Impact of the Presence of Embassies on Trade: Evidence from Turkey

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Abstract

This paper analyzes the impact of the presence of foreign missions on trade using Turkey's unique expansion in its foreign embassy network (39 new embassies in 8 years) as the source of variation in a panel data setting. A majority of the existing empirical studies use cross-sectional bilateral trade data due to lack of variation over time (Rose, 2007; Moons and Bergeijk, 2013). Employing a panel data analysis, this paper is able to address the endogeneity issues that are associated with a standard cross-sectional analysis. The dependent variable in the paper is the trade between Turkey and 190 countries for 2006 to 2016. The results indicate that presence of an embassy increases export value by 30% and this increase comes mainly from the volume effect. Categorizing goods by the Rauch (1999) classification shows that the increase in differentiated goods exports is the main driver of the export surge. The number of exporting firms increases by about 8%. There is no statistically significant impact on the exports of homogeneous goods. Replication of the analysis for imports suggests no impact on imports.

Keywords: economic diplomacy; embassy; international trade; Turkey

1. Introduction

Growth in global import demand from developed countries has declined in recent years. The share of the EU-28 countries in global imports of goods declined from 18.4% to 14.8% between 2002 and 2016, similarly the share of the United States declined from 24.9% to 17.6% for the same period (Eurostat, 2018). Such a significant decline in the relative share of the high-income countries has encouraged exporting countries to seek new markets. However, uncertainty arising from information asymmetry is one of the major trade barriers in new destinations, most of which are developing countries. Language barriers, bureaucratic procedures, security concerns all contribute to the sunk cost a firm has to take into account when entering into a new market. Thanks to improvements in information and transportation technologies, those asymmetries across trade partners have declined over time. Nevertheless, countries still continue to increase the number of their high cost foreign missions (embassies, consulates, export promotion agencies etc.), mainly to support economic relations as well as to maintain the consular affairs or political interests (Rose, 2007). Most embassies provide direct assistance to exporters through commercial and economic officers in areas such as translating the local legal framework, export opportunities, and even arranging introductions to local business persons.

There exists only a handful of studies that directly examine the causal relationship between costly foreign missions and bilateral trade across countries. Among those, Rose (2007) is one of the most relevant to the research question in this study. He carried out a cross-sectional analysis of the annual average bilateral trade from 22 large source countries to 200 destination countries for the years 2002–2003 to investigate if there is a causal relationship between the presence of

an embassy and trade. Since the cross-sectional analysis does not control for country-pair fixed effects, he uses a wide range of control variables. He also tries to address reverse causality, employing instrumental variables that may correlate with the presence of foreign missions, including oil reserve capacity and the desirability index of destination country. The validity of these instruments is questionable, as they are likely to be correlated with trade volume as well, but Rose concludes that embassy effect on exports is positive and statistically significant with a magnitude ranging between 6% and 10%.

Segura-Cayuela and Vilarrubia (2008) also investigate the trade impact of foreign missions through a cross-sectional bilateral trade analysis, following a similar method to Rose (2007). However, the authors focus on the source of the impact by considering the extensive and intensive margins of the causal effect. They find that the presence of a foreign service increases exports by around 11–18% and that this increase originates from the formation of trade links (extensive margin).

Afman and Maurel (2010) perform panel data analysis using new foreign mission openings in Eastern Europe after the dissolution of the Soviet Block. They specifically focus on the pair-wise trade between 26 OECD countries and 30 transition countries for three observation years 1995, 2000, and 2005, excluding within-group trade. The resulting impact is positive and high in magnitude (a new mission increases trade by around 40%); however, its statistical significance disappears when controlling for country pair and time fixed effects. Extracting causal interpretations from this analysis is not trivial since there are many other factors that may directly impact the trade volume of those transition countries during the observation period 1995–2005.

Head and Ries (2010) carry out a single country analysis by investigating the impact the Canadian trade missions had on Canadian exports. The authors run panel data regressions for various treatment time spans (1–4 years). They handle reverse causality by controlling for unobserved characteristics with destination fixed effects and including the lagged dependent variable among the control variables. The study finds no statistically significant effect on Canadian exports.

