

## Economic Interdependence: a Path to Peace or a Source of Conflict

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*Abstract: as economic interdependence between China and its neighboring countries continue to deepen, which has brought some changes to their political interactions. Liberalism argues that economic interdependence is a power to promote peace, while realism sees it as the root cause of a conflict. This paper, having collected panel data for years 1981-2007 between China and its 17 neighboring countries, found in the research that variables such as relative comprehensive strength, and institutional participation level are under control, economic interdependence between countries indeed significantly enhances the political relations. With the increasing importance of economic factors, China and its neighboring countries have strengthened economic exchanges, deepening interdependence continuously, and forming a community of shared destiny. In this case, the two sides strive to avoid conflict, and prefer to cooperate as a means to seek more economic benefits. Besides, the results of the analysis and the effects of controlling variables on bilateral relations can also serve a certain reference to China's diplomatic strategy.*

### I. Introduction

The relationship between China and its neighboring countries is always an important part of China's international relations. China's unique geographical environment has created a large number of its neighbors, and to maintain a good international relations with neighboring countries is an important prerequisite for China to rise. In the past more than 60 years, there are quite a few conflicts and frictions between China and its neighboring countries, but the overall good relationship between them shows a upward trend.

We note that, while China's relations with neighboring countries is gradually warming up, an obvious fact is that China's economy has witnessed a 30-year sustained rapid growth, and its trade with neighboring countries gradually increased, which indicates that the Chinese economic cooperation with neighboring countries continuously deepens, thus having formed a certain degree of economic interdependence. Then, whether there is some kind of logical relationship between the warming relationship between the states and

the deepening economic cooperation between the states. Liberalism argues that the deeper the economic interdependence between countries is, the more peace can be promoted. Whether the main driving force behind China's improved surrounding environment is due to the deepening of economic interdependence, this is the question this paper needs to think about, but also the process of examining the economic interdependence theory.

China is the largest country in Asia, but also has the largest number of neighboring countries in the world, surrounded by various religious, ethnic and cultural diversity and complexity, and these diversity and complexity are undoubtedly a good sample for the study of international relations. Just as Yahuda has also called on the international theoretical circle to take into account China's experience in order to improve the quality of international relations theories.<sup>1</sup> This paper was tracking the changing process between economic interdependence and political relations for China with its neighboring countries during the years 1981-2007,<sup>2</sup> and discussing ties

between economic interdependence and political relations for China with its neighboring countries, trying to provide a footnote for economic interdependence theory.

## II. Literature review

Does the economic interdependence promote peace or create conflict? When two countries have economic interdependence, whether they restrain themselves the impulse to use force to each other, or behave themselves to reduce the frictions, over the centuries, this interesting proposition has been fascinating thinkers and scholars, but unfortunately, has been inconclusive.

The discussion and research on this topic has experienced three peaks, i.e. before World War I, in the late 1960s to early 1970s after World War II, and after the 1980s. The study of interdependence before WWI was full of optimism, represented by Angell's "The Great Illusion". The second peak of research on economic interdependence emerged under the influence of the European integration and some important events in the 1970s in international economic field, represented by "Power and Interdependence" of Keohane and Nye. The first two stages of research mainly focused on the normative and theoretical analysis. After the 1980s, influenced by the behavioral revolution, the research began to focus on the empirical analysis, and have made a lot of achievements, represented by Polachek, Russertt and Rosecrance.<sup>3</sup>

The main viewpoints formed in the previous studies are as follows: economic interdependence promotes peace; economic interdependence increases conflict; economic interdependence may reduce or increase conflict; economic interdependence is irrelevant to political relations.\

### ***(A) Economic interdependence promotes peace***

The representative of this view point is liberalism, whose logical premise is that the core of economic interdependence between countries is the transaction link. It is the fear of breaking the bond and the loss of trade interests that neither side is willing to wage war. When the two countries economic exchanges ensure

more efficient allocation of resources, and increase wealth, outbreak of a conflict will be disastrous,<sup>4</sup> so Polachek in his article "Conflict and Trade" for the first time put forward the concept of the cost of war in 1980.<sup>5</sup> With the deepening of national economic exchanges between countries, the economic structure of specialization is formed, so a conflict will not only interrupt economic exchanges but makes both sides adjust their existing economic structure in the process of search for new markets or raw materials,<sup>6</sup> thus, increasing the cost of a conflict. So, Keohane and Nye point out when the two countries are in perplexing interdependence, which result in diverse interests overlap between them, as they rise and fall or lose and win together, it is very unwise to use force to resolve a dispute.<sup>7</sup> On the one hand, the closer the economic links between two countries, the more frequent the information exchange will be, which also reduces the possibility of conflict and war due to the asymmetry information. On the other hand, between two countries with close economic ties, a credible threat signal may also be produced, so any party may through economic punishment threaten the other side as a conflict of the economic transactions emerges,<sup>8</sup> hence, it is probable that one party will consider the economic costs and not act recklessly.

