DISCUSSION PAPERS IN DIPLOMACY

Economic Diplomacy, the Level of Development and Trade

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ABSTRACT

In this paper we analyze how economic diplomacy influences bilateral trade flows. Particular attention is paid to two aspects which have not been considered in the empirical literature so far. Firstly, we study export promotion agencies, the network of embassies and consulates and the interaction between these government instruments. Secondly, we study how the level of development influences the impact of these instruments. We discuss the economic rationale for public intervention in international business activities and investigate whether market failure might provide an explanation and see what instruments are available to solve the problems at hand. An applied trade model is used for 36 countries in the year 2006 to focus on the effectiveness of the two main instruments of commercial and bilateral diplomacy: export promotion agencies and foreign missions, such as embassies. We demonstrate that commercial diplomacy is not a relevant trade-enhancing factor for intra-OECD (Organisation for Economic Co-operation and Development) trade, but that it is significant in the bilateral trade relationships of developing countries. Finally, some implications of our findings are considered, in particular regarding the optimal geography of the network of foreign missions.

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ECONOMIC DIPLOMACY, THE LEVEL OF DEVELOPMENT AND TRADE

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Introduction

Over the last few decades, export promotion agencies have emerged in many countries as a popular tool to increase exports, both in developed and in developing countries (Figure 1). Around 1990 export promotion agencies became controversial amongst economic policy makers and analysts, especially in developing countries. The reason for this was an apparent lack of effectiveness, funds and business (i.e. client) orientation, while the macroeconomic policies at the time did not offer a solid basis for the social acceptance of an export-oriented growth strategy. As a consequence export promotion agencies mostly did not gain support from the business community and the public sector (Keesing and Singer 1991, De Wulf 2001). In spite of strong criticisms, most export promotion agencies were kept in business and worked hard to increase their effectiveness. With hindsight this was a sensible decision: the policy environment changed and the strong anti-exports bias disappeared.

Figure 1:
Development of the number of export promotion agencies in our sample (1910-2005)
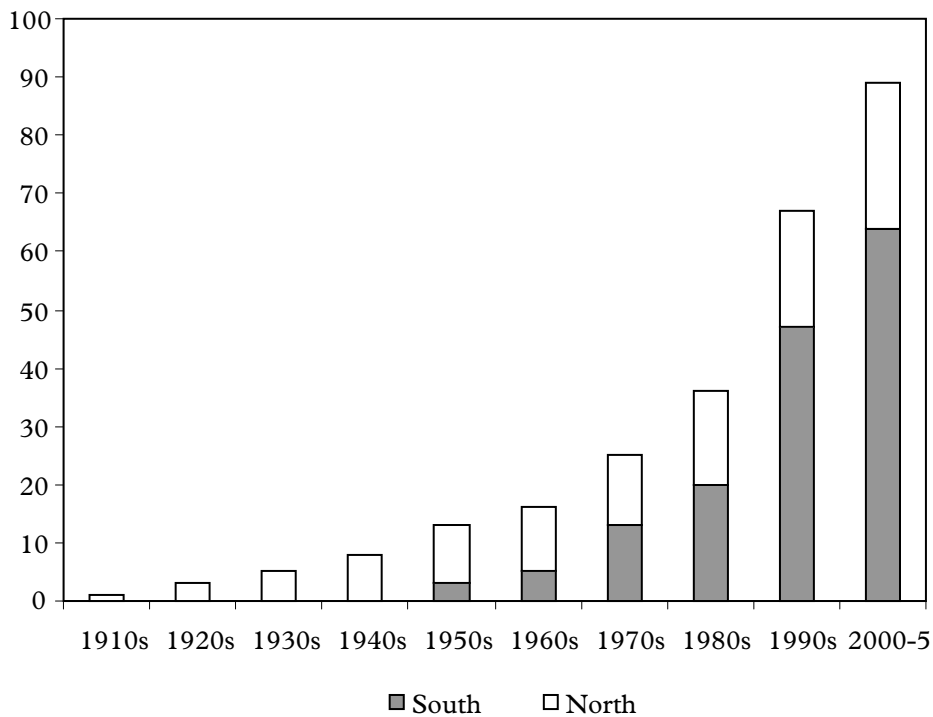
The change in the policy environment was also reflected in the activities of the Foreign Service through their network of embassies and consulates. Diplomats started to pay attention to the 'low politics' of trade and investment (Kostecki and Naray 2007). Recently, an academic discussion on the effectiveness of such bodies has emerged, partly triggered by Rose (2007), who found that the activities of the Foreign Service have a positive effect of about 6 to 10 percent on bilateral exports. Recent studies have confirmed the existence of a significant positive relationship between instruments of

economic diplomacy (export promotion, state visits, embassies and consulates) and cross-border economic activity (exports, imports, tourism).1

Rose (2007) uses a sample consisting of the bilateral trade flows of 20 exporting countries and 200 import destinations in the year 2002. Lederman et al. (2006) deal with 83 total export flows in the year 2005-6. Yakop and van Bergeijk (2009) establish a symmetric trade matrix of 63 countries for the year 2006. Afman and Maurel (2010) study the bilateral trade flows between 26 OECD countries and 30 countries of the former Eastern Block in the years 1995-2005. With so many differences in samples, periods and topics it is important to note that there is a strong consensus: the studies agree on the overall impact of export facilitation and promotion through the public sector.

One drawback of the literature is that these instruments of economic diplomacy have been studied in isolation. It is quite possible, however, that the instruments are interlinked in practice. For instance, public export promotion agencies often make use of the network of embassies and consulates abroad for hands-on information about a particular market. Therefore, the two types of bodies may benefit from considerable synergies. It is also a possibility, however, that the activities of the instruments crowd out because they are used simultaneously while the goal of that intervention could also be achieved with only one instrument. In order to empirically analyze this issue one has to simultaneously evaluate the effectiveness of a number of instruments with respect to their influence on (bilateral) exports.