Another single country analysis by Creusen and Lejour (2013) looks at the determinants of the entry decision of new exporter firms using the international trade transactions of Dutch firms between 2002 and 2008. They find a stronger effect such that the presence of foreign missions stimulates both the entry decision and volume of trade by 5–20%. In line with the literature on the role of experimentation in exporting (e.g., Albornoz et al., 2012), the adjustment process revealed by the data confirms that some firms exit after the first trial, while those who find staying in the new market profitable increase their trade volume over time.

Finally, a meta-analysis by Moons and Bergeijk (2013) compares 32 empirical studies on the impact of economic diplomacy on trade and investment, including embassies, consulates and other diplomatic facilities, investment and export promotion offices, trade and state visits. They conclude that primary studies conducted on a single country basis (panel data of a single country) will in general show a lower significance of the coefficient of interest and studies tend to generate more significant results when the dependent variable is exports rather than imports or foreign direct investment.

The majority of the above-mentioned empirical studies use cross-sectional bilateral trade data due to lack of variation overtime. However, unless a valid instrumental variable approach is employed, cross-sectional analysis is subject to simultaneity bias because of the reverse causality between the size of trade and presence of foreign missions. The case of Turkey, in this sense, is unique as it allows for panel data analysis thanks to significant variation in its foreign embassy network over a relatively short time period. Furthermore, research of the literature indicates that there are no studies that investigate the impact of foreign missions from an emerging country perspective. The example of Turkey may provide an insight for other developing countries that need to allocate their already limited resources efficiently across various policy options.

Turkey has made a significant change in its foreign policy objectives since the beginning of the twenty-first century. The main goal of this change was to develop a multi-dimensional and more proactive foreign policy, which in part led to the expansion of relations with long-time neglected Sub-Saharan Africa, Latin America, and the Asia-Pacific regions. Accordingly, Turkey declared 2005 as the 'Year of Africa' and prepared a strategic plan drafting an opening policy towards Africa. Likewise, the year 2006 was declared as the 'Year of Latin America and the Caribbean', and in line with these developments, Turkey also put into effect, in recent years, policies targeting the Asia-Pacific region. As a result of these expansion policies, Turkey opened 39 new foreign embassies in the aforementioned regions between 2008 and 2015. Table 1 shows the list of those countries and the year of embassy opening.

The purpose of this paper is to estimate whether Turkey gained positive returns in terms of export opportunities by answering the following questions: Does the existence of an embassy impact exports to (imports from) that country? Does this effect vary across differentiated versus non-differentiated products? If there is an impact on exports (imports), what are the roles of the extensive margin (number of export varieties based on the 6-digit HS 2002 classification) and intensive margin (volume effect)? And, finally, does the number of exporting firms increase?

The estimation is performed in a panel difference-in-differences setting by introducing the presence of an embassy as a control variable to the standard gravity equation. A country-specific time trend is also added as a control variable in order to deal with the possible pre-existing export (import) growth trends. The estimation results suggest that the presence of an embassy increases exports to that country by 30% while having no material impact on imports. The increase in exports is driven mainly by the exports of differentiated goods and is largely due to the volume effect (intensive margin). Finally, the number of exporting firms rises by almost 8%. The results are robust to various modifications in the baseline specification and sample size.

2. Empirical Strategy

A panel data difference-in-differences estimation method is employed to estimate the trade outcomes. Following is the estimating equation for embassy impact:

$$\ln Y_{it} = \alpha E_{it} + \beta W_{it} + \rho_i I_i T + \gamma_t + \mu_i + + \varepsilon_{it} \tag{1}$$

where $\ln Y_{it}$ is the natural logarithm of the consumer price index (CPI) adjusted export (import) value or the number of export varieties, based on the 6-digit HS 2002 classification, from Turkey to country i at time t, E_{it} is the indicator of the presence of a Turkish embassy in the partner country i at time t, W_{it} is a vector of the constant term and time variant explanatory variables, including the natural logarithm of CPI adjusted gross domestic product (GDP), an indicator of a state visit to country i from the Turkish Government at the President level, the presence of a Turkish development agency, and the existence of a direct flight from Turkey to country i.[1] ρ_i's indicates the effects of the country-specific time trend ($I_i T$), γ_t and μ_i are time and country fixed effects, and ϵ_{it} is the unobserved error term. The key parameter is α, which represents the percentage change in the outcome variable due to presence of an embassy.

