized by multilateral trade openness and a high frequency of old wars are more likely to sign FTAs. We interpret this in the light of one of our main findings in Martin, Mayer and Thoenig (2008) whereby multilateral trade openness, because it reduces bilateral economic dependence, does in fact increase the probability of a bilateral war. In other words, countries respond to the weakening of local economic ties (a side effect of multilateral trade liberalization), and its potentially peace-harming consequences, by reinforcing local political ties through a FTA. From this point of view, we interpret the proliferation of FTAs as a logical political response to globalization.

In the last section of the paper we quantify the identified mechanisms and perform several counterfactual experiments. We find that the complementarity between trade gains and the probability of war is sizeable and may even dominate the direct effect of each of these variables. This suggests that the opportunity cost channel is a first-order determinant of FTA formation. In other words, trade gains brought by FTAs are instrumentalized and are important as an intermediate objective of FTAs, their final goal being to pacify relations between countries. We also find that in a counterfactual world without any past history of warfare, the geography of FTA formation would be radically different from the one actually observed. The same is true for a counterfactual world with no multilateral trade openness.

The theoretical literature on FTA formation is very large. However existing papers focus their analysis on the economic determinants, the role of security gains and military conflicts being largely ignored.[5] From an empirical point of view, several papers study the economic determinants of FTAs (Baier and Bergstrand 2004, Egger and Larch 2008) under the identifying assumption that FTA-related trade gains are closely linked to the standard gravity covariates. Vicard (2009) in addition to those gravity covariates, analyzes the impact of conflict to explain differences in the depth of FTAs. As discussed above, this does not allow us to discriminate between the economic and political factors, which is the purpose of our study. Mansfield and Pevehouse (2000) and Vicard (2009) also look at the reverse impact of FTA formation on the occurrence of military conflicts ignoring the potential role of economic factors. Finally there is a series of recent papers which analyze how Foreign Policy affects the decision to open to trade. Acemoglu and Yared (2010) look at the impact of military expansion on international trade flows and find that increased nationalist and militarist sentiments are negatively

---

[5]This literature has analyzed the motives for building FTAs mainly from a terms-of-trade perspective (Bagwell and Staiger 1998, Ornelas 2005) and from a commitment perspective (Limao 2007, Maggi and Rodriguez-Clare 1998).

associated with trade. Berger, Easterly, Nunn and Satyanath (2010) study how US political influence is used to create a larger market for American products; they find that following CIA interventions there is an increase in foreign-country imports from the US. Conversely Davis (2008) studies the Anglo-Japanese Alliance over the 1902-1923 period to analyze how powerful states use trade and aid policies to buy influence. While related to our approach, none of those papers look at the interplay between Foreign Policy and international trade agreements.

The next section provides a simple theoretical framework and derives several testable implications. Section 3 presents the data and discusses the empirical strategy. Section 4 reports our main empirical results and performs some quantification exercises, while Section 5 concludes.

2 A simple framework

We now present a cost/benefit analysis of FTA formation. We keep the analysis as simple as possible, our purpose being to derive the minimal setup for grounding our econometric specification. Readers who wish to skip this step may go directly to the subsection 2.3. We leave for future work the building of a theory of the dynamics of FTA formation in presence of trade-disrupting conflicts. Such a theory goes beyond the scope of this paper.

2.1 Timing and Welfare

We consider an insecure world where two countries decide whether to sign a bilateral FTA, which we interpret as a decrease in bilateral trade barriers with respect to the Most Favored Nation (MFN) tariff. We analyze hereafter how this decision is shaped by economic and political forces. For ease of exposition, we focus, in this section only, on two identical countries.

Two main features describe bilateral relations between countries. First, whether they have signed a FTA or not. The variables of those who have signed a FTA are denoted with the superscript FTA; those who have not signed have no superscript. The second dimension is whether the two countries are at war or at peace.

The timing of events is as follows: in period 1, countries negotiate on the FTA. We make no particular assumption on the bargaining process but assume that there is a political cost of negotiation C that is borne by each country. In period 2, we assume that a bilateral dispute may arise with probability δ for exogenous reasons (the existence of a common border, natural resources, ethnic minorities...) and may escalate into a military conflict with an endogenous conditional probability: e in absence of FTA or e^{FTA} if a FTA is in force. In period 3, economic gains are realized and each country gets an aggregate welfare level which depends on the existence of a FTA, and on the realization of a war at date 2.

In the rest of our analysis we express all welfare gains or losses as a percentage of a benchmark welfare level, U_P, which is realized in the state of peace in absence of FTA. In this state both countries trade bilaterally and the MFN tariff is applied. When war occurs, we assume that bilateral trade is fully disrupted and both countries go back to bilateral economic autarky. This trade disrupting effect of war is empirically well grounded (Blomberg and Hess 2006; Martin, Mayer and Thoenig 2008; Glick and Taylor 2005). Hence, welfare under war is given by $(1 - W)U_P$ with $0 < W < 1$, whether a FTA is in force or not. The parameter W captures the direct costs of war (ie. destructions, death toll, etc.) augmented by the loss associated with bilateral economic autarky (with respect to the MFN situation). When a FTA is in force, additional welfare gains with respect to the MFN situation are generated only if peace is maintained; in that case welfare is given by $(1 + T)U_P$. According to standard trade theory, $T > 0$ if the trade creation effect of the FTA dominates the trade diversion effect; otherwise $T < 0$.

The opportunity cost of war corresponds to the welfare differential between war and peace. From the previous discussion we see that in absence of a FTA, this differential is equal to WU_P while it is equal to $(W + T)U_P$ when a FTA is in force. As a consequence signing a FTA potentially increases the opportunity cost of a war by T/W percent.

2.2 Signing a FTA: testable implications

At date 1, a FTA is signed when, for each country, the expected utility gains induced by the FTA, Γ, is larger than its political cost. Denoting with V^{FTA} and V the *expected* welfare with and without FTA, the condition for FTA signature is:

$$\Gamma \equiv V^{FTA} - V \geq C, \tag{1}$$

where $V = (1 - \delta e)U_P + \delta e(1 - W)U_P$ and $V^{FTA} = (1 - \delta e^{FTA})(1 + T)U_P + \delta e^{FTA}(1 - W)U_P$. Without loss of generality, we can express the political cost as a percentage of the benchmark welfare: $C = c \times U_P$. Below, we detail some likely determinants of the negotiation cost c. Combining those equations with equation (1), the condition for signing a FTA becomes:

$$\Gamma \equiv \underbrace{(1 - \delta e^{FTA})T}_{\text{economic gains}} + \underbrace{\delta\left(e - e^{FTA}\right)W}_{\text{security gains}} \geq c, \tag{2}$$

where on the LHS we have decomposed the net expected surplus of FTA formation into pure economic gains and security gains. Economic gains result from the increase in welfare from U_P to $(1+T)U_P$ when the FTA is active; however the FTA related trade gains T are realized only in periods of peace which occur with probability $(1 - \delta e^{FTA})$. The security gain of a FTA is associated with the

potential decrease in the probability of escalation of disputes into war from e to e^{FTA} ; this allows to save on the costs of war W.

We now analyze the differential $(e - e^{FTA})$. As shown by the international relations literature (see Fearon 1995 and Powell 1999 for surveys), escalation to military conflicts can be interpreted as the failure of negotiations in a bargaining game. ¿From this perspective, the probability of escalation depends negatively on the opportunity cost of war and positively on the degree of informational asymmetry between the two countries.[6] The rationale for the first channel is that, as the opportunity cost of war increases, countries have more incentive to make concessions in order to avoid the escalation of a dispute into a military conflict. The rationale for the second channel is that information asymmetries imply that during negotiations, countries do not report their true outside option, in order to extract larger concessions. This may prevent negotiations from succeeding and disputes may escalate into war.

We assume that the signature of a FTA affects the probability of escalation, e, through these two distinct channels. First, as discussed before, a FTA increases the opportunity cost of war by T/W percent and thus reduces the probability of escalation. Second, a FTA produces a political spillover on conflict resolution by reducing the degree of informational asymmetries: successful negotiations on economic and trade matters and the repeated interactions that follow these negotiations enable policy makers to learn about the other country. This channel has been discussed at length in the political science literature, and many FTAs, such as the EU, ASEAN or MERCOSUR, have become venues for discussing political issues and potential disputes.[7] Hence, we assume that the change in the probability of escalation due to a FTA can be decomposed into two effects:

$$\frac{e^{FTA} - e}{e} = -\varepsilon_{cost}\frac{T}{W} - \varepsilon_{pol} < 0, \tag{3}$$

where $\varepsilon_{cost} > 0$ corresponds to the elasticity of escalation e to the cost of war while $\varepsilon_{pol} > 0$ stands for the political spillover effect. In the rest of the paper we refer to $(\varepsilon_{cost}, \varepsilon_{pol})$ as the security gains of FTA formation.

Under the reasonable assumption that the FTA related trade gain T is small with respect to the cost of war W, we can combine (2) and (3) to get a first-order Taylor approximation of the FTA signature condition (see the appendix for details):[8]

---

[6] For a formal proof, see for example Martin, Mayer and Thoenig (2008) where we consider a fairly general bargaining game such that: (i) war is Pareto dominated by peace; (ii) countries have private information on the military and political strength of the other country; (iii) countries can choose any type of negotiation protocol. The negotiation is such that escalation to war is avoided whenever countries agree upon the sharing of the economic surplus under peace.

[7] This argument, under the name of issue linkage, has been developed by political scientists working in the field of international relations, see Keohan and Nye (1977) , Haas (1980) and Mansfield and Pevehouse (2000).

[8] In the next section our empirical estimates show that the magnitude of T is approximately 1 percentage point of welfare. This is far below the existing estimates of the average cost of war W that can be found in the empirical literature

$$\Gamma \equiv T + \varepsilon_{pol}(\delta e \times W) + (\varepsilon_{cost} - 1)(\delta e \times T) \geq c, \tag{4}$$

where Γ corresponds to the utility gain from FTA formation. This equation is our key theoretical relationship and serves as a foundation for the econometric estimation. It contains five main predictions on the determinants of signing FTAs:

1. The first term on the left hand side of this inequality, T, corresponds to the standard economic gains generated by the FTA on which the literature has focused. *Larger economic gains are predicted to increase the probability that the two countries sign a FTA.* The difficulty here is to produce a quantitative estimate of those trade gains for all country pairs. We shall return to this issue in the empirical section.

2. The second term corresponds to the political spillover of FTAs. *A higher probability of war δe increases the likelihood of signing a FTA.* Since signing a FTA allows countries to reduce asymmetry of information, it reduces the probability of escalation to war by ε_{pol} percent. Note that this political gain of FTAs is large when the potential welfare loss of war W is large.