This paper is structured as follows. Section two discusses the economic rationale for government intervention dealing with trade barriers and market failures. It also looks at the question of how governments can offer solutions. Section three presents the overall empirical analysis. We will provide a broad description of the applied trade model that we use (the gravity model) and present the overall results for a sample that consists of the 1242 bilateral trade flows of 36 countries. Section four delves deeper into the data as we distinguish between low and middle-income countries and high-income countries in order to analyze differences related to levels of development. In

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1) For wide ranges of instruments and activities the estimated elasticity is about 0.1, which means that an increase in the 'amount' of economic diplomacy of 10% increases bilateral trade flows by 1%. Likewise, a 10% reduction of embassy staff would decrease exports by 1%. See for example Lederman (2006), Gil-Pareja et al (2007), Head and Ries (2006), Nitch (2007), Yakop and Bergeijk (2009) and Afman and Maurel (2010).

particular we take a look at differences between and within these country groupings. Section five compares our findings to earlier studies, draws conclusions and suggests some issues for further research.

The Economic Rationale For Government Intervention

Economists have always been very critical about economic and commercial diplomacy. Their theoretical argument against government intervention is straightforward: a transfer of resources to an export industry is an implicit subsidy that potentially distorts the efficient outcome. This can be the case when it causes overconsumption and/or overproduction of a good or service or when the taxes that are needed to finance the subsidy discourage beneficial economic activities in other sectors of the economy. Such inefficient allocation occurs in both national and international activities.

In international activities, however, the transfer generates an additional terms-of-trade loss, because shippers will export the good up to the point where the domestic price exceeds the foreign price by the amount of the subsidy. Goods are sold on the world market at a price which is too low and the subsidy thus finances consumption abroad. This is the case for explicit subsidies but it is equally true for implicit subsidies – that is when the government provides certain diplomatic services for free or below market value to the private sector.

Not all subsidies are inefficient instruments. Subsidies can, for example, be efficient instruments of economic policy if they address and solve some sort of market failure. Thus, economists only see a role for public intervention if markets fail, that is if markets for some reason cannot attain the efficient outcome. Therefore a preliminary economic question is: why do exports need to be promoted, or in other words, why do productive firms not utilize their full export capacity without export promotion? We will first take a look at the barriers to trade that hinder the decision to export, and then consider which market failures could motivate government action.

Barriers to international trade

Firms that want to start exporting must overcome many barriers. The existence of substantial and significant border effects suggests that although many formal (conventional) trade barriers have decreased or been removed over the last decades, there are many other – often intangible – hurdles that need to be overcome in international trade. For instance, multilateral negotiations in the WTO have led to a gradual removal of many tariffs. Also, transport costs have been falling steadily.

In spite of such trends, the effect of distance is increasing: countries increasingly conduct trade with nearby countries (Van Bergeijk 2009). Since the conventional trade barriers have been reduced and as transportation has become cheaper, other factors must have gained prominence. Cultural and institutional distance seems to assume an ever more important role in international (trade) relations. Ramaswami and Yang (1990) describe several (perceived) barriers to trade for firms that wish to export or expand their current exports. They distinguish between four categories of barriers: 1) lack of export knowledge (informational barriers), 2) internal resource constraints (financial or human resources), 3) procedural barriers (language, cultural differences, red tape), and 4) exogenous barriers (fluctuations in the exchange rate, taxation, corruption, etc.).

Most of these barriers apply in particular to non-OECD economies (Brunetti et al., 1997). Keesing and Singer (1991) point out that in developing countries exporters have had more difficulty in obtaining permissions and dealing with restrictions and controls. Delivery is often slower and less reliable in developing countries; quality and service levels are often lower. Non-OECD countries could thus gain more from (public) export promotion. For exporters in developing countries, quality standards abroad (in OECD countries) are often higher than domestic standards (De Wulf, 2001) making it more difficult for exporters to compete in foreign markets. (Potential) exporters in industrialized countries are hampered less by such barriers to export and this is especially so for exports between the most developed countries.

Market failures

A market failure is a situation where the free market does not generate an efficient allocation of goods and services. Many market failures have been recognized, also in developed, free-market oriented economies, although market failures are considered to be much more severe in developing countries (Stiglitz, 1989; Krueger, 1990). Examples of market failures with a high incidence are the existence of informational imperfections (asymmetry between buyers and sellers, incomplete or costly information), transaction costs or agency problems (adverse selection or moral hazard) and imperfect competition (market power). Furthermore, various types of externalities can cause market failures, as well as the characteristics of certain goods (e.g., public goods), inertia (inflexible labour and product markets that are unresponsive to price signals) or uncertainty.

Market failures are especially relevant in international markets and for developing countries. Entry into foreign markets requires a good knowledge of foreign legislation, cultural differences and local preferences and the search for and an evaluation of potential international business partners is costly and time-consuming (Volpe Martincus and Carballo, 2008). Exporting thus requires an investment in information that cannot be recovered if the export project fails, but if the project succeeds demonstration effects will result in copycat behaviour by competitors.2 A firm will only make an investment if it is certain that this will provide a competitive edge, but is less inclined to do so if other firms are able to observe the (changed) behaviour of the firm, so that they will also benefit from the information, but without making any investment (the free-rider problem) (e.g., see Hausmann and Rodrik, 2003). The market therefore tends to under-provide 'trade knowledge capital', which is a public good to a large extent. Due to these market failures private firms invest too little in trade-relevant knowledge and this may justify public intervention.

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2) Likewise, sunk costs occur for the adaptation of export products to foreign technical and/or administrative standards or to comply with foreign regulations (Blanes-Cristóbal et al., 2008).

The existence of market failures offers the theoretical economic justification for active government involvement in international activities.3 According to Krueger (1990), the compensation of market failures is even one of the most important roles of the government, next to providing 'social overheads' and 'infrastructure'. The government can improve efficiency in markets by alleviating the effects of existing market failures and provide incentives for firms to adjust themselves to become an exporter and/or to increase their export capacity.