Rosecrance believes that, due to various reasons, compared to war, trade is a better way to obtain profits. He also proposed in his "The Rise of the Trading State" that science and technology development and the deepening interdependence raise the economic and political costs of war, reduce the relative utility effect of occupying territory, make the cost higher and higher for gaining benefits through war, while income from the mutual trade can be faster and more effective than the achievements yielded through territorial occupation, so trade is one of the best means to replace war, countries are more willing to solve problem in peaceful and effective way.<sup>9</sup> Different with the social economy before the nineteenth Century, the use of paper money is now bestowed many wealth with mobility, so occupied countries can transmit their wealth to

other countries overnight, thus, the effectiveness of gaining profits through military conquest is greatly reduced.<sup>10</sup>

Constructivism believes that economic interdependence is a necessary condition for the formation of collective identity, and the formation of collective identity is a necessary condition to achieve peace. Economic interdependence promotes mutual exchanges, in which process the original identity of the parties is weakened and every one learns to look at itself with the opposite view, but also changes the definition of self identity. Before anybody's any discussion about behavior, common reproduction of interdependence and a group consciousness constructed by interdependence is possible, once a significant pair is in existence, a possible formation of collective identity in the system may also exist.<sup>11</sup> Therefore, economic interdependence is likely to generate a group awareness through constructing mutual identity, thereby promoting peace between nations.

***(B) Economic interdependence increases conflict***

Contrary to liberalism, realism claims that a high level of interdependence would increase rather than decrease the likelihood of war. This view comes with Morgenthau and Waltz.<sup>12</sup> Waltz's view represents the view of realism, high interdependence means strong connection, which increases the chance of accidental conflict.... Relations among interdependent countries not yet standardized is bound to bring conflict or even war. If interdependence develops faster than the central government can control, then, interdependence increases the likelihood of war.<sup>13</sup>

In the view of realism, the essence of international politics is the international anarchy, the impact of this anarchism on state is fundamental, so mutual interdependence should be understood as the fragility of state, interdependence is the fragile mutual relationship, any party in this relationship needs to pay great price if breaking the situation status. Moreover, the cost of distribution is usually unequal, which naturally forms a dependency relationship. Now that there is a dependency relationship, it also produces

power. So Hirschman believes that there is phenomenon of abuse of power in the asymmetry dependence relations, which will have a negative impact on the relationship between states. As the interdependence between countries is asymmetry, especially the structural asymmetry, dependent states worry about their internal and external policies affected by effect of this asymmetry superiority, therefore, not hesitate to use military means to eliminate this effect in order to protect the freedom and independence of the country.<sup>14</sup> Nye also believes that the asymmetry is the core of interdependence politics, whoever has less dependence has the power.<sup>15</sup> So Barbieri views that trade can indeed increase wealth from cooperation and promoting peace, but this so-called peace promotion can only be effective under the circumstances of trade symmetry,<sup>16</sup> Realism argues that in the international society of anarchism, a state is always worried about others economic strength to be converted into military strength, and to threaten its own safety, thus hiding the root cause for military conflict.<sup>17</sup>

***(C) Other points of view***

As a balance or convergence between Neo-liberalism and Neo-realism, Copeland introduces a new independent variable --- the future trade expectation, which he argues is the variable to decide peace or war. He holds that the current level of trade is low, and the future level is expected to be high, so the economic interdependence will promote peace, but on the contrary will increase conflict.<sup>18</sup> Other scholars, in study of the issue, always attach some premises, for example, Hegre, taking the level of development of a country as the premise, argues that the economic interdependence between developed countries is more likely to promote peace.<sup>19</sup> Some others take democracy as the conditions, and argue that the economic interdependence between democratic countries can promote peace while the economic interdependence between undemocratic countries increase conflict.<sup>20</sup> Still others combine democracy, economic interdependence and international organizations together, and argue that these three actors can independently promote

international order and can interact with each other to promote international peace.<sup>21</sup>

There is also a view arguing that the level of economic interdependence is not directly related to conflict, because these two relations are produced by different causes. The political relationship is the result of political and military considerations, and the driving force behind the economic interdependence is the market and the society. The pursuit of national security is the first priority, as the national sovereignty is invaded or national security threatened, the country will not hesitate to interrupt trade.<sup>22</sup> Study by Barbieri and Levy found that trade and conflict are not significantly related, even trade between two countries in conflict is still very close, they called it sleeping with enemy.<sup>23</sup> Therefore, close economic ties does not mean conflict can be restrained.

To sum up, whether trade and economic interdependence are conducive to peace, or are not related to each other, on which scholars always have different views. Normative and theoretical analysts cannot reach a consensus, empirical positivist research is not conclusive either. After the Second World War, especially after the Cold War, the world has witnessed for decades general peace, during which almost no serious military conflict emerged, meanwhile, the weight of economic factors in international affairs is on the rise, and economic development is not only the fundamental principle for the developing countries, but also for the developed countries. This article believes that there is a strong internal link between this unprecedented economic interdependence and the long-term peace and welfare.

This paper takes China and its neighboring countries as the research object, and discusses the interaction between economic interdependence and bilateral relations for China and its neighboring countries from the perspective of empirical analysis. Reuveny and Kang pointed out that for the quantitative research in the area of economic interdependence, selection of states should be based on the following two criteria: one is the availability of data. Two is the choice of large

countries or bordering countries.<sup>24</sup> China's neighboring countries include big countries, small countries, land neighbors, maritime neighbors, developed countries, developing countries. This diversity should be a good sample for the study of interdependence theory. But in addition to Masterson's research in the field,<sup>25</sup> there is no one showing any interest. Masterson's research includes 1987-2001 period after the Cold War, because he referred to the Goldstein method of measurement,<sup>26</sup> which method cannot well reflect whether the bilateral relations is friendly or hostile, therefore, Masterson's measurement methodology for national relationship is one-sided. For example, at some point two countries have neither cooperation nor conflict, the Goldstein method gives it a zero value, which indicates that the bilateral relationship between the two countries is neither hostile nor friendly. But the fact is not the case, because the state of the relations between the two countries is still under the influence of the previous "stream of events". The panel data during the years 1987-2001 Masterson's selected is not parallel, and the 10 countries selected involve in different periods of years, so it is difficult to capture the law of change. His feedback evaluation method uses the mixed effect model, which is possible for errors to exist in estimation as well.