3. The third term interacts trade gains with the probability of war. It is of ambiguous sign and depends on whether the pacifying effect of FTAs through its impact on the economic opportunity cost of war is sufficiently large, i.e. if $\varepsilon_{cost} > 1$. Two effects pull in opposite directions: on the one hand a high probability of conflict δe reduces the expected gain from a FTA because these gains are lost in times of war. On the other hand, a high probability of conflict also means that the pacifying effect of a FTA is very valuable. If policy makers believe that FTAs are indeed strong elements of pacification, this second effect dominates, and *we expect this interaction term to enter with a positive sign.*

4. The term c on the right-hand-side of 4 is the political cost of negotiation. It is linked to the current state of relations between the two countries. We expect in particular that c increases after a war: Grief brought by war generates vengeful feelings in the population which increase the political cost of such negotiations. Even though difficult to measure, vengeful feelings do exist and have been shown to depreciate over time (see recent statistical evidence for victims of crimes in Mocan, 2008). This directly leads to our fourth testable implication: *Recent outbreaks of war reduce the probability of FTA formation.*

5. Note from equation 4 that any factor that decreases the cost of war W has two opposite effects. On the one hand, this reduces the incentive to sign a peace-promoting FTA. On the other hand,

---

(see Glick and Taylor 2005)

the probability of escalation increases (see equation 3) and this in turn increases the incentive to sign such a FTA. A sufficient condition for the second effect to dominate is $\varepsilon_{cost} > 1$. One factor that may decrease the cost of a bilateral war is multilateral trade openness. In Martin et al. (2008) we indeed show theoretically and empirically that, everything else being equal, a country pair with a higher level of multilateral trade openness has a higher probability of bilateral conflict. The rationale is that multilateral trade openness provides alternative trade partners and reduces bilateral trade dependence. Applied to our current setup, this means that country pairs that are more open to multilateral trade and that have a higher probability of conflict, have a stronger incentive to sign a FTA. *Multilateral trade openness and the probability of war are expected to have a complementary impact on the probability of FTA formation.* A FTA can therefore be interpreted as a political response to the weakening of regional economic ties that comes with multilateral trade openness. This result supports the view that the development of multilateralism during the 1980s and early 1990s could have triggered the wave of regionalism of the late 1990s. This echoes a recent empirical finding by Fugazza and Robert-Nicoud (2009) whereby in the US case, multilateralism has pushed towards regionalism. They find that the extent of post-Uruguay Round FTAs is positively affected by the extent of MFN tariff cuts negotiated by the US during the Urugay Round.

2.3 Econometric implementation

We now present the econometric implementation of our model of FTA formation. To this purpose we relax the assumption of identical countries. Considering a country pair (i, j) in year t, our theoretical equation (4) implies that a FTA is signed when:

$$\Gamma_{ijt} > c_{ijt}. \tag{5}$$

In this equation, Γ_{ijt} is the expected utility gain from signing the agreement, and c_{ijt} corresponds to the negotiation cost. Empirically, c_{ijt} is the unobserved component of the decision process, submitted to stochastic shocks in political affinity for instance, which transforms (5) into a probability of FTA formation. The functional form taken by this probability depends upon the distribution assumed for c_{ijt}. With a Gumbel /Type I extreme value distribution (see Train, 2003), we obtain the logit probability to be estimated using maximum likelihood:

$$\mathbb{P}(\text{FTA}_{ijt} = 1) = \frac{\exp(\Gamma_{ijt})}{\exp(\Gamma_{ijt}) + 1}. \tag{6}$$

where the dependent variable FTA_{ijt} is a dummy coding for the existence of a FTA between i and j in year t, and Γ_{ijt} follows from equation (4):

$$\Gamma_{ijt} = \alpha + \beta_1 \min(\hat{T}_{ijt}, \hat{T}_{jit}) + \beta_2 WAR_{ij} + \beta_3 \min(\hat{T}_{ijt}, \hat{T}_{jit}) \times WAR_{ij} + \boldsymbol{\beta}\mathbf{Z}_{ijt}. \tag{7}$$

In the previous equation $(\hat{T}_{ijt}, \hat{T}_{jit})$ correspond to our *empirical estimates* of the FTA-induced economic gains; they are retrieved from the estimation procedure described in Section 3.2. We consider the country-pair minimum $\min(\hat{T}_{ijt}, \hat{T}_{jit})$ as a consequence of our theoretical view that FTA formation must be Pareto-improving in absence of any compensatory transfers within the country pair.[9] In our robustness analysis we allow for the possibility of transfers by measuring trade gains with the country-pair average $(\hat{T}_{ijt} + \hat{T}_{jit})/2$ rather than the minimum. Finally WAR_{ij} is a proxy for the probability of war δe (see section 3.3 for details on its measurement) and $\mathbf{Z}_{ijt}$ is a set of control variables.

In equation (7) we expect β_1 to be positive. The coefficient β_2 tests for the existence of a political spillover from a FTA. It is expected to be nonnegative. The interpretation of the sign of β_3, the coefficient of the interaction term, can be misleading in a logit specification due to the non-linearity of this model (see Ai and Norton 2003). The logit specification also makes the handling of panel data techniques such as within estimation more complicated, while the marginal effects tend to be similar to the Linear Probability Model (LPM) in many cases as shown in Angrist and Pischke (2009, p107). Hence in all specifications of (7) that include the interaction term, we estimate a linear probability model rather than a logit model. This standard choice also facilitates the interpretation of the coefficient.[10] In that case the coefficient β_3 corresponds to a marginal effect and it can be simply interpreted as a test of complementarity versus substitutability between economic and security gains: complementarity and $\beta_3 > 0$ is expected when the opportunity cost channel is at work (i.e. the pacifying effect of FTAs is large so that $\varepsilon_{cost} > 1$).

3 Empirical analysis

3.1 Data

There are two main parts to the empirical investigations of this paper. In a first step we estimate the economic gains of FTA formation, which involves essentially running a gravity equation over a sufficiently long time period to be able to identify the trade creation effect of FTAs in the within dimension (see Carrere 2006). In a second step we estimate the econometric model of FTA formation that is exposed in the previous section.

---

[9]In our theoretical setup the two countries i and j are assumed to be symmetric for the sake of exposition. Relaxing this assumption and ignoring compensatory transfers, the condition (4) is now country-specific given that the trade gains (T_{ij}, T_{ji}) are potentially asymmetric. A FTA is formed when the minimum of the two country-specific conditions (4) is positive.

[10]However, an area where logit (or probit) is undoubtedly preferable to LPM is the predictions one can make when changing one or more variables more than marginally. Probabilities have to be bounded between 0 and 1 by the model then in order to yield meaningful predictions. In our quantification exercise, we therefore return to the logit specification.

We make use of the gravity dataset constructed for Martin et al. (2008) and extended for Head et al. (2010), which is described in greater detail in those two papers. Essentially, any gravity dataset requires source data for a trade flow variable, and a list of gravity controls. The trade flow source is IMF DOTS, with a procedure to extract the most possible information from mirror flow declarations. The list of gravity controls includes the classical bilateral distances, contiguity, colonial linkages, and a common (official) language dummies. All those come from the CEPII distance database (`http://www.cepii.fr/anglaisgraph/bdd/distances.htm`). Later in the paper we also use a common legal origin dummy available from Andrei Shleifer at `http://post.economics.harvard.edu/faculty/shleifer/Data/qgov_web.xls`, and a variable for bilateral genetic distance, available from Spolaore and Wacziarg (2009).

More central in our case are the free trade agreements. A FTA dummy is the dependent variable of our second and main empirical exercice, which explains their formation. FTAs are constructed from three main sources: Table 3 of Baier and Bergstrand (2007) supplemented with the WTO web site (`http://www.wto.org/english/tratop_e/region_e/summary_e.xls`) and qualitative information contained in Frankel (1997). In those regressions, our main RHS variables of interest are related to old and new wars. The source data for military conflicts are taken from the Correlates of War project (`http://www.correlatesofwar.org/`). More precisely, we use the information contained in the Militarized Interstate Disputes database that lists all bilateral interstate conflicts from 1816 to 2001, and quantifies their intensity on a scale from 1 to 5 (for a precise description of the source data and some examples, see Martin et al. 2008).[11] We concentrate on the 1870-2001 period because 1870 is essentially the time when most modern European countries start to have a stabilized geographical and political structure. The old wars variable calculates the percentage of years with active military conflicts between the two countries, during the 1870-1944 period. This creates problem for countries that did not exist in this period. We need to infer the historical war propensity of the pair Algeria - Nigeria for instance. Due to the absence of detailed information on conflicts for all pairs of ex-colonies and all years prior to independence, we consider several strategies, which range from assuming peace to dropping those observations. Those strategies and results are detailed below in the results section. Recent wars are taken to be percentage of military conflicts for a moving window of 20 years before the year under consideration. For both variables, we consider only the two most severe types of wars, coded 4 and 5 in the COW database.

We use other bilateral political variables as controls in the list of FTA determinants. Those include the correlation of roll-call votes recorded for the two countries in the General Assembly of the United Nations (from Gartzke et al., 1999), a dummy for the existence of a military alliance (from COW),

---

[11] The scale is the following: 1 = No militarized action, 2 = Threat to use force, 3 = Display of force, 4 = Use of force, and 5 = War, defined as a conflict with at least 1000 deaths of military personnel.

and the sum of democracy indices (from Polity IV).

3.2 Estimating the economic gains of a FTA

The main objective of our empirical analysis is to estimate the econometric model characterized by equation (7). Our first task is to obtain $(\hat{T}_{ijt}, \hat{T}_{jit})$, the estimates for the economic gains of FTA formation between countries i and j at date t. The existing literature on FTA formation (Baier and Bergstrand 2004, Egger and Larch 2008) proxies those gains with the standard gravity covariates, such as economic size, geographical distance, remoteness, contiguity, etc. in a reduced-form estimation of FTA formation. Given that our purpose is to understand the relationship between economic and political factors, we cannot follow the same route. Indeed it is extremely likely that the gravity covariates affect both economic and political factors. Hence we rely on a theory-driven empirical strategy to assess the economic gains of FTA formation and to disentangle them from the political factors.

Let us consider the wide class of trade models where aggregate welfare is derived from a CES utility function.[12] Country i welfare at date t is given by $U_{it} = E_{it}/P_{it}$, where E_{it} is nominal GDP and P_{it} is the price index. The price index can be written as

$$P_{it} = \left[\sum_k \mu_{kt} \tau_{kit}^{1-\sigma} \right]^{1/(1-\sigma)}, \tag{8}$$

where σ is the elasticity of substitution between goods, μ_{kt} stands for all factors in the model that makes country k a good exporter and $\tau_{kit}^{1-\sigma}$ represents bilateral trade freeness, where $\tau_{kit} > 1$ is the iceberg-type price shifter which accounts for all trade barriers.[13] In this context, bilateral trade obeys the following gravity equation governing imports of i from j in year t:

$$m_{jit} = \mu_{jt} E_{it} P_{it}^{\sigma-1} \tau_{jit}^{1-\sigma} \tag{9}$$

We estimate the welfare gains of a FTA between countries i and j in a partial equilibrium framework. The general equilibrium case raises analytical complexities that go far beyond the scope of this paper.[14] We do this by estimating only the reduction in price index due to FTA formation. This choice yields a proxy for economic gains of FTA while maintaining closed-form solutions that can be brought directly

---

[12]The Dixit-Stiglitz-Krugman (DSK) monopolistic competition approach is an example of such modelling, the national product differentiation approach of Anderson and van Wincoop (2003) is another example.

[13]In the DSK model for instance, this term is $n_k p_k^{1-\sigma}$, a positive function of the number of varieties, and negative one of the price charged by firms located in k.

