Does Money Follow the Flag?

Nandini Gupta and Xiaoyun Yu[1]

This version: April 2009

[1]Gupta and Yu are at the Kelley School of Business, Indiana University, nagupta@indiana.edu and xiyu@indiana.edu. We are grateful for comments from Raj Aggarwal, Magnus Dahlquist, Mariassunta Giannetti, and seminar participants at the ECB Conference on Financial Integration and Stability in Europe (Madrid), Swedish Institute for Financial Research (SIFR), Stockholm School of Economics and the University of Minnesota. Financial support from the Center for International Business Education and Research (CIBER) at Indiana University is gratefully acknowledged. All remaining errors are our own.

Abstract

We examine whether bilateral political relations can explain investment and trade flows between the United States and other countries. We treat political relations as endogenous using instrumental variable analysis and investigate whether an exogenous shock to political relations, the 2003 war in Iraq, leads to a shift in economic flows. The results suggest that a deterioration in bilateral relations is followed by a significant decrease in economic flows between the United States and that country. These results are robust to country fixed effects, income, industry growth, financial market development, and risk.

Keywords: international capital flows, foreign portfolio investment, political relations

1 Introduction

Political relations between countries have long been viewed as an important determinant of global economic flows (Mill, 1848; Keynes, 1919). While the modern economics literature has focused on the influence of domestic special interest groups on trade and investment policy (Grossman and Helpman, 1994), the political science literature typically does not address the endogeneity between international political relations and economic flows (Polachek, 1980, 1997; Morrow, Siverson, and Taberes, 1998). In this study we return to the classical question of whether political relations affect global economic flows. Specifically, we investigate whether a shift in the United States' relations with other countries affects bilateral investment and trade flows between the United States and these countries.

Political relations between countries are likely to be endogenous to economic flows. Hence, the U.S. government may maintain better relations with countries that American firms and investors have business dealings with, and *vice versa*. For example, the recent thaw in relations between the Indian and U.S. governments due to the United States' interest in the region following the events of September 11, 2001, may have been prompted in part by an increase in trade and investment between the two countries.[1] To address this issue, we adopt the following empirical strategy: First, we control for country fixed-effects, which will address the type of endogeneity that arises if both political relations and economic flows are driven by unobservable time-invariant country-specific factors. Second, we treat political relations as endogenous in an instrumental variable analysis, and third, we use exogenous shock to political relations – the 2003 war in Iraq – to identify a shift in political relations between the United States and other countries.

Bilateral political relations may affect economic flows through a number of different channels. International trade and investment flows are likely to be affected by asymmetric information between domestic and foreign firms and investors (Brennan and Cao, 1997; Rauch, 2001; Portes and Rey, 2005). Political relations between countries can influence these information costs by facil-

[1] Prior to a 2006 visit to India, President George W. Bush is quoted as follows: "India's middle class is now estimated at 300 million people. Think about that." The article goes on to say, "The Bush administration is acutely aware of India changing...the President will fly into New Delhi along with a large contingent of business leaders to secure a new relationship with India." ("Booming India finds that America wants to be its new best friend," The Guardian, February 26, 2006.)

itating or reducing interactions between economic agents. Trade and investment flows are also likely to depend on country-specific political risk, such as the protection of intellectual property rights (Lee and Mansfield, 1996) and expropriation risk (Thomas and Worrall, 1994; Stulz, 2005). Political relations can affect political risk, e.g. the closure of U.S. firms in Venezuela following a deterioration of relations between the Venezuelan and U.S. governments (U.S. Department of State, 2005). Barriers to capital flows and trade may also depend on the political relations between countries. Recent examples include the U.S. government's decision to exclude some countries from the rebuilding process in Iraq,[2] and the backlash against American products in some parts of the world.[3]

We have collected data on bilateral investment and trade flows, and on political relations between the United States and a wide range of developed and developing countries. The political relations measures distinguish between government relations and public opinion as the two may differ. For example, the Spanish government contributed troops to the Iraq war in 2003 despite strong public opposition in Spain to the war. We measure bilateral government relations using voting records from the United Nations on issues identified as important to U.S. interests. Cross-country opinion polls about foreign citizens' perceptions of the United States and U.S. citizens' perceptions of foreign countries provide measures of public opinion.

Our results suggest that both foreign and U.S. investors take into account a change in bilateral political relations in their investment strategies. In particular, bilateral portfolio and direct investment flows between the United States and other countries decline significantly if relations between the United States and other country governments deteriorate. For example, an increase of one percentage point in the fraction of votes cast by a country in opposition to the U.S. position

[2] News reports have circulated about the effects of a U.S. backlash on the market returns of firms. "...The latest was a radio report in Paris on Monday that a French catering company, Sodexho Alliance, had lost a $1 billion contract to supply food to the U.S. Marine Corps....Sodexho's shares plunged 14 percent..." ("French and German business wary of backlash", The International Herald Tribune, March 19, 2003).

[3] "...according to a new survey of 8,000 international consumers released this week by the Seattle-based Global Market Insite...One third of all consumers in Canada, China, France, Germany, Japan, Russia, and the United Kingdom said that U.S. foreign policy, particularly the 'war on terror' and the occupation of Iraq constituted their strongest impression of the United States. Twenty percent of respondents in Europe and Canada said they consciously avoided buying U.S. products as a protest against those policies," ("U.S. Businesses Overseas Threatened by Rising Anti-Americanism", OneWorld United States, December 29, 2004).

in the United Nations is followed by an average decrease of $92 million in quarterly investment in U.S. corporate securities from that country. Bilateral portfolio flows also respond to changes in public opinion - a decline in foreign public approval of the United States is followed by a significant decrease in portfolio flows from that country to the United States, and a decrease in U.S. portfolio flows to that country.

Trade flows also respond significantly to a shift in political relations. We find that exports of U.S. products are significantly lower to countries that experience deteriorating relations with the U.S. government, and whose public view the United States less favorably. For example, an increase in one percentage point in the fraction of votes cast by a country in opposition to the U.S. position in the United Nations is followed by an average decrease of $337 million in quarterly imports to the United States from that country. Foreign imports into the United States also decrease significantly following a deterioration in bilateral government relations. Note that these results correct for endogeneity in political relations and are robust to country fixed-effects and time-varying country characteristics.

It is important to investigate the determinants of cross-country trade and investment flows because the globalization of economic flows has been shown to have a positive impact on poverty reduction and economic growth (Dollar and Kraay, 2004). The literature has focused on "frictions" including regulatory barriers (Levine, 2005; Bekaert, Harvey, and Lundblad, 2005), static institutional factors such as shareholder and creditor rights (La Porta et al., 1998), dynamic political factors (Rajan and Zingales, 2003), political risk (Lee and Mansfield, 1996), and asymmetric information between foreign and domestic investors (Brennan and Cao, 1997; Froot, O'Connell, and Seasholes, 2001; Rauch, 2001; Portes and Rey, 2005), to explain patterns of international economic flows. Several recent studies also suggest that social institutions such as trust and culture may affect cross-border flows (Stulz and Williamson, 2003; Guiso, Sapienza, and Zingales, 2009; Siegel, Licht and Schwartz, 2008). Relatedly, Morse and Shive (2008) argue that one explanation for the "home bias" puzzle is that countries whose citizens are more "patriotic" hold smaller foreign equity positions.

