

The Impact of Bilateral Relations on Bilateral Trade

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Abstract

How do bilateral political relations affect trade between countries? This paper reviews the existing theoretical and empirical studies. By introducing the bilateral relationship index and bilateral trade volume data of China, Vietnam and Indonesia, it is found that the bilateral political relationship has an impact on bilateral trade, but the relationship between the two is not always consistent due to the influence of economic, social and other factors. At the same time, this paper also uses the monthly event data of China and 13 APEC member countries in the GDEL database from 2018 to 2022 to quantify the changes in bilateral relations between the two countries, and empirically analyzes the impact of changes in bilateral relations between China and APEC member countries on trade exchanges. The findings are as follows: First, the fluctuation of bilateral relations has a positive correlation with the total trade volume of the two countries, that is, the improvement of bilateral relations has a promoting effect on the trade volume of the two countries. Second, bilateral geographical distance has a significant impact on bilateral trade. Third, the market size of member countries has a very significant impact on the change of trade volume, but increasing the control variable of market size reduces the significance level of the impact of bilateral political relations on bilateral trade.

Keywords

Bilateral Relations; Bilateral Trade; GDEL Database.

1. Introduction

In recent years, the international situation has been volatile and changing, geopolitical conflicts have persisted, unilateralism, protectionism and hegemonism have prevailed, and the COVID-19 pandemic has led to a global economic recession, but China has always adhered to the principle of mutual benefit and win-win cooperation, promoted high-quality Belt and Road cooperation with other countries, and continued to carry out bilateral and multilateral cooperation. Under the influence of geopolitics, economic environment and other factors, the ten ASEAN countries have become China's most important economic and financial partners. China-asean economic and financial cooperation is the most important part of China's opening up and international cooperation, and plays an important role in leading and stabilizing regional economic development. Among the ten ASEAN countries, the relationship between China and Vietnam has grown increasingly comprehensive, in-depth and sustainable. The two countries have continuously strengthened cooperation in the political, economic, cultural and other fields and maintained coordination and cooperation on multilateral occasions. The bilateral trade volume between China and Vietnam will reach 171.9 billion U.S. dollars in 2023. In the first nine months of 2024, the bilateral trade volume between China and Vietnam reached 190.38 billion US dollars, an increase of 17.6 percent year-on-year, showing the close relationship in industrial chain and supply chain cooperation. China is Vietnam's largest trading partner and second largest commodity export market, while Vietnam is China's largest trading partner in ASEAN and the fifth largest trading partner in the world. The political, economic, cultural and maritime "four-wheel drive" cooperation between China and Indonesia has been upgraded to "five pillars" cooperation, and security cooperation has been added as the fifth

pillar. Political mutual trust between the two countries has been continuously enhanced and cooperative relations have maintained a strong momentum of development. Bilateral trade will exceed 100 billion U.S. dollars in 2021 and reach about 150 billion U.S. dollars in 2022. In the first eight months of 2024, bilateral trade reached 92.79 billion U.S. dollars, up 1.5 percent year on year. China has been Indonesia's largest trading partner for 11 consecutive years and the second largest source of foreign investment in Indonesia, and Indonesia is China's second largest investment destination in the ASEAN region. The Asia-Pacific Economic Cooperation (APEC) is an international organization of economies in the Asia-Pacific region that aims to promote economic cooperation and exchange among its members, promote economic integration and trade in the region, and address sustainability and social equity issues. However, with the turbulent global political situation and the continuous development of globalization in recent years, the bilateral relations between APEC member countries have increasingly become one of the key factors affecting international trade and economic development. Therefore, in this paper, we first analyze the changes of bilateral relations and trade volume between China, Vietnam and Indonesia, and then empirically test the impact of bilateral political relations between China and APEC member countries on bilateral trade by combining specific data in the GDEL database. And whether trade between China and different countries is equally sensitive to changes in bilateral political relations.