The main issue that arises in such settings is the reverse causality between exports and the opening of an embassy in a country. If an embassy is opened because of a pre-existing export growth trend, the estimated embassy coefficient will be upward-biased. This should be less of a concern in the case of Turkey because opening of 39 new embassies in just a few years was in large related to a new foreign policy targeting the countries in Sub-Saharan Africa, Latin

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[1] Time variant variables such as corruption, political stability, and education indices are included in robustness checks as well. Since those indicators are not available for a sizeable share of the countries in the sample, they are not included in the preferred specification.

Table 1. List of the countries with new embassies by opening year

2008	2009	2010	2011	2012	2013	2014	2015
Montenegro	Ivory Coast	Angola	Gambia	Burkina Faso	Brunei Dar.	Benin	Guatemala
	Malta	Cameroon	Mauritania	Chad	Cambodia	Botswana	
	Tanzania	Colombia	Mozambique	Djibouti	Dominic. Rep.	Congo	
		Ghana	Somalia	Ecuador	Eritrea	Costa Rica	
		Madagascar	Zambia	Gabon	Panama	Rwanda	
		Mali	Zimbabwe	Guinea			
		Peru		Myanmar			
		Uganda		Namibia			
				Niger			
				Sri Lanka			

America, and Asia-Pacific regions as discussed in the introduction. However, I carried out the following exercise to check if reverse causality exists. I regressed the natural logarithm of exports on a set of dummies corresponding to +1, +2, +3, +4 ,+5 years since the opening and –1, –2, –3, –4, –5 years before the opening of an embassy together with country fixed effects and GDP. The goal of this exercise was to see if export growth after the opening of the new embassies represented a significant departure from the pre-existing trends. Figure 1 shows the coefficients and confidence intervals for the before and after dummies. The departure from the pre-existing level after embassy opening is visually evident. All dummies representing the years after embassy opening are positive and statically significant, whereas the dummies representing the years before
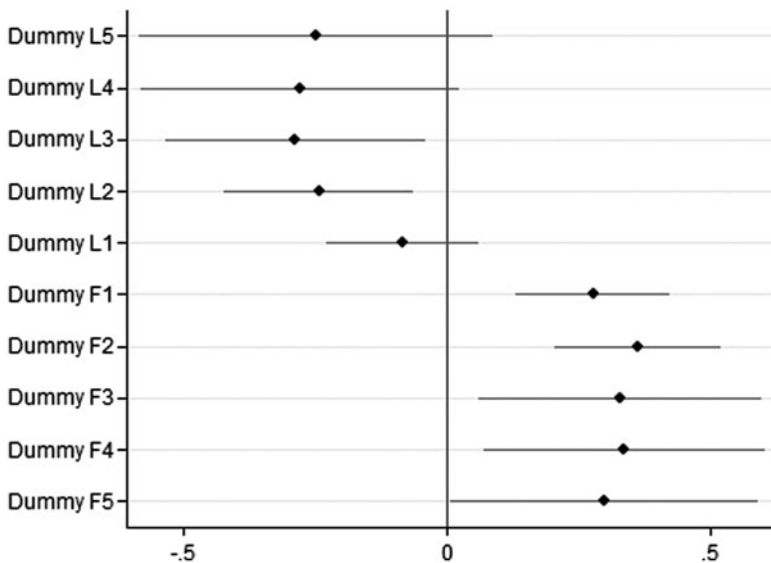

Figure 1. Before and after analysis of the embassy impact
Notes: Coefficients and confidence intervals of before (L) and after (F) dummies that indicate the time before or after an embassy is opened. The coefficients are retrieved from a regression in which the log exports are regressed on these dummies, the log GDP, the time dummies, and the country dummies.

embassy opening are negative. This clear shift in level suggests that reverse causality is not likely to impact our estimates. Nevertheless, much of the robustness analysis below will focus on whether reverse causality exists.

2.1 Data and Summary Statistics

The export and import data at the 6 digit and country levels are obtained from the Turkish Statistical Institute (Turkstat). The number of exporting firms by country is retrieved from the Entrepreneurship Information System of the Ministry of Industry and Technology. The export and import data are further categorized as homogenous goods and differentiated goods using the 2007 version of Rauch (1999) classification of goods. Annual GDP values are obtained from the UNstats database (United Nations Statistics Division, 2018). Country specific development indices are gathered from the World Bank World Development Indicator (World Bank, 2018). Historical data on the presence of embassies and consulates and information on the regulatory process were obtained from the Prime Minister's Office in Turkey. Information on the other types of foreign diplomacy institutions was collected from the annual reports of the related organizations.