### III. Measurement models and data description

With the political relations as explanatory variables, and the degree of economic interdependence as the core variables, the paper examines whether the economic interdependence between China and its neighboring countries conforms to liberal hypothesis. To select the control variables according to the previous experience and related theories,<sup>27</sup> this paper chooses the neighboring countries democracy index, relatively comprehensive national strength, military spending, and institutional participation as variables.

#### *(A) description and operation of variables* *(1) bilateral political relations*

It is rather challenging to study economic interdependence theory and take measurement of bilateral relations. Most scholars start with the variables of conflict, and observe the relationship with the economic interdependence, but conflict itself can be strong or weak, and there is a continuous spectrum between the minimum conflict and maximum conflict. As far as bilateral relations is concerned, a statement unfavorable to bilateral relations or outbreak of a large scale war can be both regarded as a conflict. Because of this uncertainty, there is no uniform approach in measurement, international data banks of conflict have different standards in selecting conflicts, researchers in their work usually use different database in line with their own judgment.

Polachek uses the data in Conflict and Peace Data Bank (COPDAB), processing conflicts as continuous variables. He assumed that the more the bilateral trade exchanges become, the better the bilateral relations, the less the conflict incidents. Based on this assumption, he defines a variable of “net conflict”, i.e. the conflict score is subtracted from the cooperation score between two countries. The less the “net conflict” is, the better the relationship is; and on the contrary the more hostile is, the worse the relationship is.<sup>28</sup>

Barbieri defines conflict as military warning, military deployment or real act of war occurring between two or more countries. Her definition corresponds to the data she uses in the Militarized Interstate Disputes (MIDs), in particular years, the conflict between two countries is recorded 1, or 0.<sup>29</sup> Oneal and Russett do research with related data and their definition on conflict is similar to that of Barbieri's.<sup>30</sup> There are some other measurement methods, but there is no unified standard, showing a distinct personality.

These above-mentioned methods are relatively rough, reflecting a positive or negative effect of economic interdependence on political relations, respectively, with the increase or decrease of the number of conflicts, but the results enjoy low credibility. Take the Logit commonly used as an example, in measurement of conflict, an outbreak of a

military conflict or not is judged as the standard, if Yes, the value is set for 1, otherwise the value is 0. According to this method, when one or more conflicts occur between a country and another in a given year, the explanatory variable value is set for 1, which cannot reflect the numbers and intensity of the conflict. In reality, the decreasing number of conflicts or 0 zero number of conflict does not necessarily mean the promotion of political relations. Distinction is only made between Yes or No, without referring to intensity of a conflict, so that this measure of political relations is not objective.

Compared with the previous measurement methods, the author believes that the measurement method of bilateral relationship applied by Yan Xuetong and his colleagues in the Institute of International Studies of Tsinghua University is more scientific and accurate. This paper, based on procedures of the method, the standard on scoring events and calculation method, measures the relationship between China and its neighboring countries. Its basic idea is the following: the quality of bilateral relations is alternately reflected by numerous events, with the passage of time these events accumulated to form a stream of events, and together with new events determine the bilateral relations, namely bilateral relations measurement should be done simultaneously in the two dimensions of accumulation of events and flow of events. The method sets the value range of the changing bilateral relationship from 9 to -9, of which -9 represents the worst bilateral relations level while 9 represents the best relationship level between two countries, and this is the two ends of the two extremes. Center is set for 0, indicating that these two countries are neither enemy nor friends. More than 0 refers to positive relationship, less than 0 to negative relationship. Between 9 and -9, there are 6 levels of division, from good to bad relations, i.e. friendly, good, ordinary, and quarrel, tension, confrontation, each level is divided into high, medium and low sublevels.<sup>31</sup> This method gives consideration from two dimensions of cooperation and conflict, which results in a continuous variables. From the perspective of statistical analysis, there is no



need to have a complete data available publicly, so long as the data is reliable. For example, to measure relationship between China and its neighbors, whose needs can be basically met with the data provided by the People's Daily and Foreign Ministry's website.<sup>32</sup> Therefore, in view of reliability and operability, the data used by the paper is mostly from the People's Daily (on CD).

### (2) *Economic interdependence*

Keohane and Nye argue that the mutual relationship is not equal to the mutual dependence, close contact does not mean high level of interdependence, because the most important difference is that the mutual relationship has no obvious exit costs, but mutual dependence means that its disconnection has obvious impact on this relationship.<sup>33</sup> In order to describe the consequences, Keohane and Nye use two words of "*sensitivity*" and "*vulnerability*" with two characteristics. *Sensitivity* refers to a direct and initial impact on the country as another country changes the bilateral relationship. And *vulnerability* refers to the ability of a country to repair and rebound in the case of loss caused by the change of policy on bilateral relationship by another country.<sup>34</sup>

Barbieri divides interdependence into two dimensions for consideration, combines the two indicators -- sensitivity and vulnerability of Keohane and Nye -- into the first dimension --- *salient*, which refers to the importance of certain trade relations against other trade relations. The second dimension is *symmetry*, which is the relative equilibrium of economic interdependence. Based on "*salient and symmetry*", Barbieri calculates the bilateral interdependence, and individual interdependence. Oneal and Russett's definition on interdependence is similar to that of Barbieri's.

