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Climate Policy and International Capital Reallocation

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Abstract

This study employs bilateral data on external assets to examine the impact of climate policies on the reallocation of international capital. We find that the stringency of climate policy in the destination country is significantly and positively associated with an increase in the allocation of portfolio equity and banking investment to that country. However, it does not show significant effects on the allocation of foreign direct investment and portfolio debt. Our findings are not driven by valuation effects, and we present evidence that suggests diversification, suasion, and uncertainty mitigation as possible underlying mechanisms.

Keywords: capital flows, climate change policy, green investment, international asset allocation

JEL classification: F21, F36, F64

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1 Introduction

The urgent need to address climate change has brought forth a new frontier in global governance regarding climate policies aimed at reducing carbon emissions and curbing temperature increases. Nevertheless, the stringency of climate policies varies among countries, and regulatory risk is identified as the top climate-related risk to businesses and investors according to a survey of finance academics, professionals, regulators, and policy economists (Stroebel and Wurgler 2021). International capital flows, with total external assets amounting to approximately 200 trillion dollars and 200% of global GDP as of 2019, are significantly exposed to climate policies.[1] The question arises as to how the international financial market responds to this divergence in climate policies across nations. Will more capital be allocated to countries with lax policies, thereby undermining efforts to combat climate change? Alternatively, will capital favor countries with more rigorous climate policies, thus fostering a global improvement in environmental regulation? Understanding the consequences of the underlying competing hypotheses — that investors either race to the bottom to evade climate responsibility or race to the top to reward stricter rules — has important implications for the efficiency of global coordination of climate policies.

Focusing on a cross-country setting with a broad set of capital investments is crucial to address the spillovers of the national climate policies and the significant differences among asset types (Levchenko and Mauro 2007, Contessi et al. 2013, Giordani et al. 2017, Converse 2018, Cerutti et al. 2019, Cerutti and Hong 2021). The patterns generally observed in aggregate capital flows may not apply uniformly across all types of flows, and it is not immediately apparent which direction the evidence will point. In particular, foreign direct investment (FDI) is noted for its resilience and long-term nature, whereas portfolio investment and other investment (mostly bank loans) are recognized for their volatility and sensitivity to external conditions, reflecting changes in investors' risk pref-

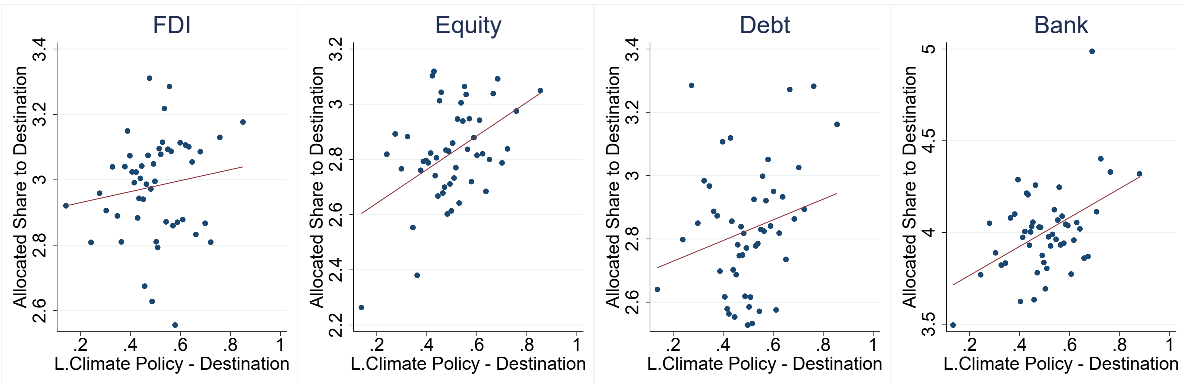
[1] These figures are derived from the External Wealth of Nations database by Lane and Milesi-Ferretti (2018). We calculated the sum of financial claims on nonresidents including foreign direct investment (FDI), portfolio equity, portfolio debt, and other investments, while excluding derivatives and gold holdings, from all countries. Figure A1 in the appendix shows the scale of global external investments over the years.

erences and diversification strategies in the financial markets. Within the latter types of assets, portfolio equity generally exhibits limited volatility and is less prone to maturity mismatches, unlike portfolio debt and bank investments, which tend to display greater volatility and persistence. Until this point, there has been scant systematic analysis of how various types of capital flows respond to climate policies. This paper fills this gap and contributes to the empirical evidence on the relationship between the dynamics of international asset allocation and the stringency of climate policies worldwide.

We use data on bilateral asset holdings across different asset types and national climate policy stringency indicators, covering approximately 40 countries, 1,470 country pairs, from 2009 to 2019, to examine the impact of climate policies on international capital reallocation. Specifically, we focus on examining the role of the stringency of a destination country's climate policy in affecting the foreign capital allocated to it. We highlight the comparison of the impact on four different types of assets under the same framework: FDI, portfolio equity, portfolio debt, and bank investment. We first construct the weight of each destination country in the international assets holdings, in one of the four types of assets, of each source country, and then we examine whether and how the climate policies in the destination country are associated with the share of assets allocated to this country. With the granular bilateral data, we can saturate the identification using country pair and source country-year fixed effects, which allow us to isolate the influence of variations in climate policies in the destination countries. These variations are less susceptible to the influence of foreign investors, helping to mitigate concerns about reverse causality in our empirical findings. Moreover, we employ a rich set of control variables and exploit the differences in the climate policy between source and destination countries to mitigate concerns about omitted variables. To further address concerns about endogeneity, we employ an instrumental variable (IV) approach that leverages exogenous variation in country-specific geographic features, combined with global pressure to adopt climate policies in response to natural disasters. Lastly, we employ local projection methods to explore the dynamic effects and address concerns regarding autocorrelation over time.

To provide a glimpse of our baseline findings, Figure 1 shows a binscatter plot between a measurement of the climate policy of the destination country and the weight of cross-border assets allocated to this country. We take 50 bins that are equal in size based on the values of the climate policies in the horizontal axis and show the average weights of assets in each bin in the vertical axis. We control for country-pair and source-country-year fixed effects in this exercise. The figure shows that the role of climate policies varies across asset types. FDI and portfolio debt are insignificantly correlated with the climate policy in the destination country, meanwhile, the allocation of portfolio equity and bank investment tend to be positively correlated with it. The more stringent the destination country is regarding climate change, the higher the weight of equity and banking assets allocated there.

Figure 1: Binscatter Plot of Climate Policy Stringency and Asset Allocation



Notes: The vertical axis reports the share of assets allocated to the destination country for 50 equal-sized groups defined in terms of the climate policy stringency in the destination country on the horizontal axis. The climate policy index is obtained from Germanwatch.

Our empirical analyses formally test and confirm these findings. Specifically, when the climate policy in the destination country tightens by one standard deviation, approximately the gap of average policy restrictiveness between Turkey and Austria, there is a noteworthy increase in the share of allocated portfolio equity assets and banking assets to this country of about 0.12 and 0.17 percentage points, respectively. These impacts are meaningful given the average share of equity and banking assets allocated across countries being 2.82% and 4.01%, respectively. Moreover, we find that advanced countries play a key role in driving the baseline results by directing their assets toward other advanced countries based on climate policies, and the magnitude almost doubles that in the baseline. In contrast, the reallocation effect is insignificant regarding emerging markets as either the source or destination country. Furthermore, local projections show that the positive effect on portfolio equity reallocation is persistent over the five-year horizon.

Next, we conduct various tests to show the robustness of the baseline results. Our main findings remain when we use alternative measurements of climate policy stringency and external assets positions, examine the role of climate change performance in parallel to climate policies, and account for potential substitution effects between different types of assets. In addition, a set of placebo tests based on reshuffled climate policy data shows that it is the true policy stringency that drives our results.

Finally, we investigate several potential mechanisms behind the positive relationship between climate policy stringency and cross-border allocation of portfolio equity and banking assets. First, we examine the valuation effects on currency values and equity prices and show that our findings are not driven by passive reallocation. Second, we assess a country's overall exposure to climate policy stringency based on the composition of its international portfolios. We find a stronger effect on both equity and banking assets allocation when the country is exposed to a pool of alternative destinations (excluding the given destination country) with lax climate regulations, indicating a diversification mechanism. Third, we use the share of Green Parties in the parliament as a proxy of investors' green awareness in the country and find a more pronounced effect on portfolio equity reallocation when the country's green awareness is high, indicating a suasion mechanism. Lastly, we provide evidence for an uncertainty mitigation mechanism as we detect a stronger impact of climate policy stringency when the energy price uncertainty is high.

We contribute to the literature by conducting a comprehensive examination of the heterogeneous impacts of climate policies on the international allocation of four different types of assets and across different country groups. We also look into the granular policy classifications and compare the effect of market-based and non-market-based policies. Moreover, we provide discussions on the mechanisms of diversification, suasion motivations, and uncertainty mitigation. The policy implications are that international equity and banking investments tend to race to the top and follow stringent climate policies, especially the non-market-based ones, and the international financial market could foster the coordination of climate policies across nations.

The rest of the paper is organized as follows. Section 2 provides a review of related literature and highlights the innovation and contribution of this study. Section 3 describes the data source and construction of key variables used in the analysis. Section 4 presents the empirical analysis, including the identification strategy, baseline findings, and robustness checks. Section 5 examines the underlying mechanisms.Section 6 concludes.

2 Related Literature

This study contributes to the growing research on climate change and finance. There are many studies documenting the challenges that financial markets face during the transition to a green economy; see Giglio et al. (2021) for a review. This strand of literature includes the discussions on both regulatory risks (Krueger et al. 2020, Mueller and Sfrappini 2022, Bartram et al. 2022, Kacperczyk and Peydró 2022, Reghezza et al. 2022, Ramelli et al. 2021, Seltzer et al. 2022, Khalil and Strobel 2023, Hale et al. 2024) and psychical risks (Bernstein et al. 2019, Bakkensen and Barrage 2022, Nguyen et al. 2022) on the domestic financial markets including firm investment, equities, bonds, and bank loans. Surprisingly, however, there have been few studies examining the impact of climate policies on cross-border capital allocation until recently.[2]

Moreover, the recent literature relating climate change risks to international capital flows all focuses on a certain type of assets, with the effect on FDI being the most investigated (Cole et al. 2017). Theoretically, Dijkstra et al. (2011) provide a framework suggesting that more stringent environmental regulation can attract more FDI as it increases the production costs for all firms and foreign firms have a cost advantage due to more efficient technologies, and Gu and Hale (2023) propose a model for firm production

[2]Besides the impact on capital flows, Hale (2024) focus on the impact of climate-related disasters on real exchange rates and examine the role of different belief formation assumptions.

location choice that incorporates transition and physical risks and it predicts a reduction in FDI while highlighting the role of emission productivity of firms. Habla (2018) models capital and fossil fuels as mobile production factors across countries and shows that resource tax leads to capital and resource flight while capital subsidy reallocates both capital and resources back to the home country.

Empirical evidence is mixed as well. For instance, Gu and Hale (2023) do not find robust evidence on whether multinational firms react to climate-related physical risks and mitigation policies using cross-country data. Based on national policy changes, Hanna (2010) uses U.S. data to show that there is an increase in FDI in response to more stringent regulations as implemented by the Clean Air Act Amendments, Chung (2014) uses Korean data to show that polluting industries tend to invest more in countries with laxer environmental regulations, and Cai et al. (2016) and Ni et al. (2022) use Chinese data to demonstrate that environmental regulations lead to less FDI inflows on average.

There are also increasing efforts using syndicated loan data to test how banks' international lending activities respond to climate policies. Demirgüç-Kunt et al. (2023) find that after authorities in the host country strengthen their climate-related actions, there is a marginal increase in the lending portfolio of banks, while Benincasa et al. (2022) show that global banks react to higher climate policy stringency in their home country by increasing their cross-border lending to exploit the lack of global coordination in climate policies. Regarding the portfolio market, De Haas and Popov (2023) show that countries with deeper stock markets reduce emissions faster by facilitating the development of cleaner technologies, and Ferriani et al. (2023) is one of the few studies investigating the effects of adverse catastrophic events using the data of capital flows to mutual funds and document a shortfall in investors' net inflows to the affected country, that is, investors "flight to climatic safety".

To the best of our knowledge, we are the first study comprehensively examining the effect of climate policies on the bilateral allocation of four types of assets at the same time. Yang (2008) examines the impact of hurricanes on different types of international financial flows, but it is limited to the effect of hurricanes and only uses country-level data. In contrast, we contribute to the literature by focusing on the stringency of climate policies and comprehensively using bilateral holding data of all four categories of assets. We also provide discussions on the heterogeneity between advanced and emerging countries, granular categories of policies, and various mechanisms including valuation effects, diversification, green awareness, and uncertainty mitigation.

3 Data

3.1 Bilateral Holdings

We use various databases to access the bilateral holding positions of four types of assets between countries.[3] Specifically, we obtain the data of FDI holdings from the Coordinated Direct Investment Survey (CDIS) by International Monetary Fund (IMF), the portfolio equity and debt holdings from the Coordinated Portfolio Investment Survey (CPIS) by IMF, and banking investment positions from the Locational Banking Statistics (LBS) launched by Bank for International Settlements (BIS). We use the end-of-year values of the outstanding external asset positions to ensure the consistency of annual frequency across different datasets. We exclude tax havens such as Cyprus, Ireland, Luxembourg, Malta, Netherlands, and Singapore from our sample to focus on transparent channels of capital reallocation.[4] To compare the magnitude of the findings, in the appendix, we also report results using export data from the UN Comtrade Database.

Therefore, we have the investment positions of the above four types of assets from each source country s to each destination country d. To measure the capital reallocation, we use the weight of each destination country in the total external positions of the source country: $\frac{Assets_{sdt}}{\Sigma_d Assets_{sdt}}$, and this measurement can be applied to each type of assets. We trim the observations below the 0.5th percentile and above the 99.5th percentile to mitigate

[3] In addition to bilateral holdings, we utilize country-level external asset data compiled by Lane and Milesi-Ferretti (2018) and aggregate it across country groups. This approach allows us to present trends and compositions of the four asset types over the years. See Figure A2 in the appendix.

[4] Another way to address the concerns about tax havens is to employ the restated bilateral positions for portfolio equity and portfolio debt by Coppola et al. (2021), which adjusts for securities associated with tax havens. However, the downside of this approach is that it does not include data for FDI and banking assets, and countries belonging to the European Monetary Union are aggregated as one investor, leading to a substantial loss in variation.

the impact of outliers. Figure A3 in the appendix reports the top three source countries and their respective shares allocated to the five largest partner countries for each asset type.[5] We account for potential valuation effects that may contaminate investors' active reallocation in later discussion. In addition, we construct the intensity of assets by the ratio of investment positions in the destination country to the GDP in the source country, which is used as an alternative explained variable in the robustness check. Panel A of Table 1 summarizes the weight and intensity variables of bilateral investment variables.

3.2 Climate Policies

In the main analysis, we use the national climate policy index, a subcomponent of the overall climate change performance index (CCPI) published by Germanwatch to measure the stringency of each country's climate policies. The index examines countries' climate policies and governance frameworks that contribute to effective climate action. Specifically, expert evaluations of climate and energy policy, sourced from non-governmental organizations, universities, and think tanks, are used to assess the climate policy. These experts provide ratings by responding to a questionnaire that measures their government's performance on critical indicators including the existence and implementation of national climate strategies, emission reduction targets, adaptation plans, and measures to promote climate resilience. The ratings are given on a Likert scale ranging from one ("weak") to five ("strong"), which are subsequently transformed into an index ranging from 0 to 100. This index is a transparent and comprehensive measure of a country's climate policy. With global comparability, it has been presented at the United Nations' annual climate change policy conferences and used by the financial industry, various policy institutions, and academic research (Beyene et al. 2021, Benincasa et al. 2022).

Additionally, we also use the overall CCPI in robustness checks. The overall performance combines the information of the following three aspects in addition to climate policy. First, the indicator considers the greenhouse gas (GHG) emission per capita and

[5] Additionally, we report the same figure with tax haven countries included in the sample in Figure A4 in the appendix. At the unilateral level, Figure A5 presents the top 10 investor countries by asset type.

measures the total emissions of carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), and other GHGs produced within a country's borders. Second, it accounts for the use of renewable energy by assessing the share of renewable energy in a country's total energy consumption, investment in renewable energy infrastructure, and policies promoting renewable energy deployment. Third, it also considers energy efficiency and accounts for factors such as energy consumption per capita, energy-saving measures, energy-efficient infrastructure, and energy labeling schemes. The overall performance index is a weighted average of the scores of the four aspects: GHG emissions (40%), energy use (20%), renewable energy (20%), and overall climate policy (20%).

