

Referee report on

Wasseem Mina (2015). Political Risk Guarantees and Capital Flows: The Role of Bilateral Investment Treaties. Economics Discussion Papers, No 2015-24, Kiel Institute for the World Economy.

<http://www.economics-ejournal.org/economics/discussionpapers/2015-24>

The paper examines the impact of bilateral investment treaties (BITs) on capital flows. Using the system GMM estimator and a panel dataset for 66 middle-income countries and the period 1984-2011, the paper finds that BITs have a positive impact on non-guaranteed debt flows and on portfolio equity flows in these countries. While the topic of the paper is potentially relevant from a policy perspective, the empirical analysis of the paper is not entirely convincing. I have three major comments.

The first one refers to the identification strategy. Capital flows take place between countries, that is, at a bilateral level. BITs are ratified at a bilateral level as well. The empirical analysis, on the other hand, uses total capital inflows and the total number of BITs ratified (with OECD countries). This is not very convincing. As a consequence, the paper focuses on the signaling effect of BITs rather than the protection effect. This approach is highly questionable in terms of the identification of the main linkages between BITs and various forms of capital flows. I recommend using a gravity model with bilateral capital flows and BITs.

My second major comment refers to the treatment of BITs in the paper. In all regressions, BITs are assumed to be homogenous, as the total number of BITs ratified with OECD countries (relative to the total number of OECD countries) is computed. Since the analysis focuses on a rather long time series (beginning in 1984), this can be problematic for the results. So far, we have seen three different types (or generations) of BITs. They differ with respect to the coverage and extent of investor protection. More recent BITs, for example, are far more comprehensive than those ratified in the 1980s. Treating all of them as homogenous is not appropriate and can lead to biased results.

My final comment refers to the econometric methodology used in the paper. For all regressions, the system-GMM estimator has been used. While the system-GMM itself is an appropriate estimator for the hypothesis to be examined, the reported results do not convince the reader that the estimations are unbiased. For a start, the system-GMM estimator has been established for “small T and large N” datasets. In view of 66 middle-income countries and 28 periods, this is hardly the case. Major problems show up in the test statistics. For example, the number of instruments is relatively high (due to the long time series), which weakens the Hansen test. In many regressions the J test is equal to 1 or close to 1, making that test unreliable. As shown by David Roodman (2009), the number of instruments can severely affect the GMM results. I fear that too many lags have been used in the paper. In view of the findings reported by Roodman, that would be a mistake. I recommend using different lag structures and – in the majority of regressions – applying not only the collapse option but also only one instrument per endogenous variable. Also, the test statistics for the Arellano-Bond test in first differences – AR(1) – should be reported in addition to the AR(2) results. To sum up, I fear that the empirical results in the paper are seriously biased.

Finally, some minor points:

- Why are middle-income countries used only? I would assume that information on at least some low-income countries must be available.
- Are 3-month US treasury bills really a good proxy for the risk-free cost of capital? (page 11).
- Using system-GMM regression is quite standard these days. I recommend shortening the

presentation of that estimator on pages 15 and 16.

- The information provided below the tables can be shortened considerably (at least in Tables 6A and higher).

Reference

Roodman, David (2009), A Note on the Theme of Too Many Instruments, Oxford Bulletin of Economics and Statistics, Vol. 71, No. 1, pp. 135-158.