Referee Report on
Dragana Stanisic’s CERGE-EI Dissertation entitled:

Topics in Security Economics

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1. The three-essay dissertation explored the links between terrorist incidents and external capital flows and public opinion. The first two essays studied the effect of terrorist incidents on external capital flows. The first one explored three types of capital flows into a particular country: FDI, new external debt, and portfolio investment and found that only FDI flows are affected by the frequency of terrorist incidents. The second essay built on the finding in the first essay and quantified the effects of terrorist incidents on FDI flows more thoroughly using country-pairs data set and confirmed an important role of insecurity on direct investment flows. The third essay established a link between public support for terrorism and its occurrence.

2. The dissertation is generally well written and main findings are new and interesting. The main contribution is the finding that terrorist incidents do not affect all external capital flows equally and in particular that they do not affect external debt and portfolio flows. The establishment of the link between public support for terrorism and frequency of terrorist incidents is also helpful and could have practical policy implications.

3. The conclusions in the first two essays perhaps warrant more discussion, since there is not a coherent theory why FDI should respond to terrorist incidents while external debt and portfolio flows should not. Dragana’s comments would be welcome to the following questions:

- Increasing frequency of terrorist incidents elevates country risk and thus required profit premium to invest in a particular country. Based on this, one could expect that some investors will reduce flows. However such hypothesis presumably holds for all external flows, especially considering that the difference between FDI, debt, and portfolio investments is not so large. Long-term external debt and FDI have similar maturity, while several flows classified as FDI might still have similar character as portfolio investment – the threshold of 10 percent ownership is rather arbitrary). What are the distinguishing characteristics between types of external flows that would justify the conclusions in the essay?

- The decision to engage in FDI is the final stage of foreign companies’ engagement in a local market. Companies first export to a country and when efficiencies presents themselves, companies enter the market and establish assembling and distribution lines, while still importing parts. The final stage is the local sourcing of components for their products. Reversely, companies might decide to disinvest FDI independently of the occurrence of terrorist incidents, which would increase imports and weaken the
trade balance. *Wouldn’t make sense to add country’s trade balance as an explanatory variable for the FDI flows?*

- The time profile of FDI profitability is not linear. It has been shown in the literature that return on FDI is negative in the initial one or two years and then turns positive until it reaches maximum. In about ten years, the initial investment is written off. Therefore depending on the profitability cycle – vintage of FDI, companies make decisions about dividends and reinvestments, that is, reduce or increase FDI inflows independently of terrorist incidents. *Wouldn’t it be appropriate to add some nonlinear explanatory variable capturing the vintage of FDI?*

- Brown field FDI flows might be different from the green field ones. FDI flows often represent mostly reinvested profits. These might be easily reversible if terrorist incidents intensify. *Does Dragana think that it might be worthy to consider breaking down FDI flows into reinvested profits and the rest and test the hypothesis of terrorist incidents on these?*

- Table 1.3 shows that the data sample size is changing across different types of external flows. While FDI flows are studied on 169 countries, the external debt regression uses only 120 countries. This difference is large and could make the conclusions subject to the particular sample. *Would the results for FDI flows still hold if we used the same country sample as for the external debt?*

- Table 2.6, regression 1 shows that occurrence of armed conflicts affects negatively the size of the FDI flow. However, it is somewhat surprising that armed conflicts in the selection equation turned out to have positive and significant coefficient. This would mean that occurrence of armed conflicts increases probability of FDI inflows into receiving country. *Is my interpretation correct?*

4. **The text might benefit from some clarifications.** Although generally well written, there are several occasions when the write-up tends to be misleading. For example:

- Page 1 of Chapter 1. The abstract says that “we also find that FDI flows are more sensitive to terrorism than either portfolio investments or external debt flows.” However, page 3 of the Introduction states that “we find no evidence of the effect of terrorism on external debt and portfolio investment”. It might be good to decide on one correct formulation and use it throughout the text.

- Page 12 of Chapter 1, first sentence: the word choice “master country” does not seem appropriate.

- Page 42 of Chapter 3, “… disapprove of the leadership …” the word “of” should not be there.
5. **The thesis clearly reaches the standards for a successful defense.** My comments above are meant to help Dragana to develop an additional robustness check for her results and to be discussed at the time of the defense but should not be interpreted as conditions for a defense. I believe that the current version is satisfactory to be successfully defended.