It is worth noting that our main analysis relies on the national policy index, a subcomponent of the overall climate policy index in CCPI. This index captures a country's domestic climate regulations and governance, focusing on policies implemented at the national level. In contrast, the global policy index, another subcomponent of policy index in CCPI, measures a country's engagement in global climate initiatives, such as participation in international agreements and commitments at climate summits. The overall policy index combines both national and international dimensions, offering a broader but less precise measure of regulatory effort. Beyond policy, as described above, the overall CCPI integrates policy assessments with environmental outcomes, including emissions levels, renewable energy adoption, and energy efficiency. A detailed description of all CCPI components, including their definitions and weightings, is provided in Table A3 in the appendix. While Benincasa et al. (2022) use the overall CCPI index—which encompasses both policy and performance indicators—we focus specifically on the national policy index to isolate the role of domestic regulatory frameworks in shaping international capital flows. This approach helps eliminate potential contamination of regulatory transitions by physical transitions.

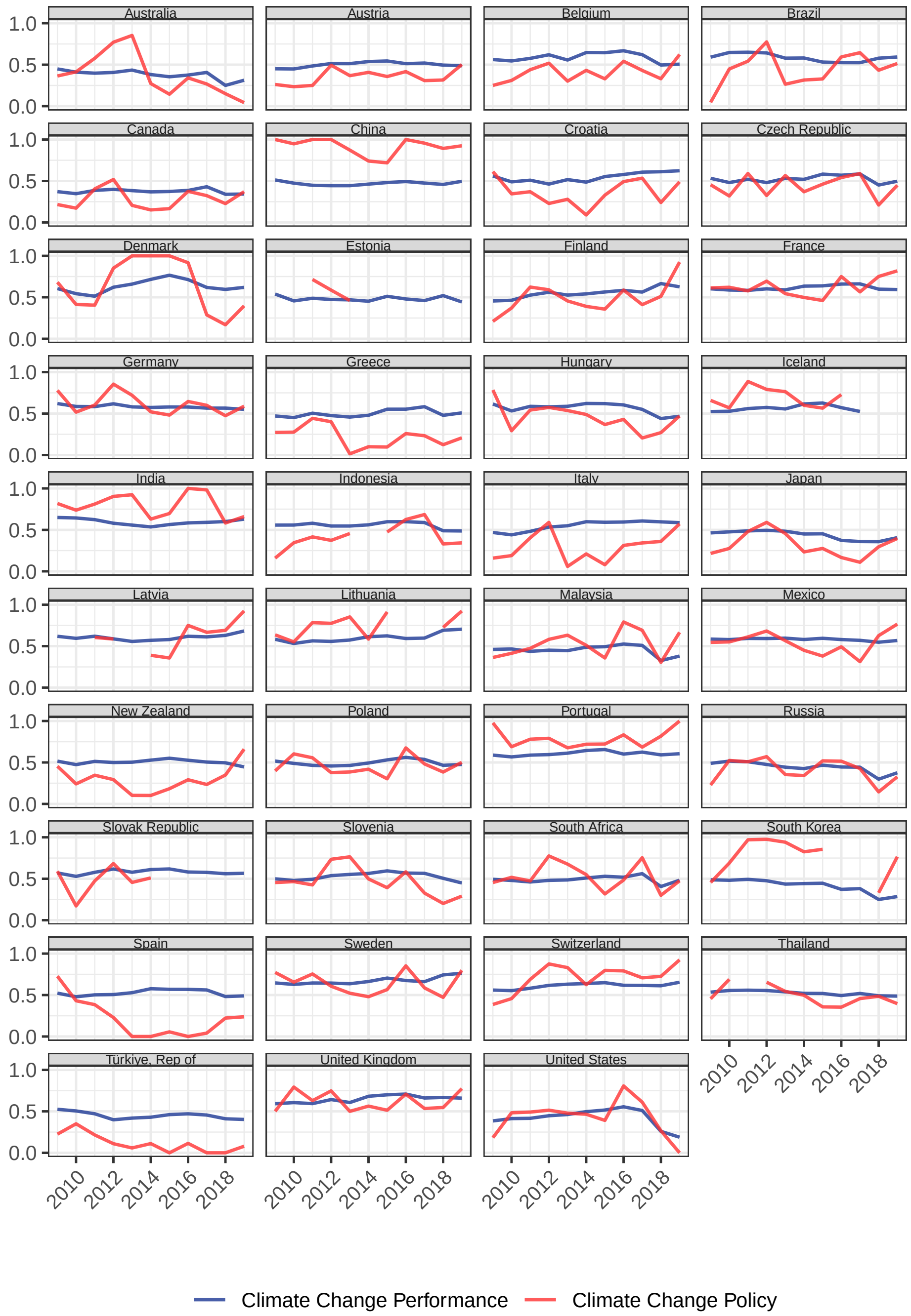
Both the original policy and performance indicators rank countries on a scale from 0 to 100, with higher scores indicating more restrictive policies or better performance. Throughout this study, we divide the original indicators by 100 to make them range from 0 to 1, in order to ease the interpretation of coefficients in the empirical analysis. Figure

2 shows the time series of both the climate policy and performance variables for each country in our sample.[6] We observe large variations across years and countries, which provide a good base for identification in later empirical analysis. Furthermore, Figure A6 in the appendix shows the average scores of the two indicators for advanced and emerging countries separately. It demonstrates that advanced countries have better climate change performance than emerging countries and both groups have volatile climate policy stances over the years.

We also incorporate the Environmental Policy Stringency (EPS) Index developed by the Organization for Economic Co-operation and Development (OECD) as an alternative, though its country coverage is smaller than that in the Germanwatch database. Contrary to the Germanwatch index, this index quantifies the stringency of environmental policies based on objective metrics rather than expert evaluations. It evaluates the stringency of environmental policies through a blend of market-based policies, non-market-based policies, and technology support policies, each carrying a weight of one-third. The market-based policy component encompasses a spectrum of measures, including taxes on carbon dioxide (CO2), nitrogen oxides (NOx), sulphur oxides (SOx), and diesel emissions, as well as trading schemes encompassing CO2 and renewable energy certificates. The non-market-based policy component assesses standards like emissions limit values for NOx, SOx, particulate matter (PM), as well as sulfur content limits for diesel. The indicator for technology support policies includes R&D subsidies directed towards low-carbon energy technologies as well as renewable energy support for solar and wind technologies.

[6]There are some gaps in the climate policy data for certain countries due to the absence of expert ratings in those years. To mitigate concerns about the unbalanced panel resulting from missing data, we performed analyses using the baseline specification on a balanced sample. This sample includes only countries with complete data for all baseline control variables over the full sample period. The results of these analyses are presented in the appendix in Table A4 and Figures A7-A8.

Figure 2: Climate Change Performance and Policy Indicators by Country



Notes: This figure shows the climate change policy and performance index from Germanwatch for each country. The missing data on the climate change policy index means that Germanwatch found no experts in that country-year to evaluate.

Lastly, our analysis also integrates a range of control variables to account for potential economic and financial influences. Specifically, we control for the CO2 emission intensity when the CCPI index is not used; it is measured as the logarithm of CO2 emissions in kg per unit of GDP and sourced from the Climate Watch Historical GHG Emissions and

Table 1: Summary Statistics

Variable	Mean	SD	Min	Max	N
Panel A: International Capital Allocation					
Allocated Share of FDI Assets (%)	2.99	6.85	0.00	58.96	10636
FDI Assets/GDP	0.65	2.29	0.00	65.51	10636
Allocated Share of Portfolio Equity Assets (%)	2.82	7.54	0.00	65.14	11396
Portfolio Equity Assets/GDP	0.39	1.71	0.00	46.96	11396
Allocated Share of Portfolio Debt Assets (%)	2.82	6.52	0.00	57.28	11363
Portfolio Debt Assets/GDP	0.59	1.80	0.00	25.03	11363
Allocated Share of Banking Assets (%)	4.01	8.63	0.00	68.67	4365
Banking Assets Assets/GDP	1.66	4.40	0.00	53.19	4365
Allocated Share of Exports (%)	2.52	4.42	0.00	32.39	13288
Exports/GDP	0.62	1.35	0.00	20.86	13288
Panel B: Climate Policy and Performance					
Climate Policy - Destination	0.50	0.23	0.00	1.00	390
Climate Policy - Source	0.49	0.23	0.00	1.00	378
Climate Change Performance - Destination	0.54	0.08	0.25	0.74	390
Climate Change Performance - Source	0.54	0.08	0.25	0.74	378
Log CO2 Intensity - Destination	-1.20	0.73	-2.98	0.47	390
Log CO2 Intensity - Source	-1.22	0.71	-2.98	0.45	378
Panel C: Control Variables					
GDP Growth Rate - Destination	2.23	3.09	-9.36	13.48	390
GDP Growth Rate - Source	2.10	2.89	-9.36	9.81	378
Inflation - Destination	2.78	3.25	-5.99	24.46	390
Inflation - Source	2.76	3.23	-5.99	24.46	378
Long-term Government Bond Yield - Destination	4.33	3.09	-0.36	20.23	390
Long-term Government Bond Yield - Source	4.34	3.13	-0.36	20.23	378
Central Bank Policy Rate - Destination	2.76	3.17	-0.75	15.79	390
Central Bank Policy Rate - Source	2.74	3.18	-0.75	15.79	378
Log Exchange Rate	-0.02	3.23	-9.93	9.93	11396

WDI. For macroeconomic variables, we include the average real GDP growth rate over two years obtained from the World Development Indicators (WDI), the inflation rate sourced from the IMF, the short-term central bank policy rate and long-term government bond yield, obtained from Datastream. Furthermore, we construct the logarithm of bilateral exchange rates using cross rates against the USD based on data from Thomson Reuters' Refinitiv, which provides information on currency fluctuations and trade dynamics, and we express the bilateral exchange rate in the way that an increase in its value indicates an appreciation of the destination country's currency. Panel B of Table 1 reports the summary statistics of these variables. The number of observations differs because some variables – such as climate policy and performance indicators, as well as macroeconomic control variables– are defined at the country level, while others – such as international capital allocations and exchange rates – are defined at the country-pair level. Additionally, discrepancies in the number of observations for destination and source countries arise due to asymmetries in financial reporting and investment activity, resulting in slightly more destination countries than source countries covered in the data. Table A1 in the appendix presents the detailed definition of each variable.

The country and year coverage of the final dataset are the results of the availability of both bilateral holdings and climate policy data. Overall, our sample spans the period from 2009 to 2019 and covers 1,470 unique source-destination relationships. We exclude the years of the global financial crisis and the COVID-19 pandemic due to the very different characteristics of the global economy during these periods. Regarding FDI, portfolio equity, and portfolio debt, 26 out of 39 countries in our sample are advanced countries and for banking assets, 18 out of 26 countries are advanced countries. Table A2 in the appendix lists the countries in the sample for each type of asset.

4 Empirical Analysis

In this section, we empirically examine whether and how international capital allocation responds to climate policy stringency. Section 4.1 outlines our baseline specifications and identification strategies, incorporating a granular set of fixed effects and control variables in panel regressions. Section 4.2 presents our main findings. To assess the persistence of these effects, we employ local projections in Section 4.3. In Section 4.4, we address potential endogeneity concerns by systematically ruling out multiple sources of bias and establishing causality through an instrumental variable approach that leverages exogenous variation in global climate shocks interacted with country-specific vulnerability. Section 4.5 tests the robustness of our results across various model specifications and alternative measures of climate policy stringency. Finally, Section 4.6 explores heterogeneous effects across country groups and different types of climate policies.

4.1 Identification Strategy

We first examine the responses of international capital allocation to the climate change policies of both the source and destination countries using the following specification:

$$Share^{type}_{s,d,t} = \beta_{s1}CP_{s,t-1} + \beta_{d1}CP_{d,t-1} + \beta_{s2}X_{s,t-1} + \beta_{d2}X_{d,t-1} + \alpha_{s,d} + \delta_t + \epsilon_{s,d,t} \quad (1)$$

where s, d, and t denote source country, destination country, and year, respectively. The dependent variable $Share^{type}_{s,d,t}$ is the share of external assets of country s allocated in country d in year t, and *type* denotes one of the four types of assets: FDI, portfolio equity, portfolio debt, and banking investment.[7] On the right hand side, $CP_{s,t-1}$ and $CP_{d,t-1}$ are the climate policy indices for the source and destination country as described before. X is a set of control variables that could correlate with capital allocation, including the log CO2 emission intensity, the average real GDP growth rate in the previous two years, the inflation rate, the short-term central bank policy rate, and the long-term government bond yield for the source and destination country separately, and the log bilateral exchange rate for the country pair. We take the lagged terms of climate change policies and control variables to mitigate the concern about reverse causality. $\alpha_{s,d}$ and δ_t are country-pair and year fixed effects, which are important for the identification as they absorb any confounding factors that are constant across the source-destination pair such as cultural distance and language similarities and that are common for all countries in a given year such as global financial conditions. $\epsilon_{s,d,t}$ is the error term. Throughout the paper, we cluster the standard errors at the country-pair and source country-year level to account for potential correlations.

The coefficients we are interested in are β_{s1} and β_{d1}, which capture the impact of climate change policies of the source and destination country, respectively, on the capital allocation. Moreover, focusing on the effect of the destination country's climate policies,

[7] In addition, to compare with the effects on international trade, we use the share of exports allocated to a destination country as the dependent variable and present the results in Table A6 in the appendix. We also show results adding export allocation as a control variable in Table A7.

we enhance the identification by adding the source country-year fixed effect $\theta_{s,t}$, thereby the estimated impact absorbs all push factors from the source country and arises from differences across the destination country alone:

$$Share_{s,d,t}^{type} = \beta_{d1}\prime CP_{d,t-1} + \beta_{d2}\prime X_{d,t-1} + \alpha_{s,d} + \theta_{s,t} + \epsilon_{s,d,t} \quad (2)$$

In this specification, the estimates of all source country variables are absorbed, and the coefficient $\beta_{d1}\prime$ provides the impact on reallocation when the climate policy in the destination country becomes more stringent by one unit, while holding the same source country-year. On one hand, since the policy and economic conditions in the destination country are exogenous to the source country, and all confounding effects that are time-variant at the source country are removed, this specification provides a robust identification that effectively addresses concerns of reverse causality.[8] On the other hand, despite the rich set of control variables and granular fixed effects, concerns about omitted variables and confounding factors persist. For instance, there might be some characteristics that are not controlled for and affect climate policy stringency and capital allocation at the same time, thus bias our estimates.

To mitigate concerns about endogeneity, we first exploit the difference in policy stringency between the destination and origination country rather than control for them separately, as it is highly unlikely to argue for an omitted variable to be correlated with this difference. Additionally, we formally address endogeneity by applying the Oster (2019) approach to assess the impact of unobserved confounders and by employing an instrumental variable strategy that leverages exogenous variation in global climate shocks interacted with country-specific vulnerability. The intuition behind this approach is that countries more exposed to climate risks are more likely to tighten their climate policies in response to global climate-related disasters, generating plausibly exogenous variation in policy stringency. This enables us to establish the causal effect of climate policy on

[8]One might consider that foreign investors could attempt to influence climate policies in destination countries to their advantage. However, it is important to note that the influence of investors, even significant ones, is likely confined to regional policies since national governments prioritize broader environmental objectives.

international capital allocation. The results are presented in Section 4.4.

4.2 Baseline Results

Table 2 shows the baseline results from panel regressions, where we first report the estimates without other control variables except the climate policies and then include them and gradually saturate the identification using more fixed effects.

