Referee Report 1

Report on „Political Risk Guarantees and Capital Flows" (MS #1453)

The present paper looks at the influence of political risk guarantees on capital flows. It distinguishes between FDI and portfolio flows. It finds that bilateral investment treaties (BIT) have a positive effect on the amount of non-guaranteed capital flows, such as portfolio flows. The paper uses a GMM method to establish these results.

While the paper covers an important topic, I find a number of flaws with the paper as it stands now.

My main worry is that the papers declared aim is not properly addressed in the paper. While the author argues to consider the influence of BITs, the literature reviewed does not address any single paper that looks at the role of BITs, although there is a very substantial literature. It merely mentions some literature (partly no contained in the list of references!) in footnotes but does not establish any connection with it. Readers would expect a connection to that literature and a thorough discussion how the author's findings are related to that literature. Although there is literature that comes to different conclusions concerning the effectiveness of BITS (such as Tobin and Rose-Ackerman 2012), it is not mentioned here. I would expect some comment on this and related papers. Instead, the literature review is focused on the effectiveness of capital controls, corruption and capital flows and the relation between shocks and capital flows. I fail to see the connection of these issues to this paper. At present, the title of the paper is grossly misleading.

Response:

Thank you for your comment. I have added a brief survey of this literature on pages 10 and 11 and made reference to it in footnote 8 on page 6.

Moreover, there is no discussion why the simple number of BITs with OECD countries should be an adequate representation of risk guarantee. I like the idea that BITs and ICRG can have different influences on different types of capital flows but that idea should be developed more fully, better placed in the overall literature, and explicitly pursued. One might also consider using additional variables, such as the Freedom House Index as robustness check. At present, it is not sufficiently well explained why the author believes his G and X variables capture different things and should thus be distinguished.

Response:

Thanks for raising this point. As explained in the introduction on page 3, the *de facto* purpose of BITs is to establish a guarantee against the risk of investment expropriation or political risk. The inquiry that this paper raises is whether BITs "confidence boost" extends beyond FDI to other types of capital or "foreign investment". There is no theory to argue in favor or against one type of capital flow or the other, since BITs enhance investor confidence and reduce investment expropriation risk, *ceteris paribus*.

Having said this, I theorize in this paper that the level of political risk (risk of investment expropriation) depends on what drives it primarily. Is domestic institutions with its protection of investors from investment expropriation under domestic laws? Or is it external mechanisms which provide this protection under investment treaties?

Some countries have their own domestic institutions, regardless of how perfect/imperfect they are, and complement them with bilateral investment treaties to enhance property rights protection. This scenario is captured by the first modelling approach provided in equation 2. On the other hand there are countries which are not institutionally developed and rely primarily on BITs to attract capital flows. In this regard, BITs may be thought of as a substitute for domestic institutions. This scenario is captured by the second modelling approach provided in equation 2'. Please see the newly added footnote 14.

Based on the above points, which is the strength of domestic institutions and the substitutability/complementarity with BITs, investors may respond differently depending on their perception of the risk of investment expropriation and the degree and source of protection provided.

Minor points:

What is the variable X on page 9? I do not understand what a "rate of expropriation" should be. Presumably the author refers to expropriation risk? Similarly, G is described as a "rate of guarantee" which is an unfortunate expression as well.

Response:
As mentioned in the empirical model section, "The political risk premium for country j is function of the rate of government expropriation x_j of a dollar of foreign investment and the rate of political risk guarantee g_j of investment, which BITs provide, and the interaction between the two, $(xg)_j$." The term rate here reflects the additional cost per dollar invested (or lent). Given the two political risk premium modelling approaches, the interaction term should be dropped, which I am doing in this revised version.

The author claims to be the first to include portfolio flows in his analysis. However, a paper by Hashimoto and Wacker (IMF WP 12242) also includes portfolio flows. Very similar to the present paper it looks at the influence of institutional measures (in that case the IMF's SDDS) that should help to increase protection and transparency of capital flows. The author may take this into account.

Response:
Many thanks for bringing this important working paper to my attention. I am accounting for it in footnote 10 in the literature review section.

I suggest using gross capital flows rather than net flows since the author is interested in overall capital flows.

Response:
Many thanks for raising this interesting point. Let me first distinguish between the net vs. gross capital inflows. Net capital flows is capital inflows by foreigners less capital outflows by domestic residents. Gross capital flows separate those inflows and outflows from each other. In the context of this paper, it would be interesting to examine BITs influence on capital inflows by foreigners, as measured by non-residents' net purchases of domestic assets (direct investment or equity). Given the observation by Broner et al. (2013) that the volatility (as well as size) of gross capital flows has increased over the last decades, I have to be careful that the results may be biased (upwards or downwards). (References: Broner, F., Didier, T.,

Erce, A., Schmukler S., 2013. Gross capital flows: Dynamics and crises. Journal of Monetary Economics 60, 113-33.)

I do not particularly like the notion of guaranteed capital flows. We know that also governments often fail to serve their debt. Since the risk of expropriation is an important here, “guaranteed” debt does not much sense. The author might rather simply distinguish between private and public debt.

Response:
Good point! In the revised version, I am focusing on “private” and “public” debt flows.

The introduction of dummies for crises periods is arbitrary. In particular, I fail to see why the financial crisis is restricted to 2007-2009 but not beyond. At least a brief explanation would be welcome.

Response:
Controlling for the most recent financial crisis was the motivation for an earlier version of the paper. It is now dropped.