Government instruments

In order to promote exports, firms could be encouraged to start exporting or increase their exports by providing the right incentives. In addition, exports can be promoted by removing existing barriers to exports, but public export promotion that focuses on aspiring exporters is not sufficient and needs to be accompanied by policies that improve certain firm characteristics (such as productivity) to help exporters to become permanent exporters (Alvarez 2007). Government policies with regard to export promotion may only be worthwhile when some sort of pre-selection is done, so that only the most productive firms are assisted in their internationalization process, as only these firms will be fit enough to survive international markets (Van Bergeijk 2009).

In practice, these approaches and insights have already been incorporated in export promotion policies around the globe. In this paper only a limited subset of this broad set of policy instruments will be studied and the focus will be placed on the impact of export promotion agencies and of the international network that countries use to stimulate bilateral trade such as the permanent representations (embassies and consulates) of countries abroad.4

Traditionally, embassies and consulates not only represented the home country abroad, but they were also the eyes and ears in the host country (an informational role). Rose (2007) argues that since communication costs have fallen, information from and about other countries is more easily accessible,

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3) Kostecki and Naray (2007) list a number of non-economic reasons including visibility in the mass media, access to decision-makers (both in the public and private sector), credibility, and reputation.

4) Other instruments may include export credit insurance (Moser et al., 2006), export subsidies (Panagariya, 2000), business-sector activities (Alvarez 2004), export intermediaries (Peng and York 2001) and state visits (Nitsch 2007).

reducing the importance of the informational role of the Foreign Service. Nowadays, embassies and consulates are increasingly occupied with the promotion of the economic and commercial interests of the home country in the host country. Many Foreign Services now state that export promotion is one of their main tasks. Embassies and consulates are thus important actors in commercial diplomacy, and more specifically in the promotion of exports.

Whereas embassies are located in or near export markets, export promotion agencies (or trade promotion organizations) are often located within the exporting country. The scope of export promotion organizations has broadened over the years. The objectives of most of the agencies have come to include supporting the business sector in their internationalization process and improving the performance of exporting businesses, creating a positive image of the home country abroad, and generally increasing the home country's competitiveness. Lederman et al. (2006) divide their services into four categories: country image building, export support services, marketing, and market research and publications. Volpe Martincus and Carballo (2008) point out that export promotion agencies can alleviate information problems, distinguishing between information problems for firms that try to enter new foreign markets or sell new products abroad (extensive margin) and firms that are already exporting and attempt to increase the volume of their exports (intensive margin).

Model And Estimation Of The Overall Impact On Trade

We start this section with a broad description of the applied trade model that we use before we present the overall results for a sample that consists of the 1242 bilateral trade flows of 36 countries. The results in this section provide a numerical insight into the overall (or average) impact of export promotion in this group of countries and does not yet make a distinction as to the impact of the level of development.

Gravity model

For the empirical analysis in this paper, we use an extended form of the so-called gravity model; nowadays one of the most widely used models for empirical trade analysis. A gravity model quantifies factors that explain the volume of international trade flows in commodities. The form of this model is similar to the Newtonian gravity equation used in physics. Newton's law describes the gravitational force between two bodies that depends on a gravitational constant, the two masses and the distance between the two bodies. For economic analysis – analogously – the trade between a pair of countries depends on the economic masses of these countries (i.e., national income) and the physical distance between them.

The essence of the gravity model is that bilateral exports increase with economic size (GDP, population) but decrease with economic distance in all its multidimensional characteristics (physical, cultural, institutional, political). Typically, a basic gravity model consists of a log-linear equation in which the bilateral trade flows between two countries are related to the national incomes or gross domestic products of both countries and are inversely related to the geographical distance between the two countries. Since we aim at estimating the impact of (bilateral) economic diplomatic efforts of embassies and export promotion agencies on bilateral exports, the gravity model is the obvious choice.

Our choice for the gravity model is motivated by an excellent track record in empirical trade flow analysis as well as acknowledged theoretical foundations (Van Bergeijk and Brakman 2010). It is one of the few models that measure the impact of different variables on bilateral trade flows and thus the logical tool for our topic. Indeed many authors have used the model to quantify the impact of commercial and/or economic diplomacy on international exchange.[5] Appendix 1 provides a detailed specification of the gravity equation used for our empirical analysis.

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5) All studies mentioned in footnote 1, with the exception of Lederman et al. (2006), deploy a gravity methodology. Lederman et al. (2006) measure the impact of the export promotion budget *per capita* on the national (total) exports *per capita* per country using full information maximum likelihood (FIML) and ordinary least squares (OLS) estimators in a model that includes amongst the regressors GDP *per capita*, trade restrictiveness, market access, exchange rate volatility, compliance costs and a geography-determined trade-to-GDP ratio.

A general drawback of the empirical approach followed in this paper is that we often have to use imprecise and indirect indicators since we need to be able to measure the respective variables. For example, the staff of export promotion agencies are used in order to differentiate between (relatively) large and (relatively) small agencies, but we thereby neglect other aspects of the use of this instrument (which could include budgets, but also the availability of other instruments such as state visits). A more specific problem is that the selection of countries is partly driven by data availability and that the dataset only includes countries that have a (partly) public export promotion agency. This implies that our data set may be biased so that the results need to be interpreted with caution.

The sample of our analysis consists of 36 countries. Our analysis examines the influence of embassies and export promotion agencies across countries. The 20 exporting countries of Rose (2007) serve as a starting point, supplemented with countries for which Yakop and van Bergeijk (2009) have collected Foreign Service data and for which data was available from the survey of Lederman et al. (2006).[6] The resulting sample consists of 36 countries and provides 1260 potential observations for bilateral trade. It covers nearly half of the total world exports, more than 60% of total world GDP and nearly a quarter of the total world population. The sample covers both high-income and low-income countries, it includes OECD countries and developing countries in Africa, Asia, Latin America and the Middle East, and it also includes small as well as large countries, both in terms of population and in terms of land area. Appendix 2 discusses the data sources in some detail and provides an overview table that lists and classifies the countries and gives some basic information about their embassies, consulates and export promotion agencies.