Table 2: Baseline: Climate Policy and Reallocation Effect

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.121	0.010	0.058	0.619***	0.537**	0.529**	0.316	0.228	0.245	0.786**	0.759**	0.740**
	(0.206)	(0.195)	(0.194)	(0.232)	(0.226)	(0.224)	(0.270)	(0.255)	(0.249)	(0.360)	(0.348)	(0.343)
L.Climate Policy - Source	-0.088	-0.001		0.093	0.036		-0.183	-0.166		0.146	0.177	
	(0.121)	(0.131)		(0.150)	(0.155)		(0.246)	(0.229)		(0.164)	(0.138)	
L.Log CO2 intensity - Destination		-1.038**	-1.010**		-0.956*	-0.893		-0.423	-0.234		0.680	1.205
		(0.507)	(0.497)		(0.552)	(0.549)		(0.482)	(0.495)		(0.756)	(0.782)
L.Log CO2 intensity - Source		0.609			-0.602			-0.188			-0.395	
		(0.542)			(0.413)			(0.461)			(0.553)	
L.GDP Growth Rate - Destination		0.029*	0.030*		0.018	0.021		0.003	0.010		-0.030	-0.036
		(0.016)	(0.015)		(0.016)	(0.017)		(0.017)	(0.016)		(0.028)	(0.027)
L.GDP Growth Rate - Source		0.009			-0.027*			-0.008			-0.007	
		(0.016)			(0.016)			(0.016)			(0.044)	
L.Inflation - Destination		0.006	0.006		0.031***	0.030***		-0.002	-0.003		-0.025*	-0.024*
		(0.013)	(0.013)		(0.010)	(0.010)		(0.010)	(0.010)		(0.014)	(0.014)
L.Inflation - Source		-0.003			-0.012			0.002			-0.007	
		(0.013)			(0.023)			(0.012)			(0.029)	
L.Government Bond Yield - Destination		-0.002	-0.014		0.020	0.026*		-0.012	-0.011		0.004	0.012
		(0.021)	(0.020)		(0.016)	(0.016)		(0.022)	(0.021)		(0.019)	(0.023)
L.Government Bond Yield - Source		-0.003			-0.019			0.024			-0.045	
		(0.028)			(0.027)			(0.024)			(0.032)	
L.Central Bank Policy Rate - Destination		0.041	0.038		0.041	0.039		0.049*	0.046*		0.035	0.049
		(0.030)	(0.031)		(0.026)	(0.025)		(0.025)	(0.025)		(0.042)	(0.045)
L.Central Bank Policy Rate - Source		-0.041			0.002			-0.018			0.025	
		(0.040)			(0.036)			(0.042)			(0.051)	
L.Log Exchange Rate		0.098	0.148		0.182***	0.296***		0.086	0.243		0.927*	1.837**
		(0.083)	(0.106)		(0.068)	(0.080)		(0.084)	(0.169)		(0.521)	(0.823)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10636	10636	10636	11396	11396	11396	11363	11363	11363	4365	4365	4365
R2 Adj.	0.892	0.892	0.895	0.912	0.912	0.911	0.839	0.839	0.842	0.957	0.957	0.956

Notes: *** $p<0.01$, ** $p<0.05$, * $p<0.1$. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

We observe that climate policy is significantly associated with asset reallocation across borders, but this effect differs by types of assets. The coefficients of the climate policy in the destination country are significantly positive across all specifications for the allocation of portfolio equity and banking investment, but insignificant for the allocation of FDI and portfolio debt. Specifically, for a given source country in a year, when the climate policy in the destination country becomes more restricted by one standard deviation (0.23), which is approximately equivalent to the difference between the average policy stringencies of

Turkey and Austria, the share of equity assets and banking assets allocated to this country is significantly increased by 0.12 and 0.17 percentage points, respectively.[9] Given that the average share of equity and banking assets allocated across countries are 2.82% and 4.01%, the estimated effects are economically meaningful. These results indicate that equity investors and bank lenders care about climate change policies when constructing their overseas portfolios, and they intend to increase investment in countries that care more about the environment and climate change. These findings are consistent with the literature showing that stock market investors help to reduce emissions of carbon-intensive industries and reallocate investment towards firms that are more responsible to climate (e.g., De Haas and Popov 2023, Ramelli et al. 2021) and bank lenders show strong preferences for green assets (e.g., Demirgüç-Kunt et al. 2023, Reghezza et al. 2022).

Considering other country characteristics, we observe that a higher CO2 intensity and a lower GDP growth rate in the destination country are significantly linked to decreased FDI allocation. For an increase in the destination country's inflation rates, interest rates, and currency values, we observe a significant increase in portfolio equity allocation. Lastly, the allocation of banking assets to the destination country is significantly associated with a lower inflation rate and currency appreciation.

4.3 Dynamic Effects

In a further step, to investigate the persistence of climate policy's impact on global capital reallocation, we employ local projections (Jordà 2005) with the equation:

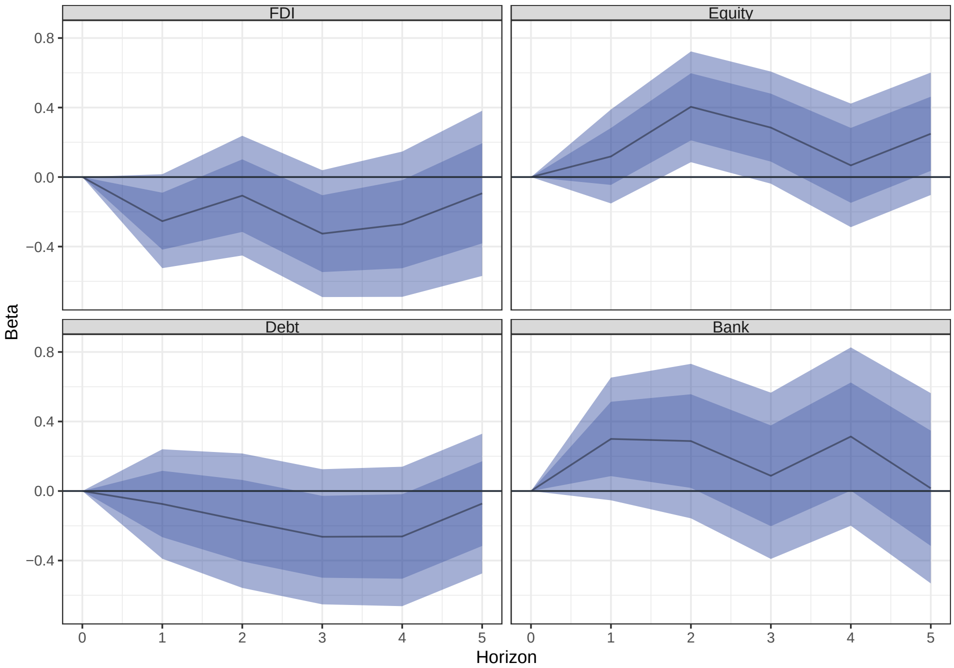
$$\begin{aligned} Share^{type}_{s,d,t+h} - Share^{type}_{s,d,t} = \beta^{h\prime} CP_{d,t-1} + \Sigma^{2}_{k=1}\gamma^{h\prime}_{k} Share^{type}_{s,d,t-k} \\ + \eta^{h\prime} X_{d,t-1} + \alpha^{h}_{s,d} + \theta^{h}_{s,t} + \epsilon^{h}_{s,d,t}, \end{aligned} \tag{3}$$

where $h = 1, ...5$ denotes the forecasting horizon. In this setting, $\beta^{h\prime}$ measures the

[9] For an alternative interpretation, we re-estimate the model using the original 5-point Likert scale values assigned by experts instead of the climate policy stringency index. The results, presented in Table A5 in the appendix, indicate that moving up one level on the Likert scale – for instance, from a medium to a rather strong evaluation of a destination country's climate policy – raises equity and banking asset allocation by 0.21 and 0.29 percentage points, respectively.

cumulative percentage points change in $Share_{s,d}^{type}$ from t to $t+h$, arising from the impulse variable $CP_{d,t-1}$. The simulated shock is a one-unit increase in the destination country's climate policy index. To allow for feedback effects within the model, we control for one- and two-period lagged values of the share of assets country s allocated in country d. In this way, this specification controls the level of asset allocation and climate policy in the past at the same time, thus capturing a substantial set of potential confounding factors that affect them both. We also control for the destination's lagged country characteristics ($X_{d,t-1}$), source-destination country pair, and source-country-year fixed effects.

Figure 3: Local Projections



Notes: Responses to a one-unit increase in the destination country's climate policy index. The shaded areas represent 68 and 90 percent confidence bands, respectively, calculated by using standard errors clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Figure 3 presents the local projection results. The dark- and light-shaded areas represent 90 and 68 percent confidence bands, respectively. The positive effect of more stringent climate policies on the allocation of portfolio equity is significant and persistent over time, with the impact peaking after two years. For bank asset allocation, the estimated effect remains positive within the 68 percent confidence interval, but this aggregate effect masks significant differences across country groups. As we show in Section 4.6, the impact on banking flows varies depending on whether advanced or emerging economies are involved.

4.4 Addressing Endogeneity Concerns

To address endogeneity concerns related to other confounding factors, we first use the differences in the climate policies between the destination and the source country as the key explanatory variable as a way to mitigate concerns on omitted confounding factors, since it would be less likely to think of a variable that correlates with both the differences in climate policy and capital allocation. Table 3 presents the results. Consistent with previous findings, it shows that an increase in the differences in the restrictiveness of the climate policies between the destination and source country is significantly associated with more portfolio equity and banking assets allocated to the destination country.

Table 3: Difference in Climate Policy Stringency

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Difference in Climate Policy	0.105	0.006	0.058	0.266*	0.254*	0.529**	0.251*	0.197	0.245	0.339	0.309	0.740**
	(0.121)	(0.123)	(0.194)	(0.138)	(0.138)	(0.224)	(0.152)	(0.141)	(0.249)	(0.207)	(0.207)	(0.343)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10636	10636	10636	11396	11396	11396	11363	11363	11363	4365	4365	4365
R2 Adj.	0.892	0.892	0.895	0.912	0.912	0.911	0.839	0.839	0.842	0.957	0.957	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

To further validate the baseline findings against omitted variable bias, we apply the approach proposed by Oster (2019) to estimate δ, the degree of selection on unobservables relative to observables required to drive the coefficient to zero. A small δ would indicate that the estimated effect is likely biased due to omitted variables. Calculating δ requires assumptions about R_{MAX}, the hypothetical R-squared from a regression including both observed and unobserved controls. We set R_{MAX} within the range between the R-squared obtained from our baseline regression and one. Based on columns (6) and (12) of Table 2, we set R_{MAX} to [0.93,1] for the equity regression and [0.97, 1] for the banking regression. The method by Oster (2019) also allows for the estimation of an error-corrected coefficient, β^*, given assumptions about R_{MAX} and δ. As a conservative approach, we set $\delta = 1$ and compute β^* across a range of R_{MAX} values.

Table 4 reports the estimated δ values for equity and banking asset allocation across different R_{MAX} assumptions. Under the restrictive bound ($R_{MAX} = 1$), selection on unobservables would need to be 8.6 and 3.4 times stronger than selection on observables for equity and banking allocation, respectively. Given the extensive set of control variables included in our model, these values appear implausibly high, suggesting that omitted variable bias is minimal. Additionally, the estimated β^* shows that accounting for unobservables increases the equity allocation coefficient from 0.53 to 0.56, while the banking allocation coefficient decreases from 0.71 to 0.57. While the effect on banking allocation appears more sensitive to omitted variables, its magnitude remains substantial, reinforcing the robustness of our findings.

Table 4: Oster (2019) Bounds

				Equity				
R_{MAX}	0.93	0.94	0.95	0.96	0.97	0.98	0.99	1
δ	121.00	42.10	25.50	18.30	14.30	11.70	9.90	8.58
β^*	0.531	0.534	0.538	0.542	0.547	0.551	0.556	0.561
				Bank				
R_{MAX}					0.97	0.98	0.99	1
δ					17.40	7.38	4.69	3.43
β^*					0.709	0.665	0.618	0.570

Notes: The table presents the Oster (2019) bounding tests results. δ indicates the degree of selection on unobservables relative to observables need to eliminate the effect. β^* is the corrected coefficient assuming $\delta = 1$. Results are shown for different R_{MAX} values.

Lastly, we employ an IV approach to address any remaining endogeneity concerns. Following Furceri et al. (2023) and Bettarelli et al. (2024, 2025), we construct an instrument by interacting a time-varying global pressure term with a constant country-specific factor that captures vulnerability to climate change.[10] Specifically, we use the global number of flood events, obtained from the International Disaster Database (EM-DAT), as a proxy for international pressure to adopt more stringent climate policies. To prevent

[10]This approach was originally introduced by Nunn and Qian (2014) in the context of studying the impact of U.S. food aid on conflict in recipient countries.

mechanical endogeneity, we exclude a country's own flood events from the global term, ensuring exogeneity to country-specific policy decisions. For the country-specific component, we measure vulnerability to flood events using the ratio of a country's coastline length to its land area. Countries with greater exposure to flooding or rising sea levels are expected to implement stricter climate policies in response to an increase in global flood events.

Regarding instrument validity, one might argue that global investors could directly assess a country's vulnerability to extreme weather events and adjust their asset allocations accordingly. However, risk-averse investors are primarily concerned with a country's capacity to mitigate such risks – such as through climate-resilient infrastructure – which is largely shaped by climate policies rather than inherent geographic exposure. Since the global term is exogenous to any individual country and geographic features like coastline length are plausibly randomly distributed across countries, this provides a valid instrument.

Table 5 presents the results from the two-stage least squares (2SLS) estimation. Across all specifications, the interaction term has a significant and positive effect on climate policy stringency in the destination country, indicating that countries more exposed to floods and rising sea levels tend to implement stricter climate policies in response to an increase in global flood events. After controlling for source country-year fixed effects in columns (3) and (6), the F-statistic for the climate policy variable in the destination country is 102 and 40, respectively, confirming the instrument's relevance.

Reassuringly, the interaction term for the source country has no significant effect on climate policy stringency in the destination country, further reinforcing the instrument's validity. If unobserved global factors – such as shifts in trade patterns or severe supply chain disruptions – were simultaneously driving both the global pressure to adopt climate policies and policy decisions in vulnerable countries, we would expect the source country's interaction term to also influence climate policy in the destination. For example, if coastal countries are more dependent on maritime trade and global economic shifts correlated with climate pressure disproportionately affect them, this could introduce bias in the instrument. However, since no such effect is observed, this confirms that our instrument isolates the intended mechanism: climate vulnerability and external pressure to implement climate policies drive policy responses without being confounded by broader global trends.

Table 5: Instrumental Variable Approach

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
			Second Stage Results			
L.Climate Policy - Destination	3.004*	3.323*	3.267*	4.916**	5.653**	6.264***
	(1.593)	(1.721)	(1.785)	(2.189)	(2.395)	(2.360)
L.Climate Policy - Source	-0.555	-0.414		-1.891	-1.815	
	(2.969)	(3.227)		(5.526)	(4.027)	
			First Stage Results for L.Climate Policy - Destination			
L2.Global # of Floods x Ratio Coastline Length to Area - Destination	0.023***	0.021***	0.021***	0.021***	0.020***	0.021***
	(0.001)	(0.001)	(0.000)	(0.001)	(0.001)	(0.001)
L2.Global # of Floods x Ratio Coastline Length to Area - Source	-0.000	-0.000		0.002	0.001	
	(0.001)	(0.001)		(0.002)	(0.001)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	11026	11026	11026	4103	4103	4103
F-Statistic (L.Climate Policy - Destination)	56.855	52.186	102.27	18.459	18.469	40.332
F-Statistic (L.Climate Policy - Source)	32.621	28.362	-	7.144	11.958	-

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: portfolio equity and banking investment. Both instruments were scaled by 1/100 for readability of output. The first stage results shown in the table are based on using the lagged climate policy stringency in the destination as dependent variable. However, we also instrument for the climate policy stringency in the source country using the same specification.

The second-stage results confirm our baseline findings, revealing significant and positive effects on both portfolio equity and banking asset allocation. The IV estimates are substantially larger than the OLS estimates, a common outcome when OLS suffers from attenuation bias due to measurement error or other endogeneity issues. To further validate our identification strategy, we employ an alternative instrument based on the interaction between the global number of major hurricanes and a country's distance from its centroid to the nearest coast. This approach captures a different aspect of climate vulnerability, as inland countries may be less immediately exposed to coastal climate risks, potentially leading to different policy responses. The rationale is that countries farther from the coast are less likely to adopt stringent climate policies in response to rising global pressure. The results, presented in Table A8 in the appendix, remain qualitatively consistent with our previous findings, further reinforcing the robustness of our estimates.

4.5 Robustness Checks

Now we provide an array of robustness checks to our baseline findings. Specifically, we show that the main findings remain when we use alternative measurements of climate policy stringency and external assets positions, use the stock intensity rather than allocation share as the dependent variable, control for climate performance in addition to climate policies, account for potential substitution effects between different types of assets, and control for further potential confounding factors. Moreover, we randomly reshuffle the climate policy indicators and demonstrate that it is indeed the true policy stringency index that leads to our results.[11]

First, we adopt the OECD's EPS index as an alternative measurement of climate policies. Although the EPS data has a smaller country coverage, it allows a more granular classification of subcategories of climate policies. We first use the aggregated EPS index and present the results in Table 6. Consistent with the baseline analysis, we observe a significant and positive association between the destination country's EPS index and the allocation of portfolio equity and banking assets towards it.

[11] Additional robustness checks related to sample selection are provided in the appendix. Specifically, we show that the estimated effects are larger when restricting the sample to the largest source countries and trading partners (Appendix Tables A9 and A10). Furthermore, we conduct a robustness check using a restricted sample where FDI, equity, and debt allocations are limited to country pairs available in the BIS dataset (Appendix Table A11).