Unlike static factors such as a common language or religion, political relations between countries can change over time. Therefore, bilateral political relations can be used to explain changes in economic flows between countries. Our results suggest that such a change in political relations can

have a significant impact on bilateral trade and investment flows.

The paper is organized as follows: In Section 2 we discuss the relationship between political relations and economic flows. Section 3 discusses the data. Section 4 describes the estimation strategy. Section 5 presents the results, and Section 6 concludes.

2 The Influence of Political Relations on Economic Flows

In this section we discuss the different channels by which political relations between countries may affect economic flows.

Bilateral political relations can affect interactions between economic agents and thereby information costs for foreign firms and investors. Recent studies have shown that economic flows are likely to be affected by asymmetric information between domestic and foreign firms and investors (Brennan and Cao, 1997; Froot, O'Connell, and Seasholes, 2001; Portes, Rey, and Oh, 2001; Rauch, 2001; Guiso, Sapienza, and Zingales, 2009; Brennan et al., 2005; Portes and Rey, 2005; Siegel, Licht, and Schwartz, 2008). For example, Brennan and Cao (1997), Froot, O'Connell, and Seasholes (2001), and Brennan et al. (2005) interpret the positive correlation between international equity flows and stock market returns in the destination country as evidence of information asymmetry between foreign and domestic investors. Portes, Rey, and Oh (2001) and Portes and Rey (2005) find that international equity flows are inversely related to the distance between countries, which they interpret as evidence that countries that are geographically closer tend to know more about each other.[4] Guiso, Sapienza, and Zingales (2009) show that bilateral trade and investment flows are higher between countries whose citizens "trust" each other more, where trust may capture information costs, and, Siegel, Licht, and Schwartz (2008) argue that by increasing information asymmetry and transaction costs, the cultural distance between markets can affect international debt flows, cross-border equity issuance, and mergers and acquisitions. Lastly, Rauch (2001) argues that business and social networks between countries can help overcome barriers to international trade in goods, such as those arising out of a lack of information about trading opportunities.

Political relations between countries can affect the risks faced by foreign investors, e.g. the

[4]The large literature on the "home bias" puzzle also documents the role of geographic proximity on investor holdings and firms' financing decisions (Tesar and Werner, 1995; Kang and Stulz, 1997; Coval and Muskowitz, 1999, 2001; Dahlquist and Robertsson, 2001; Grinblatt and Keloharju, 2001; Sarkissian and Schill, 2004).

seizure by the U.S. government of $1.4 billion of Iraq's financial assets that were held in U.S. banks.[5] Country-specific risks have been shown to impact economic flows (Lee and Mansfield, 1996; Maskus, 2000; Stulz, 2005). In particular, Lee and Mansfield's (1996) results suggest that protection of intellectual property rights significantly affects the volume and composition of U.S. foreign direct investment.

Capital and trade barriers also affect economic flows (Levine, 2005; Bekaert, Harvey, and Lundblad, 2005). Barriers to economic flows are likely to depend on political relations between countries, e.g., the failed attempt to acquire U.S. ports by Dubai Port World due to opposition in the U.S. Congress,[6] and the new U.S. trade and investment treaties with coalition partners in the Iraq war, including Australia and the Central Asian Republics.

A country's growth opportunities and political stability can have an impact on foreign investment flows (Bekaert, Harvey, and Lundblad, 2005; Carkovic and Levine, 2005). Given the United States' prominent position in the global economy, deteriorating relations with the United States can result in a decline in growth opportunities or an increase in political instability in that country. In this case we may observe a negative relationship between political relations and capital flows into the United States from that country. In particular, foreign investors based in countries that experience deteriorating relations with the United States may invest more in the United States in order to hedge their country's higher political risk. Correspondingly, a hedging response by U.S. investors may be observed if deteriorating political relations with the United States implies declining opportunities for U.S. firms in that country. For example, U.S. investors may invest more in French firms if there is a backlash against American products in France.

Lastly, deteriorating political relations may affect international trade by decreasing demand for foreign products and services. Examples include the consumer boycott in the United States of products from countries that did not support the Iraq war, notably France.[7] Note that a public

[5] "U.S. announces it will seize Iraqi assets", PBS, March 20, 2003.

[6] From CNN, "Many (U.S) lawmakers argue that allowing a foreign-owned company, particularly a company owned by the UAE, undermines national security. They note that two of the 9/11 hijackers came from the UAE and that they drew funding from Dubai banks before the attack," ("Key questions about the Dubai port deal", CNN, March 6, 2006).

[7] Quoting from CNN: "France's opposition to the Iraq war, which sparked an instant backlash against all thing French in the United States last month, has begun to take a toll on one of its top exports to this side of the Atlantic – French wines...and other French products also have been affected...Medef President Ernest-Antoine Seilliere was

backlash can be a rational response for voters seeking to influence domestic and foreign government policies.

We summarize these arguments in the hypotheses below. Note that the underlying null hypothesis is that economic flows between countries are unrelated to bilateral political relations.

Hypothesis 1a (Positive Response): *Bilateral investment and trade flows will increase if political relations between countries improve.*

Hypothesis 1b (Hedging Response): *Bilateral investment flows will increase if political relations between countries deteriorate.*

3 Measuring Political Relations and Economic Flows

The following subsections describe the different measures of bilateral economic flows and political relations between the United States and other countries used in this paper. Appendix 1 summarizes the data sources and the definitions of the variables used in the analysis.

3.1 Government Relations

We construct three measures of bilateral political relations. The first is a measure of similarity in foreign policy positions based on voting data from the United Nations General Assembly on issues "which directly affected the United States' interests and on which the United States lobbied extensively" (U.S. Department of State, 2000-2004). We define *UN Opposite Vote* as the number of votes cast by a country at the United Nations that are not identical to the U.S. vote (includes votes that are opposite to the U.S. vote, abstentions, and absences) scaled by the total number of votes, which is the sum of identical votes, opposite votes, abstentions and absences for each country.[8] An increase in the value of *UN Opposite Vote* is interpreted as a deterioration in relations between the United States and the foreign government. We observe annual data on U.N. votes for 181 countries

quoted as saying that the effects were 'measured' but that contracts had been lost because of anti-French feeling in the United States...Products decidedly French, such as wines, cheese and even French-owned hotel chains like Sofitel, have been on the receiving end of some angry American consumer sentiment ever since the start of the military engagement in Iraq," ("French wines feel the distaste", CNN/Money, April 16, 2003).

[8] Note that the regression results described below are robust to an alternative definition of this variable that only counts votes that are opposite to the U.S. vote.

in 2000, 178 countries in 2001, 186 countries in 2002, 187 countries in 2003, and 188 countries in 2004.[9] To avoid attrition bias we do not require a balanced sample.