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6) Countries that belong to the group of 20 exporters of Rose (2007) but do not occur in the dataset of Lederman et al. (2006) are Belgium, Canada, India, Indonesia, Italy, Japan, the Netherlands, Poland, Russia, South Korea and the United States. China did answer the survey but no data on either budget or staff of the export promotion agency was made available. We obtained data for the export promotion agencies of Belgium, the Netherlands and the United States via the internet.

Overall impact of export promotion agencies and embassies and consulates

The benchmark results from estimating the core gravity model are reported in Table 1, where we only list the variables of interest and the key statistics (for the full results see appendix 1, Table A1). Note that the results reported are not the results of a partial analysis but control for a great many factors such as distance to the market, production and consumption languages, trade agreements, language differences. We include these control factors in all our calculations, but for clarity we only report the effect of the trade-promoting instruments in the main text.

The first and second column in Table 1 separately include the indicators for the influence of embassies and consulates and for export promotion agencies, respectively. The third column reports on a regression that includes both the Foreign Service, export promotion agencies, and the interaction term (note that the control factors are not reported in the tables although they have been included in the estimated equations).

Table: 1
Elasticities for two instruments of economic diplomacy and their interaction

Dependent variable: Ln exports	(1)	(2)	(3)
Embassies and Consulates	**0.05**** **(0.02)**		0.09*** (0.03)
Staff of Export Promotion Agency		**-0.01** **(0.01)**	0.01 (0.01)
Interaction between economic diplomatic instruments			-0.01*** (0.00)
Adj. R^2	**0.77**	**0.77**	0.77

Notes:
*** and ** denote significance at the 1% and 5% level, respectively. Standard errors appear in parentheses. See appendix 1 for the full result.

The first column shows that the number of embassies and consulates that a country employs in a host country increases exports to that host country by about 5%. This positive effect is statistically significant but smaller than most other standard variables in the model. The effect is similar to but slightly smaller than the coefficient that is typically reported in other studies.[7] In contrast, the influence of export promotion agencies on bilateral exports in column 2 is negative (-0.01) so that an increase in their staff is associated with lower levels of exports. This effect, however, is not statistically significant, and suggests that a variation in the level of the staff of export promotion agencies does not have an impact on trade and that the negative coefficient is a result of chance. These statistically insignificant results are highly relevant in an economic sense as they actually provide the empirical evidence for refuting the hypothesis that export promotion agencies stimulate exports.

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7) See also footnote 1.

The combination of these two variables in column 3 results in a statistically significant coefficient of 9% for the Foreign Service and a coefficient for export promotion agencies that is still not statistically significant. The interaction effect, however, is statistically significant and negative (-0.01), implying that two instruments have a rivalry character (if used together they tend to weaken the effect) and thus crowd each other out. Thus the results in Table 1 indicate that the bilateral diplomatic efforts of the Foreign Service promote bilateral exports, as was found in other studies. In contrast to the results of Lederman et al. (2006) we find that export promotion agencies do not promote bilateral exports efficiently. Indeed, the positive results of Lederman et al. need to be put into the perspective of a more comprehensive context by taking into account other factors that influence trade, such as distance, income levels and the use of other instruments.

The Impact Of The Level Of Development

We now turn to one of the key points of this paper and investigate the relevancy of the level of economic development as a determinant for the impact of bilateral trade flows. In order to investigate this issue we distinguish between, on the one hand, low and middle-income countries and, on the other, high-income countries.

Low and middle-income versus high-income countries

The emerging empirical literature on new and intangible barriers to trade such as a lack of trust, cultural differences and ineffective governance (a lack of an enforceable legal framework, accountability and stability) may be especially relevant for developing countries. If so, the instruments of commercial diplomacy could be more relevant for the developing countries. In order to investigate the proposition that export promotion is more effective in low-income countries than in high-income countries, we re-estimate the restricted and unrestricted models along the lines of Figure 2 for different (cumulative) sub-groups of countries according to the exporter's GDP per capita.

We start by estimating the models on the basis of data for a group of exporters that has a GDP per capita of less than $10,000. We enlarge this sub-sample by increasing, on a step by step basis, the threshold of GDP per capita so that we have a range of sub-samples for groups of countries with

ascending (cumulative) incomes. Figure 2 shows how the impact of economic diplomacy on bilateral exports changes when we consider economies with different levels of development. It should be noted that this variability contrasts with the other parameters in the model as shown in Appendix 1. This implies that these other factors of the applied trade model that we use do not have to be specifically considered in relation to the level of development of the trading nations, but that the effectiveness of economic diplomacy can only be correctly understood if one controls for levels of development.

As has been said, we focus on the impact of the Foreign Service, export promotion agencies and the interaction of these two instruments. The number of embassies and consulates that a country employs in a host country in general has a consistently positive effect on bilateral exports to that host country as we saw in Table 1, but the influence of embassies and consulates varies depending on the level of development of the home country. This form of economic diplomacy has a small coefficient (that is actually insignificant) for countries with an income per capita below $20,000. The Foreign Service thus helps to promote bilateral exports, but not for the poorest developing countries. Its contribution is strongest in the middle-income countries and it also matters – but to a lesser extent – for the high-income countries. The coefficient for the export promotion agency's staff starts very high but consistently decreases as we include countries with higher incomes per capita. For low or middle-income countries, the influence of export promotion agencies on bilateral exports is positive and statistically significant, implying that by increasing the capacity of export promotion agencies (by increasing the staffing), bilateral exports are increased.[8]

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8) The coefficients for the samples including countries with an income *per capita* below $40,000 fall in a range of 0.21 to 0.28.

