Trade and Investment under Policy Uncertainty: Theory and Firm Evidence

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ABSTRACT: We provide theoretical and empirical evidence that trade policy uncertainty can significantly affect investment and entry into export markets. When market entry costs are sunk, policy uncertainty can create a real option value of waiting to enter foreign markets until conditions improve or uncertainty is resolved. Using a dynamic, heterogeneous firms model we show that: (i) investment and entry into export markets is reduced when trade policy is uncertain, and (ii) preferential trade agreements (PTAs) are valuable to exporters even if applied trade barriers are currently low or zero. We derive a structural equation that predicts how firm entry responds to changes in applied tariffs and a theory-based measure of policy uncertainty. We test our predictions using Portugal’s accession to the European Community in 1986 with new firm-level trade data. Our estimates suggest that the accession removed uncertainty about future preferences and this channel lead to substantial investment and entry of Portuguese exporters into EC markets. We argue that these results have broader implications for many other PTAs that aim to secure pre-existing preferences and that our approach can also be applied to analyze other sources of policy uncertainty.

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†Corresponding author. Department of Economics, University of Maryland, College Park, 20742, USA. Email: limao@econ.umd.edu. Other current affiliations: Yale University, NBER and CEPR. I thank the Bank of Portugal for financial and research support to prepare this paper for its Annual Conference on Portuguese Development. The Bank of Portugal Research Group, the Portuguese Census (INE) and Mario Centeno provided valuable help with the firm level data. I also thank Yale University’s Leitner Program, which hosted me during part of this project and the UMD Economics Department for funding to digitize data. I am grateful to Stephanie Aaronson, for helpful discussions. The usual disclaimer applies.