Table 6: Robustness Check: Alternative Environmental Policy Stringency Index

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.EPS - Destination	0.208	0.008	-0.030	0.512**	0.417***	0.407***	0.212	0.161	0.158	0.301	0.302*	0.314*
	(0.144)	(0.123)	(0.117)	(0.203)	(0.147)	(0.146)	(0.139)	(0.150)	(0.152)	(0.214)	(0.182)	(0.184)
L.EPS - Source	-0.024	0.110		0.043	-0.042		0.063	0.138		0.024	0.061	
	(0.172)	(0.169)		(0.153)	(0.159)		(0.152)	(0.139)		(0.140)	(0.171)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	7451	7451	7451	8130	8130	8130	8094	8094	8094	3953	3953	3953
R2 Adj.	0.888	0.889	0.892	0.913	0.913	0.912	0.860	0.860	0.858	0.957	0.957	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Second, we use the asset stock intensity, measured by the ratio of external assets allocated in the destination country to the source country's GDP, as the dependent variable and re-estimate the baseline specification. Table 7 shows the results. The baseline findings are confirmed again, as we observe that the more restrictive the destination country's climate policy, the higher the intensity is the portfolio equity and banking assets invested in the country. In addition, the results show that a more restrictive climate policy in the source country is also significantly associated with more outward banking investments. While our baseline findings differ from Benincasa et al. (2022), who show that banks increase cross-border lending when climate policy stringency rises in the source country but reduce it when the destination country tightens its policies, our stock intensity results offer partial reconciliation. Specifically, we also find that higher stringency in the source country leads to increased foreign banking allocations, consistent with their "flight from regulation" mechanism. However, in contrast to their findings, we still observe that banks allocate more capital to stricter destination countries. This discrepancy largely arises from differences in how climate policy stringency is defined. Benincasa et al. (2022) use the CCPI, which incorporates broader environmental indicators beyond policy measures, whereas we focus exclusively on the CCPI's national climate policy stringency component.

Table 7: Robustness Check: Stock Intensity as Dependent Variable

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.015	-0.016	-0.015	0.061**	0.049**	0.049**	0.087*	0.062	0.064	0.597***	0.526***	0.497***
	(0.040)	(0.036)	(0.036)	(0.028)	(0.025)	(0.024)	(0.051)	(0.048)	(0.047)	(0.192)	(0.169)	(0.156)
L.Climate Policy - Source	-0.056	-0.041		-0.013	-0.019		0.001	0.022		0.413**	0.445**	
	(0.040)	(0.041)		(0.023)	(0.024)		(0.048)	(0.050)		(0.172)	(0.179)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10624	10624	10624	11397	11397	11397	11377	11377	11377	4364	4364	4364
R2 Adj.	0.918	0.918	0.920	0.931	0.932	0.936	0.910	0.910	0.914	0.919	0.919	0.925

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the stock intensity, measured by the ratio of external assets allocated in the destination country to the source country's GDP.

To further investigate this, we separately control for climate change performance to distinguish the effects of policy stringency from broader environmental factors. Instead of using CO emission intensity as a control, we replace it with the CCPI, which accounts for climate policy measures as well as greenhouse gas emissions, renewable energy use, and energy efficiency.[12] This substitution allows us to explore whether the stringency of climate policy and the actual performance in addressing climate change have distinct influences on international capital allocation. Two findings stand out from the results shown in Table 8. First, the baseline results that more restrictive policies in the destination country are associated with higher weights in capital allocation of portfolio equity and banking investment still hold significantly when the performance indicator is controlled at the same time. Second, the actual environmental performance plays a role in banking asset allocation. Specifically, a worse climate change performance is associated with an increased allocation of bank assets to this country. Possible reasons for this finding relate to banks exploiting the variations of the climate change mitigation performances by increasing cross-border lending to "brown" firms in "brown" countries (Benincasa et al.

[12] A higher CCPI index indicate better climate performance. The CO2 emission intensity and CCPI index show a correlation coefficient of -0.35.

2022), and at the same time diversifying assets to countries with greener policies. More explorations on the diversification motivation are presented later in Section 5.

Table 8: Robustness Check: CCPI Performance and Policy Together

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	-0.066	-0.099	-0.064	0.524**	0.549**	0.548**	0.129	0.024	0.040	1.189***	1.167***	1.129***
	(0.223)	(0.215)	(0.215)	(0.238)	(0.246)	(0.245)	(0.330)	(0.336)	(0.326)	(0.420)	(0.425)	(0.410)
L.Performance - Destination	1.818*	1.652	1.727*	0.934	0.579	0.369	1.875	2.171	2.023	-3.990***	-4.070***	-4.118***
	(1.029)	(1.006)	(0.999)	(0.982)	(1.029)	(0.997)	(1.416)	(1.515)	(1.487)	(1.261)	(1.245)	(1.270)
L.Climate Policy - Source	-0.010	0.065		0.052	0.007		-0.099	-0.064		0.133	0.137	
	(0.168)	(0.166)		(0.203)	(0.218)		(0.308)	(0.306)		(0.300)	(0.272)	
L.Performance - Source	-0.690	-0.803		0.365	0.741		-0.645	-0.598		-0.042	0.109	
	(0.898)	(0.837)		(0.818)	(0.834)		(0.930)	(0.988)		(1.202)	(0.964)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10636	10636	10636	11396	11396	11396	11363	11363	11363	4365	4365	4365
R2 Adj.	0.892	0.892	0.895	0.912	0.912	0.911	0.839	0.839	0.842	0.958	0.958	0.956

Notes: *** $p<0.01$, ** $p<0.05$, * $p<0.1$. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Fourth, one of the benefits of comprehensively examining the impact on four types of assets is that we can take into account potential substitution effects between different types of assets. Specifically, it is a plausible argument that FDI and portfolio equity asset reallocation may be affected by each other, and the same applies to portfolio debt and banking assets, due to their similar features in terms of maturities and seniority (Beyene et al. 2021). To account for such substitution forces, we additionally control for the importance of equity assets in the overall assets when the dependent variable is the allocated share of FDI in the destination country, and *vice versa*. In the same way, we control for the importance of banking assets in the overall assets when the dependent variable is the allocated share of portfolio debt in the destination country, and *vice versa*. The importance of each type of asset is calculated as its share in the total external assets in the destination country held by a source country. Note that the calculation of the denominator requires the observation of four types of assets at the same time, and this imposes stronger restrictions on the data and results in a smaller sample in this analysis. [13]

We present the results in Table 9. The coefficients of portfolio equity weights are significantly negative for the allocation of FDI, and the same applies reversely. It demonstrates some substitutions between FDI and portfolio equity, but not between portfolio debt and banking assets. More importantly, again, our baseline findings remain after accounting for these substitution effects, based on the significant and positive coefficients of destination countries' climate policies on equity and banking asset allocation.

Table 9: Robustness Check: Accounting for Substitution Effects

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.346	0.002	0.007	1.213**	1.170***	1.125***	0.486	0.323	0.368	0.919**	0.938**	0.979***
	(0.447)	(0.417)	(0.405)	(0.477)	(0.436)	(0.411)	(0.527)	(0.495)	(0.473)	(0.388)	(0.373)	(0.363)
L.Climate Policy - Source	0.085	0.501		-0.256	-0.164		-0.232	-0.130		0.131	0.208	
	(0.249)	(0.360)		(0.209)	(0.255)		(0.372)	(0.303)		(0.231)	(0.195)	
FDI/Total Assets				-0.011**	-0.011**	-0.010**						
				(0.005)	(0.005)	(0.005)						
Equity/Total Assets	-0.048***	-0.049***	-0.046**									
	(0.017)	(0.018)	(0.021)									
Debt/Total Assets										-0.012	-0.010	-0.011
										(0.007)	(0.007)	(0.008)
Bank/Total Assets							-0.004	-0.001	0.005			
							(0.009)	(0.008)	(0.008)			
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	3587	3587	3587	3564	3564	3564	3561	3561	3561	3576	3576	3576
R2 Adj.	0.884	0.886	0.900	0.961	0.961	0.961	0.934	0.935	0.935	0.957	0.957	0.955

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated to a destination country. The controls include a source country's respective external asset which is allocated in a destination as a share of its combined external assets in this destination. For FDI we consider the share of portfolio equity in total assets as control and for portfolio equity, we use the share of FDI in total assets. The same procedure applies to portfolio debt and banking investments.

While our main control variables capture key determinants of asset allocation, additional factors may also play a role. To assess their potential influence on our findings, we conduct robustness tests incorporating several supplementary controls. These variables are added individually to avoid unnecessary sample size reductions due to data limitations. Importantly, all regressions retain the original baseline control variables, though they are omitted from the table output for clarity. Specifically, we control for macroprudential policies, sourced from the IMF's Integrated Macroprudential Policy Database

[13] As an additional test, we use the importance of each type of assets in total external assets as the dependent variable and regress them on climate policies as in the baseline specification. Results are reported in the appendix in Table A15. It does not show significant associations between climate policies and substitutions between types of assets.

(iMaPP), to account for financial regulations that may affect cross-border capital flows.[14] We also incorporate capital control measures from Fernández et al. (2016), distinguishing between inward and outward restrictions for each asset class. Additionally, we include the revised combined polity score from the Polity database as a proxy for institutional quality and political stability, which may influence investor confidence and capital allocation. Finally, we add total factor productivity (TFP) at constant national prices, sourced from the Penn World Table, to account for differences in economic efficiency and growth potential across countries. As shown in Table 10, our original results remain robust after incorporating these additional controls, confirming that the observed effects are not driven by omitted macroprudential, regulatory, or institutional factors.

Table 10: Robustness Check: Further Control Variables

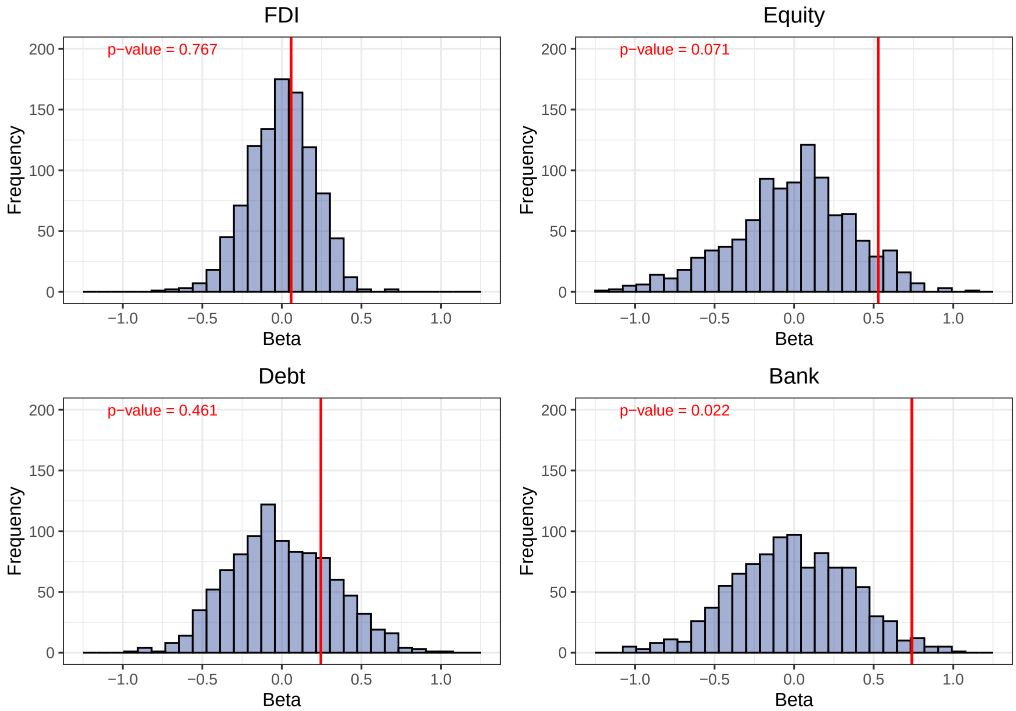
	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.177	0.060	0.143	0.769***	0.631**	0.631**	0.341	0.213	0.248	0.786**	0.708**	0.698**
	(0.228)	(0.203)	(0.206)	(0.253)	(0.248)	(0.246)	(0.306)	(0.293)	(0.286)	(0.360)	(0.355)	(0.350)
L.Climate Policy - Source	-0.067	0.067		0.110	0.029		-0.204	-0.238		0.146	0.150	
	(0.134)	(0.144)		(0.171)	(0.165)		(0.272)	(0.245)		(0.164)	(0.137)	
L.TFP - Destination		-0.519	-0.656		2.124**	1.930**		0.245	0.434		2.151	1.998
		(1.210)	(1.167)		(1.000)	(0.968)		(1.558)	(1.507)		(1.370)	(1.375)
L.TFP - Source		0.252			1.796			-2.953			-0.376	
		(1.674)			(2.247)			(2.100)			(2.419)	
L.Macroprudential Policy - Destination		0.016	0.018		-0.008	-0.007		-0.001	-0.001		-0.021	-0.021
		(0.016)	(0.015)		(0.017)	(0.017)		(0.017)	(0.017)		(0.016)	(0.016)
L.Macroprudential Policy - Source		-0.010			0.015			-0.003			-0.003	
		(0.014)			(0.015)			(0.016)			(0.014)	
L.Institutional Quality - Destination		0.022	0.012		0.021	0.016		0.028	0.019		0.126**	0.109*
		(0.062)	(0.061)		(0.024)	(0.024)		(0.027)	(0.025)		(0.055)	(0.057)
L.Institutional Quality - Source		-0.024			-0.000			0.037			-0.001	
		(0.044)			(0.048)			(0.060)			(0.089)	
L.Inward FDI Control - Destination		0.581*	0.657**									
		(0.321)	(0.328)									
L.Outward FDI Control - Source		0.028										
		(0.673)										
L.Inward Equity Control - Destination					-0.897***	-0.730**						
					(0.312)	(0.291)						
L.Outward Equity Control - Source					0.332							
					(0.217)							
L.Inward Debt Control - Destination								0.141	0.105			
								(0.232)	(0.223)			
L.Outward Debt Control - Source								0.246				
								(0.271)				
L.Inward Bank Control - Destination											0.015	-0.006
											(0.150)	(0.145)
L.Outward Bank Control - Source											0.012	
											(0.204)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	8884	8884	8884	9759	9759	9759	9618	9618	9618	4365	4365	4365
R2 Adj.	0.889	0.890	0.893	0.912	0.913	0.912	0.837	0.837	0.840	0.957	0.958	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

[14] We construct this measure by summing the number of macroprudential tightening and loosening actions within a year, as the database categorizes each policy change as either restrictive or easing. Including them separately produces qualitatively identical results.

Finally, we conduct placebo tests by reshuffling the climate policy indices across countries. Specifically, we randomly assign the true climate policy index of a country to another country, thereby generating pseudo datasets with falsified climate policies. In this test, we randomly permute the time series of all countries with each other, while keeping the order of the time dimension.[15] We repeat this reshuffling for 1000 times and estimate the baseline specification using the pseudo datasets. Then we construct the distribution of the coefficients of our interest, that is, the coefficients of the destination countries' climate policy index, and compare our estimated coefficients from the baseline analysis using the true data with the distributions of the coefficients using the pseudo data.

Figure 4: Placebo Test: Reshuffled Climate Policy Variable



Notes: The graph displays the distribution of estimated coefficients from using 1000 permutations of the climate policy in the destination country, and the red vertical lines represent the estimated coefficient from our baseline specification with the original data.

Figure 4 shows the results, where the red vertical lines represent the estimates from our baseline results. For portfolio equity and banking investment, the p-value is one-sided and measures the fraction of times in which the coefficient from the original data is smaller than the coefficient from the permuted data. As the results for FDI and portfolio

[15]We also conduct a reshuffling exercise by permuting the values of climate policies and randomize the country and year at the same time. Results are presented in the appendix in Figure A9.

debt from using the original data are insignificant, we use a two-sided p-value in these cases. Results show that our estimates for the effect of climate policies on portfolio equity and banking asset allocation in the baseline are statistically significantly larger than the estimates from placebo tests, indicating that it is the country's true climate policy index that leads to the findings.

4.6 Heterogeneous Effects

Moreover, in order to determine the role of specific country groups in our results, we introduce interaction dummies to differentiate the impact of climate policies on asset positions between advanced and emerging countries.[16] The outcomes are presented in Table 11. Two interesting findings stand out. First, it shows that the baseline results are driven by advanced countries directing their assets toward other advanced countries. Second, the effect is considerably larger for this specific group of countries, compared to the baseline estimates. Accordingly, when both the source and destination are advanced countries and the climate policy in the destination country becomes more restricted by one standard deviation, the share of equity assets and banking assets allocated to this country is significantly increased by 0.17 and 0.28 percentage points, respectively. In comparison, climate policies do not play a significant role in affecting asset allocation sourcing from emerging economies to either group of countries or sourcing from advanced economies to emerging economies.