[14]General equilibrium has to take into account firms' relocation effects following each signing of a FTA. Wages in all countries can be affected as well, with consequences on the whole distribution of nominal GDPs. Moreover the drop in tariff revenues following FTA formation affects negatively aggregate income. The economic geography literature synthetized in Fujita et al. (1999) or Combes et al. (2008) has shown that considering those effects requires numerical simulations, since no analytical solution emerges in a multiple country world of such complexity.

to the data. The level of P_{it} depends upon the existence of a FTA through the bilateral trade barriers in equation (8), specified as:

$$\tau_{jit} \equiv \eta_{jit} \exp(-\rho \text{FTA}_{jit}), \tag{10}$$

where η_{jit} is the residual component of trade costs while FTA_{ijt} is a dummy variable set equal to 1 when a FTA is in force between i and j in t. The parameter ρ depends directly on the preferential tariff cut.

We exploit equations (8) and (10) and the multiplicative separability of the utility function to obtain T_{ijt}, the percentage change in utility of i following a FTA with j :

$$T_{ijt} = \left[\frac{\sum_k \mu_{kt}\eta_{kit}^{1-\sigma}}{\mu_{jt} \exp[(\sigma-1)\rho]\eta_{jit}^{1-\sigma} + \sum_{k\neq j} \mu_{kt}\eta_{kit}^{1-\sigma}} \right]^{1/(1-\sigma)} - 1 \tag{11}$$

We estimate this equation in the panel dimension over the 1950-2000 period. This requires several steps. First, we use our definition of trade costs (10) in the gravity equation (9) to obtain a new version of the gravity equation:

$$\ln m_{jit} = \ln \mu_{jt} + \ln \left(E_{it}P_{it}^{\sigma-1}\right) + (\sigma-1)\rho \text{FTA}_{jit} + (1-\sigma)\ln \eta_{jit} \tag{12}$$

which can be estimated by a panel specification:

$$\ln m_{jit} = FX_{jt} + FM_{it} + \lambda \text{FTA}_{jit} + u_{jit} \tag{13}$$

where u_{jit} is the error term, FX_{jt} is an (exporter×year) fixed effect, and FM_{it} is an (importer×year) fixed effect. This specification has the advantage of remaining flexible in terms of the exact underlying trade model, while enabling to extract the parameters of interest for the calculation of the utility change in (11). Indeed, comparing (12) and (13), one obtains $\hat{\mu}_{jt} = \exp(\widehat{FX}_{jt})$, $\exp((\sigma-1)\hat{\rho}) = \exp(\hat{\lambda})$, and $\hat{\eta}_{jit}^{1-\sigma} = \exp(\hat{u}_{jit})$.

Our panel contains bilateral trade flows over the 1950-2000 period. We exploit the within dimension of this dataset, in order to identify the gravity impact of FTA, $\hat{\lambda}$, from entries and exits into the agreements rather than from a comparison across country pairs. Thus, in (13), we allow u_{jit} to be additively decomposed into a time-invariant and a time-varying element. The regression therefore includes dyadic fixed effects, to which we add year dummies. Finally, due to the potential existence of time-varying co-determinants of FTA formation and trade flows in (13), we instrument FTA_{jit} using the contagion index derived by Baldwin and Jaimovich (2009): $\text{contagion}_{jit} = \sum_{k\neq i,j} \text{export share}_{ikt}\text{FTA}_{jkt}$. This index summarizes the threat of trade diversion suffered by country i in market j, by weighting the count of FTAs signed between j and k with the share of k in i's exports.[15] Although one might

---

[15]Unreported first-stage regressions confirm that the contagion index is a powerful instrument for FTA signatures (results available upon request).

be worried that we exclude military conflicts from this regression, note that our estimation strategy involves both country-pair fixed effects and an IV for the timing of FTA formation. Those should control for both time-invariant and time-dependent co-determinants of bilateral trade and FTAs, such as ancient and recent wars.

Regarding results, our point estimate of $\hat{\lambda}$ is 0.258 (the non-instrumented estimate being 0.311), yielding a predicted increase in bilateral trade of 29% from entry into a FTA. For comparison purposes, Baier and Bergstrand (2007) using bilateral fixed effects and year dummies on a panel (for every five years) from 1960–2000 find an estimate of 0.68 (last column of their Table 4). Head et al. (2010) find a value of 0.378 using a tetradic method which is most comparable with the method used here (none of those papers instruments the FTA dummy however).

Our second step retrieves those point estimates and substitutes them into equation (11). This gives us our empirical estimate of the economic gain from FTA formation to country i:

$$\hat{T}_{ijt} = \left[\frac{\sum_k \exp(\widehat{FX}_{kt} + \hat{u}_{kit})}{\exp(\hat{\lambda} + \widehat{FX}_{jt} + \hat{u}_{jit}) + \sum_{k \neq j} \exp(\widehat{FX}_{kt} + \hat{u}_{kit})} \right]^{1/(1-\sigma)} - 1, \qquad (14)$$

where we use the standard calibration for the elasticity of substitution in the empirical trade literature $\sigma = 5$.[16]

Figures 1 and 2 and Table 1 describe our trade gains variable $\hat{T}_{ijt}$. In Figure 1, we plot the average estimated trade gains of joining a FTA for two types of country pairs: i) those that do enter a bilateral FTA at some point in our sample, ii) those that do not. For the second group, we want to make it as comparable as possible to the first one, and therefore, we keep only those country pairs for which both members do enter a FTA with a third country but do not sign a bilateral one.[17] The horizontal axis has the number of years before the signature of the bilateral FTA for those who sign it and the number of years until the year 2000 for the control group. The difference in trends is clear: the FTA signatories have estimated trade gains that grow as we get closer to the actual signing, whereas nothing visible happens in the control group. This suggests that our measure of economic gains from a FTA can be used as a predictor of the decision to enter a bilateral FTA, both in the cross-section in the years before the signature, and in the within dimension, looking at when countries decide to sign.

Our estimated trade gains are small overall. In Figure 1, our estimate of the average gain from entering a FTA (at the year of signature) is 0.13%. This order of magnitude is not inconsistent with standard results of trade gains estimates based on Computable General Equilibrium (CGE) analysis.

---

[16]GTAP version 5, the workhorse model for computable general equilibrium analysis of trade liberalization retains an average estimate of 5.3 (Dimaranan and McDougall, 2002). Econometric evidence by Hertel et al. (2007) points to an average elasticity of substitution of 7.0, while Broda and Weinstein (2006) estimate a mean σ of 4.0 for their most recent period and a 3-digit classification (their Table IV).

[17]This restriction does not affect radically the shape of the curve. When comparing with the whole set of country pairs which do not sign a bilateral FTA, the graph looks almost the same.
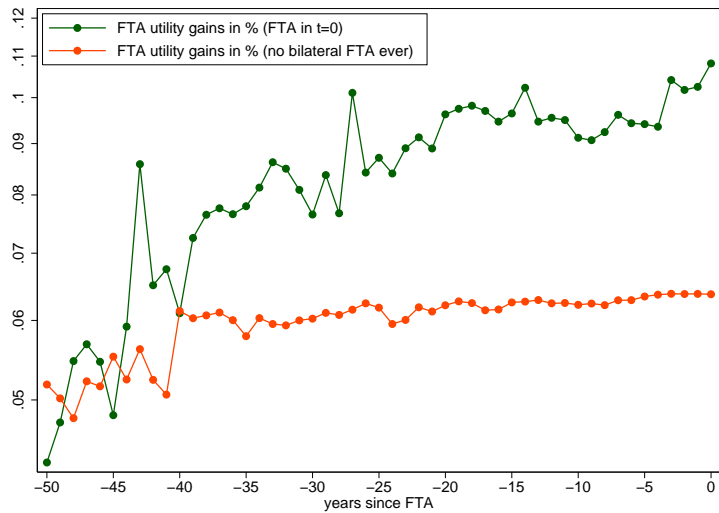
Figure 1: Utility gains FTA / no bilateral FTA

A recent example evaluating the impact of the Free Trade Agreement of the Americas by Hertel et al. (2007) finds an estimate of average utility changes for potential members of 0.25% (their Table 5).

Figure 2 focuses on the set of countries that do enter a FTA, and distinguishes the European Union members (defined as EU15). We are also able to look at what happens to our measure of trade gains after the FTA signature. One can observe that the trend before signature continues afterwards. This is not surprising: FTA gains come from trade creation, and it is therefore logical that comparing our measure of utility gains before and after the FTA implementation reflects the amount of trade created within the pair. Hence there is a potential for reverse causality from FTA formation to trade gains. This points to an important methodological issue that we shall address in Section 3.3.2.

In Table 1 we report the estimated trade gains in 1956, one year before the Treaty of Rome, for the subsample of 50 country pairs (out of a sample of 8240) for which the trade gains are the largest. We report the country-pair minimum, $\min(\hat{T}_{ijt}, \hat{T}_{jit})$ and the country-pair unweighted average, $(\hat{T}_{ijt} + \hat{T}_{jit})/2$. There can be considerable discrepancies between these two figures, especially in asymmetric country-pairs where the smaller country tends to gain much more than the bigger country. The interpretation of the table is the following: in 1956, the United States and Canada would have increased their welfare at least by 1.8 percent if they had formed a FTA.[18] Note also that one year before the Treaty of Rome, the country pairs composed of the EEC founding countries (in bold) are in the group of large trade winners, but not systematically among the top ones.

---

[18]Regarding this USA-Canada example, the percentage increase in welfare is 1.8% for the USA and 5% for Canada such as the country-pair average increase is 3.4%.

