CONFLICT AND TRADE: THE CASE OF THE BASQUE COUNTRY

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Abstract

The aim of this contribution is to determine whether the conflict of the Basque Country with the Spanish State in some way influences the region's foreign exports. Empirical analysis, based on the gravity model approach for the period 2000−2017, indicates that both intrastate conflict in the Basque Country and the foreign trade of the region are related. The regression results show that Basque foreign exports are positively associated with past values of conflict, and more specifically that conflict is associated with higher export flows to the European Union. Hence, foreign trade appears to act as insurance against conflict escalation, as predicted by Martin et al. (2008).

Keywords

Basque Country, Foreign Trade, Conflict, Gravity Model

I. Introduction

The last wave of secessionist movements in Europe attracted the attention of both politicians and academics. One such movement is the long-lasting conflict of the Basque Country with the Spanish state. Given the rich empirical evidence on the negative effects of conflict on trade (e.g. Reuveny and Kang 1996, Martin et al. 2008, Marano et al. 2013), I expect the conflict in the Basque Country to affect the region's foreign trade. Moreover, following the literature on the role of economic integration on the political disintegration (see e.g. Alesina et al. 1997), I suppose the European Union to play a specific role in this process.

The aim of this contribution is to determine whether the conflict in the Basque Country in some way influences the region's international exports. My analysis is based on the gravity model approach for the period 2000−2017. The dataset includes 166 export destinations of the Basque country. I suppose that the higher the level of conflict between the region and Spain, the higher the motivation of exporters to seek partners from abroad.

The will of the inhabitants to secede from Spain, together with the terrorist attacks carried out by ETA are expected to influence the region's exports.[2] Exporters might search for new sales markets abroad because they thereby minimize their exposure to future conflict escalation. In order to account for the role of European integration in the process, I control for the influence of conflict on trade with EU members.

The contribution has the following structure. The first part briefly describes the conflict between the Basque Country and Spain, as well as the dependence of the region on trade with the rest of the country. Then I refer to the theory behind the trade-conflict relationship and explain my hypothesis. The following part presents the gravity model of foreign trade, including the data and variables, as well as the results and their interpretation. The last section concludes.

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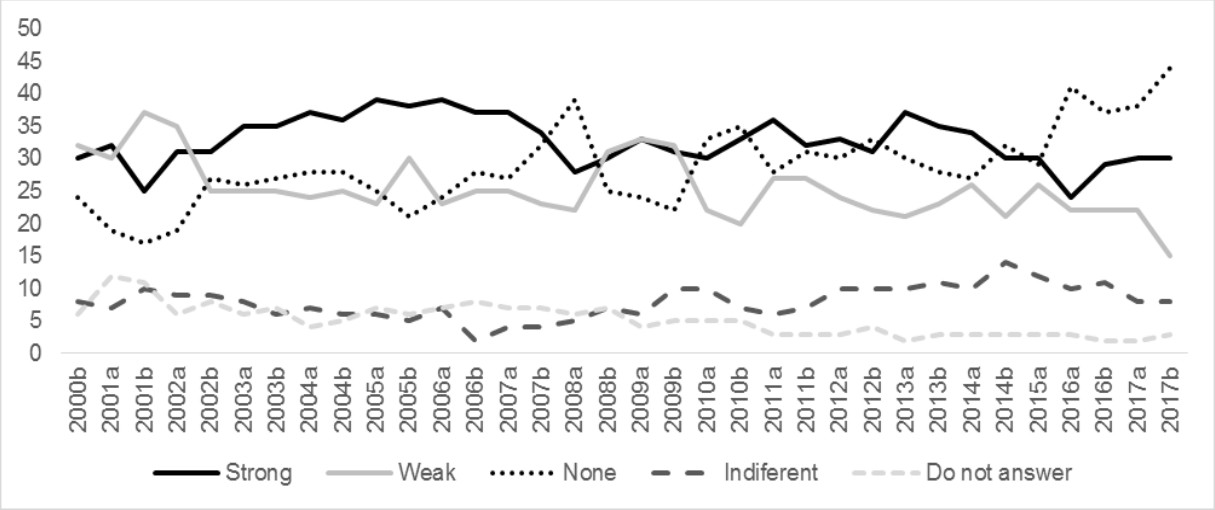
[2] Similarly, we could also expect the same effect for importers. However, as pointed out by Marano et al. (2013), trade is far more damaged by conflict in the exporting country than by conflict in the importing one.