A possible explanation for these findings may be the convergence of similar priorities, higher environmental standards, and more developed financial markets typically found among advanced economies. The shared commitment to sustainability and climate-conscious policies could lead to a more pronounced response to destination's climate policy scores within this subset of nations. To assess the role of financial development, we interact climate policy stringency with dummy variables indicating high or low financial development, as defined by the IMF's Financial Development Index. As shown in Table A12 in the appendix, the impact of more stringent climate policies is amplified in finan-

[16] We follow the International Monetary Fund (2023) to classify advanced and emerging countries, and they are labeled in Table A2 in the appendix.

cially more developed countries, suggesting that financial market maturity plays a key role in shaping cross-border capital reallocation in response to climate policies.[17]

Table 11: Between Advanced and Emerging Countries

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
EM to EM x L.Climate Policy - Destination	-0.591	-0.688*	-0.463	0.353	0.237	0.421	0.536	0.432	0.179	1.074	0.925	0.916
	(0.434)	(0.412)	(0.435)	(0.317)	(0.335)	(0.373)	(0.577)	(0.583)	(0.654)	(0.784)	(0.814)	(1.079)
EM to AE x L.Climate Policy - Destination	-0.345	-0.461	-0.565	0.891	0.829	0.855	0.414	0.382	0.534	-0.628	-0.528	-0.652
	(0.435)	(0.429)	(0.474)	(0.729)	(0.724)	(0.770)	(0.851)	(0.837)	(0.919)	(1.919)	(1.867)	(1.956)
AE to EM x L.Climate Policy - Destination	0.569*	0.459	0.447	-0.040	-0.176	-0.160	-0.077	-0.228*	-0.068	0.206**	0.055	0.185***
	(0.328)	(0.329)	(0.323)	(0.132)	(0.143)	(0.156)	(0.116)	(0.136)	(0.137)	(0.099)	(0.135)	(0.065)
AE to AE x L.Climate Policy - Destination	0.245	0.139	0.173	0.867***	0.786***	0.728***	0.425	0.341	0.398	1.281***	1.287***	1.229***
	(0.271)	(0.268)	(0.274)	(0.281)	(0.274)	(0.280)	(0.338)	(0.323)	(0.317)	(0.384)	(0.373)	(0.371)
EM to EM x L.Climate Policy - Source	0.775	0.842		0.919*	0.738		-0.630	-0.617		-0.696	-0.592	
	(0.795)	(0.816)		(0.468)	(0.461)		(0.504)	(0.512)		(0.811)	(0.794)	
EM to AE x L.Climate Policy - Source	-0.328	-0.119		-0.106	-0.208		0.540	0.560		0.766	0.682	
	(0.365)	(0.387)		(0.566)	(0.581)		(0.610)	(0.584)		(0.476)	(0.468)	
AE to EM x L.Climate Policy - Source	0.014	0.059		0.190	0.145		0.252*	0.273*		0.693	0.762	
	(0.190)	(0.182)		(0.195)	(0.208)		(0.152)	(0.158)		(0.446)	(0.462)	
AE to AE x L.Climate Policy - Source	-0.217	-0.151		-0.033	-0.049		-0.574	-0.543		-0.123	-0.101	
	(0.158)	(0.161)		(0.171)	(0.162)		(0.380)	(0.369)		(0.221)	(0.193)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10636	10636	11143	11396	11396	12000	11363	11363	11992	4365	4365	4413
R2 Adj.	0.892	0.892	0.896	0.912	0.912	0.909	0.839	0.839	0.837	0.958	0.958	0.956

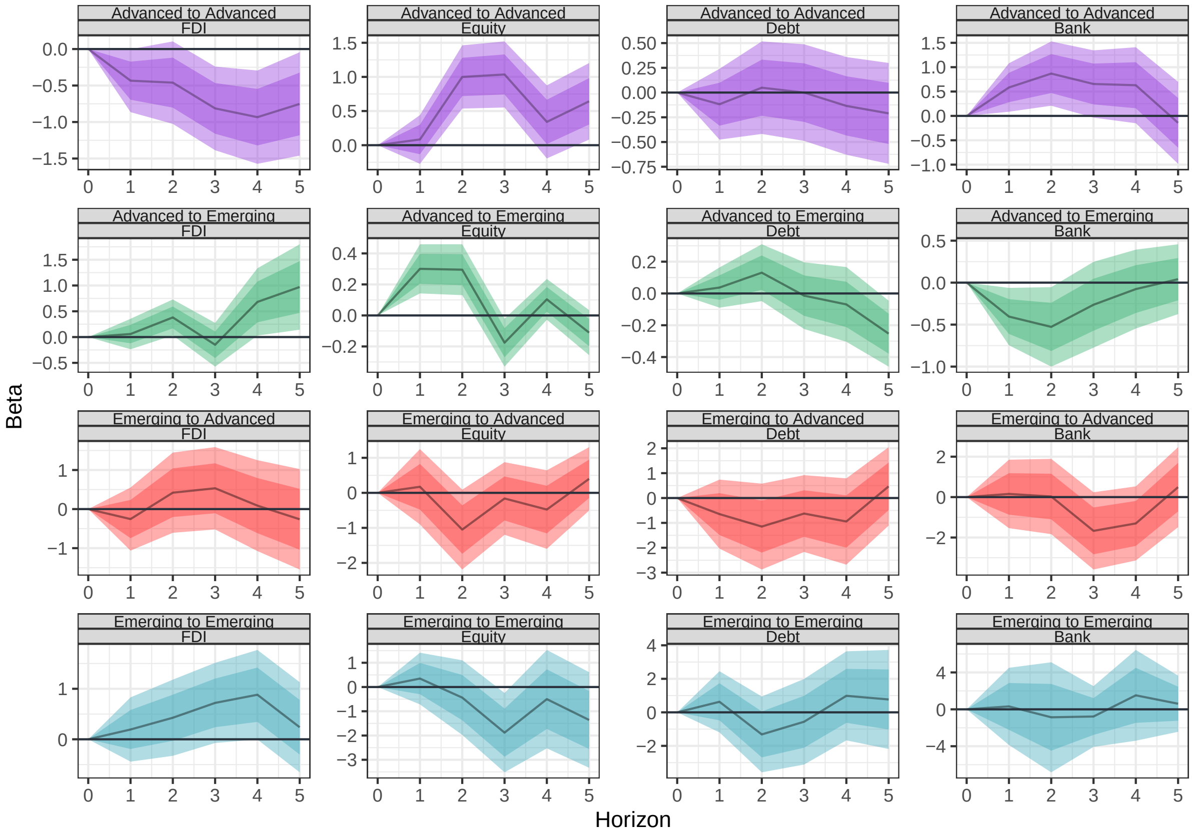
Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. EM and AE denote emerging countries and advanced countries, respectively. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

To further examine how these heterogeneous patterns across country groups evolve over time, we use local projections to analyze their dynamic effects. Results shown in Figure 5 indicate that there could be some offsetting forces for the dynamic effects in different country groups. Specifically, the first row shows that more restrictive climate policies in advanced countries are significantly and persistently associated with increased equity and banking assets allocated to them from other advanced countries. The impact on FDI, however, is negative and persists over five years, reflecting firms' choices of locations within advanced economies to reduce the environmental regulatory costs of production. Interestingly, the second row indicates that when emerging countries increase climate policy stringency, advanced countries tend to significantly allocate more portfolio equity in the short run and FDI in the long run. Meanwhile, the response in banking investment tends to act as substitute (Cerutti and Hong 2021). The last two rows demonstrate that when capital flows originate from emerging countries, the allocation of

[17] As an alternative measure of financial development, we use the ratio of domestic credit to GDP (see Table A13 in the appendix). The results remain qualitatively unchanged.

all asset types is insignificantly affected by an increase in the stringency of climate policies in the destination country. This suggests a less pronounced preference for climate issues among investors from emerging markets. To sum up, in terms of persistence, the baseline findings of positive effects on equity and banking capital reallocation from more stringent climate policies apply well between advanced and advanced countries, while results are mixed concerning emerging countries as either recipients or investors.

Figure 5: Local Projections - Heterogeneity Across Country Groups



Notes: Responses to a one-unit increase in the destination country's climate policy index. The shaded areas represent 68 and 90 percent confidence bands, respectively, calculated by using standard errors clustered at the country-pair and source country-year levels. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Then we consider three categories of environmental policies: market-based policies, non-market-based policies, and technology support, each contributing a weight of 1/3 to the aggregated EPS index. Table 12 shows that our main findings arise from non-market-based policies such as NOx emission limits, SOx emission limits, PM emission limits, and sulfur emission limits. Moreover, the positive effects of more restrictive non-market policies are observed across all asset types except FDI, with portfolio equity being the most affected, followed by banking assets. In contrast, market-based policies and technology support policies do not exhibit significant effects on cross-border asset reallocation.[18]

Table 12: Market Policies, Non-Market Policies, and Technology Support

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Market Policies - Destination	0.171	0.001	-0.025	0.279*	0.200	0.191	-0.012	-0.044	-0.045	0.319*	0.350*	0.313
	(0.150)	(0.134)	(0.136)	(0.155)	(0.147)	(0.144)	(0.142)	(0.139)	(0.136)	(0.186)	(0.189)	(0.195)
L.Non-Market Policies - Destination	0.274**	0.194	0.211	0.569***	0.569***	0.571***	0.412***	0.417***	0.411***	0.428**	0.456**	0.454**
	(0.135)	(0.131)	(0.131)	(0.192)	(0.174)	(0.176)	(0.121)	(0.121)	(0.125)	(0.194)	(0.183)	(0.181)
L.Tech. Support - Destination	-0.036	-0.064	-0.085	-0.005	-0.011	-0.015	-0.047	-0.055	-0.054	-0.082	-0.062	-0.051
	(0.065)	(0.061)	(0.058)	(0.053)	(0.050)	(0.050)	(0.058)	(0.063)	(0.063)	(0.073)	(0.071)	(0.072)
L.Market Policies - Source	-0.216	-0.098		0.019	-0.085		-0.045	0.033		0.013	0.060	
	(0.141)	(0.111)		(0.089)	(0.089)		(0.132)	(0.125)		(0.111)	(0.108)	
L.Non-Market Policies - Source	0.128	0.169		0.004	-0.051		0.018	0.053		0.004	0.003	
	(0.127)	(0.141)		(0.110)	(0.119)		(0.119)	(0.119)		(0.165)	(0.167)	
L.Tech. Support - Source	-0.006	0.022		0.012	0.001		0.031	0.043		0.003	0.011	
	(0.059)	(0.058)		(0.058)	(0.056)		(0.057)	(0.052)		(0.067)	(0.071)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	7451	7451	7451	8130	8130	8130	8094	8094	8094	3953	3953	3953
R2 Adj.	0.888	0.889	0.892	0.913	0.914	0.913	0.860	0.860	0.858	0.958	0.958	0.956

Notes: *** $p<0.01$, ** $p<0.05$, * $p<0.1$. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country.

5 Mechanism Examination

Focusing on our main results of the positive relationship between climate policy stringency and reallocation of portfolio equity and banking assets, we investigate several possible mechanisms to explain the findings. First, we test the valuation effects on currency values and equity prices and do not find evidence suggesting that passive reallocation drives the results. Second, we explore the diversification mechanism that investors might prefer countries with more stringent climate policies when their overall international asset exposure to environmental regulatory risk is low, and our results are consistent with such a diversification explanation. Third, we test whether green awareness drives the preference

[18]We further decompose the EPS index into 13 policy subcategories. For instance, market-based policies include CO2 trading schemes, renewable energy trading schemes, CO2 tax, NOx tax, SOx tax, and diesel tax; non-market-based policies encompass NOx emission limits, SOx emission limits, PM emission limits, and sulfur emission limits; and technology support policies cover RD expenditure on low-carbon energy technologies and renewable energy support. The results are presented in Table A14 in the appendix.

towards countries with more restrictive climate policies and we find results indicating so for international portfolio equity investors. Lastly, as higher climate policy stringency lowers climate-related regulatory uncertainty, we examine the mechanism of uncertainty mitigation and show that the baseline findings are stronger when investors are faced with a high oil price uncertainty.

5.1 Valuation

We begin with testing the valuation effect. Specifically, international capital flows could be affected by the exchange rates and asset prices (Tille and Van Wincoop 2010, Gourinchas and Rey 2007), and the climate policy in a respective country might influence both valuation factors against partner countries. To examine the potential valuation effects of currencies, we use the log exchange rate vis-à-vis the US dollar as the dependent variable and conduct country-level regressions on climate policies. The first two columns in Table 13 show that there are no significant impact of a country's climate policy on currency values. For the stock prices, we use the stock returns as the dependent variable in the country-level setting. The stock returns are calculated using the country stock market indices obtained from Thomson Reuters. Results are shown in the last two columns of Table 13 and they also do not demonstrate any significant effects of climate policy on equity prices. Overall, these findings suggest that our observed reallocation effects are not driven by valuation effects stemming from currency denominations or equity price changes, and they are likely due to active reallocation by investors.

Table 13: Valuation effects - country level

	FX		Stock Return	
	(1)	(2)	(3)	(4)
L.Climate Policy	2.542	0.788	-0.062	-0.009
	(2.014)	(2.219)	(0.049)	(0.058)
Country	YES	YES	YES	YES
Year FE	YES	YES	YES	YES
Controls	NO	YES	NO	YES
Num.Obs.	390	390	291	291
R2 Adj.	0.255	0.270	0.456	0.508

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country level. FX is the percentage change in the exchange rate, expressed as local currency vis-à-vis the US-Dollar.

5.2 Diversification

Next, we investigate the motivation of diversification in reallocating international assets with respect to differences in climate policies. Diversification is an important factor in constructing equity and banking portfolios (DeMiguel et al. 2009, Conine and Tamarkin 1981, Winton 1999, Gorton and Winton 2003). It is plausible that investors diversify assets to countries with more restrictive climate policies when their portfolios are exposed to lax environmental regulations.

To test this, we construct a variable measuring the source country's overall exposure to climate policies leaving out a given destination country. Specifically, for a given source country and a destination country, we weigh the climate policy stringency index of other destination countries using the share of assets allocated to them and then calculate the sum to obtain the climate policy exposure. That is, for a source country s and destination country d, $Exposure_{sdt} = \Sigma_{j \neq d} \omega_{sjt} Climate\ Policy_{jt}$, where $\omega_{sjt} = \frac{Assets_{sjt}}{\Sigma_{j \neq d} Assets_{sjt}}$. Based on the median value of this exposure measurement, we define two dummies $D(LowExposure)$ and $D(HighExposure)$ to indicate a low and high exposure and interact them with the climate policy stringency index of the destination country as in the baseline specification. Thus, when $D(LowExposure)$ equals 1, the source country primarily allocates assets to countries with relatively weaker climate policies. Conversely, when $D(HighExposure)$ equals 1, the majority of the source country's asset allocations are directed toward countries with more stringent climate policies. These dummy variables allow us to assess whether the impact of a destination country's climate policy depends on the broader regulatory environment in which the source country's investments are distributed.

The diversification motivation would predict a more pronounced effect of a tighter climate policy on capital reallocation if the country is in the low exposure group. Results in Table 14 show that the reallocation of both equity and banking assets is consistent with the diversification mechanism, as the coefficient of climate policies in the destination country is significantly larger in the first row when the source country is more exposed to other countries with lax climate policies.

Table 14: Mechanism Investigation: Diversification

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Exposure)	0.978***	0.833**	0.631*	1.061**	1.030**	0.904**
	(0.365)	(0.351)	(0.356)	(0.427)	(0.413)	(0.397)
L.Climate Policy - Destination x D(High Exposure)	0.317	0.232	0.266	0.387	0.382	0.333
	(0.227)	(0.232)	(0.229)	(0.319)	(0.309)	(0.312)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	9816	9816	9816	4338	4338	4338
R2 Adj.	0.910	0.910	0.915	0.957	0.957	0.956

Notes: *** $p<0.01$, ** $p<0.05$, * $p<0.1$. Standard errors are clustered at the country-pair and source country-year level. We interact the climate policy in the destination with an indicator for the level of a source country's share weighted exposure to climate policies from other destination countries, grouped into low and high exposure.

5.3 Suasion

Then we examine the suasion mechanism arising from green awareness. Our baseline results are consistent with a positive message that investors care about climate issues and would allocate more assets to destinations that impose more stringent policies to mitigate climate change. To test this mechanism, we access the share of a source country's Green Party seats in its national parliament and we assume that a stronger support for Green Party reflects voters' preference for environmental protection and stronger green awareness. As not all countries in our sample have a multi-party system with identified Green Parties, in this analysis the sample is limited to Austria, Belgium, Canada, Switzerland, Germany, Denmark, Spain, Finland, France, Hungary, Latvia, Mexico, Norway, New Zealand, Portugal, Sweden, and the United Kingdom. Similar to the diversification mechanism investigation, we create two dummies to indicate the source country with low and high green awareness based on the median values of the Green Party shares and then interact them with the climate policy stringency of the destination countries. The suasion mechanism would predict a more pronounced impact for countries that have more Green Party seats.

Table 15 shows the results. We observe a clear indication of green awareness in driving the reallocation of portfolio equities as the coefficients of the climate policies in the destination country are more pronounced and significant when the source country has a high share than a low share of Green Parties. For banking assets allocation, source countries with both a low and high share of Green Parties demonstrate a positive effect of climate policy stringency in the destination country, and the effect for countries with a low share of Green Party is even larger.[19] As a result, our evidence suggests that the green awareness mechanism has a greater impact on international equity allocation than on the reallocation of banking assets.