Table 1: Estimated Trade Gains for the top 50 country-pairs in 1956

Country pair		Trade gains		bil. open.	dist.	ever fta?
		min T	mean T	min $\frac{\text{imports}}{\text{GDP}}$	kms	
SUN	CHN	1.95%	2.919%	.622%	5507	No
USA	CAN	1.786%	3.399%	.748%	2079	Yes
NLD	**BEL**	**1.054%**	**1.261%**	**4.38%**	**161**	**Yes**
CZS	SUN	1.031%	1.891%	.323%	2388	No
POL	SUN	.741%	1.715%	.231%	2067	No
SYR	LBN	.667%	1.064%	2.917%	228	No
CAN	GBR	.637%	.718%	1.661%	5850	No
ROM	SUN	.617%	2.294%	.192%	2142	No
FRA	**DEU**	**.57%**	**.789%**	**1.019%**	**790**	**Yes**
POL	CZS	.568%	.701%	.743%	387	No
NLD	**DEU**	**.564%**	**.976%**	**1.009%**	**379**	**Yes**
GBR	AUS	.546%	1.899%	1.128%	16602	No
BEL	**FRA**	**.546%**	**.754%**	**.559%**	**526**	**Yes**
BRA	ARG	.498%	.555%	.855%	2392	Yes
USA	GBR	.488%	.713%	.199%	6878	No
USA	BRA	.469%	1.346%	.191%	8089	No
GBR	NZL	.457%	2.165%	.942%	18521	No
USA	VEN	.444%	2.249%	.181%	4204	No
FRA	MAR	.424%	1.986%	.433%	1706	Yes
SUN	FIN	.385%	.665%	.119%	1635	No
BGR	SUN	.381%	1.84%	.118%	2391	No
BEL	**DEU**	**.38%**	**.789%**	**.677%**	**423**	**Yes**
FRA	IRQ	.376%	.384%	.383%	3805	No
CZS	CHN	.369%	.429%	.161%	7790	No
DEU	SWE	.361%	1.017%	.643%	929	Yes
USA	JPN	.352%	1.49%	.143%	10286	No
DEU	**ITA**	**.346%**	**.671%**	**.615%**	**1014**	**Yes**
AUT	ITA	.338%	.479%	.506%	701	Yes
GBR	SWE	.337%	.702%	.692%	1293	Yes
GBR	IND	.329%	1.161%	.676%	7324	No
GBR	NLD	.319%	.483%	.657%	468	Yes
HUN	SUN	.319%	1.066%	.098%	2334	No
USA	DEU	.312%	.713%	.127%	7595	No
JPN	PHL	.301%	.535%	.432%	2957	No
SWE	NOR	.29%	.676%	.766%	503	Yes
USA	CUB	.289%	2.737%	.118%	2581	No
POL	CHN	.287%	.288%	.125%	7457	No
GBR	DNK	.285%	1.008%	.585%	920	Yes
IRN	IND	.274%	.362%	.235%	2916	No
NLD	**FRA**	**.274%**	**.276%**	**.284%**	**661**	**Yes**
SAU	JPN	.273%	.315%	.512%	8854	No
ITA	SAU	.273%	.323%	.408%	3586	No
CHE	DEU	.273%	1.024%	.484%	543	Yes
JPN	IND	.267%	.349%	.372%	6003	No
SWE	DNK	.266%	.464%	.703%	450	Yes
USA	MEX	.264%	2.733%	.107%	2468	Yes
NLD	SWE	.261%	.402%	1.433%	1009	Yes
GBR	FRA	.261%	.337%	.422%	750	Yes
NOR	DNK	.26%	.263%	1.047%	560	Yes
CHE	ITA	.26%	.485%	.388%	610	Yes

Note: Lines in boldface indicate pairs that sign the Rome Treaty establishing the European Economic Community a year later.
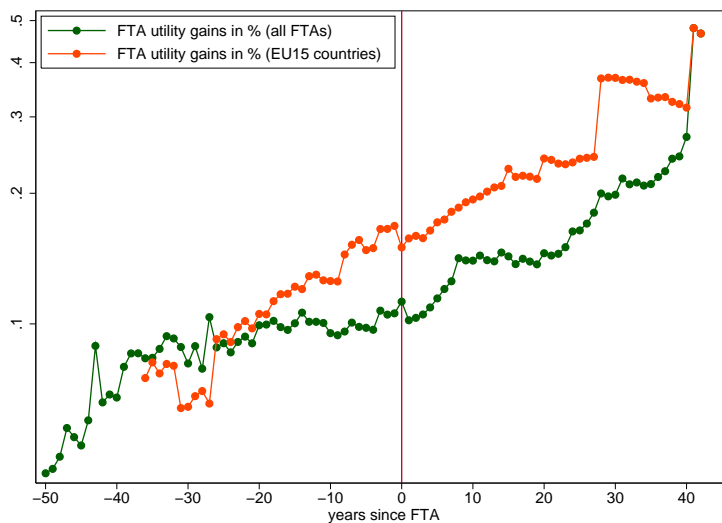
Figure 2: Utility gains average FTA / EU15

3.3 Measuring the latent probability of conflict

In equation (7), the two central variables are $\hat{T}$ and WAR. We now turn to our measurement of war probability, WAR. A natural proxy for this probability is the historical frequency of wars within each country pair. However, there are issues with this way of measuring WAR.

Our theoretical discussion shows that although the *probability* of war tends to make FTA formation more likely, the *realization* of war, by increasing the political cost of negotiation, tends to make FTA formation less likely. Therefore if we measured WAR with the country-pair historical frequency of wars, the two channels would be mixed and the estimated coefficient would capture the net effect of the two mechanisms. The sign of this net effect could then be either positive or negative.

Our identifying assumption is that war realizations raise the political cost of subsequent bilateral negotiations but that this cost decreases over time. One way to think about this is that feelings of revenge and grievance that follow a war are most vivid just after a war and then "depreciate" over time. By contrast, as supported by empirical evidence, we assume that bilateral war probability is more stable over time. A very robust finding of the empirical literature on conflicts is that the frequency of old wars is a strong predictor of the frequency of current wars (Collier et al. 2004). This result stems from the existence of important time-invariant determinants of disputes and war that may or may not be observed by the econometrician.

Hence, we proxy the probability of war at date t, WAR_{ijt}, with the country pair frequency of bilateral wars which occurred between 1870 and 1945. We call it frequency of *old wars*. This proxy being time invariant, we suppress the time index, which yields the variable WAR_{ij} in the econometric

equation (7). We proxy the realization of wars with the country pair frequency of bilateral wars which occurred during the 20 years preceding t. We call this the frequency of *recent wars.* If this strategy is relevant we should observe the marginal effect of recent wars to be negative as it captures the political cost of realized conflicts. The marginal effect of old wars should be positive because it captures the probability channel through which FTAs are more beneficial to country pairs with a high propensity for conflicts. In our robustness analysis we test definitions of old and recent wars with alternative time spans.

3.4 Endogeneity issues

The estimates of our main coefficients of interest, β_1, β_2 and β_3, in equation (7), are potentially contaminated by several sources of endogeneity, which we now discuss.

Measurement error

Our approach to measure WAR_{ij} has the advantage of purging the effect of recent realizations from the impact of war probability that we intend to capture. However, relying on the old history of conflicts introduces noise in the measurement of current war probability. Some causes of disputes in the late 19th century (e.g. the building of colonial empires) may have lost their explanatory power. Simultaneously, new causes have emerged in the late 20th century. Those time-varying determinants imply measurement error in the current probability of war which leads to an attenuation bias in the estimation of β_2.

Reverse causality

Figure 2 highlights the possible reverse causality link from FTAs to trade gains *following* FTA formation. In order to eliminate this problem which might lead us to overestimate the coefficient β_1, we need to compare $\hat{T}_{ijt}$ across country pairs or time *before* the agreement actually took place. Similarly, this reverse causality issue may bias β_2 downwards if FTA formation reduces the probability of future conflicts.

In the cross-section dimension we thus estimate equation (7) in year $t = 2000$ for country pairs without a FTA. For dyads where the two countries are members of a FTA in 2000, their RHS variables are set to their values one year before the FTA formation. For example, in the case of USA-Canada, this means that all the RHS variables take their 1988 values. This methodology generalizes the approach by Baier and Bergstrand (2004) and allows us to control for reverse causation. Correspondingly, in the panel estimates of (7), we focus on "FTA onset", that is we analyze, for each dyad, years up to the signature of the FTA, dropping observations after the signature. This is very similar to the method used by researchers studying the determinants of conflicts (Fearon, 2005, is an example).

Omitted variables

In equation (7), the coefficients on the economic gain variable and on its interaction with WAR, β_1 and β_3, could be contaminated by omitted co-determinants of economic gains, $\hat{T}_{ijt}$, and of unobserved political costs of FTA formation, c_{ijt} (i.e. the residual). This may arise because the structural relationship (14) defining $\hat{T}_{ijt}$ depends on $\hat{u}_{jit}$, the estimate of (log) bilateral trade freeness retrieved from the auxiliary gravity equation (12). Indeed, several determinants of bilateral trade freeness (or conversely trade barriers) might also affect the bilateral political affinity and consequently the political costs of FTA formation (e.g. commonality of language and culture, economic embargo, etc.). A striking illustration is provided in Michaels and Zhi (2007) who show that the deterioration of political relations between the US and France over the 2002-2006 period resulted in a significant increase in their bilateral non-tariff trade barriers following changes in attitudes towards France in the United States.

To address this concern, we first add to the set of control variables $\mathbf{Z}_{ijt}$ a series of co-determinants of bilateral trade barriers and political relations. This encompasses the standard time invariant gravity controls (distance, contiguity, common language, etc.) and various time-varying proxies of bilateral political affinity such as a dummy variable coding for the existence of a military alliance, a measure of bilateral correlation in UN votes from Gartzke et al. (1999) and lastly the country-pair sum of democracy indices from the Polity IV database. Indeed, the democratic peace hypothesis, which has been studied by both political scientists and economists (see Levy and Razin, 2004, for a recent explanation of the hypothesis) states that democratic countries are less prone to violence. But democratic countries are also more open to trade. In the panel specifications, we can be more general in those controls, by including a country-pair fixed effect to purge remaining time-invariant unobserved heterogeneity.

In spite of all these controls, we cannot rule out the possibility that the coefficient of trade gains, β_1, is still contaminated by unobserved *time-varying* co-determinants of bilateral trade freeness, $\hat{u}_{jit}$, and political affinity, c_{ijt}. To solve this last problem, we directly include $\hat{u}_{jit}$ as a control variable. This strategy allows us to identify β_1 by exploiting variations in trade gains $\hat{T}_{ijt}$ net of $\hat{u}_{jit}$. This solves the omitted variable problem because those variations are not driven by bilateral shocks and so cannot be correlated with the (residual and unobserved) political costs of negotiations c_{jit}. Indeed a look at the structural relationship (14) makes it clear that those variations are driven by changes in the exporter fixed effects $\widehat{FX}_{kt}$. This strategy is in fact similar to a control function approach (see Imbens and Wooldridge, 2007) where the trade gains $\hat{T}_{ijt}$ are instrumented with a remoteness index based on the exporter fixed effects $\widehat{FX}_{kt}$.

Regarding β_2 and β_3, the coefficients of the probability of war and of its interaction with trade gains in the econometric specification (7), the omitted variable bias is a potentially important issue. Several

time-invariant components of the unobserved heterogeneity in political costs of FTA formation c_{ijt}, are also likely to affect the underlying probability of war, WAR_{ij}. For example, recurrent disputes linked to common borders, natural resources, religion, culture, etc., are likely to increase the underlying probability of war and make negotiation on FTA formation politically more costly. This suggests a downward omitted variable bias which should go against our hypothesis. Note that the various gravity and political affinity controls included in $\mathbf{Z}_{ijt}$ are likely to absorb most of those cross-sectional variations in bilateral disputes.[19] More importantly, in our panel estimates, we include country-pair fixed effects in order to absorb the residual time-invariant heterogeneity in political costs. This makes impossible the identification of β_2, the coefficient of the time-invariant variable WAR_{ij}. Nevertheless, we can still estimate our most important coefficient of interest, β_3, which is now immune to the omitted variable bias.[20] These panel specifications are clearly our preferred specifications in term of causality assessment.