Trade volume has become an important indicator for measuring interdependence, but with continuously increasing foreign direct investment (FDI), FDI is also viewed as an salient criteria. Some scholars have found in their research that FDI is related to military conflict in a negative way.<sup>35</sup> Hence, this paper also takes investment as an important

factor to measure interdependence.

### (3) *Democracy index for neighboring countries*

According to the observation of democratic peace theorists, from the angle of history, especially from the reality of contemporary international relations, democratic states rarely launch war against each other. In 1983, Doyle made a systematic discussion in a long article on democratic peace. Having looked at the 118 major wars in the world in the past 300 years, he found that the free states are involved in numerous wars with non-free states, but no war had happened between constitutionally stable free states.<sup>36</sup>

Democratic peace theorists argue that because of institutional constraints of democracy and freedom, as well as the relevant norms and cultural precepts, no war would break out between democratic nations in general. But democratic peace theorists are met with much critics domestically. This paper takes the democracy in a country as a variable affecting bilateral relations.

### (4) *China's comprehensive strength relative to the surrounding countries*

The strength gap between states is an important consideration of whether to launch an armed conflict. There are two very different conclusions about this aspect by researchers. The balance of power argues that between two countries, the closer their strength is, the easier the checks and balances situation is formed, the more probable to avoid the outbreak of conflict. While hegemonic stability believes that the bigger the strength gap is between two countries, the more conducive to avoid the outbreak of conflict. Based on this, this paper puts China's comprehensive strength relative to its surrounding countries as a variable of a model (relative comprehensive strength).

Regarding the evaluation score of the comprehensive strength of each country, this paper uses the Composite Index of National Capability Score (CINC) of the national hard power in The Correlates of War Project (COW). Here, using in the given years China's comprehensive strength score divided by comprehensive strength score of each neighboring country in order to reflect the

strength of China relative to neighboring countries in the corresponding years.

*(5) Military spending by neighboring countries*

Military spending is a control variable that must be taken into account, and high military spending may mean being in a hostile environment, under such circumstances the relationship between states is likely to deteriorate. Here using the neighbor's annual military spending proportion to GDP to measure this indicator. Annual military spending data is taken from the Stockholm International Peace Research Institute (SIPRI).

*(6) Institutional participation*

It is not difficult to understand that there are more opportunities to meet and communicate for member states of an organization or alliance, which provides a platform for peaceful settlement of disputes. Bremer's research also shows that there is less chance of a conflict between member states of the same group than with those outside the group.<sup>37</sup> If this is true, and it means that the more common organizations the neighboring countries and China join, the less likely they run into conflict with each other, and the greater the opportunity to raise their political relationship. However, some scholars believe that an international organization is not an official alliance, unable to create rigid member obligations, so they create a policy with only a very small common denominator.<sup>38</sup> This paper measures this relationship with China and the neighboring countries to jointly participate in the same organizations. The specific measurement method is: in a given year, a country joining the same organization with China scores 1 point, joining two organizations with China scores 2 points, and so on. The criteria is to join the following organizations: G20, BRICS, ASEM, APEC, ASEAN leaders meeting (10+3), China-ASEAN Summit (10+1), the East Asia Summit, the China-Japan-ROK trilateral cooperation, ASEAN Regional Forum, the Asia Cooperation Dialogue, the Greater Mekong Sub-regional Economic Cooperation, the Shanghai Cooperation Organization.

**(B) Model setting**

In order to verify whether the economic interdependence between China and its neighboring countries promotes the political relationship, this paper assumes that the economic interdependence between China and its neighboring countries promotes the upgrading of bilateral political relations.

In summary, set the linear regression model (LRM) as follows:

$$VALUE_n = INTEx_n + DEM_n + MILIn + ALLIn + CAPAn + e$$

Within the model, *i* refers to neighboring countries, *t* to years, value to scores of relations with China. *intex* includes 3 different index measuring economic interdependence: *inteGDP* refers to economics and trade interdependence, *inteTatTra* to trade interdependence, and *inteFDI* to investment interdependence. The above-mentioned equation includes 3 regression models, regression models corresponding to the 3 index are termed as model(1), model(2) and model(3). *dem* refers to democracy, *mili* to military spending, *alli* to joining organizations with China, i.e. institutional participation, *capa* to China's relative comprehensive strength and *e* to a random intercept.

**(C) The basic statistical analysis of data**

Because the data is not available or in serious deficiencies, in the process of collecting panel data, some neighboring countries such as Afghanistan, DPRKorea, Myanmar, Nepal and Bhutan are not included, this paper finally collected panel data in 1981-2007 on China and 17 neighboring countries. In order to make the data more stable, some variables take the form of natural logarithm, itself as a percentage, keeping the original data containing negative or zero variables. Logarithm is strictly monotone increasing function, does not change the causal relationship between the data. A statistical description of the variables is shown in Table 1.