Table 15: Mechanism Investigation: Green Awareness

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Share Green Party - Source)	0.486**	0.426*	0.351	1.155***	1.057***	1.027***
	(0.244)	(0.231)	(0.252)	(0.353)	(0.318)	(0.369)
L.Climate Policy - Destination x D(High Share Green Party - Source)	1.154***	1.104***	1.165***	1.071**	0.945**	0.971**
	(0.345)	(0.328)	(0.362)	(0.453)	(0.425)	(0.468)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	5647	5647	5647	2807	2807	2807
R2 Adj.	0.963	0.963	0.963	0.962	0.962	0.960

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. We use the median value of the share of Green Parties in the parliament to separate the source countries into low and high groups.

5.4 Uncertainty Mitigation

Finally, we explore the mitigation of uncertainty as an underlying mechanism. Existing studies have shown that climate policy-related uncertainty is associated with less energy-saving technology innovation and green investment (Fuss et al. 2008, Noailly et al. 2022, Khalil and Strobel 2023). In a highly uncertain market, investors are likely to extract any opportunities that mitigate uncertainty. As a more restrictive climate policy signals government commitment and helps lower the uncertainty of market expectation, it can attract investors through the uncertainty mitigation mechanism.

To test this, we use the worldwide oil price uncertainty to proxy the market's perception about climate-related uncertainty as energy price is substantially affected by climate policies. The index, developed by Abiad and Qureshi (2023), is constructed based on the

[19] In Table A16 in the appendix, we replace the dummy classification of Green Party share with a continuous variable. The results confirm a significant difference in the impact of destination-country climate policy on equity allocation, reinforcing the green awareness mechanism. However, for banking assets, the interaction term does not yield a statistically significant effect, suggesting a more uniform impact in this category.

frequency of newspaper articles discussing oil price volatility, following the text-based methodology of Baker et al. (2016). It captures fluctuations in oil price uncertainty by analyzing global news coverage and identifying articles that mention oil price-related terms alongside uncertainty-related keywords. Same as before, we use the median value to define low and high uncertainty periods and then interact with the climate policy stringency of the destination country. Results in Table 16 are consistent with the uncertainty mitigation mechanism, since our baseline findings for the allocation of both portfolio equity and banking assets are more pronounced when the oil price uncertainty is high.

Table 16: Mechanism Investigation: Uncertainty Mitigation (World Oil Price)

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Oil Price Uncertainty)	0.422*	0.335	0.327	0.634*	0.634*	0.631*
	(0.231)	(0.232)	(0.227)	(0.351)	(0.333)	(0.332)
L.Climate Policy - Destination x D(High Oil Price Uncertainty)	0.733***	0.656**	0.647**	0.874**	0.833**	0.805**
	(0.269)	(0.259)	(0.259)	(0.378)	(0.369)	(0.362)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	11396	11396	11396	4365	4365	4365
R2 Adj.	0.912	0.912	0.911	0.957	0.957	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. D(Low Oil Price Uncertainty) and D(High Oil Price Uncertainty) are dummy variables representing low and high uncertainty periods, respectively, based on the median value of the world oil price uncertainty index.

In addition, we utilize the country-level energy-related uncertainty indexes developed by Dang et al. (2023) as a substitute for the worldwide oil price uncertainty index. These indexes are derived from a similar textual analysis methodology, albeit using different text sources. Specifically, Dang et al. (2023) analyze reports from the Economist Intelligence Unit and count the frequency of terms of uncertainty and energy-related keywords. Again, we use the median values of the index to categorize the low and high energy uncertainty in the destination country and examine their interaction with the stringency of climate policies. However, the limited coverage of countries by this energy uncertainty index results in a smaller sample. The results, presented in Table 17, indicate that stringent climate policies play a more significant role in attracting international equity and banking investments in countries experiencing higher energy uncertainty. These findings align with the uncertainty mechanism previously described.

Table 17: Mechanism Investigation: Uncertainty Mitigation (Country-Level Energy Price)

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Energy Uncertainty - Destination)	0.645*	0.520	0.595	0.649*	0.724*	0.725*
	(0.380)	(0.383)	(0.375)	(0.375)	(0.388)	(0.388)
L.Climate Policy - Destination x D(High Energy Uncertainty - Destination)	1.343***	1.271***	1.371***	1.449**	1.542**	1.539**
	(0.477)	(0.453)	(0.453)	(0.698)	(0.640)	(0.641)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	6588	6588	6588	3069	3069	3069
R2 Adj.	0.911	0.912	0.911	0.956	0.956	0.954

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. D(Low Energy Uncertainty) and D(High Energy Uncertainty) are dummy variables representing low and high uncertainty periods, respectively, based on the median value of the energy uncertainty index.

To sum up, in this subsection, we look into the mechanisms behind our main findings and document evidence of a diversification motivation and uncertainty mitigation mechanism for both equity and banking assets reallocation and a green awareness motivation for equity reallocation, while no evidence of a valuation channel concerning currency values and stock prices.

6 Conclusion

This study investigates the impact of climate policies on international capital reallocation using bilateral external assets data, which allows granular fixed effects to saturate other potential confounding factors and address endogeneity concerns. We distinguish between four types of investment, i.e., FDI, portfolio equity, portfolio debt, and banking investment, and look at the reallocation effects for each type of investment under the same framework.

Our results suggest that climate policies matter, and the effects are heterogeneous across different country groups and asset types. The prudence of the climate policy in the destination country is significantly and positively associated with the share of portfolio equity and banking investment allocated to the country, meanwhile, it does not play a significant role in the allocation of FDI and portfolio debt. To ensure the validity of our findings, we address potential endogeneity concerns through multiple strategies, including leveraging differences in policy stringency between source and destination countries and employing an instrumental variable approach based on exogenous variations in global climate shocks and country-specific vulnerability. Our main results remain robust across various checks, confirming that they are not driven by valuation effects or omitted variable bias. Moreover, our results highlight that the investment between advanced and advanced countries manifests the most pronounced response to the climate policies of the destination country, while the impact is inconclusive regarding emerging countries. Finally, we provide evidence indicating the underlying mechanisms of diversification, suasion, and uncertainty mitigation.

The findings of this study carry significant policy implications, suggesting that international capital tends to gravitate towards destinations with rigorous climate policies, especially the non-market-based ones. As such, a more globalized and integrated financial market can contribute to a harmonized global response to climate change by fostering international cooperation and coordination in climate policies.

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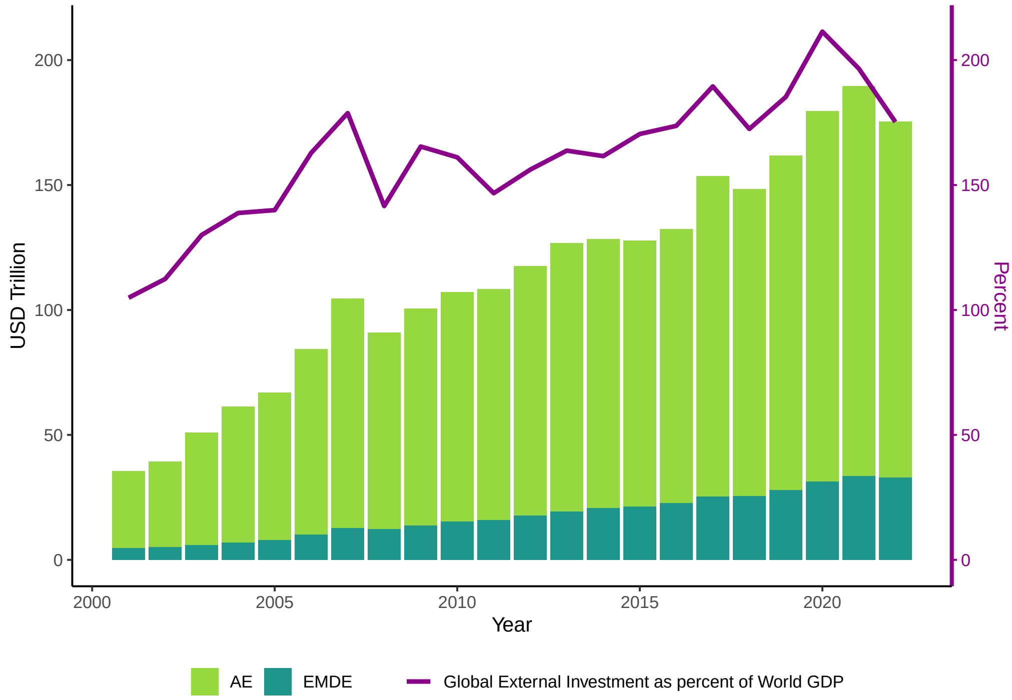
Climate Policy and International Capital Reallocation

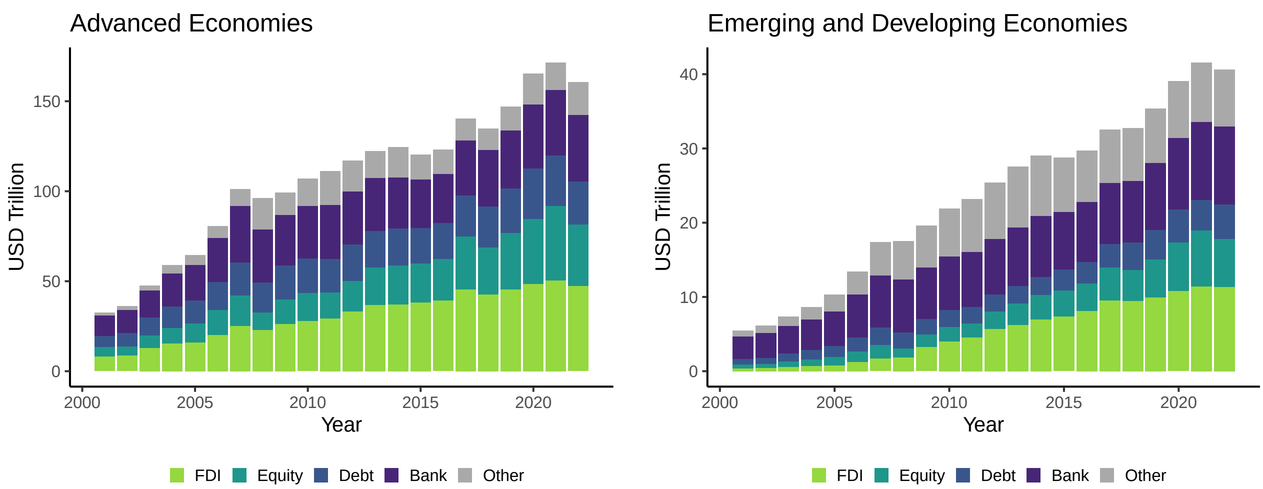
Online Appendix

Figure A1: Global External Assets



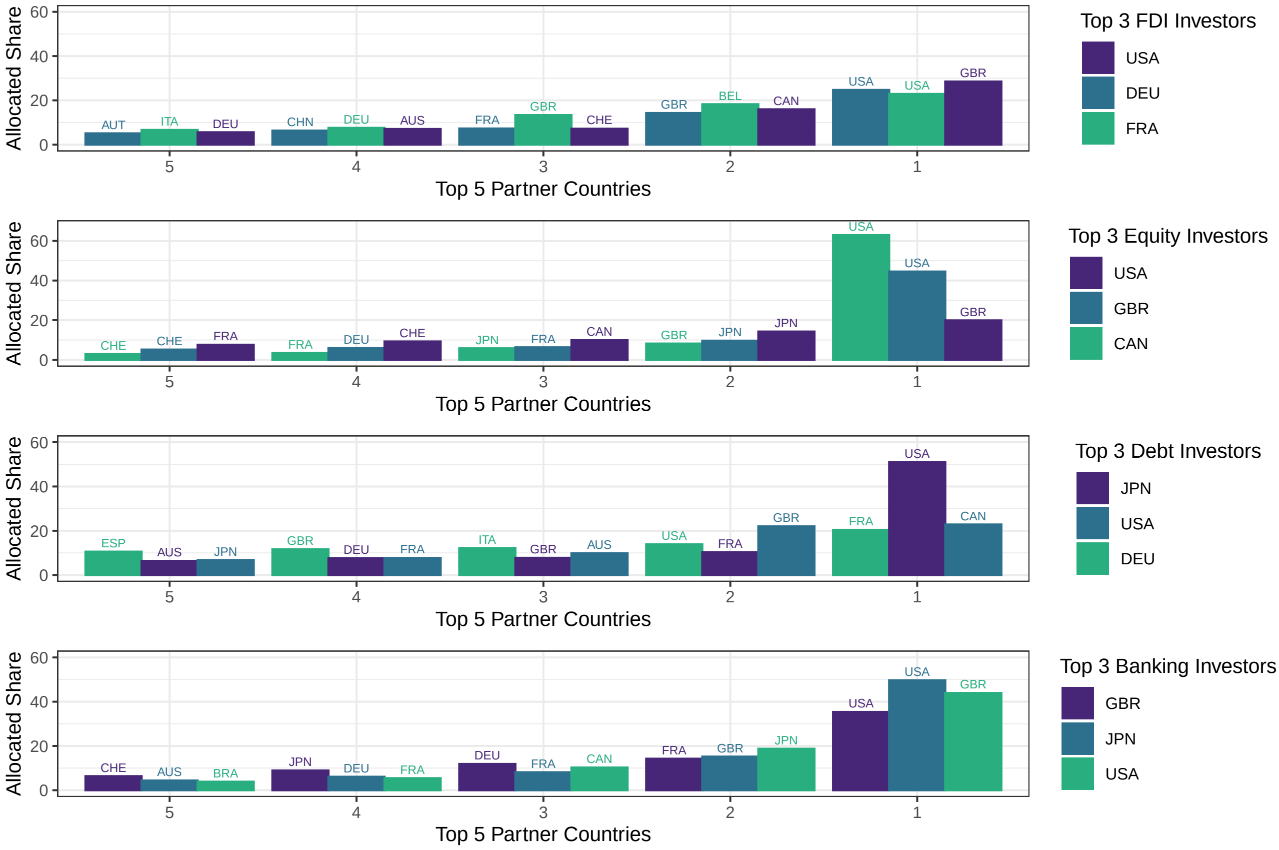
Notes: This figure is based on the External Wealth of Nations database provided by Lane and Milesi-Ferretti (2018). We calculated the sum of financial claims on nonresidents including FDI, portfolio equity, portfolio debt, and other investments, while excluding derivatives and gold holdings, from all countries in the database. The country group classification is based on International Monetary Fund (2023).

Figure A2: External Assets By Asset Types



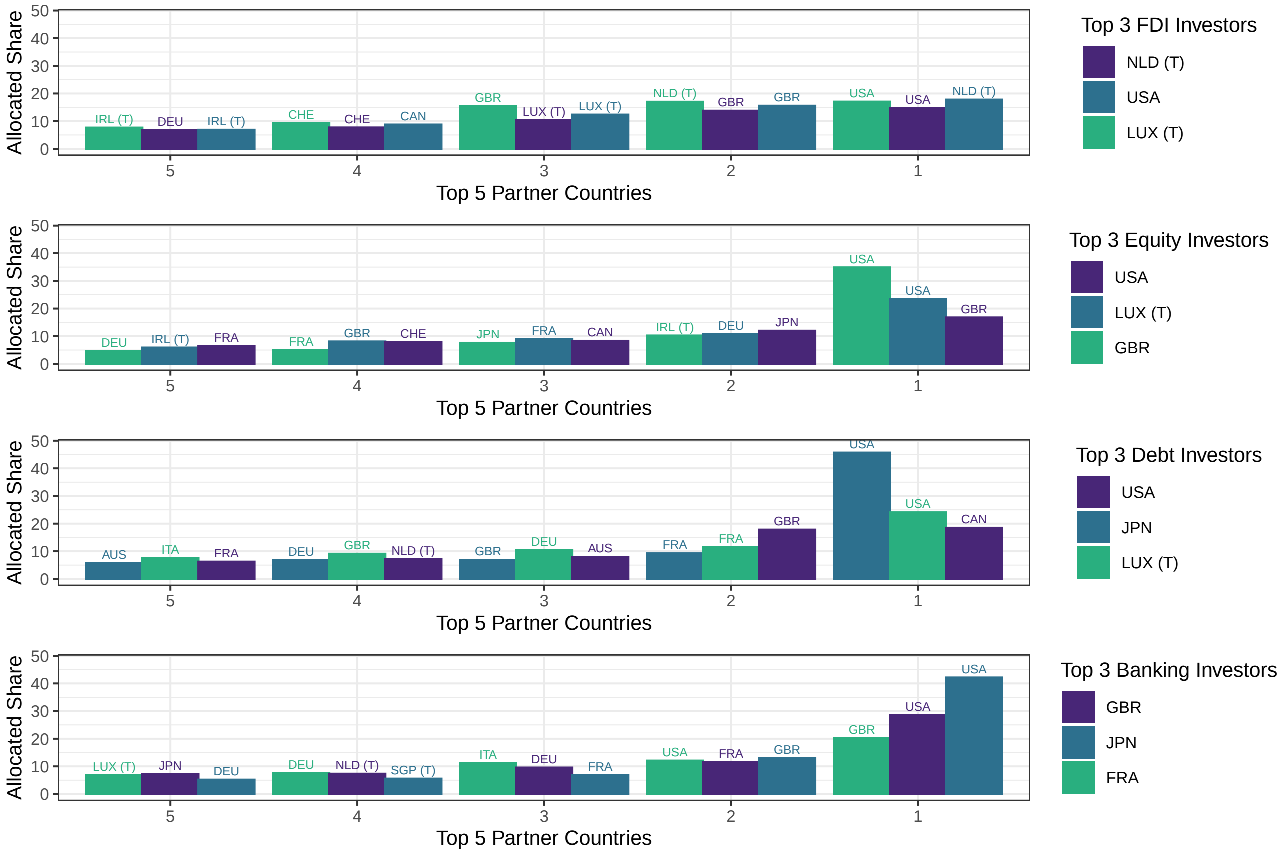
Notes: This figure is based on the External Wealth of Nations database provided by Lane and Milesi-Ferretti (2018). We calculated the sum of financial claims on nonresidents for all countries in the database while distinguishing between both country groups and asset types. The country group classification is based on International Monetary Fund (2023).