Figure 2:
Estimated coefficients of special interest for increasing cumulative GDP per capita

Gross Domestic Income *per capita* (maximum in subsample)
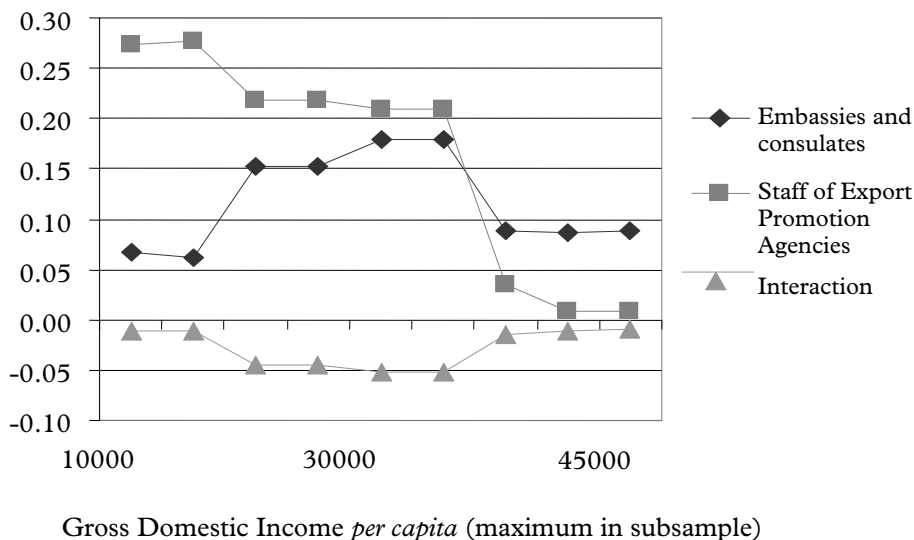
However, the coefficient drops when the threshold of a GDP per capita of $40,000 is crossed and we include developed countries in the sample. Indeed when we include high-income countries in the sample, the coefficients become close to zero and are no longer statistically significant. Whereas export promotion agencies thus have a significant influence on bilateral export flows from low and middle-income countries, this influence vapourizes for high-income countries with incomes per capita of about $40,000 or more.

The interaction term between the Foreign Service and export promotion agencies is negative but only becomes significant at incomes per capita from $20,000 and higher. A negative interaction effect suggests that there is a crowding out of export promotion by the Foreign Service and export promotion agencies. This is especially apparent in the middle-income countries in the sample ($20,000 to $40,000), where both export promotion agencies and embassies do have a significant, positive effect on bilateral exports.

Our results indicate that export promotion agencies are an efficient tool to promote the exports of developing countries, but not for OECD countries. Embassies and consulates appear to be important for middle and high-income

countries, but not for the poorest countries. The impact of the instruments of economic diplomacy is strongest for the middle-income group.

So far, we have only taken the level of development of the exporting economy into account, but also the level of development of the destination market could be important to measure the effectiveness of economic diplomacy. We should therefore take a closer look at the trade flows within and between different country groupings and re-estimate gravity models on these sub-samples. 'Within' trade relates to intra-OECD trade (where we only consider trade flows with their origin and destination in the high-income countries) and trade with its origin and destination in the low and middle-income countries. 'Between' trade relates to goods exported by high-income countries and imported by low and middle-income countries and vice versa.

Table 2: 'within' and 'between' effects

2.a embassies and consulates		TO	
		Low and middle income	High income
FROM	Low and middle income	0.19	0.06
		(0.23)	(0.07)
	High income	0.25★★★	0.02
		(0.09)	(0.03)
2.b Staff of Export Promotion Agencies		TO	
		Low and middle income	High income
FROM	Low and middle income	0.29★★★	0.28★★★
		(0.09)	(0.06)
	High income	-0.01	-0.02★
		(0.02)	(0.01)

Note: Interaction effects have been included but are not reported in the Table because they were insignificant.

Regarding the impact of the Foreign Service (Table 2.a), the coefficients are positive but only the between effect for exports from OECD countries to low and middle-income countries is statistically significant. The effects of the Foreign Service on export flows within the same group of countries are not significant, neither is the effect of the Foreign Service for exports from low and middle-income countries to high-income countries. The only significant coefficient for the Foreign Service (for exports from high-income countries to

low and middle-income countries) is 0.25 and this is highly significant. This positive effect means that each additional embassy or consulate of a high-income exporter increases bilateral exports to a low or middle-income host country. These results suggest a case for export promotion by way of the Foreign Service of high-income countries that is targeted towards countries that are in a lower stage of development (low or middle-income countries). For high-income countries, export promotion towards other high-income countries does not have any significant effect. Commercial ties between the high-income countries are mostly already well established and barriers to trade are likely to be less severe within the group of high-income countries.

Regarding the influence of export promotion agencies on bilateral exports (Table 2.b), the results are comparable to the results reported previously. The findings show that larger export promotion agencies in low and middle-income countries are associated with increases in bilateral trade. The estimated coefficient for the influence of export promotion agencies of low and middle-income countries is 0.29 within the group of low and middle-income countries, and 0.28 for the influence of agencies on exports from low and middle-income to high-income countries (between). Both effects are highly statistically significant. For high-income countries, on the other hand, the picture is entirely different, as both the within (-0.02) and the between (-0.01) effects are negative. This negative effect is statistically significant for the effect within high-income countries. Larger export promotion agencies in high-income countries are thus not associated with increases in bilateral trade with low and middle-income countries, and are negatively associated with increases in bilateral exports with high-income countries.

Conclusion

This paper uses an empirical trade model to analyze the contribution of embassies, consulates and export promotion agencies in a group of 36 countries in the year 2006. This econometric tool enables us to control other economic variables such as GDP, transportation costs and trade agreements, and non-economic factors, such as common languages or specific characteristics of the geographical position of countries (for example, landlocked or island economies) and thereby to distil the added value of embassies, consulates and export promotion agencies.

The first contribution of this paper is that it is the first time that these instruments of economic and commercial diplomacy have been analyzed simultaneously and in a coherent multi-nation framework. In doing so, we are able to show that the overall effect of export promotion agencies is insignificant whereas the overall effect of embassies and consulates is positive and significant. The estimated elasticity is in the range of 0.05 to 0.09. This means that a 10% larger number of consulates and embassies are associated with a 0.5 to 0.9% larger trade flow. This may seem a small increase, but this should be related to the actual value of trade flows in order to evaluate the costs and benefits of the economic activities of diplomats. In the major export markets the benefits will exceed the costs by very substantial amounts.