In Table 1 we report summary statistics describing the political relation variables. To capture differences based on a shift in political relations due to the war, we divide the sample into countries that were part of the 2003 Iraq war coalition, and non-coalition countries.[10] The list of coalition countries are provided in Appendix 2. The summary statistics suggest that both before and after the war, coalition countries oppose the United States less frequently in the United Nations compared to non-coalition countries (59% vs. 77% before and 60% vs. 75% after the war, respectively).

3.2 Public Opinion

Data on public opinion polls were obtained from the Gallup Organization and the Pew Research Center for the People and the Press. These data cover a smaller subset of countries than the data on bilateral government relations.

We construct two measures of public opinion: Foreign citizens' perceptions of the United States and U.S. citizens' perceptions about foreign countries. Data on public perceptions about the United States in other countries is from Pew's Global Attitudes survey. The survey was conducted in 27 countries in 2000, 44 countries in 2002, 9 countries (March) and 21 countries (May) in 2003, and 9 countries in 2004. We average the poll values for the seven countries surveyed in both March 2003 and May 2003. These countries are the United Kingdom, France, Germany, Italy, Spain, Russia, and Turkey. We use data from the following question in the survey: "*Please tell me if you have a very favorable, somewhat favorable, somewhat unfavorable or very unfavorable opinion of the United States*". The variable *Poll* is the fraction of foreign citizens who hold a "very favorable" or "somewhat favorable" view of the United States.

From Table 1 we note that after the war, there is a significant decline of 27 percentage points in the fraction of foreign citizens holding a favorable opinion of the United States. While before the war, citizens of coalition countries viewed the United States more favorably compared to non-coalition countries (71% and 61%, respectively), after the war there is a sharp decline in the fraction of the public in coalition countries with a favorable opinion of the United States, from 71% to 45%.

[9] Note that data on bilateral economic flows with the United States is not available for all these countries.

[10] In the regression analysis we use the full sample of countries and do not distinguish between coalition and non-coalition countries.

Data on public perceptions in the United States about foreign countries is from Gallup's "Perception of Foreign Countries" survey. This poll surveys the opinion of U.S. citizens about 11 countries in 2000 and between 20 and 21 countries for the years 2001-2004. We use the data from the following question: "*Is your overall opinion of a country very favorable, mostly favorable, mostly unfavorable, or very unfavorable?*" The variable *Perception* is the percentage of U.S. citizens who hold a "very favorable" or "mostly favorable" view of the foreign country in question.

We note from Table 1 that countries that joined the Iraq war coalition are viewed significantly more favorably by U.S. citizens both before (66%) and after the war (64%), relative to non-coalition countries (46% and 44% before and after the war, respectively). However, we note that in contrast to foreign public opinion of the United States, U.S. perceptions of other countries remain relatively stable before and after the war.

The number of observations reported for the political variables in Table 1 is different from the regression analyses below because in the regressions we also require data on economic flows and control variables for each country.

3.3 Economic Flows

Portfolio investment: We observe quarterly values of purchases of U.S. securities by foreign investors, in millions of U.S. dollars. The portfolio flows data are from the U.S. Department of the Treasury. We observe an unbalanced panel of foreign portfolio inflows into U.S. security markets for 61 countries in 2000 and 63 countries in each of the years 2001-2004. The securities include (1) Marketable U.S. Treasury and federal financing bank bonds and notes, (2) Bonds of U.S. government and federally sponsored agencies, (3) U.S. corporate and other bonds, and (4) U.S. corporate stocks. In the regression analysis, foreign portfolio investment in U.S. corporate securities is constructed as the sum of (3) and (4) for each country divided by aggregate quarterly portfolio inflows into all U.S. securities from all countries. By using ratios we control for the possibility that some countries invest more in U.S. securities than others.

We observe quarterly values of purchases of foreign stocks and bonds by U.S. residents (millions of U.S. dollars) for 61 countries in 2000, and 63 countries in each of the years 2001-2004. U.S. portfolio investment in foreign securities is constructed as the sum of U.S. purchases of foreign

stocks and bonds in a country, divided by aggregate U.S. portfolio investment in all countries.[11] These data do not distinguish between investment in government and corporate securities. From Table 2 we note that U.S. portfolio investment in coalition countries is more than four times as high as U.S. investment in non-coalition countries.

Foreign direct investment: We obtain quarterly data on foreign direct investment (FDI) inflows and outflows (in millions of U.S. dollars) from the Bureau of Economic Analysis. FDI inflows measure direct investment in the United States by foreign firms based in 37 countries, for each of the years 2000-2004. FDI outflows measure direct investment by U.S. firms in 55 countries, for each of the years 2000-2004. We use the log of FDI inflows and FDI outflows in the regression analysis. The summary statistics in Table 2 show that after the war, quarterly foreign FDI inflows into the United States fell by more than half, from $1.2 billion to $576 million. This decrease was driven by countries that did not join the Iraq war coalition - FDI from non-coalition countries into the United States dropped nearly 67% after the start of the Iraq war. Interestingly, before the war, FDI flows into the United States did not differ significantly between coalition and non-coalition countries.

Trade flows: We obtain quarterly exports and imports data from the International Trade Center, UNCTAD, in millions of U.S. dollars. The data is observed for 51 countries in each of the years 2000-2004. We use the log of exports and imports in the regression analysis. The summary statistics in Table 2 suggest that non-coalition countries are larger trading partners of the United States than coalition countries. On average, both exports of U.S. products and imports of foreign products into the United States are nearly twice as high from non-coalition countries than coalition countries.

The number of observations reported for the economic flow variables in Table 2 differs from the regression analyses because in the regressions we also require data on the political and control variables for each country.

[11] The U.S. portfolio outflows data identify the country of transaction rather than the country in which the foreign security is issued. Warnock and Mason (2001) argue that since transactions that go through financial centers (Hong Kong and the United Kingdom) may involve securities issued in other countries, the treasury data may result in overestimating U.S. outflows to the financial centers. As a robustness check, we remove Hong Kong and United Kingdom from the sample and find that the regression results reported below are not affected. These results are available on request.

3.4 Country-specific Controls

In the regression analysis we control for several country-specific factors that can influence foreign investment and trade flows. First, since investment opportunities are likely to depend on country risk, we use the log value of each country's total risk score (*Country Risk*) obtained from Euromoney Magazine's country risk ranking for the sample period of 2000-2004.[12] A higher value indicates lower overall country risk. We also control for country-specific factors that are likely to influence investment and trade flows, including per capita GDP (*GDP per capita*), domestic growth opportunities as measured by the growth rate of industry value added (*Industry Growth*), financial market development measured by the ratio of domestic credit to GDP (*Domestic Credit/GDP*), inflation measured by the GDP deflator (*Inflation*), and exchange rate risk measured by the current account balance as a percentage of GDP (*Current Account Balance/GDP*). These data are from the World Bank's World Development Indicators database. While other factors such as country legal system and geographic distance may influence bilateral economic flows, these variables cannot be identified in our regressions because we include country fixed-effects.