4   Results

4.1   Econometric estimates

We start in Table 2 with a cross-sectional analysis of FTA determinants. Our first column is a logit with only the log of the estimated trade gains [21] and the frequency of old wars as covariates. As expected both enter positively, with a large overall explanatory power, and a high degree of statistical significance. The fact that our two main variables of interest are sufficient to explain more than a quarter of the observed variance in FTA formation provides encouraging empirical support to our theory-driven estimate of trade gains. In this first column, the old war variable WAR_{ij} is restricted to the small number of dyads which exist before 1945. In particular, all country pairs that involve a former colony (India-Japan, Germany-Ivory Coast for instance) are dropped from this regression. In column (2) we adopt the following alternative strategy: We set WAR_{ij}, the old war variable, to 0 for country-pairs which did not exist before 1945; we also include a dummy variable coding for those pairs. As can be seen from the comparison of columns (1) and (2), the two variables of interest have very close coefficients with this procedure and the fit is very comparable, which makes us confident that it does not alter our results while augmenting substantially the number of observations.[22] We

---

[19] We also include as a control variable a measure of bilateral genetic distance. Spolaore and Wacziarg (2009) show that genetic relatedness has a positive effect on bilateral conflict propensities in the cross-section. This is because more closely related populations, on average, tend to interact more and develop more disputes over sets of common issues. Hence we expect genetic distance to reduce the probability of war and to increase the probability of FTA formation.

[20] It is indeed unlikely that unobserved heterogeneity in political costs affects differentially more the likelihood of FTA formation for country-pairs with larger trade gains. As a consequence, β_3, the coefficient of the interaction term between probability of war and trade gains, should be properly estimated once we include country-pair fixed effects.

[21] We take the log of this variable because of the left-skewness of the distribution of estimated trade gains.

[22] It can be noted that those non-existing dyads, mostly combinations of colonies at the end of WWII, have been less involved in the FTA movement, as revealed by the negative coefficient of the dummy variable.

maintain this procedure throughout.

Column (3) introduces $\hat{u}_{jit}$, the estimate of bilateral trade freeness obtained from the gravity equation (12). As stated above, this is intended to circumvent any contamination of the coefficient on trade gains, by unobserved co-determinants of bilateral trade freeness and political affinity. As expected, this variable enters positively and results in a decrease of the effect of trade gains as it purges from contemporaneous bilateral affinity which causes both the probability of signing a FTA and the trade gains to be high.

One of our main variable of interest is the interaction term between old wars and FTA trade gains. Interaction terms have a non-straightforward interpretation in discrete choice models like the logit, because of their non linear nature (Ai and Norton, 2003). As explained in details above, we therefore resort to a linear probability model (LPM), which has the additional advantage of handling fixed effects more easily in our panel estimates. Column (4) is simply the LPM version of the logit specification of column (3). While this different estimation method naturally yields different coefficients, the signs and significance levels are preserved in column (4). Column (5) introduces the interaction term of trade gains with old wars. This interaction term enters positively and significatively at the 1 percent level. This supports our hypothesis that economic gains and security gains are complement: Dyads with large estimated economic gains are more likely to enter a FTA, and this effect rises with the historic intensity of wars of the partners.

In column (6) we include a number of bilateral controls: the two most important gravity variables, namely geographical distance and contiguity, and a list of controls for political affinity (UN vote correlation, the sum of Polity IV reported democracy indices, a dummy for the existence of a military alliance and an index of genetic distance). All of those variables add to the likelihood of belonging to the same agreement. To discriminate between the effect of probability vs realization of wars we also include the frequency of recent wars, which, according to our discussion in section 3.3, is expected to enter negatively through their effect on the political cost of negotiations. The coefficient is negative and significant at the 1 percent threshold. The opposite impact of old and recent wars suggests that a "window of opportunity" mechanism is at work. Having had a history of conflicts in the past makes a country-pair more likely to sign a FTA at the condition that their recent history is not too conflicting. Hence, any exogenous event that prevents two ancient enemies to fight for some period improves the chances that they sign a FTA, with the consequence of reducing further the chances of conflict escalation. We quantify the size of those effects later in the paper.

In spite of the inclusion of all these control variables and the resulting reduction by one third of the sample size, all the coefficients of interest in column (6) keep the expected sign and remain statistically significant at the 1 percent threshold. In particular the coefficient of economic gains is

Table 2: FTA determinants, benchmark regressions

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Model									
Dep. Var.	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA onset
Period	2000	2000	2000	2000	2000	2000	2000	1950-2000	1950-2000
trade gains ($\hat{T}_{ijt}$)	0.553^a (0.038)	0.415^a (0.019)	0.330^a (0.021)	0.016^a (0.001)	0.014^a (0.001)	0.013^a (0.001)	0.009^a (0.001)	0.007^a (0.001)	0.002^a (0.000)
war freq. pre-1945 (WAR_{ij})	7.840^a (1.337)	8.328^a (1.271)	9.257^a (1.273)	1.912^a (0.116)	5.169^a (0.341)	3.823^a (0.390)	7.963^a (0.757)		
dyad did not exist pre-1945		-0.783^a (0.107)	-0.902^a (0.109)	-0.053^a (0.007)	-0.063^a (0.007)	-0.034^a (0.008)	-0.045^a (0.008)		
ln bil. trade freeness			0.217^a (0.025)	0.010^a (0.001)	0.010^a (0.001)	-0.009^a (0.002)	-0.011^a (0.002)	-0.003^a (0.001)	-0.002^a (0.000)
trade gains × wars pre-1945					0.354^a (0.035)	0.309^a (0.038)	0.460^a (0.042)	0.163^a (0.026)	0.062^a (0.011)
war freq. $[t-20; t-1]$						-0.262^a (0.074)	-0.441^a (0.076)	-0.067^a (0.019)	-0.003 (0.008)
ln distance						-0.151^a (0.004)	-0.127^a (0.004)		
contiguity						0.108^a (0.019)	0.095^a (0.018)		
UN vote correlation						0.121^a (0.011)	0.076^a (0.011)	0.054^a (0.005)	0.003 (0.002)
sum of democracy indexes						0.069^a (0.007)	0.053^a (0.006)	0.024^a (0.003)	0.011^a (0.001)
military alliance						0.081^a (0.011)	0.127^a (0.010)	0.110^a (0.007)	0.027^a (0.003)
genetic distance						0.004 (0.004)	0.009^b (0.003)		
multi. openness							-0.021^a (0.004)	0.004^b (0.002)	-0.001 (0.001)
multi. open. × wars pre-1945							1.567^a (0.292)	0.629^a (0.053)	0.195^a (0.024)
Method	logit	logit	logit	LPM	LPM	LPM	LPM	cty pair FE	cty pair FE
Sample	pre-1945 pairs	whole	whole	whole	whole	whole	whole	whole	whole
Observations	1694	9836	9836	9836	9836	6395	6152	36701	35737
R^2	0.263	0.224	0.240	0.138	0.147	0.359	0.359	0.081	0.017

21

unaffected. This confirms that unobserved heterogeneity is already filtered out by the inclusion of $\hat{u}_{jit}$ in previous specifications. Regarding the coefficient of old wars, it is reduced but it remains positive and significant.

Column (7) tests our last theoretical prediction, namely that multilateral trade openness and the probability of war have a positive and complementary impact on the FTA decision. As expected, the coefficient of the interaction term between multilateral openness and old war is positive; and it is highly significant. Column (7) establishes our main results with a substantial set of controls, and we consider it as our benchmark specification. Remarkably the five coefficients of interest all have the expected sign and are statistically different from zero.

The two remaining columns extend the sample to the panel dimension. Both specifications include country-pair fixed effects. The coefficient on old wars cannot be estimated any more, but its interaction with trade gains can. For each dyad, we average data over non-overlapping time windows of 5 years, a method comparable to Egger and Larch (2008) and Martin et al. (2008). Column (8) considers the full sample. In column (9), we drop observations following the signature of FTA for those who do become members. This FTA onset specification is very demanding and, in spite of the five year averaging procedure, it is highly sensitive to measurement errors in the time-series dimension. With respect to the benchmark cross-sectional estimates in column (7), all the coefficients of interest keep their expected sign and are statistically significant, with the exception of the coefficient on new wars in the FTA onset specification. An important change is also the size of the coefficient on trade gains, when going from FTA (in col. 8) to FTA onset (in col.9) as a dependent variable. This was to be expected from our analysis of Figure 2 and from our discussion of the reverse causality issue: FTAs boost trade volumes, which reinforces the FTA-related economic gains after their implementation.

Table 3 pushes further the robustness investigation. Those regressions take column (7) of Table 2 as a benchmark specification (with gravity controls unreported). In the first column, we re-estimate this benchmark specification using logit instead of LPM. All signs of the relevant variables remain unchanged. The global explanatory power is very high, and the level of significance of the interaction term between old wars and trade gains is now slightly above ten percent (11.5% exactly). This logit estimate is the one which we use in the quantification section.

In the second column, we return to LPM and extend the set of gravity controls to include common language or legal system, colonial linkages, landlockness and remoteness of the country pair. All our variables of interest keep the same sign. Column (3) changes the definition of bilateral trade gains to be the average of the two countries FTA-related trade gains rather than the minimum. Given that the minimum is always smaller than the average, this translates mechanically into a decrease in the coefficient of trade gains.

Column (4) adds a set of dummy variables coding for each country, a feature which can be properly identified in our cross-sectional sample of (non directional) country pairs. These dummy variables control for all time-invariant unobserved characteristics of a country that might make it more likely to fight wars in the past and to sign FTAs now. The global fit naturally increases substantially while leaving our results of interest remarkably similar. Column (5) adds a dummy to control for the fact that the two countries belong to the same geographical region of the world (following the World Bank definition of regions). This increases the probability of FTA significantly, while again leaving our results on trade gains and conflictuality unaffected.

Column (6) removes intra-EU observations by excluding all country-pairs where both countries belong to the European Union at 15. This is intended to check that our results are not entirely driven by European countries, which are characterized both by a rich history of warfares and by the creation of the worldwide deepest trade agreement. In this specification, all variables related to wars have slightly smaller coefficients, but they remain very significant.

Column (7) extends our definition of old wars by including a variable that accounts for war frequency 20 to 40 years before FTA signature. This results into a smoother representation of the history of wars with very recent ones, those that are more than one generation old, and the very old wars (before 1945). The pattern of coefficients is that recent wars tend to reduce the FTA probability, less recent ones tend to slightly promote them, while old wars have a much stronger positive effect. This finding matches well with our identification strategy. The difficulty to negotiate a FTA after a war is gradually overturned by the incentive to pacify a long history of conflicts.

## 4.2 Quantification and counterfactual experiments

Up to this point, we have mostly analyzed the signs and statistical significance of coefficients. We now want to quantify the magnitude of the effects we have identified. In order to calculate counterfactuals we need to resort to a logit econometric model where the FTA probability cannot go outside the 0-1 range.