II. Basque Country−Spanish relations: Conflict and trade

Contrary to Catalonia, in the Basque Country, support for independence is currently very low (see Figure 1). According to López Basaguren (2018, in Ivánnikova 2018), this is due to the general satisfaction of the inhabitants with the level of autonomy of the region. This includes economic privileges, i.e., the so-called *economic agreement* (*concierto económico*)[3] (highly desired by the Catalans), as well as the revival of *euskera*, the Basque language in education and other spheres of public life.

Figure 1: Evolution of the desire for independence in the Basque Country in percentage points.[4]



Source: Universidad del País Vasco (2018)

Nevertheless, as can be seen from Figure 2 the relationship with the rest of Spain was not always so friendly. This was especially true following terrorist attacks carried out by ETA (Euskadi Ta Askatasuna, Basque Homeland and Freedom). The organization was especially active during the transition period following General Franco's death in November 1975. Although the number of victims in the period under consideration was well below those levels from that period following Franco's death, the organization was still active until 2010.

Nevertheless, during the first decade, the conflict over secession in the region de-escalated (HIIK 2011). In October of 2011, ETA announced the definitive end of its armed activity and called for a dialog with the Spanish central government. On October 24th, a meeting between the country's Prime Minister, José Luis Rodríguez Zapatero and the leader of the Basque Nationalist Party (PNV) was held. Consequently, Basque prisoners were relocated from the centre to their autonomous region (HIIK 2012).

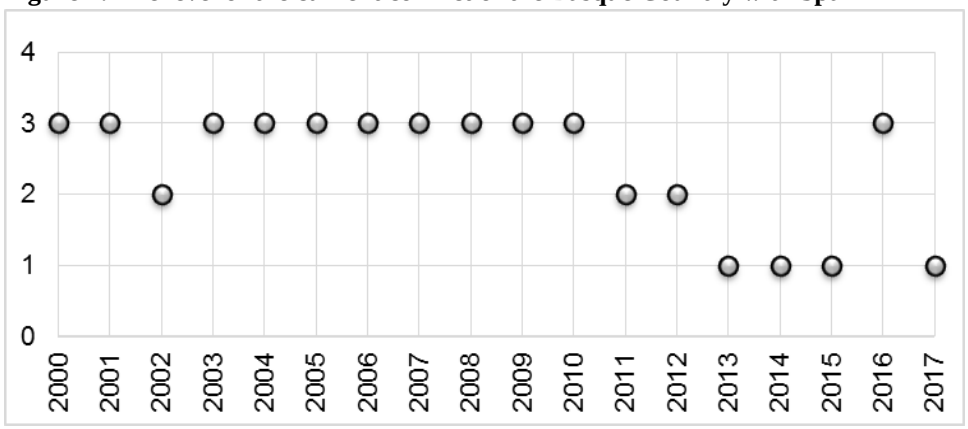
In the following years, the conflict remained relatively benign, with the exception of 2016 when it once more reached the level of violent crisis as the consequence of an incident among 40 Basque citizens and two Civil Guards in a bar in Navarre province. Nevertheless, the reasons for the conflict were not clear over whether it was renewed nationalism or other causes. The Basque nationalists alleged that the dispute was initiated by the Civil Guards. On the contrary, the Audiencia Nacional (Spanish criminal court) labelled the incident as terrorism.

[3] This agreement is a specific system of distribution of financial resources valid since 1981, "which endows the three historic territories of Araba, Bizkaia and Gipuzkoa with powers to formulate, regulate and collect 92% of all taxes−which means all taxes except for customs duties levied on goods imported from outside the EU" (Goikoetxea 2013). After that, the region pays 6.24% of the total expenses of the Spanish state in order to finance areas not included in its competences, such as army, foreign diplomacy etc. This fixed contribution to the Spanish Treasury is called *cupo* (*ibid.*).