The second contribution of this paper lies in analyzing how the level of development of exporting countries influences the overall effect of embassies, consulates and export promotion agencies. This is a potentially relevant issue as shown by our economic theoretical discussion which highlighted many difficulties of exporting to and importing from developing countries and the potential relevance of economic and commercial diplomacy in solving those difficulties. The empirical analysis confirms the theoretical analysis. For example, we find that export promotion agencies are an efficient tool to promote the exports of developing countries, but not for OECD countries. The relationship between the overall effect and the level of development is not straightforward, which we have shown through our finding on embassies and consulates, namely that they appear to be important for middle and high-income countries, but not for the poorest countries. Overall, the impact of the instruments of economic and commercial diplomacy is the strongest for low and middle-income countries, which confirms the economic theory that it is less important for high-income countries.

The third contribution of this paper can be found in our analysis of the impact of the level of development of both the exporting and importing country, which allowed us to distinguish between 'within' trade (within the group of high-income countries, or within the group of low and middle-income countries) and 'between' trade (between high-income countries and low and middle-income countries). The empirical findings show that these detailed distinctions are highly relevant for the effectiveness of the instruments of economic and commercial diplomacy. Indeed the main message of this paper is that this effectiveness can only be understood correctly if one takes the level of development of both trading nations into account. This implies that economic and commercial diplomacy should deploy different instruments depending on the level of development of the exporting and importing nation. This contrasts with earlier empirical studies that grosso modo argue that economic diplomacy in general stimulates bilateral trade.

Our empirical analysis illustrates this general point by means of some specific econometric findings. For example, we find that only the Foreign Services of high-income countries with embassies and consulates positioned in low and middle-income countries are effective in increasing exports, but this is only so in the context of exports to low and middle-income countries, not to other high-income countries. In particular, for developed countries trade promotion does not provide an argument for an increase in the number of embassies and consulates in other developed countries. Developing countries should not, according to our research, expect an increase in their bilateral trade if they increase the number of embassies and consulates.

Focusing on export promotion agencies, we find that the export promotion agencies of high-income countries do not stimulate exports to low and middle-income countries and even have a significant negative influence on bilateral exports to other high-income countries. In economic terms this suggests that export promotion agencies in the developed countries are on average too large. In contrast, the export promotion agencies of low and middle-income countries are effective in increasing bilateral exports, and this is true for both exports to other low and middle-income markets and exports to high-income countries.

The overall conclusion is that the effectiveness of economic diplomacy can be substantially increased by considering more closely the appropriateness of its instruments in particular for the markets that are targeted.

Appendix I: Specification of the gravity model and details on the regression analysis

The studies of Rose (2007) and Lederman et al. (2006) are combined and expanded as we combine an extended gravity model and dataset a la Rose (2007) with the data on export promotion agencies collected by Lederman et al. (2006). Moreover, whereas the impact of different instruments of economic diplomacy so far has been measured separately, both embassies and export promotion agencies are simultaneously included in our model. We report estimates of different specifications of the following equation:

$$\ln(X_{ij}) = \beta_0 + \beta_1 \ln(D_{ij}) + \beta_2 \ln(Y_i) + \beta_3 \ln(Y_j) + \beta_4 \ln(Pop_i) + \beta_5 \ln(Pop_j) + \beta_6 Lang_{ij} + \beta_7 Landl_{ij} + \beta_8 Island_{ij} + \beta_9 \ln(Area_i Area_j) + \gamma EmbCon_{ij} + \delta StaffEPA_i + \eta (EmbCon_{ij}*StaffEPA_i) + \varepsilon_{ij} \qquad (1)$$

Where i denotes the exporter, j denotes the importer, and the variables are defined as follows:

X_{ij} denotes the exports from country i to country j. Since we have a logarithmic transformation $\ln(0)$ is not defined so that we exclude 18 zero observations and thus $X_{ij} > 0$

D_{ij} is the distance between i and j. We expect $\beta_1 < 0$ because transportation costs, transportation time and the 'economic horizon' of the exporter (all assumed to correspond roughly with the geographic distance between the exporting and importing country) have a negative impact on trade.

Y_i, Y_j represent the gross domestic product *per capita* of i and j, respectively. We expect $\beta_2 > 0$ and $\beta_3 > 0$ because countries with larger GDP have larger production capacity in i and larger markets j for export products

$Pop_i Pop_j$ refer to the population of i and j, respectively. We expect $\beta_4 > 0$ and $\beta_5 > 0$ because a larger population would also mean that the countries have larger labour supply (i) and more consumers (j)

$Lang_{ij}$ is a binary (1,0) dummy variable that is unity if the countries in the pair share the same official language and else zero. We expect $\beta_6 > 0$ because countries that share the same official language trade more easily since trading costs (repackaging, translation and marketing) are lower

and because countries with similar languages often share cultural patterns and preferences.

$Landl_{ij}$ is a dummy variable (0, 1, 2) that denotes the total number of countries in a country-pair that are landlocked. It assumes the value 2 if both countries are landlocked, 1 if only one country is landlocked, and 0 if neither country is landlocked). We expect $\beta_7 < 0$ because land-locked countries trade less as their connectivity to the world market is lower and their average trading costs higher because the goods that flow in and out of these countries have to pass more borders.

$Island_{ij}$ is a dummy variable (0, 1, 2) that denotes the total number of countries in a country-pair that are islands (value is 2 if both countries are islands, 1 if only one country is an island, and 0 if neither country is an island). We expect $\beta_8 < 0$ because island economies typically have a larger distance to markets.

$Area_i Area_j$ is the product of the land areas of i and j. We expect $\beta_9 < 0$ because countries that are larger tend to trade less basically because many products are already within their border so that internal trade may substitute for international trade.