In all that follows we adopt the following strategy. We start by running a benchmark regression using logit (column 1 of Table 3), to estimate the coefficients of interest which gives us the benchmark probability of signing a FTA for each country pair in the sample. We then select a group of observations and we run a counterfactual by attributing them other values for one or more explanatory variables. For instance we take the country pairs in the lowest decile of the frequency of the old war variable and we give them an artificial history of wars. Using the logit formula with the benchmark estimated coefficients, we recalculate their FTA probability and compare it with the benchmark probability to evaluate the magnitude of the effect of the altered variable. This procedure ensures that the probability

Table 3: FTA determinants, robustness

Model	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dep var	FTA	FTA	FTA	FTA	FTA	FTA	FTA
war freq. pre-1945 (WAR_{ij})	44.866^a	8.209^a	4.637^a	6.175^a	6.075^a	3.823^a	6.046^a
	(15.989)	(0.754)	(0.900)	(0.670)	(0.662)	(0.676)	(0.662)
trade gains ($\hat{T}_{ijt}$)	0.296^a	0.007^a	0.003^b	0.005^a	0.005^a	0.004^a	0.005^a
	(0.042)	(0.001)	(0.002)	(0.001)	(0.001)	(0.001)	(0.001)
trade gains $\times$ wars pre-1945	1.582	0.463^a	0.302^a	0.333^a	0.324^a	0.193^a	0.325^a
	(1.003)	(0.041)	(0.071)	(0.037)	(0.037)	(0.037)	(0.037)
war freq. $[t-20; t-1]$	-7.423^a	-0.464^a	-0.500^a	-0.188^a	-0.173^b	-0.154^b	-0.321^a
	(2.123)	(0.076)	(0.081)	(0.069)	(0.068)	(0.066)	(0.106)
multi. open. $\times$ wars pre-1945	17.364^a	1.684^a	0.777^b	1.446^a	1.396^a	0.865^a	1.375^a
	(5.980)	(0.291)	(0.325)	(0.257)	(0.254)	(0.253)	(0.254)
multi. openness	-1.995^a	-0.020^a	-0.027^a	-0.222^a	-0.216^a	-0.218^a	-0.217^a
	(0.233)	(0.004)	(0.005)	(0.012)	(0.012)	(0.011)	(0.012)
# of landlocked in dyad		-0.000	-0.004	-0.850^a	-0.855^a	0.044	-0.852^a
		(0.005)	(0.006)	(0.163)	(0.161)	(0.156)	(0.161)
common language		-0.019^b	-0.012	-0.020^a	-0.014^c	-0.012	-0.015^c
		(0.008)	(0.009)	(0.008)	(0.008)	(0.007)	(0.008)
colonial link		-0.031	-0.029	-0.075^a	-0.066^a	-0.052^a	-0.066^a
		(0.019)	(0.020)	(0.017)	(0.017)	(0.017)	(0.017)
common legal origin		-0.002	-0.010	-0.003	-0.017^a	-0.011^b	-0.017^a
		(0.006)	(0.007)	(0.005)	(0.005)	(0.005)	(0.005)
remoteness		0.083^a	0.097^a	-0.126^a	-0.153^a	-0.080^a	-0.152^a
		(0.011)	(0.013)	(0.025)	(0.025)	(0.024)	(0.025)
same region					0.114^a	0.050^a	0.116^a
					(0.010)	(0.010)	(0.010)
war freq. $[t-40; t-20]$							0.169^c
							(0.092)
Method	logit	LPM	LPM	cty FE	cty FE	cty FE	cty FE
Sample	whole	whole	whole	whole	whole	no EU15	whole
Trade Gains	min	min	average	min	min	min	min
Observations	6152	6152	5274	6152	6152	6071	6152
R^2	0.576	0.366	0.350	0.572	0.582	0.518	0.582

Figure 3: The interaction terms

(a) economic gains and security gains

(b) multi. openness and security gains
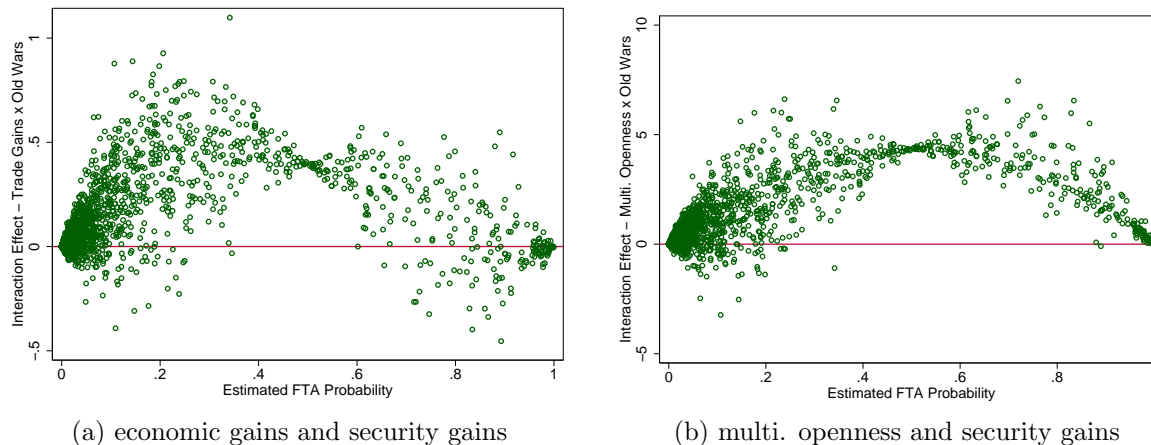
remains in the admissible range, while performing a "what if" experiment: what if low conflict dyads had had an intense past history of warfare, keeping everything else constant?

4.2.1 Complementarity is a first-order effect

We first quantify our complementarity result between old wars and trade gains in the formation of FTAs. The coefficient of the interaction term between trade gains and old wars is positive both in our benchmark LPM specification (col.7, Table 2) and in our benchmark logit specification (col. 1, Table 3). However Ai and Norton (2003) show that interaction terms have a sign that can be deceptive in a logit framework, and that cannot be interpreted readily. To investigate this question more fully, we calculate the marginal effect of this interaction term for the whole range of benchmark probabilities. In our case, we need to take care of the fact that old wars is interacted with trade gains, but also with multilateral openness. This complicates somewhat the computation of the marginal effects with respect to Ai and Norton (2003) as shown in the appendix. Results are graphed in figure 3. The two panels report the marginal effects for each of the two interaction terms; each dot corresponds to an observed country-pair. We see that the marginal effects of the two interaction terms are very dominantly positive. Due to the functional form of the logit probability distribution, the sign of the marginal effect of the interaction terms can be different from the sign of the coefficient β_3 if the estimated probability of FTA is close (but different) from 0 or 1 (see appendix). Since in our sample those estimated probabilities are concentrated at those two extreme values, verifying that those marginal effects are indeed positive is important.

We now turn to the quantification of the interaction term. To this purpose we choose pairs of countries that are located inside the middle decile of those two variables, that is around the median level

Figure 4: Complementarity between economic gains and security gains

(a) 3d view (b) 2d view
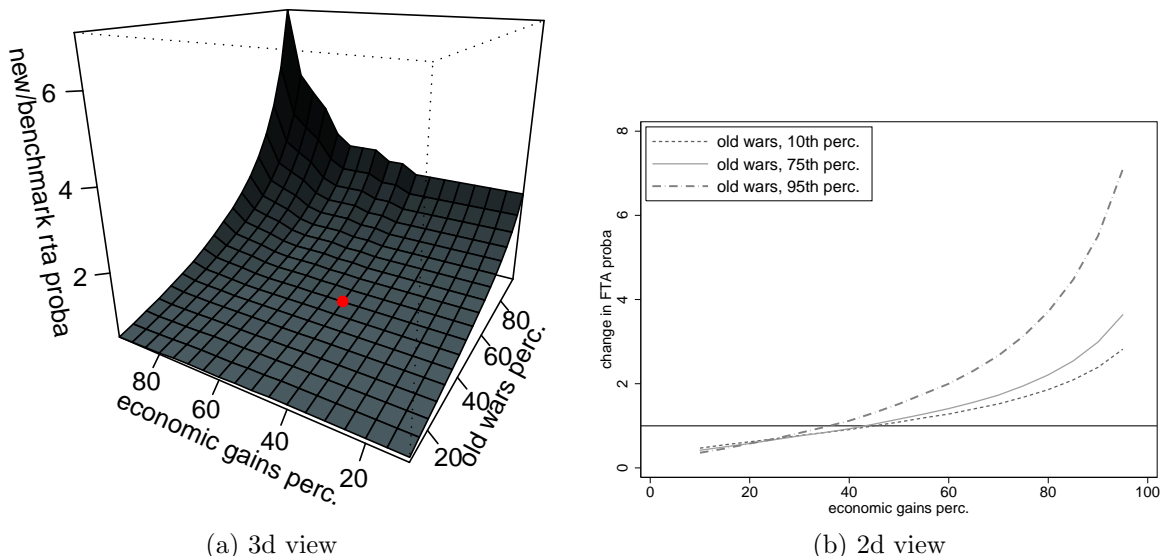
of old wars and trade gains. We then calculate the ratio of counterfactual to benchmark probabilities of FTA formation following the procedure just described, and spanning over the 10th to 95th percentiles of each variable. Results are in figure 4.

In panel (a), it is clear that trade gains increase the probability of signing a FTA, and that the effect increases strongly with old wars. Panel (b) allows to better illustrate the effect. The x-axis reports trade gains while the y-axis reports the ratio of counterfactual to benchmark probabilities. Each curve corresponds to different levels of old wars. For a dyad that moves from the median to the top 20% of trade gains, the FTA probability is multiplied by two (1.96) if the dyad is in the middle range of old wars, while the multiplicative factor is almost 3 if the same dyad is in the top 10% of war history.[23] We see that the interaction term has a first-order importance. This confirms our intuition that trade gains are important not only as an final objective of FTAs but also as an intermediate objective that allows to secure strategic gains.

4.2.2 Windows of opportunity

Our second simulation uses the same method described at the start of this section to quantify the effect of the *probability* of war, measured by the frequency of old wars, and to compare it with the effect of the *realization* of war, measured by the frequency of recent wars. This is intended to highlight the existence of windows of opportunity during which interrupted conflict between old enemies may

---

[23]The benchmark probabilities of signing a FTA in this precise sample have an average value of 7.7%. The median is much lower at 0.75%, which shows that most country pairs in the world have a very low FTA probability, while a few of them have a quite high one (ten percent of the sample has a benchmark probability higher than 20%).