Figure A3: Top 3 Source Countries and Their 5 Largest Partners



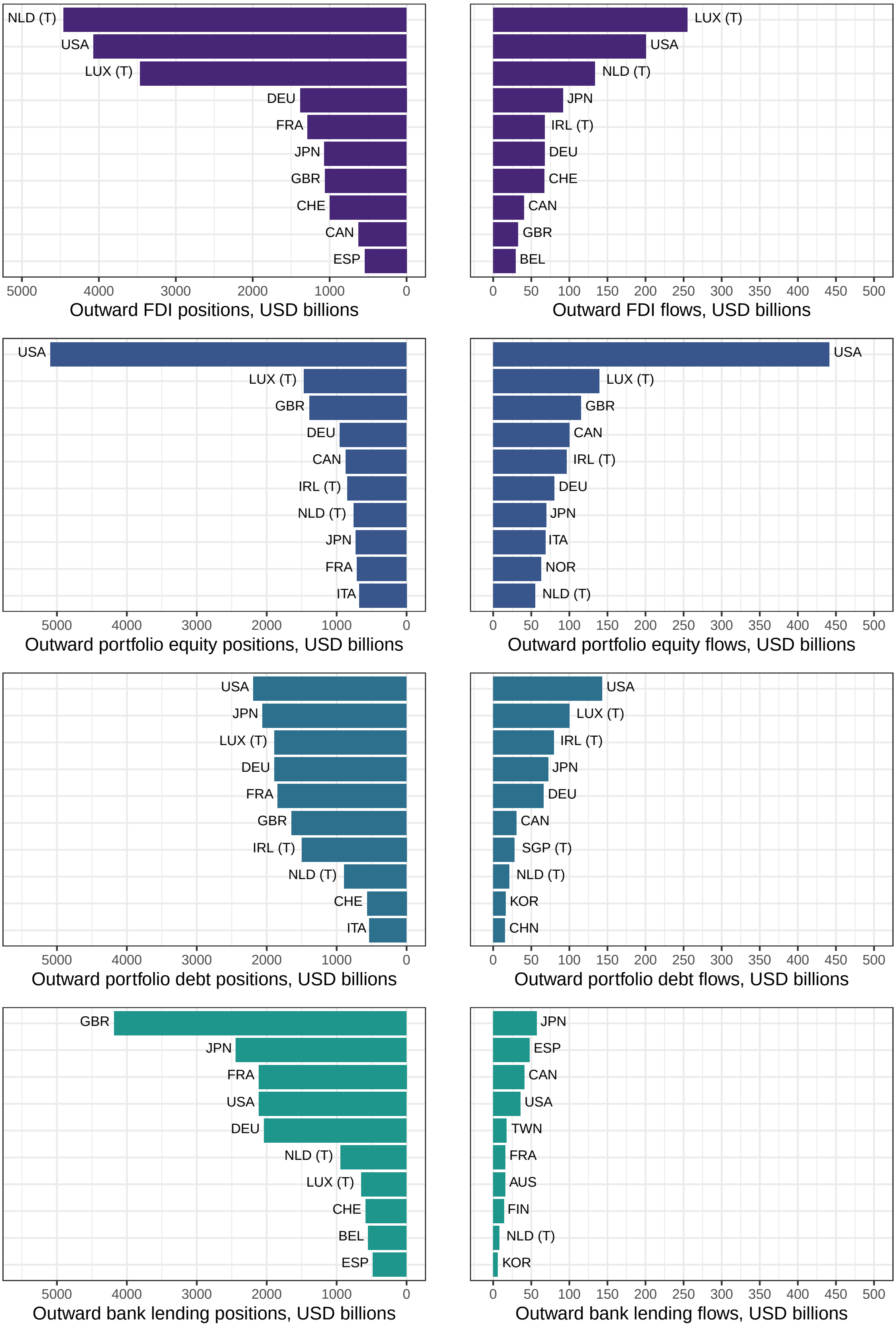
Notes: The figure displays the top 5 partner countries of the top 3 source countries for each type of asset, respectively. For each type of asset, the top 3 source countries are determined by the highest average bilateral external assets in absolute terms over the sample period from 2009 to 2019. Their top 5 partner countries, respectively, are determined by the highest average allocated share towards the partner country.

Figure A4: Top 3 Source Countries and Their 5 Largest Partners, including Tax Havens



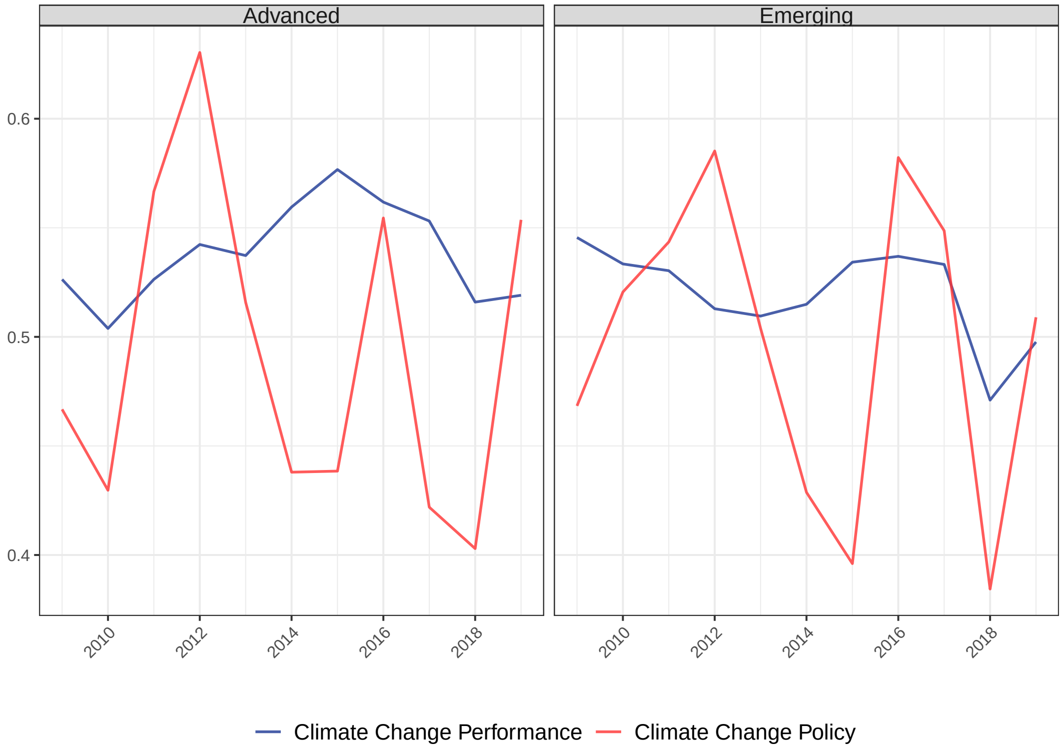
Notes: The figure displays the top 5 partner countries of the top 3 source countries for each type of asset, respectively, including tax havens. For each type of asset, the top 3 source countries are determined by the highest average bilateral external assets in absolute terms over the sample period from 2009 to 2019. Their top 5 partner countries, respectively, are determined by the highest average allocated share towards the partner country. Tax haven countries are marked with a (T).

Figure A5: Top 10 Investor Countries by Type of Asset, including Tax Havens



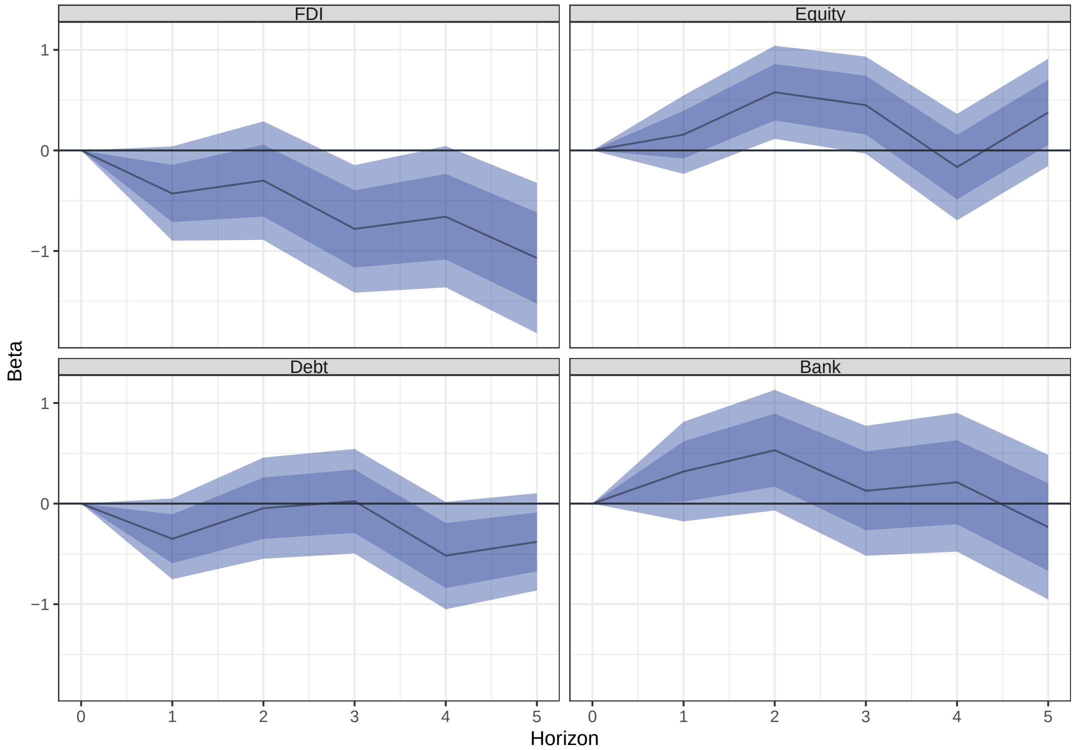
Notes: The figure displays the top 10 investor countries by type of asset, including tax havens (T). The top 10 countries are determined the highest average bilateral external assets over the sample period from 2009 to 2019, distinguishing between stock positions (left) and flows (right).

Figure A6: Climate Change Indicators by Advanced and Emerging Countries



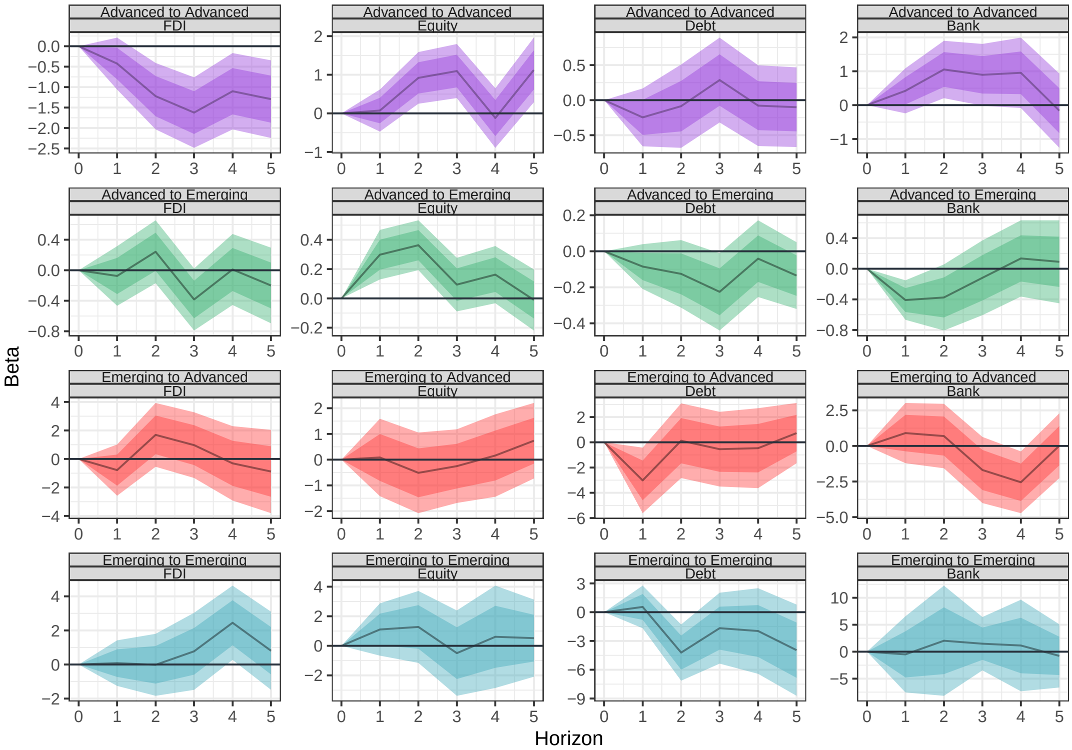
Notes: This figure shows the climate change policy and performance index from Germanwatch, aggregated over country groups.

Figure A7: Local Projections with Balanced Sample



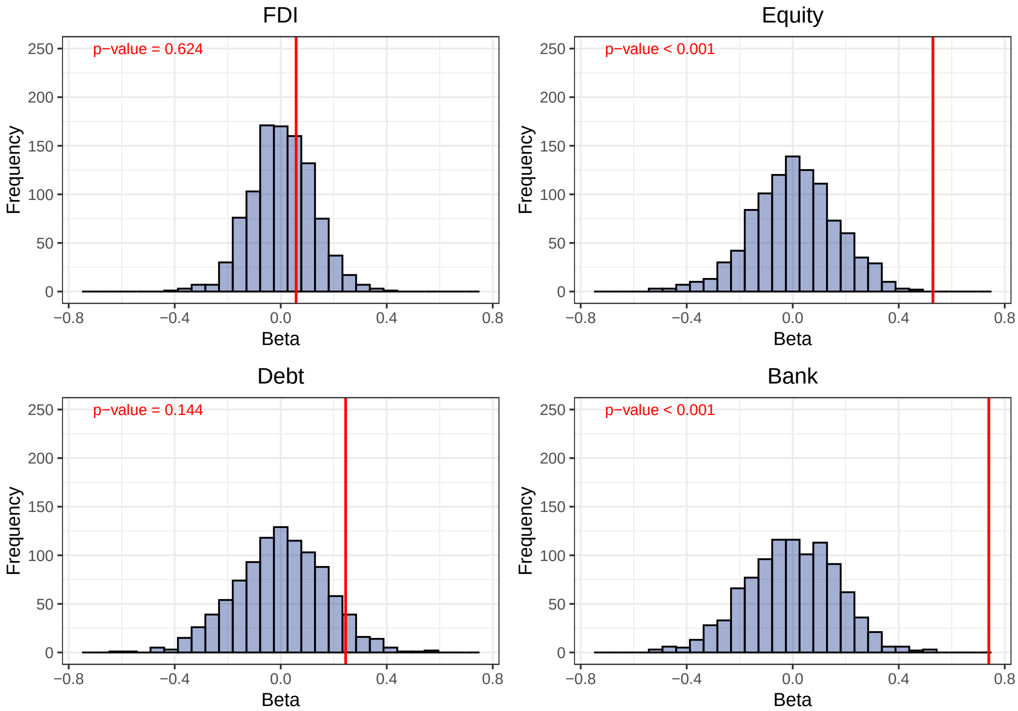
Notes: Responses to a one-unit increase in the destination country's climate policy index. The shaded areas represent 68 and 90 percent confidence bands, respectively, calculated by using standard errors clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Figure A8: Local projections with Balanced Sample: By Country Groups



Notes: Responses to a one-unit increase in the destination country's climate policy index. The shaded areas represent 68 and 90 percent confidence bands, respectively, calculated by using standard errors clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Figure A9: Placebo Test: Permutations of Climate Policy Variable - Country and Time



Notes: The graph displays the distribution of estimated coefficients from using 1000 permutations of the climate policy in the destination country. In this test, we randomly permute the values for both countries and years. The red vertical lines represent the estimated coefficient from our baseline specification with the original data. For portfolio equity and banking investment, the p-value is one-sided and measures the fraction of times in which the coefficient from the original data is smaller than the coefficient from the permuted data. As the results for FDI and portfolio debt from using the original data are insignificant, we use a two-sided p-value in this case.