Table 2 presents the summary statistics of various outcome and control variables for the treatment and control countries before and after the treatment period. A country is defined as a treatment country if a new Turkish embassy was opened during the observation period. The remaining countries are considered as the control group but divided into two sub-groups. The first consists of countries that never had a Turkish embassy and the second group consists of countries that already had an embassy before 2008.

Descriptive evidence from the simple log mean comparison in Table 2 suggests that the exports to the treatment countries increased more than the exports to the control countries between 2008 and 2016. Divergence is larger between the treatment countries and the countries that never had a Turkish embassy. Also, the differential increase in the exports of differentiated goods and in the number of export varieties (extensive margin) is greater, which is expected since the associated information asymmetry is greater for those types of goods. However, descriptive evidence also indicates a differential increase in the GDP of the treatment countries relative to the GDP of control

Table 2. Summary statistics

VARIABLES	Treatment countries (N = 38)			Never had an embassy (N = 62)			Had embassy before 2008 (N = 90)		
	2008	2016	Change	2008	2016	Change	2008	2016	Change
Log exports	21.52	21.63	**0.11**	20.91	20.96	**0.05**	25.53	25.62	**0.10**
Log exports (differentiated)	21.18	21.25	**0.08**	20.67	20.52	**−0.14**	25.14	25.25	**0.11**
Log exports (non-dif)	20.29	20.47	**0.18**	19.36	19.91	**0.55**	24.38	24.44	**0.06**
Log variety	9.25	10.13	**0.88**	8.75	9.40	**0.65**	11.98	12.12	**0.14**
Log variety (differentiated)	9.10	9.98	**0.88**	8.60	9.24	**0.64**	11.73	11.85	**0.12**
Log variety (non-dif)	7.23	8.17	**0.94**	6.76	7.47	**0.71**	10.49	10.69	**0.19**
Log number of firms	8.44	9.43	**0.99**	8.10	8.86	**0.76**	12.06	12.50	**0.44**
Log GDP	27.63	27.99	**0.36**	27.26	27.59	**0.33**	31.73	31.90	**0.17**
Development agency (sum)	0	6	**6**	0	0	**0**	14	23	**9**

countries. Thus, a causal relationship between the mentioned trade outcomes and the presence of embassies can only be argued after controlling for other time-varying factors that may also impact the outcomes, such as GDP, presence of direct international flights, and state visits.

3. Results

3.1 Export Results

Table 3 shows the baseline regression results from the specification in equation (1). The first column presents the estimation result of a Poisson maximum likelihood estimation when the level of exports is regressed on the natural logarithm of GDP and the embassy, time, and country dummies. The dependent variable is the natural logarithm of exports and the estimations are from ordinary least square specifications. Each column differs in terms of the set of control variables. The lagged dependent variable in column (3), region specific trends in column (4), country specific time trends in column (5), time varying foreign diplomacy measures other than the embassies in column (6), and finally time varying country development indices such as political stability in column (7) are introduced as additional control variables. The embassy effect is stable and statistically significant across all specifications. Column (7) represents the richest set of control variables but the sample size drops substantially since the development indices are not available for some countries. Coefficients on the development indicators are all not statistically significant probably because these indicators are reflected in GDP values. Therefore, the column (6) is preferred as the baseline specification in order to keep the sample size large as much as possible. The coefficient of interest in the preferred specification is statistically significant at the 5% level, which implies that the presence of an embassy in the partner country increases exports to that country by almost 30%. Other foreign diplomacy factors are all statistically insignificant.

Table 4 presents the regression results of the preferred specification (column 6 of Table 3) when exports are categorized as differentiated versus homogenous goods according to the Rauch (1999) classification. The outcome variables in the first three rows are the natural logarithm of all exports, differentiated exports, and homogenous exports, respectively. Regression results show that the impact of embassy opening is statistically significant for differentiated goods exports and the magnitude of impact is larger than the impact on overall exports. On the other hand, there seems to be no statistically significant impact on homogenous goods exports. This is consistent with the fact that the information asymmetry associated with differentiated goods is greater than that for homogenous goods.