2. Influencing Mechanism and Literature Review

The following is a review of the relevant literature on how bilateral political relations between countries affect trade, from the perspectives of security, benefits, costs, risks and government behavior, to explore the influencing mechanism, and to discuss heterogeneity and the impact on third countries.

2.1. Safety

The reason for the reduction of trade caused by bilateral conflicts lies in the consideration of a country's own security. A country is inclined to reduce trade with a country in conflict because it is worried that the country in conflict will gain more benefits from trade than itself (translated into military power), pose a threat to its own security, or worry that its dependence on the country in conflict will increase (Gowa,1989; Gowa and Mansfield,1993). Rogowski(1989) proposed that trade would change the power balance of different political factions in the country due to its distributive effect. For those groups that have a vested interest in trade with the country in conflict but have no stake in the political conflict between the country and the country, the development of trade with the country in conflict will help them build their constituency and win more support. So leaders restrict trade with countries with conflicting political interests to prevent this from happening. Gowa and Mansfield(2004) believe that international political alliance can promote bilateral economic and trade growth.

2.2. Benefits

Pollins(1989) was the first to introduce inter-state political relations into the modern economic framework (i.e. utility maximization under budgetary constraints). Based on the perspective of public choice theory, he believes that the actors in trade decision-making, whether national governments, interest groups, enterprises or consumers, include economic interests and traditional security considerations in their utility, so they tend to reward friends and punish enemies to minimize trade risks. Reuveny(2001) constructed a model in which trade and political relations were determined simultaneously. Using Pollins' hypothesis, he built a mathematical model involving multiple decision makers of governments, importers, and exporters, in which the political relationship between two countries is part of the importer's utility function. Yang Lianxing et al. (2016) believe that friendly bilateral political relations can

promote portfolio diversification, expand the investment scale of foreign companies and improve the success rate of investment, and optimize and complement the bilateral institutional environment. Wei Yunyan and Fan Xiufeng (2017) investigated the influence of bilateral political relations on the three-way margin of China's exports to Eurasian countries by using the data of China's exports to Eurasian countries from 1996 to 2014. The investigation results show that the most important factor in enhancing mutual trust and mutual benefit between the two countries is the bilateral political relations. Moreover, bilateral political relations can also actively promote the growth of export volume margin.

2.3. Cost

Another direct reason to reduce trade is the rising cost of bilateral trade, political conflicts may interfere with the smooth operation of transportation and market, and increase the government's trade restrictions, etc. For example, in the model of Martin et al. (2008), it is directly assumed that bilateral trade barriers will increase after military conflicts between two countries. With the development of the trade gravity model, starting from Pollins(1989) and including the subsequent empirical studies, the extended trade gravity model was directly adopted to introduce political relations as a part of the distance or multilateral resistance term. Jiang Yeheng and Li Qingru (2013) believe that the prerequisite for in-depth economic and trade development is a good diplomatic relationship between the two countries, and mutual trust and mutual benefit between the two sides can reduce the cost of trade between the two countries. Du et al. (2017) conducted an empirical study on the bilateral trade data between China and partner countries from 1990 to 2013 with the help of gravity model, and found that the improvement of political relations between countries can reduce the searching cost of enterprises in searching for transaction objects by improving the transparency of policies and regulations; In addition, we can strengthen bilateral political and cultural mutual trust to deepen bilateral understanding and reduce the cost of contract implementation. Using the extended gravity model, Zhao Yongliang et al. (2019) conducted an empirical study on China's export trade to partner countries from 2010 to 2017 and found that the improvement of bilateral political relations could eliminate misunderstandings, disputes and frictions between countries, provide a relatively stable political environment for trade exchanges, and reduce legal costs and trade friction costs.