**IV. Regression results and related analysis**

The above data is used in the following to empirically study the impact of economic interdependence between China and its

neighboring countries on their political relationship. We primarily make a simple screening of the models for the regression

equation. There are three kinds of models that can be considered for processing panel data, a

**Table1. Statistical description of variables**

variables	contents	Average value	standard deviation	minimum value	maximum value
<i>Value</i>	Bilateral political relations scores	5.26	3.39	-7.42	8.30
<i>inteGDP</i>	Economic interdependence (logarithmic form)	-3.882557	1.893711	-11.51293	-0.6945994
<i>inteTatTra</i>	Trade interdependence (logarithmic form)	-3.229195	1.749534	-11.51293	-0.8067139
<i>inteFDI</i>	Investment interdependence	0.000878	0.0040751	0	0.0293
<i>dem</i>	Democracy Index	1.346988	6.501585	-8	10
<i>mili</i>	Military spending percentage of the GDP	3.029033	2.887069	0.3	18
<i>alli</i>	Institutional participation	1.933735	2.117735	0	7
<i>capa</i>	Relatively comprehensive strength (logarithmic form)	3.147533	1.693059	-0.4543343	6.680681

Source: value calculated according to the event data of the People's Daily (CD); *inteGDP*, *inteTatTra*, and *inteFDI* calculated according to commodity trade statistics databank of the World Bank, the United Nations and the data of the Chinese Statistical Yearbooks; *dem* selected from the Policy IV; *mili* calculated according to the data of SIPRI and the World Bank; *alli* summarized on the basis of the Chinese Foreign Ministry website data; *capa* is calculated according to the CINC data in COW.

mixed effect model, a fixed effect model and a random effect model. The mixed effect model views the panel data as a data section, and directly uses OLS to make estimates. While the difference between the fixed effect model and the random effect model is that the latter assumes that the individual effects and the explanatory variables are unrelated to each other, regards it as a part of the error term and the model as a regression equation with the random intercept. While the fixed effect model assumes that the individual effects are related

to the explanatory variables, and they are treated as explanatory variables. In making the choice of the three models, we first make comparison in pairs, using Wald to test, thus excluding the mixed effect model. Then the fixed effect model and the random effect model remain to be selected, usually through Huasman test. When the Huasman test is significant at the 10% level, we chose the fixed effect model. Huasman test results show that Huasman tests by the models (1) (2) (3) are significant at the 5% level, so here only report



the results of the fixed effect model. See Table 2

From the results of Table 2, the core explanatory variables of the models (1) (2) - *inteGDP* and *inteTatTra* - respectively are significant at the 1% level, and the coefficient is positive. While the core explanatory variables of the model (3) fails the test of significance. Models (1) (2) seem to give us a signal that economic interdependence can promote the upgrading of bilateral relations. However, we cannot simply accept this conclusion before considering endogeneity. In theory, economic interdependence has very high endogenous expectation in the bilateral political relations equation,<sup>39</sup> because

bilateral relations and economic interdependence are likely to interact with each other, and generate reciprocal causality. For example, as the bilateral relations are on fast rise, it is very likely to promote bilateral trade, thereby affecting the degree of interdependence between the two sides. On the contrary, as the economic interdependence becomes stronger, it is possible to force two sides to avoid deterioration of relations. In the study of economic interdependence and conflict, some scholars take economic interdependence as independent variables, some take conflict as independent variables, so there is reason to question whether the *inteGDP*, *inteTatTra* and *inteFDI* are endogenous variables.

**Table 2. Results of the fixed effect model**

Explanatory variables	Model(1)	Model(2)	Model(3)
economic interdependence	0.575*** (8.41)		
trade interdependence		0.582*** (8.77)	
investment interdependence			31.51 (0.83)
democracy index	0.0412* (0.08)	0.0393 (1.93)	0.00739 (0.27)
relative comprehensive strength	2.624*** (6.14)	2.250*** (5.29)	1.996*** (4.79)
military spending percentage of GDP	0.428*** (7.87)	0.414*** (7.63)	0.0439 (0.49)
institutional participation	0.251** (4.11)	0.324*** (5.57)	0.513*** (6.55)
CONS	4.311** (3.09)	4.240** (3.07)	1.385 (0.21)
N	411	411	411
Adj-R2	0.8541	0.8561	0.7861

Note: (1)\*\*\*, \*\* and \* indicating relatively significance at 1%, 5% and 10% levels.

(2) t value in brackets

Data source: estimate results of the table 1 done by a calculation software.

Determining whether there is endogeneity can be tested by Davidson-MacKinnon method. The original hypothesis of the Davidson-MacKinnon test method is that if there is no endogeneity, the two estimation results are in unity whether to use the OLS evaluation or the instrumental variable method. As this paper uses this method to test, all the three models reject the original assumption at

the 5% level, indicating that endogeneity exists within the models. The elimination of endogeneity is to find an instrumental variable highly related to the endogenous variables but irrelevant to interference term. Because it is difficult to find the instrumental variable that meet these requirements outside of the models, so one of the methods is to push the endogenous variables to be delayed one or

several periods as the instrumental variables. This paper takes *inteGDP*, *inteTatTra* and *inteFDI* to be delayed one phase or two phases

as their instrumental variables to be evaluated. Table 3 is the results of estimation.

**Table 3. Results of IV estimation**

Explanatory variables	Model(1)	Model(2)	Model(3)
Economics and trade interdependence	0.745*** (9.48)		
trade interdependence		0.798*** (9.94)	
investment interdependence			43.09 (1.01)
democracy index	0.0486* (2.73)	0.0500* (2.43)	0.00778 (0.29)
relative comprehensive strength	2.479*** (5.31)	1.998*** (4.25)	1.682** (2.70)
military spending percentage of GDP	0.435*** (7.39)	0.421*** (7.11)	0.0683 (0.71)
institutional participation	0.164* (2.55)	0.242*** (4.09)	0.546*** (5.54)
CONS	6.469*** (4.26)	6.641*** (4.35)	3.161 (1.70)
N	377	377	377
Anderson LR-p value	0.0000	0.0000	0.0001
Sargan test-p value	0.2242	0.1663	0.1127

Note: \*\*\*, \*\*, and \* are significant shown respectively at 1%, 5%, and 10% levels. *t* in brackets is the value.