4 Estimation Strategy

We address the potential endogeneity between bilateral political relations and economic flows in the following ways: First, we control for country fixed-effects in the estimations, which will address the type of endogeneity that may arise if both political relations and economic flows are driven by unobservable time-invariant country-specific factors. Second, to address selection based on time-varying unobservable factors we treat the political relations variables as endogenous using $Tourism$, the annual number of tourists traveling from each country to the United States, and $Immigration$, the annual number of immigrants from each country to the United States, as instrumental variables. Third, we use an exogenous shock to political relations, that is not related to economic flows, to identify a shift in the political relations between the United States and other countries. Specifically, we investigate whether bilateral economic flows respond to a shift in political relations between the

[12] The Euromoney country risk score is the sum of scores on political risk, economic performance, debt indicators, debt in default or rescheduled, credit ratings, access to bank finance, access to short-term finance, access to capital markets, and discount on forfeiting.

United States and other countries following the Iraq war in 2003.

We start by estimating the following two-stage instrumental variable specification with country fixed-effects:

$$\begin{aligned} Political\ Relations_{c,t}^{US} &= \beta_0 + \beta_1 War_t + \beta_2 Tourism_{c,t}^{US} + \beta_3 Immigration_{c,t}^{US} + \beta_4 Tourism_{c,t}^{US} \times War_t \\ &\quad + \beta_5 Immigration_{c,t}^{US} \times War_t + \beta_6 X_{c,t} + \alpha_c + \upsilon_{c,t} \\ Economic\ Flows_{c,t}^{US} &= \alpha_0 + \alpha_1 War_t + \alpha_2 \widehat{Political\ Relations}_{c,t}^{US} + \alpha_3 X_{c,t} + \alpha_c + \varepsilon_{c,t} \end{aligned} \quad (1)$$

where the economic flows and political relations variables are described in Section 3. War_t is a dummy variable that is equal to one starting in the first quarter of 2003, $X_{c,t}$ represents a vector of time-varying country-specific controls, which includes size (*GDP per capita*), financial market development (*Domestic Credit/GDP*), domestic growth opportunities (*Industry Growth*), inflation, exchange rate risk (*Current Account Balance/GDP*), and country risk. α_c is a country-specific fixed effect and $\varepsilon_{c,t}$ reflects unobserved shocks affecting bilateral economic flows between these countries and the United States. Finally, the standard errors in all the specifications are corrected for heteroskedasticity using the Huber-White procedure and are clustered at the country-level.

Next, to account for the impact of the war on how economic flows are related to bilateral political relations, we also estimate the following specification with country fixed-effects:

$$\begin{aligned} Economic\ Flows_{c,t}^{US} &= \alpha_0 + \alpha_1 War_t + \alpha_2 Political\ Relations_{c,t}^{US} + \alpha_3 Political\ Relations_{c,t}^{US} \times War_t \\ &\quad + \alpha_4 X_{c,t} + \alpha_c + \varepsilon_{c,t} \end{aligned} \quad (2)$$

where the coefficient of the interaction term, α_3, measures the change in economic flows in response to a shift in political relations after the war, and the other variables are as described above.

We discuss the results from estimating specification (1) in Sections 5.1-5.4 and the results from estimating specification (2) in Section 5.5.

5 Results

We report the relationship between government relations and foreign portfolio investment in U.S. corporate securities in Table 3.

5.1 Foreign Portfolio Investment in U.S. Corporate Securities

As a benchmark we estimate a pooled OLS specification, which describes the correlation between economic flows and political relations. The OLS results suggest that foreign purchases of U.S. corporate securities and *UN Opposite Vote* are negatively correlated (Column (1)). Correcting for country fixed-effects and endogeneity of political relations, the negative and statistically significant coefficient of *UN Opposite Vote* suggests that if a country opposes the United States more frequently in the United Nations, this leads to a significant decrease in investment from that country in U.S. corporate securities (Column (2)). The negative coefficient of *War* suggests that on average foreign portfolio investment in U.S. corporate securities declines significantly after the war.

Considering the influence of foreign public approval of the United States (*Poll*) on foreign purchases of U.S. corporate securities, we note that a decrease in foreign public approval of the United States is followed by a decrease in investment from that country in U.S. corporate securities (Columns (4) and (5)). This result is robust to treating *Poll* as endogenous and controlling for country fixed-effects (Column (5)). The OLS results suggest that foreign investment in U.S. corporate securities is also positively correlated with U.S. public approval of foreign countries (*Perception*), but this result is not robust to treating *Perception* as endogenous.

The impact of bilateral political relations on foreign portfolio investment flows to the United States is also economically significant. For example, an increase of one percentage point in the fraction of votes cast in opposition to the United States is followed by a decrease of about $92.2 million in quarterly investment in U.S. corporate securities from that country, holding aggregate inflows into all U.S. securities from all countries constant (Column (2)).[13]

These results are consistent with the hypothesis that deteriorating political relations may increase political risks, information and transaction costs, and barriers to investment, thereby reducing investment flows. Next we consider the relationship between political relations and U.S. portfolio investment in foreign securities.

[13] We multiply the coefficient of *UN Opposite Vote* in Column (2), equal to -0.0060, with average foreign portfolio investment in U.S. corporate securities, equal to $15.37 billion.

5.2 U.S. Portfolio Investment in Foreign Securities

The results are reported in Table 4. We find that U.S. investors invest less in countries that oppose the U.S. position more frequently in the United Nations, and this result is robust to country fixed-effects and treating political relations as endogenous (Column (2)). For example, a one percentage point increase in *UN Opposite Vote* is followed by a decline of $94.9 million in quarterly U.S. portfolio flows to that country on average, holding total U.S. portfolio investment in all countries constant (Column (2)).[14] U.S. portfolio flows to foreign countries decline significantly following the war (Column (2)).

The results suggest that U.S. portfolio investment flows respond significantly to changes in foreign public opinion. A decline in foreign public approval of the United States leads to a significant decrease in U.S. portfolio investment flows to that country (Columns (4) and (5)).

The relationship between U.S. portfolio investment in foreign securities and political relations is consistent with the hypothesis that economic flows may decline due to an increase in risk and transaction costs, or negative investor perceptions about growth opportunities, in the country experiencing deteriorating relations with the United States. Next, we investigate whether political relations influence foreign direct investment flows.

5.3 Foreign Direct Investment Flows

Table 5 reports the results with foreign direct investment flows into the United States as the dependent variable. We find that foreign direct investment flows to the United States are negatively related to *UN Opposite Vote* (Columns (1) and (2)), suggesting that foreign firms based in countries that are unfriendly to the United States may face a higher cost of doing business in the United States. In the case of public opinion, the OLS results suggest that foreign direct investment inflows to the United States are positively correlated with foreign public approval of the United States (*Poll*) and U.S. public approval of foreign countries (*Perception*). However, these results are not robust in the instrumental variable specification.

Considering foreign direct investment outflows from the United States to other countries as the dependent variable, we note from the results reported in Table 6 that while FDI flows are negatively

[14] We multiply the coefficient of *UN Opposite Vote* in Column (2), equal to -0.0087, with U.S. portfolio investment in foreign securities, equal to $10.90 billion.

correlated with *UN Opposite Vote,* the relationship is not robust to controlling for endogeneity in the instrumental variable specification. Similarly, FDI outflows do not appear to be significantly related to public opinion in the United States and other countries.