Next there are the following two variables of special interest in this research (and their interaction term):

$EmbCon_{ij}$ is the number of embassies and consulates of country i in country j.

$StaffEPA_i$ is the staff of a nation's export promotion agency (in hundreds of persons).[9]

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9) In contrast to Lederman et al (2006) we do not use the total budget of the agency because budget is much more difficult to measure than staff and thus less comparable across countries. Financial figures are often confidential and agencies may even find some benefit in under- or overstating the budget. Moreover, the specification of 'total budget' (which agencies had to supply in the survey of Lederman et al.) is problematic, as it has not been clarified what to include or exclude in the budget.

Finally there is:

ε_{ij} which represents the residual influence on bilateral exports; assumed to be a well-behaved log-normally distributed error term.

Basically this is the specification of Rose (2007) from which insignificant variables have been dropped and to which the number of staff of the export promotion agency of country i (StaffEPA$_i$) and an interaction term (EmbCon$_{ij}$*StaffEPA$_i$) is added in order to investigate whether export promotion agencies have a complementing or substituting influence on bilateral exports.

Table A.1: Benchmark estimated results for various export equations (N=1242)

Dependent variable: Ln exports	(1)	(2)	(3)	(4)
EmbCon$_{ij}$		0.05**		0.09***
		(0.02)		(0.03)
StaffEPA$_i$			-0.01	0.01
			(0.01)	(0.01)
EmbCon$_{ij}$*StaffEPA$_i$				-0.01***
				(0.00)
Ln (D$_{ij}$)	-0.76 ***	-0.75***	-0.76***	-0.74***
	(0.05)	(0.05)	(0.05)	(0.05)
Ln (Y$_i$) (p/c)	1.24***	1.23***	1.26***	1.24***
	(0.03)	(0.03)	(0.04)	(0.04)
Ln (Y$_j$) (p/c)	1.11***	1.09***	1.11***	1.09***
	(0.03)	(0.03)	(0.03)	(0.03)
Ln (Pop$_i$)	1.05***	1.04***	1.08***	1.07***
	(0.04)	(0.04)	(0.05)	(0.05)
Ln (Pop$_j$)	1.10***	1.06***	1.10***	1.07***
	(0.04)	(0.05)	(0.04)	(0.05)
Lang$_{ij}$	0.87***	0.84***	0.87***	0.84***
	(0.13)	(0.13)	(0.13)	(0.13)
Landl$_{ij}$	-0.45***	-0.44***	-0.44***	-0.44***
	(0.09)	(0.09)	(0.09)	(0.09)
Island$_{ij}$	-0.50***	-0.48***	-0.46***	-0.44***
	(0.10)	(0.10)	(0.10)	(0.10)
Ln (Area$_i$Area$_j$)	-0.12***	-0.13***	-0.12***	-0.13***
	(0.03)	(0.03)	(0.03)	(0.03)
Adj. R^2	0.77	0.77	0.77	0.77

Note: The first column shows the results for the equation that only includes the control variables. The second and third column show the results for the equations that separately include the indicators for the influence of embassies and consulates and for export promotion agencies, respectively. The fourth column reports on a regression that includes both the Foreign Service, export promotion agencies, and the interaction term.

Note that the restricted gravity model works rather well; all coefficients are highly statistically significant, the sign and size of the different variables correspond to ex ante expectations and more than three quarters of the variation in bilateral export flows is explained by the model.[10] Formal F-tests that test the restricted model ($\gamma=\delta=\eta=0$) against the extended gravity equations refute the addition of $StaffEPA_i$, while supporting the other extensions. The F-statistics are 3.88, 1.38 and 4.37, respectively. The null hypothesis that the restricted model suffices is rejected for the second model at the 5% significance level (the critical F-value (5%, 1, 1231) is 3.84) and largest model (final column) at the 1% level (the critical F-value (1%, 3, 1229) is 3.78, but for the third model, the null hypothesis could not even be rejected at the 10% level (critical F-value 2.71).

Focusing on the fully unrestricted model-specification (Table A1, column 4), Figure A1 plots the development of the coefficients of all 'standard' variables as the sample expands to include countries with higher levels of GDP per capita. The coefficients for the core variables in the gravity model remain fairly stable. Their sign and size are comparable to the results reported in the first column in Table A1and in line with expectations. The size of most coefficients decreases slightly for samples that include countries with higher GDP per capita, technically because the variance increases but also because 'standard' determinants of bilateral trade (such as distance) have less impact for countries with higher incomes per capita. This may suggest that exports in lower income countries are more susceptible to border effects and other trade determinants than are exports in high-income countries.

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10) Extensive econometric testing of the model and its specifications is reported in Van Veenstra (2009) and Yakop (2009) including fixed effect estimates and treatments of heteroskedasticity and zero trade flows.

Figure A1:
Estimated coefficients for core variables for increasing cumulative GDP per capita
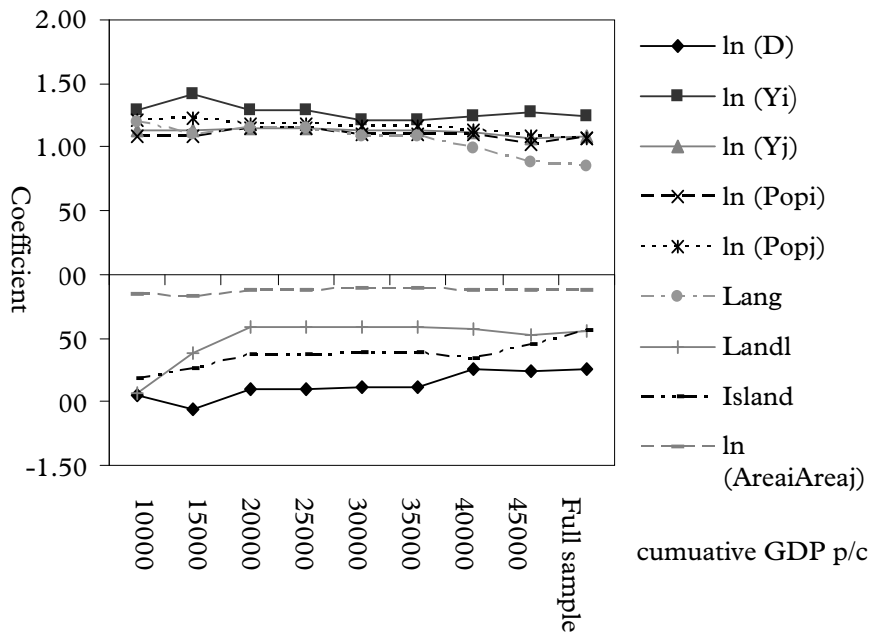
Split samples

