

ABSTRACT

How Much Do Institutions Matter for Trade?

Evidence from Transition Countries

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What is the effect of institutions on trade? A line of recent literature has observed an apparent positive correlation between measures of institutional quality and volume of trade. But this could be due to endogeneity of institutions, rather than causality. This study endogenizes institutions in estimating gravity equation for bilateral trade introducing the differences in years under the governing system of communism as an instrumental variable to isolate the causal effect of institutions on trade.

I argue that as longer a country had been under the communist regime, as stronger might have been its institutions supporting the centrally-planned features of economy and thus, the weaker would have been their adaptability to market conditions. The reduced form equation estimates provide evidence for highly economically and

statistically significant effect of the years under communism on the quality of current institutions.

The finding of the study is that institutions might indeed have a beneficial effect on bilateral trade between countries. However, the extent of influence of institutions might have been considerably misestimated while not having taken care of endogeneity. Overall, the results obtained via this approach shed a new light over the extent of explanatory power of exporter's and importer's institutions over trade that might be helpful in explaining the "missing" trade costs phenomenon having been increasingly gaining attention in recent literature on international trade. Moreover, the results suggest that the number of years under the governing system of communism indirectly affected trade, pointing out at the largely objective reasons behind the differences in the amount of trade and economic success of countries of Central and Eastern Europe and Former Soviet Union on the one hand, and on the other hand, at the lasting comparative disadvantage of transition countries in general, in inheriting the institutions from the communist regime.

Keywords: Institutions; Trade; Gravity equation; Transition countries