2.4. Risk

Morrow(1999) put forward the idea of rational expectations, indicating that traders anticipate future conflicts based on the political relationship between two countries, so they have adjusted the trade before the conflict, resulting in the regression result that trade is related to the relationship between two countries and has nothing to do with military conflicts. Li and Sacko(2002) believe that government restrictions on trade brought about by military conflicts and interference on the smooth operation of transportation and market will increase the risk of transactions or contracts, thus making trade lower than in peacetime. They assume that the state can influence trade by influencing the profit maximization of micro firms. They took into account the outbreak, duration and severity of conflicts, which are all positively correlated with government restrictions and market disruption. Athanassiou and Kollias(2002) introduced the irreversibility of contracts. In the case of irreversibility of trade contracts, uncertainty brought by future commercial risks and military conflicts would affect the supply of enterprises, and the expected loss of future conflicts would be greater than that in peacetime when the relationship was tense. Therefore, when tensions between the two countries rise (and the risk of future military conflict increases), companies delay the signing of trade contracts has a "waiting value", and trade will therefore decrease. Taglioni and Zavacka(2012) empirically analyzed the impact of uncertainty on international trade based on the vector autoregression model, and believed

that the increase of uncertainty caused by changes in international political relations would lead to exchange rate fluctuations and bring risks to trade.

2.5. Government Action

However, in bilateral political relations, the impact of government actions on international trade is not always explained by the trade cost mechanism, for example, trade restrictions are often used by countries as a signal of high costs in political disputes or negotiations. Since the restriction of trade will bring losses to both sides, a country takes this measure to show its firm attitude and position on a certain political dispute or issue (Kastner,2007; Davis and Meunier,2011), thus leading to a decline in trade with conflict. Berger et al. (2013) used the declassified data of the Central Intelligence Agency to find that the covert intervention of the US government during the Cold War made the governments of the affected countries tend to import more American products. The main reason for the increase in trade is not that the cost of trade between the two countries has fallen or that the affected country has become more democratic, but that it has been achieved through a large number of government purchases that violate the comparative advantage of trade. Fan Jianjing and Lu Bo (2021) also found that the exchange visits of national leaders can help the products that are not previously competitive in trade to enter the market of partner countries, and in the exchanges between China and neighboring countries and small countries, the exchange visits of leaders have a stronger promotion effect on the relatively weak products.

2.6. Heterogeneity

The existing theories mentioned above all imply the heterogeneous effects of bilateral political relations on trade. From the perspective of national security, the trade benefits of different sectors are different, and some products, such as weapons and strategic materials, bring greater externalities to national security. In terms of externalities, trade in industries with greater government control and intervention will respond faster or more to bilateral political relations. According to Reuveny's (2001) model and the sunk cost theory of Davis and Meunier(2011), the price elasticity of trade supply and demand for different products or sectors is different, the difficulty of finding alternative suppliers or alternative markets is different, and the sunk cost of inputs is different. This is why trade's sensitivity to political conflict varies across sectors. From a consumer perspective, consumer goods whose country of origin is obvious or whose brands are well-known in conflict countries may be more affected. Du Yingxin et al. (2017) found that there are structural differences in the influence of political relations between China and different trading partners on import trade: for example, between China and Japan, if the industry dominated by state-owned enterprises is a strategic industry, its import trade is more affected by political relations; if it is a non-strategic industry, it is less affected; Between China and the United States, the impact of bilateral political relations on trade in various industries is not obvious.

2.7. The Influence of Third Countries

The bilateral political relationship between the two countries not only has an impact on bilateral trade, but may also have an impact on multilateral trade (trade with third countries). For example, Glick and Taylor(2010) and Qureshi(2013) proposed that war or military conflict would bring spillover effects to the trade of third countries, and the impact might be large. But other studies suggest that the effect is modest. The model of Martin et al. (2008) assumes that the decline of bilateral political relations will raise bilateral and multilateral trade barriers, but has only a small impact on multilateral trade barriers. Gholz and Press(2001) argue that although war may lead to a decline in trade between belligerents and neutral countries, it also brings new trade opportunities, and neutral countries are less affected by the adjustment of their trade to provide the products and services needed by the war countries in wartime.