The results suggest that FDI inflows to the United States decline if bilateral government relations deteriorate, while FDI outflows do not appear to be robustly related to either government or public relations. Unlike portfolio investment, the decision to undertake foreign direct investment is less likely to respond promptly to changes in political relations. Next we investigate whether international trade flows depend on bilateral political relations.

5.4 Trade Flows

We discuss the results with U.S. exports to foreign countries as the dependent variable in Table 7. The negative and significant coefficient of *UN Opposite Vote* in the instrumental variable regression suggests that foreign exports of U.S. goods and services decline significantly following a deterioration in bilateral government relations (Column (2)). From the coefficient of *War* we note that U.S. exports to foreign countries decrease significantly following the war.

U.S. exports to foreign countries are significantly related to public opinion of the United States in those countries. Correcting for country fixed-effects and endogeneity of *Poll*, we note that a decline in foreign public approval of the United States is followed by a significant decline in U.S. exports to that country (Column (5)). The results suggest that U.S. public opinion about other countries is positively related to purchases of U.S. products in those countries (Columns (7) and (8)).

Examining the influence of political relations on the imports of foreign products by the United States in Table 8, we find that correcting for fixed-effects and endogeneity of political relations, foreign imports from a country to the United States decline significantly if that country opposes the U.S. position more frequently in the United Nations (Column (2)). Specifically, an increase in one percentage point in *UN Opposite Vote* is followed by a decrease of $336.8 million on average in quarterly imports from that country to the United States.[15] U.S. imports of foreign products do not appear to be robustly related to public opinion.

[15] We multiply the coefficient of *UN Opposite Vote* in Column (2) equal to -0.8214, with the average (log) value of imports equal to 7.085.

Our findings suggest that a deterioration in political relations between countries may lead to a decrease in bilateral trade flows. These results are robust to controlling for country fixed-effects, endogeneity of political relations, and country-specific controls.

5.5 Political Relations and the War

Next, we investigate whether a change in bilateral political relations due to an exogenous shock – the 2003 war in Iraq – leads to a shift in economic flows. Specifically, we estimate specification (2) described in Section 4 and report the results in Tables 3-8.

In the case of bilateral portfolio investment flows, we note from the coefficient of *War* × *UN Opposite Vote* that economic flows change significantly in response to an exogenous shift in political relations due to the war (Column (3), Tables 3 and 4). Although the overall effect of *UN Opposite Vote* on portfolio investment remains negative, the relationship is less negative after the war. This is consistent with the hedging hypothesis that foreign investors based in countries that experience deteriorating relations with the United States may invest more in the United States in order to hedge their country's higher political risk, and U.S. investors may invest more in foreign securities if deteriorating relations reduces opportunities for U.S. firms in that country.

From the coefficient of the interaction term we note that after the war an increase in *UN Opposite Vote* is followed by a decline in U.S. foreign direct investment flows to that country and a decrease in imports from that country to the United States (Column (3), Tables 6 and 8). Moreover, a decline in foreign public approval of the United States after the war leads to a significant decline in U.S. exports to that country (Column (6), Table 7). It also appears that after the war U.S. exports to a country increase following a decline in U.S. public approval of that country (Column (9), Table 7), although this result may not be robust due to the small sample size.

Controlling for country fixed-effects and country-specific characteristics, our results suggest that bilateral economic flows change significantly in response to a shift in political relations between the United States and other countries following the 2003 war in Iraq. This allows us to capture a causal impact of bilateral political relations on economic flows.

6 Conclusion

In this paper we investigate the relationship between bilateral political relations and economic flows between the United States and a wide range of developed and developing countries. Since political relations and economic flows are likely to be endogenously determined, we treat political relations as endogenous using instrumental variable analysis. In addition, we use an exogenous shock, the 2003 Iraq war, to identify a shift in political relations that is not related to economic flows.

There is a large literature on the role of a country's institutional characteristics, and the geographic and cultural proximity between countries, in determining cross-border economic flows. Unlike these static factors, political relations between countries are likely to vary over time and therefore can be used to explain changes in bilateral economic flows. Political relations between countries may affect economic flows through a number of different channels. In particular, deteriorating political relations between countries may increase risks to foreign investors and trade arising out of asymmetric information, expropriation risk, and changes in government policy. Political relations may also affect international trade through its effect on trade barriers and the consumption decisions of the public.

Our results suggest that capital flows between the United States and the world respond significantly to a shift in political relations. For example, bilateral portfolio and direct investment flows between the United States and other countries decrease significantly if relations between the foreign and U.S. government deteriorate. We find that investment flows also respond significantly to a shift in public opinion: A decline in foreign public approval of the United States is followed by a significant decrease in bilateral portfolio flows between that country and the United States.

The results suggest that trade flows also respond to a shift in political relations. For example, exports of U.S. products are significantly lower to countries that experience deteriorating relations with the U.S. government and whose public view the United States less favorably. Imports from foreign countries into the United States also decrease significantly following a deterioration in relations between the United States and the foreign country government. Therefore, these results suggest that political relations between countries are likely to be a key determinant of economic exchange.

References

Bekaert, Geert, Campbell R. Harvey, and Christian Lundblad, 2005. "Does financial liberalization spur growth?" *Journal of Financial Economics* 77, 3-56.

Brennan, Michael J. and Henry H. Cao, 1997. "International portfolio investment flows," *Journal of Finance* 52, 1851–1880.

Brennan, Michael J., Henry H. Cao, and Norman C. Strong, and Xinzhong Xu, 2005. "The dynamics of international equity market expectations," *Journal of Financial Economics* 77, 257–288.

Carkovic, Maria and Ross Levine, 2005. "Does foreign direct investment accelerate economic growth?" in Theodore H. Moran, Edward M. Graham, and Magnus Blomstrom (ed) *Does Foreign Direct Investment Promote Development*, 195-220, Washington, DC: Institute for International Economics.

Coval, Joshua D. and Tobias J. Moskowitz, 1999. "Home bias at home: Local equity preference in domestic portfolios," *Journal of Finance* 54(6), 2045-73.

Coval, Joshua D. and Tobias J. Moskowitz, 2001. "The geography of investment: Informed trading and asset prices," *Journal of Political Economy* 109(4), 811-41.

Dahlquist, Magnus and Göran Robertsson, 2001. "Direct foreign ownership, institutional investors, and firm characteristics," *Journal of Financial Economics* 59, 413-440.

Derouen, Karl, Jr. and U.K. Heo, 2004. "Reward, punishment or inducement? US economic and military aid, 1946-1996," *Defence and Peace Economics* 15, 453-470.

Dollar, David and Aart Kraay, 2004. "Trade, growth, and poverty," *The Economic Journal* 114 (493), 22-49.

Froot, Kenneth, Paul G. J. O'Connell, and Mark Seasholes, 2001. "The portfolio flows of international investors," *Journal of Financial Economics* 59, 151– 193.