Figure 5: Old wars and new wars

(a) 3dview

(b) 2d view
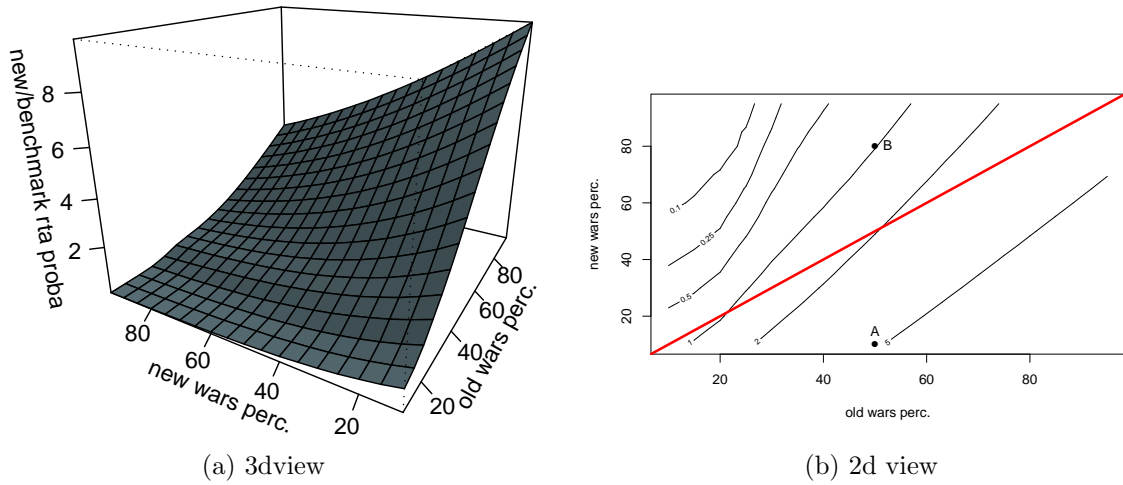
help sign a FTA and "lock in" a more peaceful bilateral relation. The left panel of figure 5 is very similar to the one in figure 4. We take the whole set of dyads with no history of recent nor old wars, and gradually move them into the war space, looking at the changes in FTA probability. As expected from the point estimates in tables 2 and 3, recent wars reduce the probability of FTA formation, while old ones increase it. The magnitude of the effects is substantial. Panel (b) uncovers an interesting trade off that leaves the change in FTA probability unchanged. Panel (b) is a contour plot, where each curve represents a probability ratio from panel (a). Old wars are on the x-axis, recent wars on the y-axis. Assume a country pair goes from a situation without old wars to the median level. This multiplies its benchmark FTA probability by almost five (point A in the figure) if there are very few recent wars, while it leaves the probability unchanged if the level of recent wars moves to the top 20% (point B in the figure). This shows that a change in old wars has in general a larger effect than a equivalent change in recent ones (as revealed by the 45 degree line in red). In other words, if a country-pair recent history of warfare perfectly reflects its long run history, then the net, overall effect of war is to increase the probability of FTA formation. By contrast, suppose now we assign the top 5% level of old wars to a country pair with no old wars. This multiplies by 10 its FTA probability if recent wars are very rare, but only by 3.5 if the country is also in top 5% of recent conflicts.

The previous simulation focuses on pairs that did not experience any conflict in the real world on the period 1950-2000. In figure 6 we take the opposite focus, and look at country pairs that experienced a large set of conflicts in the recent years. We consider four different dyads, India-Pakistan, Greece-Turkey, Egypt-Israel, and Iran-Turkey. Out of those, Greece and Turkey are the only ones in a FTA
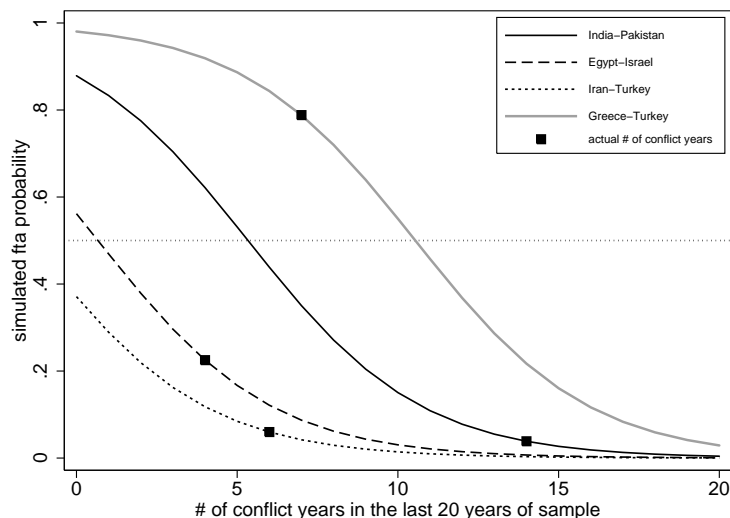
Figure 6: Window of opportunity for 4 emblematic country pairs

(through the customs union signed between the EU and Turkey in 1996).[24] For those four pairs, our variable measuring the proportion of recent conflicts (over the last 20 sample years) spans from 20 to 70% (4 to 14 years), with associated benchmark probability ranging from 4 to 80% as represented by the black squares on the graph. We then change the frequency of recent conflicts and calculate the new counterfactual FTA probability. India-Pakistan is perhaps the most impressive example: After 5 years of peace, the FTA probability is multiplied by 5 at 20%, after ten years of peace it jumps at 62%. Our results also reveal that 4 years of peace between Egypt and Israel brings their FTA probability from 23 to 57%. The effect of recent wars is large for pairs that have a high FTA signature probability (those with large potential economic gains, high proximity...). It thus suggests that the window of opportunity argument may be well grounded. For those pairs, even a short interruption of outbreaks in conflicts can increase FTA probability to a large extent and start a virtuous pacifying process. For Greece-Turkey, we observe the same overall shape of the impact of recent conflictuality, and note that in 1996, the conflictuality between the two countries seemed to have fallen to a level that made FTA possible.

4.2.3   A world without wars

Let us consider now another counterfactual experiment. Instead of taking the peaceful dyads and make them fight, we make every country pair peaceful. The frequencies of old wars, recent wars and all their interaction terms are set to zero, and the resulting, counterfactual probabilities of FTA formation are

---

[24]The recent war frequency variable is therefore calculated for 1976-1996 for Greece-Turkey, and for 1980-2000 for the three other pairs.
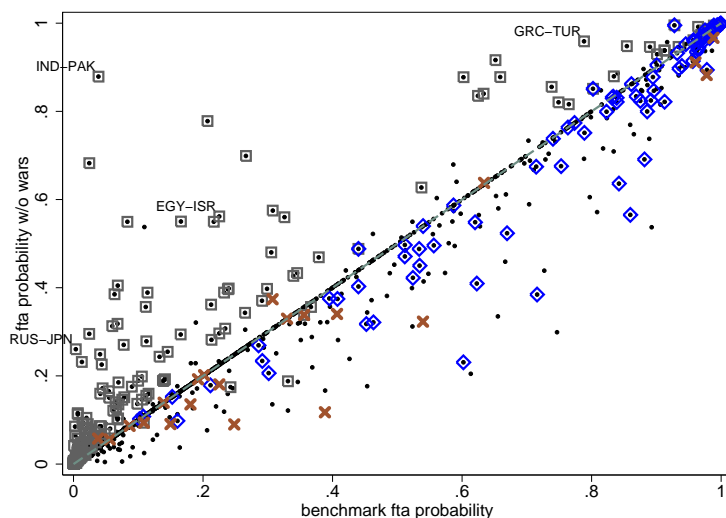
Figure 7: The world without military conflicts

estimated. Results are reported in figure 7, where the benchmark probability is on the x-axis, while the y-axis gives the counterfactual one (the dashed line corresponds to the 45 degree line). Each dot is a country-pair, and some are singled out by symbols: Blue diamonds represent intra-EU pairs; red crosses represent country-pairs that were part of the communist bloc at some point; grey squares represent pairs that have had a nonzero frequency of recent wars in the real world.

Many country-pairs are dispersed far from the 45 degree line, meaning that the geography of FTAs would substantially change in a world without war. In particular both EU and former communist country pairs would experience a drop in their counterfactual probability of FTA formation with respect to the benchmark one. This is another illustration of the window of opportunity channel. Indeed, in both cases (both parts of the European continent in fact) the history of old wars is very intense. But the history of recent wars is very calm probably because the cold war made the two blocs very stable internally between the end of WWII and the collapse of the USSR.

4.2.4 Multilateralism triggers regionalism

We now quantify the impact of multilateral trade openness on FTA formation. To this purpose we estimate the counterfactual probability of FTA formation when multilateral trade openness is set to zero for all pairs of countries and compare it to the benchmark probability. Results are reported in figure 8 where the triangles represent country pairs with an initial level of multilateral openness above the median level and where diamonds represent pairs of countries belonging to Mercosur.

In the counterfactual world without multilateral trade openness, most country pairs experience a sharp decrease in their probability of FTA formation as most observations lie below the 45° line.
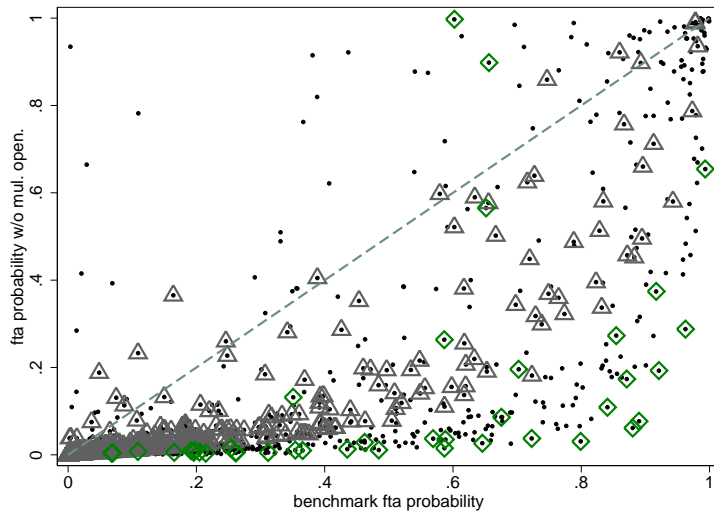
Figure 8: The world without multilateral trade

This confirms that the wave of regionalism observed in the late 90s can be interpreted as a political response to post world war multilateralism that may have been seen as dangerously weakening regional economic ties. This mechanism seems particularly relevant for explaining the formation of Mercosur - a fact that has been discussed by policy practitioners (see Manzetti 1993).

5   Conclusion

Our results suggest that political scientists and historians are right to emphasize the political motivation behind FTAs, in particular the objective of pacifying relations. However, this does not mean that economics do not matter and that FTAs are signed without taking into account their economic benefits, the trade gains. On the contrary, without trade gains of FTAs that may be lost during a war, the peace promoting effect of FTAs is greatly weakened. Hence, our story is one where politics and economics push in the same direction. Economic and security gains are complementary to explain the evolving geography of trade agreements. Trade gains of FTAs may be exploited for a superior objective of peace but that makes them more, not less, important. Another interesting result is the interaction between multilateral and regional (or bilateral) trade liberalization. The recent multiplication of FTAs is often interpreted as a response of policy makers frustrated by stalling multilateral trade negotiations. Our result suggests a radically different story, one where multilateral openness (which may come from multilateral liberalization at WTO or the multiplication of FTAs) induces the formation of additional FTAs. These additional FTAs can be interpreted as a way to reinforce bilateral economic relations within country pairs at risk of war at a time where globalization reduces

their bilateral economic dependence. The domino theory of regionalism of Baldwin (1995) comes to mind but here the danger that additional FTAs are attempting to counter is not the loss of economic attractiveness but the dangerous loss of local economic dependency that it may imply. Hence, FTAs may be contagious for political and not only for economic reasons. Finally, our results are consistent with the view that windows of opportunity for locking-in peace through trade exist. FTAs are difficult to sign for countries with an history of recent conflicts while country pairs with a long-run history of bilateral conflicts have a higher propensity to sign a FTA. Hence periods of peace between old enemies should be exploited to sign a FTA and lock-in a more peaceful bilateral relationship.

6 References

Acemoglu D. and P. Yared, 2010, "Political Limits to Globalization", forthcoming in *American Economic Review (Papers and Proceedings)*.

Bagwell, K. and R.W. Staiger, 1998, "Regionalism and Multilateral Tariff Cooperation ", in John Piggott and Alan Woodland (eds.), *International Trade Policy and the Pacific Rim*, Macmillan, London.

Baier S. and J. Bergstrand, 2004, "Economic determinants of free trade agreements?", *Journal of International Economics*, 64, 29–63.