Based on existing studies, many scholars believe that bilateral political relations will have an impact on bilateral trade through the following channels: First, countries restrict trade exchanges with countries in conflict out of consideration of their own security or political security; Second, good bilateral political relations lead to greater trade benefits. Third, good bilateral relations will reduce the cost of trade, which will lead to more trade. Fourth, the instability of political relations will increase the risk of trade between the two countries and lead to the reduction of trade. Fifth, changes in bilateral relations will also cause the government to forcibly intervene in trade, to demonstrate the government's political position or force increased trade.

3. Data Analysis of Vietnam and Indonesia

For the quantification of bilateral relations between the two countries, this paper selects the China-Great Power Relations Index to express the level of political relations between the two countries, which is derived from the Sino-Foreign relations database of Tsinghua University. This database represents the level of international relations between China and the above countries, with a value between -9 and 9. The index construction is based on news reports, the political events are classified and assigned values, and the relational scores are obtained by summing up according to the model. In this paper, the monthly data of relations between Vietnam and Indonesia and China from 2010 to 2021 are averaged to represent the annual international relations between China and Vietnam and Indonesia. It also analyzes the differences and similarities between the changing trend of bilateral relations and the changing trend of bilateral trade volume.

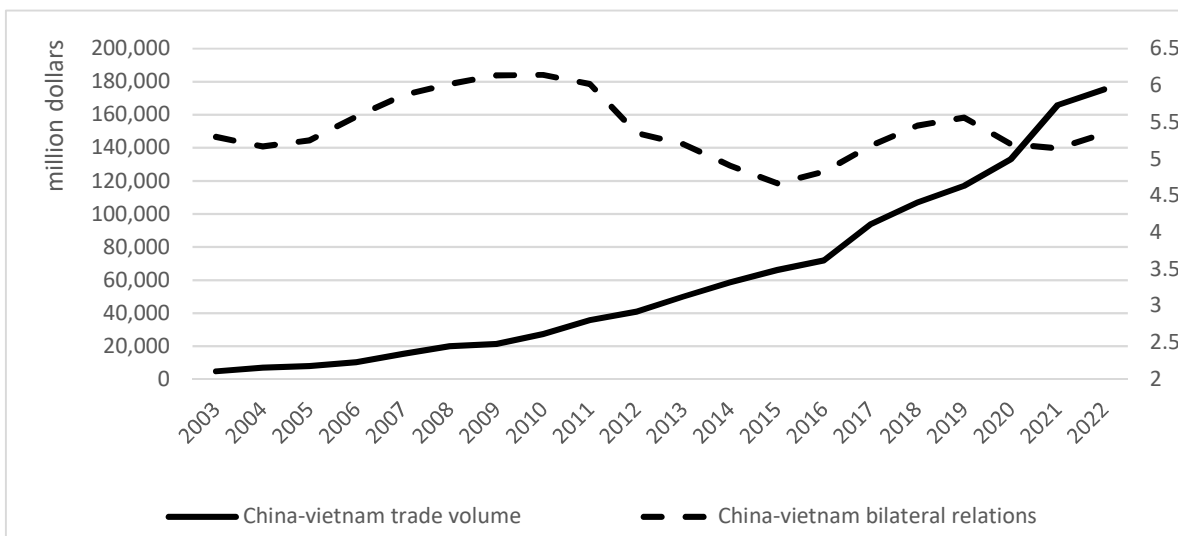


Figure 1. China-vietnam bilateral relations and trade trends

As can be seen from the graph, the overall Sino-Vietnamese relations index fluctuates between 4.5 and 6. Due to the South China Sea disputes and other issues, the Sino-Vietnamese relations show a downward trend from 2012 to 2015 and 2019, and the relations between the two countries are basically stable in other times. Bilateral trade between the two countries has been on the rise. It is worth noting that bilateral trade grew slowly from 2012 to 2015 when bilateral relations deteriorated, and accelerated in 2015 when bilateral relations warmed up. It shows that bilateral political relations have a significant role in promoting bilateral trade.