Data sources; estimation results based on table 1 variables calculated by a measurement software.

In order to test whether the instrumental variable is reasonable, here we do the test of *over identification and under identification*. In terms of applying the tests by Anderson LR and Sargan, the variables selected in this paper are reasonable, there is no problem of *over identification and under identification*.<sup>40</sup>

The regression results of instrumental variables method show that after the endogenous remission, the models (1) *inteGDP* and (2) *inteTatTra* are still significant at the 1% level, the coefficient is positive. Model (3) *inteFDI* still fails the significance test. As compared to the level of trade and economic interdependence and trade interdependence, investment interdependence level is minimal, so here we mainly look at the impact of *inteGDP* and *inteTatTra* on the political

relations. Ththrough the revised model test after the endogeneity control, we conclude that as other conditions remain unchanged, economic interdependence between China and its neighboring countries indeed has a positive role in promoting political relations, while *inteGDP* increases by 1%, the bilateral political relations score correspondingly increases 0.745 point or *inteTatTra* increases by 1%, the bilateral political relations score correspondingly increases 0.798 point.

This result is consistent with the theoretical expectation of this paper, it can be concluded that after the WWII, especially after the end of the Cold War, the economy has become a more and more important factor for a country. In order to develop the economy, China and its neighboring countries are aware

of the importance of opening up, and actively create conditions and take advantage of the opportunities provided by globalization to build close economic ties with other countries, and in the process economic interdependence between countries gets deepened. And this deepening has increased the cost of breaking the economic link, and to a certain extent, has restrained war. When committed to development of economy, countries with economic exchanges between them would take the initiative to upgrade their bilateral relations, and to create a good environment for economic exchanges, which is economic mutual promotion, and to obtain a win-win situation.

How to understand the above logic in the specific experience of China and its surrounding countries? We can find the answers from China's policy orientation and the reaction to rising China by the neighboring countries.

China's reform and opening up pioneers a path for the interaction between economic interdependence and political relations regarding China and its neighboring countries. In the late 1970s, China realized economy is the priority to develop the country and the economic interests become the fundamental interests the whole nation are most concerned with,<sup>41</sup> taking economic construction as the focus became centrality of national development. China recognizes that economic development cannot be separated from exchange with the outside world, therefore, and takes active actions in developing diplomatic relations, thus, having normalized relations with Laos and Mongolia in 1989, and with Vietnam in 1991, restored diplomatic relations with Indonesia in 1990, and established diplomatic relations with the Republic of Korea in 1992. Because of geographical adjacency and economic complementarity, China and neighboring countries have become important partners to each other for outbound economic exchanges.

To develop economy cannot be separated from a peaceful environment, so China maintains the good neighbor policy diplomatically, which promotes economic and political interactive development between China and neighboring countries. The Party's

16<sup>th</sup> National Congress proposed the diplomatic principle of fostering friendship and partnership with the neighbors, then put forward the good neighborly policy of keeping harmony, security and prosperity with neighbors, this policy means that China combines its own interests with the interests of neighboring countries closely together to achieve common development.<sup>42</sup> In this policy orientation, the economy has become a way for upgrading and improving the bilateral political relations, so as to expect harmonious neighbors brought about by prosperous neighbors. For example during the 1997 Asian financial crisis, China abided by the commitment to maintaining the RMB value, helping to prevent the neighboring countries and the adjacent regions from economic collapse. China also provided substantial economic aid to those most seriously suffered Indonesia, Thailand and other ASEAN countries, its actions were well received by neighboring countries, and it was considered to be a responsible country.<sup>43</sup> After the crisis, driven by Chinese economic growth, the disaster-stricken neighbors were able to quickly free from the economic crisis and took off again in development, which widened the road to the further cooperation between neighboring countries and China. In order to achieve a better win-win situation, China and the neighboring countries strengthen mutually beneficial cooperation, and actively participate in regional economic cooperation mechanisms. For example, a series of important instruments were signed, such as China in 2000 put forward an idea on the establishment of China-ASEAN Free Trade Area with ASEAN, signed in 2002 Framework Agreement of Comprehensive Economic Cooperation between China and ASEAN, in 2004 and 2007 respectively signed the Agreement on Trade in Goods, and Agreement on Trade in Services, in 2009 signed the Agreement on Investment, and in 2010 China - ASEAN Free Trade Area was officially launched. In South Asia in 2005 China and the four countries signed 53 bilateral documents, 2/3 of which is related to economic and trade cooperation.<sup>44</sup> In Northeast Asia China has also established several organizations and signed a series of agreements,

Summit of the local government around the Sea of Japan, Northeast Asia Economic Forum, Northeast Asia economic conference, China, Russia, the DPRK, Mongolia and the ROK established Consultative Commission for the Development of the Tumen River Economic Development Area and Northeast Asia, Memorandum of Understanding on the Northeast and Tumen River Economic Development Zone Environmental Standard, etc.. With a series of mutually beneficial cooperation measures, so the volume of trade between China and neighboring countries grows like snowball, the economic interdependence becomes deeper and deeper, forming a strong momentum of growth.