[4] "Strong" is the sum of "very strong" and "strong enough", and "weak" includes "rather weak" and "very weak".

Later on EH Bildu, the Basque pro-independence party, called for a referendum in 2018 (HIIK 2019).

Figure 2: The level of the current conflict of the Basque Country with Spain

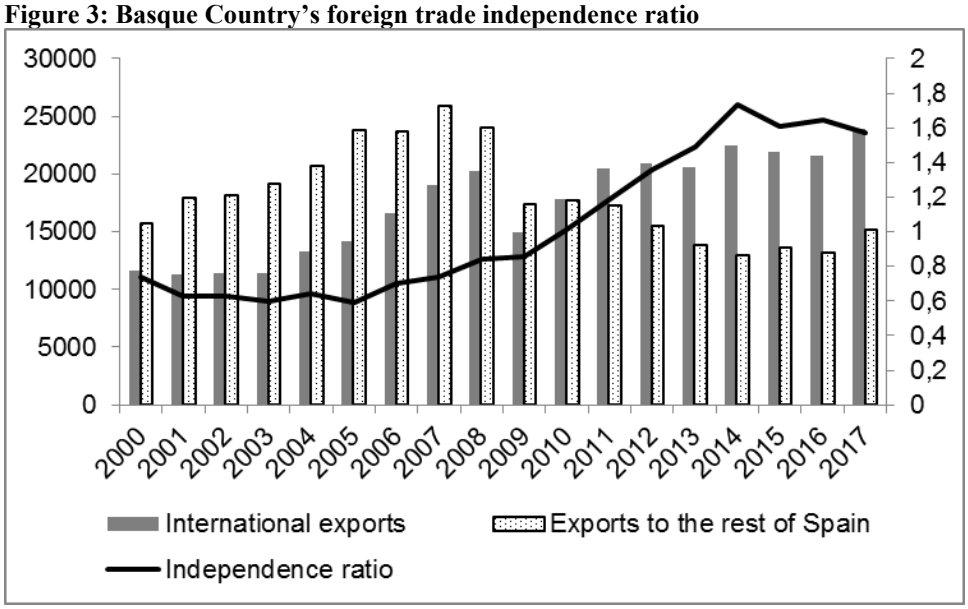


Source: HIIK (2001-2018)

Although the will in the Basque Country to become independent was no higher than that of the Catalans, the Basque conflict was generally more serious, especially due to the presence of terrorism in the region. However, during the last years of the period reviewed, the situation moderated.

Figure 3 shows international exports of the region, as well as its exports to the rest of Spain. Following Daumal (2011), I also provide the Basque Country's *independence ratio* – international exports compared to exports to the rest of Spain− which illustrates the increasing share of international exports on total Basque export. The ratio only decreased in the last years of the period under review. Whether there is any relationship between this ratio and the level of conflict will be examined in the next section.

Figure 3: Basque Country's foreign trade independence ratio



Source: C-intereg. CEPREDE (2018)

III. Literature review

According to the liberals, represented by Polachek (1980), Oneal and Russet (1997), as well as Carter and Goemans (2014), trade deters conflict, because conflict inhibits trade. Therefore, countries are motivated to cooperate in order to avoid the opportunity costs of lost trade.

Contrary to these authors, realists dispute this peace-making effect of trade on conflict. According to Barbieri (1996), trade itself can become a source of conflict, because states are concerned over their access to goods and resources. Whereas liberals point out that trade is beneficial for both partners, Barbieri and Schneider (1999) argue that if the gains from trade are asymmetric, they lead to conflict.

Martin et al. (2008) show mixed results for the relationship between civil wars and trade. On the one hand, bilateral trade deters conflict due to the opportunity costs of lost trade. On the other hand, at the same time, international trade, i.e., trade with countries not involved in the conflict, acts as an insurance, as it reduces those opportunity costs. This is in accordance with Alesina et al. (1997), for whom economic integration lowers the costs of secession.