Grinblatt, Mark and Matti Keloharju, 2001. "How distance, language and culture influence stockholdings and trades," *Journal of Finance* 56, 1053– 1073.

Grossman, Gene M. and Elhanan Helpman, 1994. "Protection for sale," *American Economic Review* 84(4), 833-850.

Guiso, Luigi, Paola Sapienza, and Luigi Zingales, 2009. "Cultural biases in economic exchange," *Quarterly Journal of Economics* forthcoming.

Kang, Jun-Koo and Rene M. Stulz, 1997. "Why is there a home bias? An analysis of foreign portfolio equity ownership in Japan," *Journal of Financial Economics* 46, 3-28.

Keynes, John, M., 1919. *The Economic Consequences of the Peace*. London: Macmillan.

LaPorta, Rafael, Florencio Lopez de Silanes, Andrei Shleifer, and Robert Vishny, 1998, "Law and finance", *Journal of Political Economy* 106(6), 1113-1155.

Lee, Jeong-Yeon and Edwin Mansfield, 1996. "Intellectual property protection and U.S. foreign direct investment," *The Review of Economics and Statistics* 78(2), 181-86.

Levine, Ross, 2005. "Finance and growth: Theory and evidence," in Philippe Aghion and Steven Durlauf, eds. *Handbook of Economic Growth*. The Netherlands: Elsevier Science.

Maskus, K.E., 2000. *Intellectual Property Rights in the Global Economy*, Washington, D.C.: Institute for International Economics.

Mill, John, S., 1848. *Principles of Political Economy*, Baltimore, Maryland: Penguin Books.

Morrow, James D., Randolph M. Siverson, and Tressa E. Taberes, 1998. "The political determinants of international trade: The major powers, 1907–90," *American Political Science Review* 92, 649–662.

Morse, Adair and Sophie Shive, 2008. "Patriotism in your portfolio," *Journal of Financial Markets* forthcoming.

Polachek, Simon, W., 1980. "Conflict and trade," *Journal of Conflict Resolution*, 24, 55-78.

Polachek, Simon, W., 1997. "Why democracies cooperate more and fight less: The relationship between international trade and cooperation," *Review of International Economics*, 5, 295-309.

Portes, Richard, Helene Rey, and Yonghyup Oh, 2001. "Information and capital flows: the determinants of transactions in financial assets," *European Economic Review* 45, 783–796.

Portes, Richard and Helene Rey, 2005. "The determinants of cross-border equity flows, " *Journal of International Economics*, 65, 269-296.

Rajan, Raghuram, G. and Luigi Zingales, 2003. "The great reversals: The politics of financial development in the 20th century," *Journal of Financial Economics* 69, 5-50.

Rauch, James E., 2001. "Business and social networks in international trade," *Journal of Economic Literature* 39, 1177– 1203.

Sarkissian, Sergei and Michael J. Schill, 2004. "The overseas listing decision: New evidence of proximity preference," *Review of Financial Studies*, 17(3), 769-809.

Siegel, Jordan, Amir N. Licht, and Shalom H. Schartz, 2008. "Egalitarianism and international investment," manuscript, Harvard Business School.

Stulz, Rene, 2005. "The limits of financial globalization," *Journal of Finance*, 60 (4), 1595-1638.

Stulz, Rene and Rohan Williamson, 2003. "Culture, openness, and finance," *Journal of Financial Economics* 70(3), 313-349.

Tesar, Linda and Ingrid M. Werner, 1995. "Home bias and high turnover," *Journal of International Money and Finance* 14, 467–492.

Thomas, Jonathan and Tim Worrall, 1994. "Foreign direct investment and the risk of expropriation," *Review of Economic Studies* 61, 81-108.

U.S. Department of State, 2000-2004. *Voting Practice in the United Nations, 2000-2004*, in Reports to Congress prepared by Bureau of International Organization Affairs, U.S. Department of State.

U.S. Department of State, 2005. "2005 Investment Climate Statement - Venezuela," Bureau of Economic Energy and Business Affairs, U.S. Department of State.

Warnock, Francis, E. and Molly Mason, 2001. "The geography of capital flows: What we can learn from benchmark surveys of foreign equity holdings," International Finance Discussion Paper, Board of Governors of the Federal Reserve System.

Appendix 1. Data Sources and Descriptions

Variable	Data Sources and Descriptions	Variable Construction	Range
	Economic flow variables		
Foreign capital inflows into U.S. corporate securities	*Source: U.S. Department of Treasury*. Capital inflow is quarterly foreign purchase of securities from U.S. residents, in millions of dollars. U.S. domestic securities include: (1) Marketable U.S. Treasury and Federal Financing bank bonds and notes, (2) Bonds of U.S. government and federally sponsored agencies, (3) U.S. corporate and other bonds, and (4) U.S. corporate stocks.	Foreign inflows into U.S. corporate securities, is the sum of (3) and (4) for each country, divided by aggregate portfolio inflows into all U.S. securities from all countries.	2000-2004
U.S. capital flows into foreign securities	*Source: U.S. Department of Treasury*. Capital outflow is quarterly purchase of foreign securities by U.S. residents from foreigners, in millions of dollars. Foreign securities include: (5) foreign bonds and (6) foreign stocks.	Purchase of foreign securities by U.S. residents is the sum of (5) and (6) for each country, divided by aggregate portfolio flows into all foreign securities of all countries.	2000-2004
Foreign Direct Investment Inflows; Foreign Direct Investment Outflows	*Source: U.S. Department of Commerce, Bureau of Economic Analysis*. Quarterly data on foreign direct investment in the U.S. and U.S. direct investment abroad, in millions of dollars. Amount less than $500,000 are coded as 0. Negative numbers are coded as missing values.	log values of FDI inflows into the U.S. and FDI outflows from the U.S.	2000-2004
U.S. exports; U.S. imports	*Source: International Trade Centre (UNCTAD/WTO).* Quarterly data aggregated from monthly U.S. imports and exports, in thousands of dollars.	log values of U.S. exports and imports	2000-2004
	Political relation variables		
UN Opposite Vote	*Source: Voting Practices in the United Nations, 2000-2004, "General Assembly – Important Votes and Consensus Actions", U.S. Department of State, Bureau of International Organization Affairs.* A country is identified as having cast an opposite vote to the U.S. if the U.S. vote on an issue is recorded as a Yes, while the country's vote on the same issue is recorded as a No, and vice versa.	For each country in each year, *UN Opposite Vote* = (number of opposite votes + abstentions + absences)/total votes, where total votes = number of opposite votes + number of identical votes + abstentions + absences	2000-2004
U.S. public perception of foreign countries (Perception)	*Source: Gallup Organization annual survey*. Based on survey question titled "Perceptions of Foreign Countries": "I'd like your overall opinion of some foreign countries. First, is your overall opinion of [RANDOM ORDER] very favorable, mostly favorable, mostly unfavorable, or very unfavorable? "	The percentage of U.S. citizens surveyed who hold a "very favorable" or a "mostly favorable" view of the foreign country	2000-2004