In order to provide a more accurate estimate of the effects, the sample is
divided in two different groups: low- and middle-income countries (612 trade
flows for 18 countries with a GDP per capita of less than $11,455) and high-
income countries (630 trade flows for 18 countries with a GDP per capita of
more than $11,455). The value of $11,455 is based on the country
classification of the World Bank between low- and middle-income countries
and high-income countries. We repeat the OLS estimations for the two
separate groups and report the results in Table A2. Clearly, there are
differences for the effects of export promotion through the Foreign Service or
export promotion agencies between the group of low- and middle-income
countries and the group of high-income countries. As before, Table A2
studies the trade flows that originate in the low- and middle-income countries

and the high-income countries, respectively, without making a distinction according to the destination of that trade.

Table A2: Estimated results for export equation at different levels of per capita income

Dependent variable: Ln exports	Low- and middle-income	High-income
N	612	630
Embassies and Consulates	0.06	0.07*
	(0.08)	(0.04)
Staff of Export Promotion Agency	0.28***	-0.02*
	(0.05)	(0.01)
Interaction term	-0.01	-0.00
	(0.03)	(0.00)
Adj. R^2	0.70	0.84

*Notes: Countries have been divided into two independent samples according to exporter GDP per capita; the breakpoint lies at $11,455. *** and * denote significance at the 1% and 10% level, respectively. Standard errors appear in parentheses. Included in the regressions analyses but not recorded here are the constant and the explanatory variables of the gravity model as reported in Table A1.*

The influence of embassies and consulates is only statistically significant for exporting countries in high-income countries. The presence of a high-income country's Foreign Service abroad has a positive effect on bilateral exports to those countries (the coefficient is 0.07 but only marginally significant at the 10% level). The coefficient of export promotion agencies is – as was the case with the cumulative income samples – much higher in low- and middle-income countries. The estimated coefficient for low- and middle-income countries is 0.28 and significant at the 1% level. On the contrary, we find for the high-income countries a coefficient of -0.02 that is statistically significant at the 10% level.

Appendix II: Data sources
Overview table

Country i	Total number of embassies and consulates of country i in 35 countries	Total number of embassies and consulates of 35 countries in country i	Year of establishment of the export promotion agency (ranking)	
Australia	35	64	1985	(17)
Austria	48	36	1946	(6)
Belgium⋆	45	52	2004	(34)
Czech Republic	41	31	1997	(23)
Denmark	52	29	2000	(29)
Finland	37	37	1919	(1)
France	88	123	2004	(35)
Germany	66	116	1951	(8)
Hungary	43	32	1990	(18)
Ireland	30	27	1998	(27)
Netherlands	62	49	1936	(4)
Norway	45	26	2004	(36)
Portugal	77	40	1949	(7)
Spain	93	97	1982	(16)
Sweden	38	45	1971	(12)
Switzerland	58	56	1927	(3)
United Kingdom	78	56	1999	(28)
United States	76	227	1921	(2)
Algeria	37	32	1997	(22)
Bangladesh	23	15	1972	(13)
Brazil	54	92	2003	(32)
Chile	61	32	1975	(14)
Dominican Republic	39	18	2003	(33)
Ecuador	33	22	1997	(24)
Egypt	49	42	1997	(25)
Israel	41	40	1958	(10)
Malaysia	31	35	1993	(19)
Mexico	81	47	1937	(5)
Morocco	67	47	1981	(15)
South Africa	36	54	2001	(31)
Thailand	34	31	1952	(9)
Tunisia	37	24	2000	(30)
Turkey	65	57	1960	(11)
Uganda	9	13	1996	(20)
Uruguay	42	21	1996	(21)
Venezuela	49	35	1997	(26)

Bilateral merchandise exports (over the year 2006), in US dollars are from Direction of Trade Statistics (IMF, September 2007) and supplemented with data from the Comtrade Database (UN).

Data on gross domestic product, in current US dollars for 2006, and data for the total population of all countries are from the World Development Indicators Database (World Bank).

Distances are geodesic great-circle distances; this indicator uses latitudes and longitudes of the most important cities or agglomerations in terms of population, which are taken from the distances dataset of the CEPII, that also provided data for the land areas (in km^2) and the dummies (contingency, language, island, landlocked and colony).

Data for the free trade agreements and currency unions are from the World Trade Organization website and reported by Yakop and van Bergeijk (2009), who also provide the number of embassies and (career) consulates country i has in country j. Budgets and staff of export promotion agencies are for the most recent year that the concerning export promotion agency could provide (mostly for 2005-2006) and have been provided by Lederman et al. (2006). Since this dataset is confidential, results for specific countries cannot be provided; the reporting is thus limited to results for the complete sample or groups of countries. The dataset has been supplemented with data for Belgium, the Netherlands and the US.

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2   Melissen (2005), p. 24.

3   Ingrid d'Hooghe, 'Public Diplomacy in the People's Republic of China', in Jan Melissen (ed), *The New Public Diplomacy: Soft Power in International Relations*, (Basingstoke: Palgrave-Macmillan, 2005) pp. 88-103.

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5   Ellen Huijgh, 'The Public Diplomacy of Federated Entities: Examining the Quebec Model', *The Hague Journal of Diplomacy*, Vol. 5, No. 1 (2010), pp. 125-150

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