In the next three rows, I carried out a simple decomposition exercise to investigate if the change in exports originated from the variety effect (extensive margin) or the volume effect (intensive margin). Rows 4–6 in Table 4 show the results of regressions when the dependent variable is replaced with the total number of export varieties based on the 6-digit HS 2002 classification, which will give the share of the extensive margin in the overall export surge.[2] The results indicate that the presence of an embassy has a statistically significant impact on export varieties with a magnitude of 9.9%. This implies that approximately one-third of the embassy impact on total export value is due to the extensive margin and the rest is due to volume effect. The extensive margin share of differentiated goods exports is in line with

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[2]Let $X = \sum_{i}^{n} v_i$, where X is the total export value and v_i is the export value (price*quantity) of variety i. We can rewrite the export equation as: $X = \bar{v}n$ where $\bar{v}$ is the average export value and n is the number of export varieties. Taking the natural logarithm of both sides, we get: $\log(X) = \log(\bar{v}) + \log(n)$. Differentiating both sides and assuming no change in export prices, we finally obtain: $\frac{\Delta X}{X} = \frac{\Delta \bar{v}}{\bar{v}} + \frac{\Delta n}{n}$. Hence, the percentage change in total export value will be sum of the percentage change in average export volume and percentage change in total number of export varieties. Note that in this decomposition the number of firms exporting a good already exported is included in the volume effect (intensive margin).

Table 3. Embassy impact on the log of total exports

VARIABLES	(1) Exports	(2) Log exports	(3) Log exports	(4) Log exports	(5) Log exports	(6) Log exports	(7) Log exports
Embassy dummy	0.242* (0.137)	0.482*** (0.123)	0.290*** (0.085)	0.368*** (0.115)	0.273*** (0.103)	0.269** (0.104)	0.253** (0.115)
Log GDP	0.858*** (0.100)	0.817*** (0.194)	0.476*** (0.128)	0.615*** (0.224)	0.740*** (0.141)	0.739*** (0.140)	0.706*** (0.197)
Dependent variable, lag 1			0.369*** (0.053)				
Direct flight						0.030 (0.070)	0.099 (0.083)
State visits by President						−0.011 (0.032)	−0.005 (0.044)
Development agency						−0.021 (0.116)	−0.251 (0.196)
Primary school com. rate							0.003 (0.005)
Political stability index							−0.009 (0.104)
Corruption index							0.317 (0.221)
Constant	−3.072 (2.345)	−3.392 (3.683)	−1.204 (2.429)	−63.936*** (21.150)	−238.585*** (5.537)	−238.053*** (6.220)	−208.444*** (49.658)
Observations	2,240	2,090	1,900	2,090	2,090	2,090	1,313
R-squared	0.973	0.314	0.369	0.361	0.561	0.561	0.589
Number of id	204	190	190	190	190	190	164
Country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Region Sp. Time Trend				Yes			
Country Sp. Time Trend						Yes	Yes	Yes

Notes: Clustered standard errors by country in parenthesis *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. Column (1) presents estimates from a Poisson pseudo-maximum Likelihood estimation whereas the rest of the columns are from OLS estimations. All variables are annual aggregates between 2006 and 2016. Countries receiving small Turkish exports that are small (less than a thousand dollar annually) are dropped from the sample in OLS estimates. All monetary variables are deflated using US Consumer Price Index. The sixth column is the preferred specification.

the total exports as shown in row (6). However, the variety effect dominates in homogenous goods exports even though the impact on value of total homogenous goods exports is not statistically significant. This suggests that opening an embassy helps homogenous goods exports by introducing new varieties even if the associated information asymmetry is lower for those goods.

Finally, row (7) in Table 4 shows the estimated coefficient when the number of exporting firms is regressed on the same set of variables. The coefficient implies that the presence of an embassy in the partner country increases the number of exporting firms to that country by almost 8%. This result can be interpreted such that the larger the role of the intensive margin in explaining the embassy impact is partly because of the increase in the number of entrant firms.