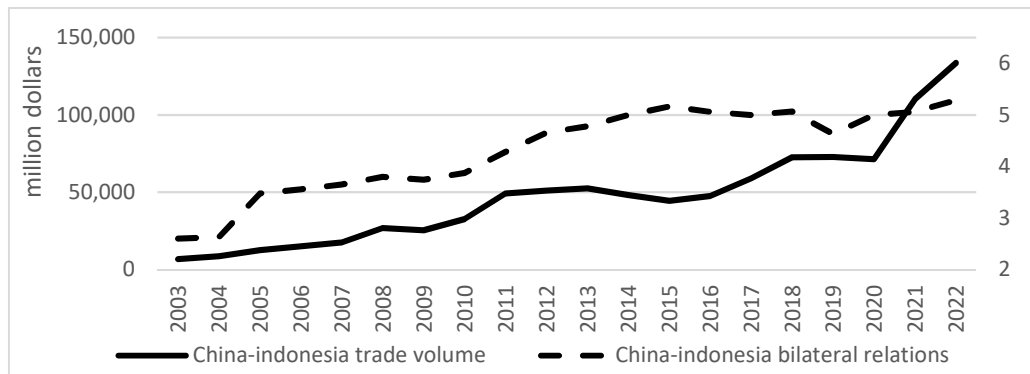


Figure 2. China- Indonesia bilateral relations and trade trends

The comparison between China and Indonesia provides a better picture of the impact of bilateral relations on trade volumes. In 2008, Sino-Indonesia relations declined slightly, and the bilateral trade volume also showed a slight decline trend. Then, with the recovery of bilateral relations, the bilateral trade volume showed a similar trend to the bilateral relations index. Moreover, when relations between the two countries declined in 2018, the growth of bilateral trade also declined significantly. All these phenomena show that changes in bilateral relations do have an impact on bilateral trade.

At the same time, we also noted that after 2011, the bilateral relations have experienced a significant decline, but the trade volume is still rising, not falling. During the period of steady growth of bilateral relations between China and Indonesia from 2011 to 2015, bilateral trade did not increase or even decreased, while during the period of decline in bilateral relations from 2015 to 2017, bilateral trade volume increased. This shows that the promotion and inhibition effects of bilateral political relations on bilateral trade cannot always be maintained in a significant state, and sometimes there is a reverse trend due to the impact of economic situation or other factors.

4. Empirical Model

4.1. Data Source and Model Setting

4.1.1. Data Description.

The core explanatory variable of this paper is the fluctuation of bilateral political relations. The purpose of quantification of bilateral political relations is to design a model to analyze the phenomena affecting bilateral relations. In this regard, scholars have proposed a wealth of alternative indicators based on various forms of cooperation and conflict political events, etc. In recent years, more and more scholars choose to use the UN General Assembly voting, major-power relations database and GDELT news event big data to build continuous indicators to achieve the quantification of bilateral political relations. The Global Database of Event, Language, Tone (GDELT Database) is currently the largest open database of political events in the world, with the most comprehensive big data on media opinion. Participants, countries, organizations, themes and emotions of news events are classified according to the CAMEO code (Conflict and Mediation Event Observations), and according to the CAMEO Goldstein scale (hereinafter referred to as the Goldstein Scale). Score different types of events (Goldstein, 1992, Shen Shi et al., 2020). Referring to Deng Meiwei's approach (2020), this paper adopts the Goldstein weighted mean score method, takes the proportion of reports of various events as the weight to weight the Goldstein weighted mean score method, and obtains the daily Goldstein weighted mean score. Then, according to the Goldstein score of the month, the monthly Goldstein weighted score average is obtained. Compared with the above indicators, the Goldstein weighted score mean method is weighted according to the proportion of the

number of different types of events, avoiding potential bias caused by simple summing or averaging of cooperation and conflict events and Goldstein scores of various events.