Since neighboring countries get benefits in economic cooperation with China, so their economic dependence on China gets deepened. While proceeding from the needs for economic development, China implements the policy of keeping harmonious with and enriching neighbors, playing down the worries of “China threat”, and being received with commendations, so most neighboring countries of China take China as a good neighbor, and favorable partner and a regional major country without threat,<sup>45</sup> and even more willing to work with China while China is rising.

It can be seen from Table 4, in 1981, the relationship between neighboring countries and China reached friendly level<sup>46</sup> included only two countries Pakistan and Cambodia, accounting for about 13%; good relationship accounts for about 27%; ordinary relations accounts for 40%, tense relations accounts for about 20%. Based on the counting down, good relations in total account for only 40%, while ordinary relations and tense relations account for about 60%, then China's surrounding environment was not favorable. With the process of China's rising, the number of friendly countries has increased, in 2007 friendly relations account for about 61%, in absolute large quantity, the number of good relations account for 33%, only Japan is marginalized (0.51) in the ordinary relationship, accounting for about 6%, so the overall surrounding environment is better than at any time since the founding of new China.

And some control variables data cannot be obtained, this paper's previous data of the regression analysis stopped with the year 2007, but in order to better explore the reaction of neighboring countries to the rising China, we here also list the relationship scores and grades in 2014. Friendly relations in 2014 accounted for about 72%, good relationship for about 17%, and bad relations for about 11%. It was found in comparison that the situation in 2014 was more complicated than that in 2007, the friendly relationship increased by 11 percentage points, while there also emerged bad relationships in 2014 that were not in existence in 2007. This shows that as China's comprehensive national strength and economic strength upgrade to a certain point, there are some subtle changes in the surrounding relations, a few countries show pessimism and anxiety, which is more highlighted by Japan and the Philippines. In China-Philippines, and China-Japan relations, the economic interdependence did not bring the expected harmony. One of the important reasons is the special binary pattern formulated in East Asia by the U.S. “engagement plus containment” China policy and China's regional economic influence. In this pattern, the neighboring countries take the hedging strategies to get both sides profits from safety protection provided by the United States and the Chinese economic growth dividends, thus weakening the effect on economics promoting politics, there even has been the phenomenon of<sup>47</sup> “sleeping with the enemy”.<sup>48</sup> Even so, we still find that the relations mainstream between the neighboring countries and China is tilted to cooperation, economic interdependence undoubtedly makes this relationship closer, win-win outcome and mutually beneficial economic cooperation improve China's surrounding environment.

Therefore, from the above process, we can see that, out of the rational demand for economy, China and neighboring countries jointly promote the political and economic interaction. China's enriching neighbor policy promotes common development in the surrounding areas, while the neighboring countries actively cooperate to form a community of shared destiny. Having tied to

the fate of the community of shared destiny is the rope of economic interdependence. Under this circumstances, China and the neighboring countries are trying hard to avoid military

conflict and various conflicts of different levels, more inclined to cooperation, which results in economic interdependence promoting relations between China and the neighboring countries.

**Table 4. bilateral relations between China and its neighboring countries**

Name of States	The relationship with China in 1981		The relationship with China in 2007		The relationship with China in 2014	
	score	Level Grade	score	Level Grade	score	Level Grade
Pakistan,	7.62	friendly	7.62	friendly	7.64	friendly
USSR/ Russia	-6,58	tense	7.93	friendly	7.77	friendly
Philippines	6.62	good	7.04	friendly	-2.67	quarrel
Cambodia	7.65	friendly	7.68	friendly	7.68	friendly
Laos	5.27	good	7.26	friendly	7.41	friendly
Malaysia	2.15	ordinary	6.64	good	7.25	friendly
Mongolia	6.18	good	7.17	friendly	7.25	friendly
Bangladesh	5.92	good	7.40	friendly	7.44	friendly
Myanmar	2.00	ordinary	5.91	good	6.73	good
Japan	2,96	ordinary	0.51	ordinary	-3.32	quarrel
Thailand	3.90	ordinary	7.80	friendly	7.90-	friendly
India	-3,96	tense	5.33	good	7.31	good
Indonesia	0.90	ordinary	5.72	good	6.87	good
Vietnam	-5.93	tense	6.39	good	6.20	good
ROKorea	0		7.63	friendly	7.74	friendly
Kazakhstan			7.90	friendly	8.00	friendly
Kyrgyzstan			6.81	good	7.62	friendly
Tajikistan			7.10	friendly	7.80	friendly

Data source: calculation based on the People's Daily events data (CD).

From the regression results, we can also simply observe the impact of the control variables on the bilateral relationships. The *dem* in the model (1) (2) is positively correlated to bilateral relations but was significant at the 10% level, is not significant in the model (3), thus the paper takes cautious attitude to democratic peace viewpoints. The *mili* in the model (1) (2) is significant at the 1% level, and the coefficient is negative, which means that the more military spending by the neighboring countries, the more hostile, and the worse their relationship with China. The *alli* in the model (1) is significant at the 10% level, and in the models (2) (3) significant at the 1% level, and the coefficient of the three models are positive. It can be concluded that the more the same

organizations China and neighboring countries participate in, the more chance and timely to have communication and dialogue for them, the more they can improve the bilateral political relations and avoid conflicts. Among the three models, the relative strength is significant at the 1% or 5% levels, the coefficient is positive, which indicates that the greater the gap of comprehensive strength between the surrounding countries and China, the less the possibility of conflict between the two sides occurs. China is a regional major country, its most neighbors are small countries, so to handle relations with them is indeed a very delicate matter.