Foreign public perception of the United States (Poll)	*Source: 2000 data is from the Office of Research, U.S. Department of State (Canada by Environics). 2002-2004 data is from Pew Global Attitudes Public Opinion survey (Pew Research Center, 2002-2004).* Based on survey question – "Please tell me if you have a very favorable, somewhat favorable, somewhat unfavorable or very unfavorable opinion of the United States".	The percentage of foreign citizens surveyed who hold a "very favorable" view or a "somewhat favorable" view of the U.S.	2000, 2002-2004

	Instrumental variables		
Tourism	*Source: Table 22, Yearbook of Immigration Statistics (2004), Office of Immigration Statistics, U.S. Department of Homeland Security*. Annual number of nonimmigrants, in thousands, admitted to U.S.	log of the annual number of nonimmigrants admitted to the U.S.	2000-2004
Immigration	*Source: Table 3, Yearbook of Immigration Statistics (2004), Office of Immigration Statistics, U.S. Department of Homeland Security*. Annual number of immigrants, in thousands, admitted to U.S.	log of the annual number of immigrants admitted to the U.S.	2000-2004
	Control variables		
GDP per capita	*Source: World Development Indicators.* Annual frequency.	log of GDP per capita	2000-2004
Industry Growth	*Source: World Development Indicators.* Annual frequency.	Growth in industry value added	2000-2004
Domestic Credit/GDP	*Source: World Development Indicators.* Annual frequency.	Domestic credit provided by banking sector as a percentage of GDP	2000-2004
Inflation, GDP deflator (annual %)	*Source: World Development Indicators.* Annual frequency.	Log of inflation	2000-2004
Current Account Balance / GDP	*Source: World Development Indicators.* Annual frequency.	Current account balance as a percentage of GDP	2000-2004
Country Risk	*Source: Semiannual Country Reports, Euromoney* Magazine. For each country each year, country risk is the time-series annual country risk score by averaging the two semiannual country risk overall score and ranges from 0 (high risk) to 100 (low risk).	log of total risk score	2000-2004

Appendix 2. Coalition Country List for War on Iraq

The 48 countries publicly committed to the coalition include: Afghanistan, Albania, Angola, Australia, Azerbaijan, Bulgaria, Colombia, Costa Rica, Czech Republic, Denmark, Dominican Republic, El Salvador, Eritrea, Estonia, Ethiopia, Georgia, Honduras, Hungary, Iceland, Italy, Japan, Kuwait, Latvia, Lithuania, Macedonia, Marshall Islands, Micronesia, Mongolia, Netherlands, Nicaragua, Palau, Panama, Philippines, Poland, Portugal, Romania, Rwanda, Singapore, Slovakia, Solomon Islands, South Korea, Spain, Turkey, Uganda, Ukraine, United Kingdom, United States and Uzbekistan

Source: March 21, 2003 news release by White House
(http://www.whitehouse.gov/news/releases/2003/03/20030321-4.html)

Table 1. Political Relations between the U.S. and Foreign Countries

This table reports the mean values of the bilateral political relations variables during the sample period of 2000-2004. *UN Opposite Vote* is the number of opposite votes, abstentions and abstentions, divided by total votes, where total votes of a foreign country are the sum of identical votes, opposite votes, abstentions and absences. *Perception* is the fraction of U.S. residents holding a "very favorable" or "mostly favorable" view of a foreign country. *Poll* is the fraction of a foreign country's residents holding a "very favorable" view about the U.S. The war on Iraq is dated from March 2003. A list of coalition countries is in Appendix 2. Satterthwaite *p*-values are used in the test of difference in political variables between any two sub-samples. ***, **, and * denote significance at 1%, 5% and 10%, respectively.

		UN Opposite Vote	*Perception*	*Poll*
Entire sample	(1) Before the war	72.43%	50.01%	64.67%
	(2) After the war	71.19%	48.51%	37.55%
	Difference between (2) and (1)	-1.24%	-1.50%	-27.11%***
Before the war	(3) Noncoalition countries	76.84%	45.72%	60.60%
	(4) Coalition countries	59.41%	66.00%	71.00%
	Difference between (4) and (3)	-17.44%***	20.28%**	10.40%***
After the war	(5) Noncoalition countries	74.84%	44.19%	33.28%
	(6) Coalition countries	59.90%	63.89%	45.25%
	Difference between (6) and (5)	-14.94%***	19.70%**	11.97%
No. of country-year observations		921	93	97

Table 2. Economic Flows between the U.S. and Foreign Countries

This table reports the mean values of the bilateral economic flows variables during the period of 2000-2004. Foreign portfolio investment in U.S. corporate securities is the sum of investment by foreign investors in U.S. corporate and other bonds, and U.S. corporate stocks for each country. U.S. Portfolio Investment is the sum of U.S. purchases of foreign stocks and bonds in a country. FDI inflows measure direct investment by foreign firms in the U.S. and FDI outflows measure direct investment by U.S. firms in other countries. Exports are purchases of U.S. goods and services in foreign countries. Imports are purchases of foreign goods and services in the United States. All the numbers are in millions of dollars. The war on Iraq occurs in March, 2003. A list of coalition countries is given in Appendix 2. Satterthwaite *p*-values are used in the test of difference in quarterly economic flows between coalition countries and non-coalition countries. ***, ** and * = significant at 1%, 5% and 10%, respectively.

		Foreign Portfolio Investment in U.S. Corporate Securities	U.S. Portfolio Investment	FDI Inflows	FDI Outflows	U.S. Exports	Imports to U.S.
Entire sample	(1) Before the war	14,724	10,366	1,229	552	3,317	5,238
	(2) After the war	16,318	11,703	576	714	3,268	5,778
	Difference between (2) and (1)	1,594	1,337	-653***	162*	-49	539
Before the war	(3) Non-coalition countries	13,475	5,443	1,052	460	4,225	6,862
	(4) Coalition countries	17,800	22,491	1,595	714	2,311	3,408
	Difference between (4) and (3)	4,326	17,049***	543	254***	-1,913***	-3,455***
After the war	(5) Non-coaliation countries	14,502	6,032	378	588	4,187	7,872
	(6) Coalition countries	20,856	25,880	995	934	2,260	3,405
	Difference between (6) and (5)	6,354	19,847***	617**	346*	-1,927***	-4,467***
No. of observations		1,252	1,252	740	1,100	1,000	1,000

Table 3. Foreign Portfolio Investment in U.S. Corporate Securities

This table describes the relationship between political relations and foreign portfolio investment in U.S. corporate securities. The sample period is 2000-2004. The dependent variable is quarterly portfolio investment in U.S. corporate securities from a foreign country as a fraction of total foreign portfolio investment in U.S. security markets from all countries. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita)*, *Domestic Credit/GDP*, *Industry Growth*, *log(Risk)*, *log(Inflation)*, and *Current Account/GDP*. Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

