

RESPONSES TO REFEREE REPORT 1

First of all I would like to thank the referee for the thoughtful comments.

- 1) **COMMENT:** *“I am not sure about the deflator used in equation (1) for capital and investment. Ideally, this should be at the firm level to account for firm heterogeneity in price setting. As this is not very frequently available, many studies use industry level deflators. What is the deflator used here?”*

RESPONSE: The referee is right. Ideally the deflator should be at the firm level to account for firm heterogeneity in price setting. Since this is not available I construct investment price deflator by dividing aggregate industry investment data by prices of 2010.

- 2) **COMMENT:** *“Foreign ownership is defined if a foreign ultimate owner holds at least 50% of the shares. Does the author have the actual ownership share? If yes, some robustness checks should be undertaken with alternative definitions of foreign ownership (e.g., > 10% or fully owned) to see whether this makes a difference.”*

RESPONSE: Unfortunately I do not have the actual ownership share in order to undertake robustness checks of my empirical results. The Amadeus database's "foreign firms" are those that have a "foreign" ultimate owner (>49% ownership) and that is all the data I have.

- 3) **COMMENT:** *“Equation 2 needs to define variables properly. In particular, it is only explained later on what A is.”*

RESPONSE: The referee is right. In the first paragraph of Section III the symbol A_{it} of the profitability shock should be placed after the sentence "Before making any adjustment decision, the firm observes the current period profitability shock".

FINAL THOUGHTS: I would like to thank the referee for her/his comments. I would be keen to receive any further feedback she/he would care to give in light of my responses above.