The causality was often reversed, and many scholars focused on the effects of actual conflict on trade. For example, Gowa and Mansfield (1993) show that military conflict reduces trade. According to Glick and Taylor (2010), wars have a strong, negative and long-lasting effect on bilateral trade. These effects are more substantial in the case of intrastate, rather than interstate conflicts (Marano et al. 2013, or Martin et al. 2008). Moreover, according to Pollins (1989), there is a negative influence of deteriorating political relations on trade, whether they escalate into war or not.

Conflict in the Basque Country is specific, because it is also influenced by terrorism. Fratianni and Kang (2006) show that the impact of terrorism on bilateral trade is greater for geographically closer countries and weakens with increasing distance. Terrorism, according to the authors, also hardens national borders and causes trade diversions. For Nitsch and Schumacher (2004) all internal instabilities, including terrorism, have a significantly negative effect on trade.

Nevertheless, according to Morrow (1999), Li and Sacko (2002) and Simmons (2005), economic agents are able to anticipate conflict and, as a consequence, will attempt to lower their exposure to it in order to minimize future losses. This holds on both the level of businesses (e.g., Simmons 2005), states (Kastner 2007), as well as consumers (Davis and Meunier 2006).

Consequently, if economic agents are both rational and forward-looking, as well as trying to maximize their utility, they will work to minimize the costs of possible future conflict. In the case of exporters, this should find expression in a lower trade dependence on the domestic market. On one hand, there is a negative effect of terrorism on the Basque Country's trade with Spain, as well as with third countries. On the other, secessionist tendencies may push exporters from the region to try to lower their dependence on Spanish markets. I expect the latter effect to be stronger, because in the 21st century, the frequency of terrorist attacks in the Basque Country was rather low.

IV. Data and methodology

Trade-conflict literature often uses the gravity model of foreign trade in order identify the main determinants of a given country's exchange of goods and services (for example, the above cited Pollins (1989), Li and Sacko (2002), Nitsch and Schumacher (2004), Simmons (2005), Fratianni and Kang (2006), Kastner (2007), Martin et al (2008), Glick and Taylor (2010), or Marano et al. (2013). The main advantage of the model is its flexibility, which enables the direct incorporation of conflict variables (Pollins 1989).

The following regression equation has been specified in order to determine whether there is any relationship between the level of conflict in the Basque Country and the volume of the region's international exports:

$$ln\_Export_i^t = \beta_0 + \beta_1 ln\_GDP_i^t + \beta_2 ln\_GDP\ per\ capita_i^t + \beta_3 ln\_Distance_i + \beta_4 FTA_i^t + \beta_5 Currency_i^t + \beta_6 Sea_i + \beta_7 Contiguity_i + \beta_8 Languague_i + \beta_9 Conflict^{t-1} + Conflict\_EU^{t-1} + \gamma t + \varepsilon_i^t \quad (1)$$

The dependent variable accounts for international exports of the Basque Country between 2000 and 2017 and includes 166 countries. The time span was defined on the basis of disposable data for the level of conflict as reported by the HIIK (2001−2018). The data for exports flows were retrieved from the DataComex database provided by the Spanish Ministry of Industry, Commerce and Tourism (2018) and they are denoted in millions of US dollars.

Because the dataset is unbalanced, as it includes some zero (missing) trade flows, I use the Poisson estimator (PPML), as proposed by Santos Silva and Tenreyro (2006). According to Martin and Pham (2008), this approach can only be used if the share of unreported flows is minor, which is my case (less than 2%). Other advantages of PPML are that it does not impose great demands on the model's assumptions and can cope with the heterogeneity of data that is typical of gravity models (Shepherd 2016).

For the Poisson model, the equation has multiplicative form, which has been specified as follows:

$$Export_i^t = \exp[ln\_\beta_0 + \beta_1 ln\_GDP_i^t + \cdots]\varepsilon_i^t, \quad (2)$$

where the dependent variable was rounded to millions of dollars.