4.1.2. Model Setting.

Gravity model is a classic model to study the trade flow between countries, and also a common model to study the impact of international relations on trade. Therefore, this paper uses the gravity model to explore the impact of changes in bilateral relations between China and some APEC members on trade exchanges. The model is set as follows:

$$\ln Tra_{it} = \alpha_0 + \alpha_1 Rel_{it} + \alpha_2 \ln GDP_{it} + \alpha_3 \ln Dist_i + \alpha_4 Bor_i + \varepsilon_{it}$$

Where, i represents APEC member countries, t represents time, and $\ln Tra_{it}$ is the explained variable, that is, the logarithm of the trade volume between China and APEC member countries i in time t . Rel_{it} is the explanatory variable, namely, the fluctuation of the bilateral relationship between China and the subject country i at time t , expressed by the mean of the Goldstein score for all interactions between China and i at time t . $\ln GDP_{it}$ is the market size of the trade, expressed as the logarithm of the average GDP of the target country i . $\ln Dist_i$ is the control variable and is the logarithm of the geographical distance between China and Country i . Bor_i indicates that whether China borders with State i is a dummy variable. In addition, ε_{it} is a random disturbance term. Data are derived from China Customs data, GDELT database, and World Bank open database. Descriptive statistics of the main variables are shown in Table 1.

4.2. Empirical Analysis

Regression analysis was carried out according to the model equation, and the regression results were shown in Table 2. The regression results show that when only the bilateral trade volume and the fluctuation value of bilateral relations are analyzed by regression, a significant impact can be obtained at the confidence level of 10%. However, when the control variables are added, the change of bilateral relations between China and the target country has no significant impact on bilateral trade. The size of the market has a significant impact on the bilateral trade volume. The larger the market size, the greater the total trade volume. The geographical distance between the two countries also has a significant impact on the bilateral trade volume, but the standard regression coefficient is negative, which may be because the market size of the country with a long distance, such as the United States, has too great a promoting effect on trade, which exceeds the negative effect caused by the excessive geographical distance, and therefore affects the empirical results. Constant terms have a high level of significance in regression models, which means that constant terms are important to explain the variability of the dependent variable and not just exist due to randomness.

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models, which means that constant terms are important to explain the variability of the dependent variable and not just exist due to randomness.

Table 1. Descriptive statistics of variables

Variable	Mean	Sd	Min	Max	N
Trad	15695.93	14040.87	992.6	73497.2	780
Intra	9.314821	0.861472	6.900328	11.205	780
Rela	1.408915	1.203493	-3.47918	5.504597	780
GDP	2.40x10 ¹¹	4.81 x10 ¹¹	1.77 x10 ¹⁰	2.12 x10 ¹²	780
lnGDP	25.20854	1.237426	23.59441	28.38333	780
Dist	5025.769	3670.637	133	12000	780
lnDis	8.082328	1.172268	4.890349	9.392662	780
Bor	0.307692	0.461835	0	1	780

Table 2. Baseline regression results

Variable	lnTra	lnTra	lnTra	lnTra
Rela	0.00772	0.00781	0.00794	0.0140
	(1.22)	(1.23)	(1.25)	(1.82)
lnGDP	1.369***	1.332***	1.352***	
	(19.84)	(19.67)	(19.42)	
lnDis	-0.426**	-0.550***		
	(-2.68)	(-4.20)		
Bor	0.667			
	(1.65)			
Cons	-21.95***	-19.84***	-24.79***	9.295***
	(-10.33)	(-10.78)	(-14.05)	(38.05)
N	780	780	780	780
The t value is in parentheses. * p<0.05, ** p<0.01, *** p<0.001				

In the above empirical analysis, with the increase of control variables, the significance level of the influence of bilateral political relations on bilateral trade decreases, which may be because the influence of bilateral political relations on bilateral trade level is relatively complex. For example, political relations may be directional, and the attitude of one country toward another country may have different degrees of influence on the export and import of one country to another country. However, it is difficult to meet the significance level when studying the impact of bilateral relations on the total bilateral trade volume. Because of the large amount of data in the GDELT database, this paper only selects the monthly data of the five years from 2018 to 2022 for research, and selects the weighted average of Goldstein's score to represent the changes of bilateral political relations. In addition, the bilateral trade volume from 2020 to 2022 is greatly affected by the epidemic, so the study period should be increased, or the impact of some major events should be excluded from the model to obtain more ideal results.