Baier S. and J. Bergstrand, 2007, "Do free trade agreements actually increase members'international trade?", *Journal of International Economics*, 71, 72–95

Baier S. and J. Bergstrand, 2008, "Estimating the Effects of Free Trade Agreements on International Trade Flows using Matching Econometrics", *Journal of International Economics*, forthcoming.

Baldwin, R., 1995, "A Domino Theory of Regionalism," in *Expanding European Regionalism: The EU's New Members,* Baldwin, R.P. Haaparanta and J. Kiander (eds), Cambridge University Press.

Baldwin, R., and D. Jaimovich, 2009, "Are Free Trade Agreements Contagious?" CCES Discussion Paper Series, No.12.

Berger D., W. Easterly, N. Nunn and S. Satyanath, 2010, "Commercial Imperialism? Political Influence and Trade During the Cold War", mimeo Harvard University.

Broda, C. and D. Weinstein, 2006, "Globalization and the Gains from Variety," *Quarterly Journal of Economics* 121(2):541–585.

Carrere, C., 2006, "Revisiting the effects of regional trade agreements on trade flows with proper specification of the gravity model", *European Economic Review*, 50(2):223-247.

Collier, P., Hoeffler, A., and Söderbom M., 2004, "On the Duration of Civil War", *Journal of Peace Research*, 41, 253-273.

Davis C., 2008, "Linkage Diplomacy: Economic and Security Bargaining in the Anglo-Japanese Alliance, 1902-23", *International Security*, 33, 3, 143–179.

Dimaranan, B.V., McDougall, R.A., 2002, Global Trade, Assistance, and Production: The GTAP 5 Data Base. Center for Global Trade Analysis, Purdue University.

Egger, P. and M., Larch, 2008, "Interdependent preferential trade agreement memberships: An empirical analysis", *Journal of International Economics*, vol.76.

Estevadeordal, C. Freund and E. Ornelas, 2008, "Does Regionalism Affect Trade Liberalization toward NonMembers" *Quarterly Journal of Economics*, , Volume 123, Number 4, 1531 - 1575.

Fearon, J., 1995, "Rationalist Explanations for War", *International Organization*, 49 (3), 379–414.

Fearon, J., 2005, "Primary Commodity Exports and Civil War", *Journal of Conflict Resolution*, 49, 483-507.

Fugazza, M. and F. Robert-Nicoud, 2009, "The emulator effect of the Uruguay round on U.S. regionalism", mimeo UNCTAD.

Glick, R. and A.Taylor, 2005, "Collateral damage: trade disruption and the economic impact of war", NBER WP 11565, forthcoming *Review of Economics and Statistics*.

Head, K., T. Mayer, and J. Ries, 2010, "The erosion of colonial trade linkages after independence", *Journal of International Economics*, 81(1):1-14

Hertel, T. M. Ivanic, R. Keeney, 2007, "How Confident can we be in CGE-Based Assessments of Regional Trading Agreements?" *Economic Modeling* 24:611-635.

Keohan R. and J. Nye, 1977, *Power and Interdependence*, Boston, Little Brown.

Haas, E. 1980, "Why Collaborate? Issue linkage in international politics" *World Politics*, Vol. 32, No. 3 pp. 357-405

Imbens G. and J. Wooldridge, 2007, "Control Function and Related Methods" in *What's New in Econometrics?* NBER, Summer 2007, Lecture 6. `http://www.nber.org/WNE/lect_6_controlfuncs.pdf`

Levy, G. and Razin, R., 2004, "It Takes Two: An Explanation for the Democratic Peace", *Journal of the European Economic Association*, 2 (1), 1–29.

Limao, N., 2007, "Are Preferential Trade Agreements with Non-trade Objectives a Stumbling Block for Multilateral Liberalization? ", *Review of Economic Studies*, vol. 74 no 3: pp. 821–855.

Maggi, G. and Rodriguez-Clare, A., 1998, "The value of trade agreements in the presence of political pressures ", *Journal of Political Economy*, vol. 106: p. 574–601.

Mansfield E. and Jon C. Pevehouse, 2000, "Trade Blocs, Trade Flows, and International Conflict", *International Organization*, Vol. 54, No. 4, pp.775–808

Manzetti, L., 1993, "The political economy of MERCOSUR", *Journal of Interamerican Studies and World Affairs*, 35 (4).

Martin, P., T. Mayer and M. Thoenig, 2008, "Make Trade not war?", *Review of Economic Studies* 75(3):865–900.

Michaels G. and X. Zhi, 2007, "Freedom Fries", CEPR Discussion Paper 6380

Oneal, J. R. and B. M. Russett, 1999b, "Assessing the Liberal Peace with Alternative Specifications: Trade Still Reduces Conflict", *Journal of Peace Research*, 36 (4): 423-442.

Ornelas, E., 2005, "Endogenous free trade agreements and the multilateral trading system ", *Journal of International Economics*, vol. 67 no 2: pp. 471–497.

Polachek, S., 1980, "Conflict and Trade," *Journal of Conflict Resolution*, 24, 55-78.

Mocan, N., "Vengeance", 2008, NBER Working Paper No. 14131.

Powell, R., 1999, *In the Shadow of Power: States and Strategies in International Politics*, Princeton University Press.

Spoalaore E. and R. Wacziarg, 2009, "War and Relatdness", NBER Working Paper 15095.

Vicard, Vincent, 2008, "Trade, conflicts and political integration : explaining the heterogeneity of regional trade agreements", mimeo Université Paris 1.

7   Appendix

7.1   Derivation of equation (4)

We assume that the probability of war is small, $\delta e \sim 1\%$, and FTA-related trade gains are small with respect to the welfare cost of wars, $T/W \sim 1\%$. Both assumptions are validated by existing

empirical studies. We also assume that the cost of negotiation represents only a small fraction of the total welfare: $C/U_P \equiv c \sim 1\%$. Finally for a FTA of having a first-order impact on the probability of escalation both through the opportunity cost channel and trough the political spillover channel, we have to assume in equation (3): $(\varepsilon_{pol}/\varepsilon_{cost}) \sim (T/W)$. Combining (2) and (3) we obtain:

$$(1 - \delta e)T + (\delta e)W\varepsilon_{cost}\left(1 + \frac{T}{W}\right)\left(\frac{\varepsilon_{pol}}{\varepsilon_{cost}} + \frac{T}{W}\right) \geq c \tag{15}$$

A first order approximation of this equation leads to

$$(1 - \delta e)T + \delta e(\varepsilon_{pol}W + \varepsilon_{cost}T) \geq c \tag{16}$$

which corresponds to equation (4) in the main text.

7.2   Marginal Effect and Interaction

Let denote x_1, x_2, x_3 our three variables of interest and $\mathbf{Z}$ the vector of covariates. Our logit preferred specification (7) writes as

$$\mathbb{P} = \frac{1}{1 + \exp[-\beta_1 x_1 - \beta_2 x_2 - \beta_3 x_3 - \beta_{12}x_1x_2 - \beta_{13}x_1x_3 - \boldsymbol{\beta}\mathbf{Z^t}]} \tag{17}$$

where $\mathbb{P}$ is the estimated probability of FTA formation. Simple computations lead to

$$\frac{\partial^2 \mathbb{P}}{\partial x_1 \partial x_2} = \mathbb{P}(1 - \mathbb{P})\beta_{12} + \mathbb{P}(1 - \mathbb{P})(1 - 2\mathbb{P})(\beta_2 + \beta_{12}x_1)(\beta_1 + \beta_{12}x_2 + \beta_{13}x_3) \tag{18}$$

This shows that the sign of the marginal effect of the interaction term can be different from the sign of the coefficient β_{12} if the probability $\mathbb{P}$ is close (but different) from 0 or 1.

7.3   Further country pairs in trade gains table

Table 4: Estimated Trade Gains for the 51th-100th country-pairs in 1956

Country pair		Trade gains		bil. open.	dist.	ever fta?
		min T	mean T	min $\frac{\text{imports}}{\text{GDP}}$	kms	
USA	COL	.259%	2.262%	.105%	4251	No
FRA	**ITA**	**.256%**	**.338%**	**.261%**	**892**	**Yes**
THA	IDN	.256%	.305%	.615%	2306	Yes
GBR	DEU	.256%	.29%	.526%	809	Yes
NLD	IDN	.249%	.548%	1.363%	11346	No
CAN	VEN	.248%	.262%	.683%	4647	No
BEL	SWE	.244%	.3%	.941%	1152	Yes
DEU	DNK	.239%	.845%	.425%	538	Yes
CZS	BGR	.236%	.72%	.307%	1084	No
GBR	ZAF	.234%	1.474%	.481%	9489	Yes
JPN	IDN	.23%	.731%	.329%	5482	No
FRA	SWE	.227%	.262%	.231%	1616	Yes
HUN	ROM	.225%	.235%	.128%	540	Yes
SAU	IND	.223%	.3%	.191%	3509	No
DEU	AUT	.222%	1.358%	.393%	592	Yes
CHN	LKA	.219%	.426%	.095%	4914	No
CHN	JPN	.216%	.3%	.167%	1975	No
FRA	CHE	.214%	.57%	.217%	474	Yes
ARG	GBR	.213%	.3%	.438%	11137	No
CZS	ROM	.212%	.456%	.275%	902	No
HUN	BGR	.211%	.256%	.278%	693	Yes
GBR	IRL	.209%	2.164%	.429%	425	Yes
BRA	SWE	.209%	.247%	.545%	10185	No
IND	PAK	.208%	.271%	.178%	1238	No
VEN	NLD	.207%	.226%	.571%	7972	No
POL	AUT	.203%	.211%	.227%	549	Yes
BGR	ROM	.2%	.257%	.105%	370	Yes
BRA	URY	.193%	.568%	.368%	2168	Yes
SDN	EGY	.193%	.644%	.462%	1736	Yes
USA	BEL	.192%	.601%	.078%	7303	No
BRA	DNK	.19%	.191%	.365%	9776	No
ROM	EGY	.19%	.198%	.1%	1792	No
POL	HUN	.19%	.298%	.196%	520	Yes
ARG	ITA	.188%	.298%	.281%	11214	No
CHL	ARG	.184%	.338%	.255%	1157	Yes
SYR	SAU	.182%	.278%	.686%	1463	No
BRA	FIN	.179%	.219%	.34%	10749	No
HUN	CHN	.178%	.336%	.077%	7710	No
GBR	BEL	.177%	.417%	.363%	448	Yes
IDN	AUS	.175%	.211%	.501%	5078	No
CHE	AUT	.175%	.277%	.587%	576	Yes
ARG	DEU	.174%	.473%	.309%	11646	No
BRA	ESP	.174%	.201%	.206%	7821	No
LBN	SAU	.172%	.226%	.648%	1417	No
HND	SLV	.171%	.274%	.519%	244	Yes
JPN	AUS	.171%	.404%	.346%	7827	No
SYR	JOR	.169%	.317%	.733%	373	No
BRA	NOR	.168%	.169%	.324%	10018	No
AFG	PAK	.168%	.257%	.104%	806	No
ITA	SWE	.166%	.194%	.248%	1833	Yes

Note: Lines in boldface indicate pairs that sign the Rome Treaty establishing the European Economic Community a year later.