Foreign Portfolio Investment in U.S. Corporate Securities									
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	-0.0106***	-0.0060**	-0.0046***						
	(0.002)	(0.003)	(0.001)						
War × *UN Opposite Vote*			0.0028**						
			(0.001)						
Poll				0.0002***	0.0002*	0.0001***			
				(0.000)	(0.000)	(0.000)			
War × *Poll*						0.0000			
						(0.000)			
Perception							0.0005***	0.0003	-0.0003***
							(0.000)	(0.000)	(0.000)
War × *Perception*									0.0000
									(0.000)
War		-0.0007**	-0.0023**		0.0036	0.0039*		-0.0012	-0.0024
		(0.000)	(0.001)		(0.002)	(0.002)		(0.002)	(0.004)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	1100	732	768	276	236	240	244	156	160
No. of countries		47	49		26	27		13	14

Table 4. U.S. Portfolio Investment in Foreign Securities

This table describes the relationship between political relations and U.S. portfolio investment in foreign equity and bonds. The sample period is 2000-2004. The dependent variable is quarterly U.S. portfolio investment in bonds and stocks of a foreign country as a fraction of total U.S. portfolio investment in security markets of all countries. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita)*, *Domestic Credit/GDP*, *Industry Growth*, *log(Risk)*, *log(Inflation)*, and *Current Account/GDP*. Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

	US Purchase of Foreign Securities								
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	-0.0113***	-0.0087***	-0.0052***						
	(0.002)	(0.003)	(0.001)						
War × *UN Opposite Vote*			0.0020**						
			(0.001)						
Poll				0.0002***	0.0002**	0.0001***			
				(0.000)	(0.000)	(0.000)			
War × *Poll*						0.000			
						(0.000)			
Perception							0.0006***	0.0003	-0.0003***
							(0.000)	(0.000)	(0.000)
War × *Perception*									0
									(0.000)
War		-0.0009***	-0.0018**		0.0036*	0.0029		-0.0009	-0.0015
		(0.000)	(0.001)		(0.002)	(0.002)		(0.002)	(0.003)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	1100	732	768	276	236	240	244	156	160
No. of countries		47	49		26	27		13	14

Table 5. Foreign Direct Investment Inflows into the United States

This table describes the relationship between political relations and foreign direct investment in the United States. The sample period is 2000-2004. The dependent variable is the log of quarterly direct investment flows into the United States from a foreign country. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita)*, *Domestic Credit/GDP*, *Industry Growth*, *log(Risk)*, *log(Inflation)*, and *Current Account/GDP*. Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

	FDI Inflows								
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	-5.118***	-9.374*	-4.439**						
	(0.547)	(4.922)	(2.216)						
War × *UN Opposite Vote*			0.683						
			(1.655)						
Poll				0.041**	0.076	-0.081			
				(0.016)	(0.172)	(0.138)			
War × *Poll*						-0.149			
						(0.112)			
Perception							0.088***	-0.044	-0.145
							(0.014)	(0.341)	(0.216)
War × *Perception*									-0.021
									(0.103)
War		-1.051	-1.171		0.143	2.572		0.472	1.704
		(0.511)	(1.165)		(3.515)	(3.824)		(1.443)	(7.449)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	672	372	372	140	104	104	152	84	84
No. of countries		26	26		12	12		8	8

Table 6. U.S. Direct Investment Outflows to Foreign Countries

This table describes the relationship between political relations and U.S. direct investment in foreign countries. The sample period is 2000-2004. The dependent variable is the log of quarterly U.S. direct investment flows to a foreign country. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita), Domestic Credit/GDP, Industry Growth, log(Risk), log(Inflation),* and *Current Account/GDP.* Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

	FDI Outflows								
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	-1.135**	-2.415	1.952						
	(0.466)	(4.883)	(1.289)						
War × *UN Opposite Vote*			-2.211*						
			(1.345)						
Poll				0.008	0.034	0.018			
				(0.009)	(0.033)	(0.026)			
War × *Poll*						0.039			
						(0.040)			
Perception							0.049***	-0.028	-0.082
							(0.011)	(0.150)	(0.078)
War × *Perception*									0.018
									(0.031)
War		0.4779	1.745**		0.866	-0.835		1.029	-0.385
		(0.317)	(0.686)		(0.894)	(1.641)		(0.923)	(2.056)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	1,032	704	704	236	188	188	232	144	144
No. of countries		46	46		21	21		13	13

Table 7. Exports of U.S. Goods and Services to Foreign Countries

This table describes the relationship between political relations and exports of U.S. goods and services to foreign countries. The sample period is 2000-2004. The dependent variable is the log of quarterly U.S. exports to a foreign country. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita)*, *Domestic Credit/GDP*, *Industry Growth, log(Risk), log(Inflation),* and *Current Account/GDP.* Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

Exports (Foreign Purchase of U.S. Products and Services)									
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	2.2448***	-1.613***	-0.3964***						
	(0.282)	(0.401)	(0.135)						
War × *UN Opposite Vote*			-0.1314						
			(0.144)						
Poll				0.0035	0.0182***	0.0056*			
				(0.005)	(0.006)	(0.003)			
War × *Poll*						0.0043**			
						(0.002)			
Perception							0.0418***	0.028**	0.0044
							(0.005)	(0.013)	(0.004)
War × *Perception*									-0.0052*
									(0.003)
War		-0.1897***	-0.0178		0.4595***	-0.0329		-0.0059	0.3317
		(0.043)	(0.085)		(0.172)	(0.135)		(0.061)	(0.235)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	953	641	688	226	188	188	199	120	120
No. of countries		42	45		20	20		11	11

Table 8. Imports of Foreign Goods and Services into the United States

This table describes the relationship between political relations and imports of foreign goods and services into the United States. The sample period is 2000-2004. The dependent variable is the log of quarterly U.S. imports from a foreign country. The variable *War* is equal to 1 for quarters including and after the first quarter of 2003 and equal to 0 otherwise. FE refers to country fixed-effects regressions. IV is an instrumental variable specification with country fixed-effects and log of *Tourism* and log of *Immigration* as instrumental variables. Control variables include *log(GDP per capita)*, *Domestic Credit/GDP*, *Industry Growth*, *log(Risk)*, *log(Inflation)*, and *Current Account/GDP*. Standard errors corrected for heteroskedasticity using the Huber-White procedure and clustering at the country level are in parentheses below coefficients. ***, ** and * indicate significant level at 1%, 5% and 10% respectively.

Imports (U.S. Purchase of Foreign Products and Services)									
	OLS	IV	FE	OLS	IV	FE	OLS	IV	FE
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Variables of Interest									
UN Opposite Vote	2.5264***	-0.8214**	0.0145						
	(0.305)	(0.418)	(0.121)						
War × *UN Opposite Vote*			-0.3925**						
			(0.16)						
Poll				0.0074	-0.0002	0.0046**			
				(0.005)	(0.005)	(0.002)			
War × *Poll*						-0.0025			
						(0.002)			
Perception							0.0237***	-0.0166	-0.0047
							(0.008)	(0.012)	(0.006)
War × *Perception*									0.0019
									(0.004)
War		-0.0039	0.2995***		0.0520	0.2664***		-0.0286	-0.1409
		(0.044)	(0.085)		(0.150)	(0.086)		(0.056)	(0.295)
Control Variables	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Country Fixed-Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
No. of observations	953	641	688	226	188	188	199	120	120
No. of countries		42	45		20	20		11	11