Table 4. Decomposition of the embassy impact

DEPENDENT VARIABLE	Embassy impact
(1) Log of total exports	0.269** (0.104)
(2) Log of total differentiated exports	0.310*** (0.116)
(3) Log of total homogenous exports	0.142 (0.210)
(4) Log of the total variety of exports	0.099** (0.040)
(5) Log of the total variety of differentiated exp.	0.094** (0.040)
(6) Log of the total variety of homogenous exp.	0.146** (0.065)
(7) Log of the number of exporting firms	0.078** (0.031)

Notes: Clustered standard errors by country in parenthesis *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. All regressions are run on the same set of control variables from the preferred specification in Table 3 column (6). The total amount of variety represents the total number of export industries at 6 digit HS2002 classification by partner country

3.2 Robustness Checks

Table 5 represents the results of various robustness checks when the observation period and the sample of countries used in the regressions are reorganized. The goal in undertaking this exercise was to check whether the result was driven by a particular year or group of countries. The first row is the original model. The second and third rows show estimates when the observation period was extended or shortened. Rows (4) through (7) represent results when the high-income countries, countries with very small population, countries that had an embassy prior to 2008, and countries that never had an embassy as of 2015 are dropped from the original sample, respectively. In all specifications, the results are robust to the original model in terms of the sign and significance level but the magnitude changes slightly.

I further run a placebo test by changing the observation period from 2006–2016 to 2000–2010 while keeping the treatment variable (embassy dummy) the same, meaning that the embassy dummy at year t for this exercise reflects the presence of an embassy at year t + 6. The results are all statistically insignificant both for extensive and intensive margins.

3.3 Import Results

A new Turkish embassy may help to reduce the information asymmetry not only for Turkish exporters but also for importers and exporters from the partner country. In addition, 28 countries out of 38 countries with a new Turkish embassy did also open their embassies in Turkey simultaneously or in the following years due to reciprocity. Table 6 represents the results when the imports by Turkey are regressed on the same set of control variables in the preferred specification in export estimation (column 6 in Table 3). The sign of the embassy coefficient is positive but not statistically significant. This is probably due to the fact that most of the countries with new embassies are small and low income countries, the exports of which are mainly composed of homogenous goods that are less prone to information asymmetry. Indeed, when homogenous goods imports are the outcome variable (column 3), the coefficient becomes significantly larger and the *t*-value improves but not enough

Table 5. Robustness checks for the overall embassy impact

SAMPLE	Embassy impact
(1) Original model: all countries, 2006–2016	0.269** (0.104)
(2) Longer period: 2005–2016	0.240** (0.104)
(3) Shorter period: 2007–2016	0.255** (0.104)
(4) High-income countries (>$75,000 per capita) excluded	0.259** (0.108)
(5) Small countries excluded (<0.5 mil. population)	0.243** (0.110)
(6) Only countries with no embassy as of 2006	0.252** (0.103)
(7) Only countries that currently have an embassy	0.280** (0.108)

Notes: Clustered standard errors by country in parenthesis *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. Each row represents a regression that differ only in sample. All regressions are run on the same set of control variables from the preferred specification in the Table 3, column (6).

Table 6. Embassy impact on imports

	Total import value			Total number of import varieties		
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	All	Differentiated	Homogenous	All	Differentiated	Homogenous
Embassy	0.2533 (0.1944)	−0.2828 (0.3608)	0.5815 (0.3693)	−0.0626 (0.0734)	−0.1590 (0.1098)	0.0978 (0.0595)
Observations	1,738	1,738	1,738	1,738	1,738	1,738
R-squared	0.391	0.337	0.319	0.438	0.374	0.406
Number of id	158	158	158	158	158	158
Country FE	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes
Country spec. TT	Yes	Yes	Yes	Yes	Yes	Yes

Notes: Clustered standard errors by country in parenthesis *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. All regressions are run on the same set of control variables from the preferred specification in the Table 3, column (6).

to make the coefficient statistically significant at the 10% level. Controlling for reciprocal embassy opening does not alter the results.

4. Conclusion

This study analyzes the impact of the presence of embassies on trade outcomes by exploiting the significant variation in Turkey's foreign mission network between 2008 and 2015. Departing from the existing studies, this study employs a panel difference-in-differences strategy that exploits the size of the variation over a short time period. After controlling for country-specific time trends

and standard gravity covariates, I found that the presence of an embassy increases exports by 30% and has no statistically significant impact on imports. The increase in the level of exports comes from differentiated goods exports and is largely explained by the volume (intensive margin) effect. The extensive margin (export varieties) channel explains only one-third of the rise in exports. The greater role of the intensive margin in explaining embassy impact is partly due to the increase in new entrant firms.

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