## V. Summary



In the international community after the Cold War, economic factors become more and more important, and the economic mutual-benefits replace the international rivalry centered on traditional military security. Under the impetus of this trend, China and its neighboring countries have incubated needs to strengthen their economic ties, and achieved considerable economic success. As countries are committed to economic development, the economic interdependence will have a peaceful effect. From the negative sense, because of the fear of losing the expected economic results triggered by war in the peaceful future, thus trying hard to avoid the occurrence of war; from a positive point of view, in order to expand economic achievements and enhance cooperation, friendly bilateral relations will be needed to provide a convenient environment. The experiences of China and its neighboring countries follow this logic, and has verified the regression analysis, and also verified the core proposition of the Liberal School of international relations -- the economic interdependence is a force to promote peace.

In the verification process, in order to better measure the bilateral relationship, this paper uses the method of measuring bilateral relations by the Institute of International Studies, Tsinghua University, to measure the relationship scores for China relations with neighboring countries, having produced more comprehensive bilateral relationship scores, thus enriching the matter's interpretation. Most of the existing literature has considered from the conflict side, arguing that the less the conflict, the better the bilateral relations, and the more the conflict, the worse the bilateral relations. But in fact, reducing conflict does not necessarily imply increasing cooperation, since bilateral relations is composed of conflict and cooperation, is a "chemical product" of the two, but cannot see the whole picture only from the perspective of conflict.

This paper uses three indexes (inteGDP, InteTatTra, inteFDI) to measure the degree of economic interdependence, believes that the two measurement indexes (inteGDP, InteTatTra) measuring interdependence with bilateral trade volume play a positive role in promoting

bilateral relations, and have very similar conclusions in the regression results, which confirm the conclusions that trade interdependence between China and neighboring countries can help to promote bilateral relations, but also raise peaceful expectations generated by the economic interdependence in the surrounding areas. Because these two indexes respectively take GDP and foreign trade volume as the base, and both play a role in upgrading the bilateral relations, as the trade volume between neighboring countries and China amounts to smaller percentage of their GDP, but may have accounted for a larger proportion of their total foreign trade, or vice versa, accounting for smaller percentage of their total foreign trade volume, but may account for a larger proportion of its domestic GDP. But as long as one of the two indicators improve, both would play a role in promoting bilateral political relations. Compared with the trade interdependence, inteFDI is relatively weak, and fails in the significance test for its role in promoting bilateral relations. But, does this mean that investment interdependence is unimportant? The answer is negative, we believe that investment interdependence is very important. From the beginning of 1979, China and the world see a rapid investment growth. From 1979 to 1984, the total actual use of foreign direct investment by China was US\$4.101 billion, US\$1.956 billion in 1985, US\$4.366 billion in 1991, then a rapid growth to reach US\$117.586 billion in 2013. The amount of overseas investment of China is also increasing, before 2000 encouraging to attract foreign investment, and placing restrictions on overseas investment.<sup>49</sup> China has little amount of overseas investment, only US\$1 billion overseas investment in 2000, but then entered the fast lane, especially grew fast obviously after 2003, overseas direct investment was US\$2.85 billion in 2003, and grew to \$107.84 billion in 2013.<sup>50</sup> These growing direct investments constitute an important part of the economic interdependence. Therefore, investment interdependence is also an important factor to study the impact of economic interdependence between China and

other countries on the political relationship between China and those countries.

*By regression and analysis of the results, policy recommendations of this paper are as follows;*

*First of all, against the backdrop of an effective means to deepen economic cooperation* to promote bilateral relations, China should continue to uphold the concept of win-win cooperation, to further promote construction of the community of shared interests and the community of shared destiny in the surrounding areas, and carry out cooperation on all levels, in all areas and complementary to each other, and mutually coordinative. Through a series of economic measures to create a new diplomatic situation in the surrounding areas, for example, having consecutively introduced a series of new thinking such as the Silk Road Economic Zone, the Maritime Silk Road, China-India-Myanmar economic corridor, China-Pakistan Economic Corridor, and China - ASEAN Free Trade Zone, etc..

*Second, with the deepening of cooperation, there is the need to promote the regional economic institutional arrangements* with their common participation, strengthen bilateral cooperation and multilateral cooperation with the neighboring countries, so as to promote the formation of a stable dialogue and consultation mechanisms. Once the mechanisms formed, on the one hand, it is conducive for them to enhance the ability to resist external economic risks and shocks,<sup>51</sup> on the other hand also conducive to the exchange of information

between countries so as to provide a platform for peaceful settlement of contradictions.

*Finally, it is necessary for China take a combined policy of good-neighborhood and growth.* On the one hand, China provides economic aid, and brings along economic prosperity to the surrounding areas, on the other hand, continues to improve its overall national strength, and its bargaining chips in negotiations. Since we recognize that the deepening economic interdependence will not necessarily prevent a friction and even a military conflict, because the interaction between two countries is comprehensively decided by multiple variables.

Of course, the research method by this paper has certain limitations, the models used cannot include in the international factors having important impact on the relations between China and its neighboring countries as control variables, such as the U.S. factor. Due to the lack of data, this paper cannot expand the sample size such as extending the time period of the study, if it had been done, the results would have been more convincing. However, in understanding the connection between the economic interdependence and political relations concerning China and its neighboring countries, the interactions between China and its neighboring countries provide a convenient observation and the local experience to be discussed, and has an important reference value. In addition, there are still rooms for further work regarding the research method and issues discussed.

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