5. Conclusion

From the data trend analysis of Vietnam and Indonesia and the literature review above, we can conclude that bilateral political relations can indeed have an impact on bilateral trade. The political relations between countries often directly or indirectly affect the trade activities between them. For example, political stability is one of the important factors in promoting international trade, and a stable political environment helps to provide predictability and

reliability of business activities. If the political relationship between the two countries is unstable, it may lead to uncertainty of business partners, which will affect the development and sustainability of trade. And the quality of the political relationship can affect the ability of the two countries to sign or maintain trade agreements and agreements. Positive political relations may contribute to cooperation between the two countries, thereby promoting trade liberalization and cooperation. Instead, political tensions could lead to the shelving or discontinuation of trade agreements. Political tensions can also lead one country to impose higher tariffs or other trade restrictions on products from another. And political disputes can lead to trade wars, increasing the cost of imported and exported goods, thus affecting bilateral trade. At the same time, instability in political relations can affect currency and financial markets, and thus trade. Political events may lead to financial problems such as currency depreciation and exchange rate fluctuations, affecting the trade costs and profits of enterprises. However, bilateral trade volume may be inconsistent with changes in bilateral relations due to the interweaving of various factors, including economic, political and other social factors. The changes in supply and demand, changes in industrial chain structure, currency exchange rate fluctuations, global economic fluctuations and other factors between the two countries will greatly affect the changes in the trade volume between the two countries, and even cause the bilateral trade volume and bilateral political relations to change in the opposite direction.

At the same time, this paper uses the GDELT database and the weighted average of Goldstein's score to represent the change of bilateral relations, and studies the impact of bilateral relations between China and APEC member countries on bilateral trade. The conclusions are as follows: First, the fluctuation of bilateral relations has a positive correlation with the total trade volume of the two countries, that is, the improvement of bilateral relations has a promoting effect on the trade volume of the two countries. However, with the increase of the control variables, the significance level of this effect decreases, which may be because the influence of bilateral political relations on bilateral trade is relatively complicated. Subsequently, the influence of one-way political attitudes can be studied from the aspects of import and export. Second, bilateral geographic distance has a significant impact on bilateral trade, possibly due to factors such as transportation costs. Third, the market size of member countries has a very significant impact on the change of trade volume, but increasing the control variable of market size significantly reduces the significance level of the impact of bilateral political relations on bilateral trade. This may be because for countries with different market sizes, the degree of impact of bilateral political relations on bilateral trade is very different, resulting in a correlation between the two variables.

Therefore, for the future economic and trade cooperation between China and the rest of the world, the following suggestions are put forward: Promote political dialogue and confidence-building. Establish and strengthen mechanisms for high-level political dialogue to enhance understanding and trust between the two Governments. Political dialogue should be used to resolve sensitive issues that may affect cooperation, reduce misunderstanding and miscalculation, and enhance the sustainability of cooperation. Strengthen people-to-people exchanges and educational cooperation. Through cooperation in culture, education, tourism and other fields, the friendly feelings between the people will be enhanced, the social basis for political cooperation will be provided, the exchange of students and scholars will be encouraged, the understanding between the two sides will be deepened, the friendship will be enhanced, the cultural and political identity of the people will be increased, and the political mutual trust between the two countries will be increased. Coordinate bilateral political issues. Coordinate economic and trade cooperation with political issues, and ensure the comprehensiveness and sustainability of cooperation by establishing a balance between the political and economic agendas. The two sides are encouraged to cooperate under multilateral frameworks and strengthen coordination within international organizations and mechanisms to safeguard

common interests. By strengthening political cooperation and mutually beneficial cooperation in the economic and trade fields, China and ASEAN can build more stable and comprehensive bilateral relations and promote the common development of the two regions. Political stability and cooperation not only help promote the growth of trade and investment, but also create a more favorable environment for the two sides to resolve potential problems.

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