In order to check the validity of the estimates, I also use the Tobit model (Soloaga and Winters 2001, Linders and de Groot 2006), which censors all the zero (missing) flows. Because the natural logarithm of zero cannot be defined, all the logarithms of the missing flows were substituted by a small number and consequently dropped from the regression.

$$\ln\_Export_i^t = \ln\_Export_i^{t*} \quad \text{if} \quad \ln\_Export_i^{t*} > \ln \alpha$$

$$\ln\_Export_i^t = \ln \alpha \quad \text{if} \quad \ln\_Export_i^{t*} \leq \ln \alpha \quad (3)$$

The right side of the equation includes the following variables:

- The *GDP* term reflects values of the gross domestic product in purchasing power parity in millions of 2011 constant US dollars (World Bank 2018). It is expected to have positive influences on both exports and imports (Bubáková 2013). Despite the fact, that one country's product is a function of its net exports, Frankel (1997) states that endogeneity causes negligible change in the results and is therefore ignored by vast majority of authors.
- The purchasing power of the trading partner is approximated by *GDP per capita* (Bubáková 2013). The data set was also retrieved from the World Bank database (2018). Because of the population component, the expected sign is not clear (Nilsson 2000).
- The *Distance* term is expected to negatively influence exports, because the larger the distance, the higher the transportation costs. The data, provided by the geobytes.com website[5], is based on the great-circle approach and reflects distance in kilometres that separate Bilbao from the capital of its corresponding trading partner. Bilbao has been chosen as the capital of the Basque Country, as it is traditionally considered to be the commercial centre of the region. The same occurs with Frankfurt in Germany.

[5] In cases when the geobytes.com did not contain the corresponding information I used the GeoDataSource data (2018).

- The dummy variable *Sea* takes the value of 1 if the country has access to the sea and 0 otherwise. I expect this variable to have a positive effect on the region's exports, as access to the sea lowers transportation costs (e.g. Grančay et al. 2015, Glick and Rose 2015).
- *Contiguity* is 1 for countries that share a land border with the Basque country and 0 for those that do not. In accordance with Bubáková (2013), I expect this variable to positively influence the foreign trade of the region.
- The countries' membership within the same free-trade area is expected to positively influence the Basque Country's foreign exports (Grančay et al. 2015, or Glick and Rose 2015). For this reason, I include the dummy variable *FTA*, which is 1 for countries that were members of the European Common Market (ECM) in a given year and 0 otherwise. The volume of the region's exports is also expected to be positively influenced by the possibility to pay in the same *Currency* (Glick and Rose 2002 and 2015).
- Moreover, all the things being equal, according to Egger and Lassman (2012), bilateral trade should be larger among those countries that share a language, as it also lowers transaction costs. In order to account for this influence, I include a dummy variable *Language*, which takes the value of 1 for those countries where the official language is Spanish and 0 for those where not. I use database provided by Mayer and Zignago (2011).
- The *Conflict* variable ranges from 0 (no conflict at all) to 3 (violent crisis), in accordance with the HIIK (2001−2018).[6] Following Li and Sacko (2002) and Kastner (2007), I include this variable one period lagged in order to avoid possible simultaneity bias and because exports might well be influenced by the conflict level in the previous period, rather than by its current levels.
- As already mentioned, for Martin et al. (2008), foreign trade acts as insurance, as it represents a substitute to trade with the rest of the home country. For this reason, I expect trade diversification to be more pronounced towards the EU countries. Hence, one additional variable was created in order to account for the role of the European Union in the process. This term is *Conflict_EU*, which assigns the conflict level values only to countries that are members of the Union and 0 to other countries.
- Time dummies γt account for all events that are specific to the year t that might affect international trade.
- β_0 is an intercept
- ε_i^t is the error term.

V. Results and discussion

Table 1 shows results for the gravity model of foreign trade within the Basque Country. The GDP has the expected sign and magnitude. All others equal, the region trades more with countries with higher demand that with those with smaller needs. GDP per capita also seems to have positive effect on the region's foreign trade.

The distance term is negative and significant on 1% level, which reflects the expectation that countries further away from the Basque Country trade less with the region due to higher transportation costs. Also highly significant is the parameter estimate of the variable that accounts for countries with access to the sea. Therefore, the Basque Country, *ceteris paribus*, apparently trades more with less remote countries, as well as with those with sea ports.

[6] Level 1 corresponds to dispute and level 2 to non-violent crisis.

The parameter estimate of the Contiguity term presents ambiguous results, which is in accordance with my previous results for Catalonia (Coufalová [unpublished]). The same occurs with the parameter estimates of the influence of the European Monetary Union (EMU). Whereas the PPML predicts a positive effect of the Currency term on Basque foreign exports, according to the Tobit model, the estimates are negative. This result is in accordance with Glick and Rose (2015), who pointed out that different estimation techniques predict different results of the effect of EMU on foreign trade among its member states. The parameter estimate of the FTA variable is not statistically significant.

All others equal, the region seems to trade significantly more with those countries with Spanish as the official language, which reflects the fact that language lowers transaction costs.

The lagged value of the conflict variable is not significant in any of the models. Nevertheless, when accounting for the specific influence of conflict on trade with EU members, the parameter estimates are positive in both cases and significant on a 5% level. This means that *ceteris paribus*, an increase in the level of conflict with the Spanish state, is associated with relatively higher exports to countries from the European Union. Hence, trade with EU member states appears to act as insurance, as predicted by Martin et al. (2008). Nevertheless, the results are not convincing enough. As can be seen from Figure 3, the independence ratio has been increasing since 2005. However, its significant increase occurred mainly after 2009, when the country was hit by the global economic crisis. It is therefore possible that Basque exporters were simply looking for new selling markets due to a decline in Spanish demand for their goods.

Time dummies were statistically highly significant. Their inclusion significantly lowered all the information criteria and increased the other goodness of-fit measures.

According to Goenner (2011), the relationship between trade and conflict can be reciprocal. In such a case, my conflict variable would be endogenous and the estimates inconsistent. Nevertheless, in this case the endogeneity of the conflict variable was rejected by the Hausman test (p-value > 0.9), which means that the IV method should not be used. Anyway, as pointed out earlier, I account for the possible problems of endogeneity by using the lacked values of the conflict variable.

Table 1: Gravity equation of the foreign trade of the Basque Country

	Tobit	PPML
Intercept	-2.613***	-12.93***
	(0.7754)	(0.6324)
GDP	1.211***	0.7835***
	(0.02865)	(0.01706)
GDP per capita	0.1038**	0.3564***
	(0.04808)	(0.03271)
Distance	-1.733***	-0.9146***
	(0.07779)	(0.05021)
Sea	1.569***	0.3815***
	(0.1281)	(0.06418)
Contiguity	-1.003***	0.3237***
	(0.1155)	(0.05428)
FTA	0.1853	0.1223
	(0.1308)	(0.08069)
Currency	-0.3107***	0.1762***
	(0.1051)	(0.05806)
Language	2.128***	1.143***
	(0.09594)	(0.07090)
Conflict_1	-0.08315	0.02403
	(0.09814)	(0.04598)
Conflict_EU_1	0.1307**	0.06975**
	(0.05144)	(0.03176)
Time effects	YES	YES
Number of observations	2819	2822
Left censored observations	106	

The *, ** and *** indicate significance on 10, 5 and 1 % level of significance.
Source: own processing

VI. Conclusion

In recent decades there is a new wave of secessionist movements across Europe. One such movement is the Basque Country's conflict with the Spanish State, known primarily for the terrorist attacks for which the ETA was responsible.

The literature review showed there is an important relationship between trade and conflict. Should the conflict aggravate, the trading relations would be partially damaged. If the exporters are rational, forward-looking and utility-maximizing, they will try to prevent future loss via diversification of their sales markets.

According to the gravity model presented in this paper, the conflict in the Basque Country seems to be associated with higher export flows to the European Union, corroborating Martin's et al. (2008) argument that international trade acts as insurance against conflict escalation. Nevertheless, this link is weak, which contrasts with my previous results for Catalonia, Scotland and Northern Ireland (for example, Coufalová [unpublished]).

Acknowledgements

This work was supported by the Masaryk University under Grant MUNI/A/1031/2018. I thank the anonymous reviewer for his valuable comments.

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