Table A1: Variable Description

Variable	Definition	Source
	A: Bilateral-Level	
FDI	Percentage share of external FDI stocks of country s allocated in country d.	IMF Coordinated Direct Investment Survey
Equity	Percentage share of external portfolio equity stocks of country s allocated in country d.	IMF Coordinated Portfolio Investment Survey
Debt	Percentage share of external portfolio debt stocks of country s allocated in country d.	IMF Coordinated Portfolio Investment Survey
Bank	Percentage share of external banking investment stocks of country s allocated in country d.	BIS Locational Banking Statistics
Exports	Percentage share of exports of country s directed to country d.	CEPII Gravity Database
Log Exchange Rate	Log bilateral exchange rate, expressed as local currency vis-à-vis foreign currency.	Thomson Reuters Refinitiv Eikon
	B: Country-Level	
Climate Policy	Index for the stringency of national climate policies, ranging from 0 to 1.	Germanwatch
Climate Policy Rating	Assesses climate policy stringency on a 5-point Likert scale, where 1 indicates very weak policy and 5 indicates very strong policy.	Germanwatch
Climate Change Performance	Index for the overall climate change performance in a country, ranging from 0 to 1.	Germanwatch
GDP Growth Rate	Average real GDP growth rate over the previous two years.	World Bank Open Data
Inflation	Year-over-year inflation rate.	World Bank Open Data
CO2 intensity	Log kilogram CO2 usage per unit of GDP.	World Bank Open Data
Central Bank Policy Rate	The percentage benchmark interest rate set by the central bank.	Oxford Economics
Longterm Government Bond Yield	Percentage yield of longterm government bonds with varying maturity, depending on the country under observation.	Thomson Reuters Refinitiv Eikon
FX	Log exchange rate, expressed as local currency vis-à-vis the US-Dollar.	Thomson Reuters Refinitiv Eikon
Stock Return	A country's average yearly stock return of its largest stock exchange.	Thomson Reuters Refinitiv Eikon
Exposure	The allocated share of an asset from country s in d, respectively, is weighted by country d's climate policy. Then, for each source country, the weighted asset share is aggregated across all other countries, leaving out the destination under consideration.	Own construction
Share Green Party	Share of a source country's Green Party seats in its national parliament. We only consider countries where in at least one year during our sample period, the share of Green Party seats was above zero.	Armingeon et al. (2023)
Oil Price Uncertainty	Index for the worldwide oil price uncertainty, averaged over a year.	Abiad and Qureshi (2023)
Energy Uncertainty	Index capturing energy-related uncertainty based on textual analysis of economic and energy-related terms in news reports, averaged over a year.	Dang et al. (2023)
Global of Floods/Hurricanes	Global number of major flood or hurricane events.	EM-DAT
Ratio Coastline Length to Area	A country's coastline length in km relative to land area in km^2	World Resources Institute
Distance from Centroid to Coast	Minimum geodesic distance (in km) from a country's centroid to the nearest coastline, computed using GIS spatial analysis	Own calculation using R (sf, geosphere, rnaturalearth)
Macroprudential Policy	Sum of macroprudential tightening (+) and loosening () actions within a year, where each action is counted as one unit.	IMF Integrated Macroprudential Policy Database (iMaPP)
Capital Control (FDI, equity, debt, bank)	Index of restrictions on cross-border capital flows, covering inflows and outflows across asset classes on a 0-1 scale.	Fernández et al. (2016)
Institutional Quality	Approximated by the Revised Combined Polity Score, measuring institutional quality and political stability on a scale from -10 (autocracy) to +10 (democracy).	Polity Database
TFP	Total Factor Productivity at constant national prices	Penn World Table
Financial Development (IMF)	Index measuring the depth, access, and efficiency of financial institutions and markets, ranging from 0 to 1.	IMF
Financial Development (Domestic Credit to GDP)	Ratio of domestic credit provided by financial institutions to a country's GDP.	World Bank Open Data
EPS	OECD's environmental policy stringency index, ranging from 0 to 6.	OECD Environmental Statistics Database
Market Policies	A subcategory of EPS, contributing a weight of one-third to the overall EPS. It measures the stringency of market based climate policies and ranges from 0 to 6.	OECD Environmental Statistics Database
Non-Market Policies	A subcategory of EPS, contributing a weight of one-third to the overall EPS. It measures the stringency of non-market based climate policies and ranges from 0 to 6.	OECD Environmental Statistics Database
Technology Support	A subcategory of EPS, contributing a weight of one-third to the overall EPS. It indicates the level of technology support and ranges from 0 to 6.	OECD Environmental Statistics Database
CO2 Certificates	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of CO2 trading schemes and ranges from 0 to 6.	OECD Environmental Statistics Database
Renewable Energy Certificates	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of renewable energy trading schemes and ranges from 0 to 6.	OECD Environmental Statistics Database
CO2 Tax	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of carbon dioxide taxes and ranges from 0 to 6.	OECD Environmental Statistics Database
NOx Tax	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of nitrogen oxides taxes and ranges from 0 to 6.	OECD Environmental Statistics Database
SOx Tax	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of sulphur oxides taxes and ranges from 0 to 6.	OECD Environmental Statistics Database
Diesel Tax	A subcategory of Market Policies, contributing a weight of one-sixth to it. It indicates the stringency of diesel taxes and ranges from 0 to 6.	OECD Environmental Statistics Database
NOx Emission Limit	A subcategory of Non-Market Policies, contributing a weight of one-fourth to it. It indicates the stringency of emission limit values for nitrogen oxides and ranges from 0 to 6	OECD Environmental Statistics Database
SOx Emission Limitx	A subcategory of Non-Market Policies, contributing a weight of one-fourth to it. It indicates the stringency of emission limit values for sulphur dioxides and ranges from 0 to 6.	OECD Environmental Statistics Database
PM Emission Limit	A subcategory of Non-Market Policies, contributing a weight of one-fourth to it. It indicates the stringency of emission limit values for particulate matter and ranges from 0 to 6.	OECD Environmental Statistics Database
Sulphur Emission Limit	A subcategory of Non-Market Policies, contributing a weight of one-fourth to it. It indicates the stringency of the allowed concentration of sulphur in diesel for automobiles and ranges from 0 to 6.	OECD Environmental Statistics Database
R&D Expenditure	A subcategory of Technology Support, contributing a weight of one-half to it. It indicates the level of public R&D expenditure relative to a country's nominal GDP and 0 to 6.	OECD Environmental Statistics Database
Adoption support Solar	A subcategory of Technology Support, contributing a weight of one-fourth to it. It indicates the level of price support for solar technologies and ranges from 0 to 6.	OECD Environmental Statistics Database
Adoption support Wind	A subcategory of Technology Support, contributing a weight of one-fourth to it. It indicates the level of price support for wind technologies and ranges from 0 to 6.	OECD Environmental Statistics Database

Notes: For more detailed information about the methodology of OECD's EPS and its subcategories, see Kruse et al. (2022).

Table A2: Country coverage

FDI/Equity/Debt/Exports	Bank
Australia	Australia
Austria	Austria
Belgium	Belgium
Brazil (EM)	Brazil (EM)
Canada	Canada
China (EM)	China (EM)
Croatia (EM)	Denmark
Czech Republic	Finland
Denmark	France
Estonia	Germany
Finland	Greece
France	India (EM)
Germany	Indonesia (EM)
Greece	Italy
Hungary (EM)	Japan
Iceland	Malaysia (EM)
India (EM)	Mexico (EM)
Indonesia (EM)	Portugal
Italy	South Africa (EM)
Japan	South Korea
Latvia	Spain
Lithuania	Sweden
Malaysia (EM)	Switzerland
Mexico (EM)	Turkey (EM)
New Zealand	United Kingdom
Poland (EM)	United States
Portugal	
Russia (EM)	
Slovak Republic	
Slovenia	
South Africa (EM)	
South Korea	
Spain	
Sweden	
Switzerland	
Thailand (EM)	
Turkey (EM)	
United Kingdom	
United States	

Notes: (EM) represents emerging countries.

Table A3: Climate Change Performance Index (CCPI) Components

Component	Weight	Subcomponent	Weight
Climate Policy	20%	National Climate Policy	10%
		International Climate Policy	10%
GHG Emissions	40%	Current Level of GHG Emissions per Capita	10%
		Past Trend of GHG Emissions per Capita	10%
		Current Level of GHG Emissions per Capita compared to a well-below-2°C compatible pathway	10%
		GHG Emissions Reduction 2023 Target compared to a well-below-2°C compatible pathway	10%
Renewable Energy	20%	Current Share of Renewables in Total Primary Energy Supply (TPES) from Renewable Energy Sources	5%
		Development of Energy Supply from Renewable Energy Sources	5%
		Current Share of Renewables in TPES compared to a well-below-2°C compatible pathway	5%
		Renewable Energy 2023 Target compared to a well-below-2°C compatible pathway	5%
Energy Use	20%	Current Level of Energy Use (TPES/Capita)	5%
		Past Trend of TPES/Capita	5%
		Current Level of TPES/Capita compared to a well-below-2°C compatible pathway	5%
		TPES/Capita 2023 Target compared to a well-below-2°C compatible pathway	5%

Source: Adapted from Germanwatch (2018).

Table A4: Baseline Results for Balanced Sample

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.192	-0.070	-0.047	0.765**	0.589*	0.653**	0.484	0.230	0.223	1.027*	1.078**	1.088**
	(0.270)	(0.271)	(0.286)	(0.336)	(0.309)	(0.313)	(0.442)	(0.401)	(0.393)	(0.562)	(0.540)	(0.535)
L.Climate Policy - Source	-0.239	-0.214		-0.112	-0.047		-0.090	-0.237		0.129	0.149	
	(0.216)	(0.242)		(0.216)	(0.213)		(0.430)	(0.365)		(0.187)	(0.156)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	4213	4213	4213	5522	5522	5522	5005	5005	5005	2717	2717	2717
R2 Adj.	0.897	0.898	0.896	0.916	0.917	0.917	0.874	0.875	0.875	0.945	0.945	0.943

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Table A5: Climate Policy Stringency as Rated on a 5-Point Likert Scale from Weak to Strong

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy Rating - Destination	-0.029	-0.093	-0.078	0.272***	0.218**	0.214**	0.096	0.061	0.066	0.294*	0.300*	0.292*
	(0.084)	(0.079)	(0.080)	(0.095)	(0.093)	(0.092)	(0.106)	(0.102)	(0.099)	(0.156)	(0.154)	(0.152)
L.Climate Policy Rating - Source	-0.059	-0.021		-0.020	-0.042		-0.075	-0.061		0.060	0.070	
	(0.058)	(0.064)		(0.066)	(0.070)		(0.103)	(0.100)		(0.054)	(0.058)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10480	10480	10480	11257	11257	11257	11188	11188	11188	4326	4326	4326
R2 Adj.	0.892	0.892	0.895	0.916	0.916	0.916	0.840	0.840	0.844	0.958	0.958	0.957

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment. Climate policy rating is measured using a 5-point Likert scale, where 1 represents very weak climate policy and 5 represents very strong climate policy.

Table A6: Baseline Results for Trade Reallocation

	Exports		
	(1)	(2)	(3)
L.Climate Policy - Destination	0.203***	0.134**	0.132**
	(0.058)	(0.056)	(0.056)
L.Climate Policy - Source	-0.026	-0.032	
	(0.040)	(0.037)	
Source-Destination Pair FE	YES	YES	YES
Source Country-Year FE	NO	NO	YES
Year FE	YES	YES	-
Controls	NO	YES	YES
Num.Obs.	13288	13288	13288
R2 Adj.	0.978	0.979	0.978

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of exports a source country has allocated towards a destination country.

Table A7: Adding Export Allocation as Control

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.092	0.014	0.059	0.568**	0.494**	0.482**	0.223	0.167	0.197	0.666*	0.771**	0.765**
	(0.196)	(0.191)	(0.189)	(0.225)	(0.220)	(0.219)	(0.263)	(0.251)	(0.246)	(0.345)	(0.342)	(0.337)
L.Climate Policy - Source	-0.092	-0.013		0.119	0.065		-0.226	-0.191		0.033	0.101	
	(0.127)	(0.140)		(0.152)	(0.158)		(0.241)	(0.230)		(0.137)	(0.118)	
L.Export Allocation to Destination	0.275**	0.255**	0.261**	0.142	0.119	0.117	0.213*	0.210*	0.171	0.228*	0.251**	0.250**
	(0.123)	(0.123)	(0.124)	(0.106)	(0.113)	(0.111)	(0.118)	(0.119)	(0.132)	(0.118)	(0.121)	(0.121)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	10509	10509	10509	11282	11282	11282	11261	11261	11261	4326	4326	4326
R2 Adj.	0.887	0.887	0.890	0.905	0.905	0.904	0.840	0.840	0.843	0.955	0.955	0.953

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Table A8: Alternative Instrumental Variable Approach

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
Second Stage Results						
L.Climate Policy - Destination	6.870***	7.082***	6.957***	5.490***	7.389***	7.472***
	(2.425)	(2.701)	(2.685)	(1.950)	(2.494)	(2.532)
L.Climate Policy - Source	0.591	0.627		0.291	0.368	
	(0.702)	(0.748)		(0.938)	(1.041)	
First Stage Results for L.Climate Policy - Destination						
L2.Global # Hurricanes x Distance from Centroid to Coast - Destination	-0.004***	-0.004***	-0.004***	-0.004***	-0.003***	-0.003***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
L2.Global # Hurricanes x Distance from Centroid to Coast - Source	0.000	0.000		0.000	0.000	
	(0.000)	(0.000)		(0.000)	(0.000)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	11396	11396	11396	4365	4365	4365
F-Statistic (L.Climate Policy - Destination)	215.730	171.330	340.507	92.775	57.569	115.672
F-Statistic (L.Climate Policy - Source)	233.660	187.606	-	160.530	127.754	-

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: portfolio equity and banking investment. Both instruments were scaled by 1/100 for readability of output. The first stage results shown in the table are based on using the lagged climate policy stringency in the destination as dependent variable. However, we also instrument for the climate policy stringency in the source country using the same specification.

Table A9: 10×10 Largest Investor-Partner Sample

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.994	0.252	0.566	2.181***	1.724***	1.719***	1.304	0.352	0.292	3.281***	2.968***	2.795***
	(0.692)	(0.647)	(0.539)	(0.628)	(0.516)	(0.518)	(1.028)	(0.897)	(0.953)	(0.826)	(0.882)	(0.912)
L.Climate Policy - Source	-0.098	0.739		-0.287	-0.143		-0.346	-0.167		0.124	0.911***	
	(0.570)	(0.656)		(0.327)	(0.276)		(1.294)	(1.154)		(0.405)	(0.302)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	1019	1019	1019	1020	1020	1020	1035	1035	1035	935	935	935
R2 Adj.	0.892	0.897	0.968	0.982	0.983	0.982	0.921	0.924	0.917	0.955	0.957	0.954

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment. We restrict the sample to the 10 largest investor countries and their 10 largest partner countries, selecting them separately for each asset type.

Table A10: 5×5 Largest Investor-Partner Sample

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.265	-0.042	-0.115	5.031***	5.466***	5.657***	3.844***	1.664	1.233	4.857***	4.832***	4.723***
	(1.062)	(1.433)	(1.005)	(1.476)	(1.510)	(1.465)	(1.047)	(1.259)	(1.187)	(1.061)	(1.584)	(1.576)
L.Climate Policy - Source	-0.234	2.393		-0.003	-0.737		0.080	-0.242		-0.074	-0.113	
	(0.900)	(1.649)		(0.196)	(0.831)		(1.172)	(1.234)		(1.784)	(1.218)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	252	252	252	252	252	252	261	261	261	261	261	261
R2 Adj.	0.892	0.906	0.975	0.986	0.988	0.985	0.924	0.941	0.932	0.956	0.963	0.959

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment. We restrict the sample to the 5 largest investor countries and their 5 largest partner countries, selecting them separately for each asset type.

Table A11: Aligning FDI, Equity, and Debt with BIS Banking Sample

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	0.233	-0.090	-0.057	1.121***	1.072***	1.032***	0.645	0.457	0.483	0.786**	0.759**	0.740**
	(0.418)	(0.392)	(0.383)	(0.406)	(0.377)	(0.370)	(0.442)	(0.416)	(0.405)	(0.360)	(0.348)	(0.343)
L.Climate Policy - Source	0.101	0.416		-0.296	-0.184		-0.098	0.028		0.146	0.177	
	(0.223)	(0.330)		(0.220)	(0.208)		(0.351)	(0.281)		(0.164)	(0.138)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	3928	3928	3928	4169	4169	4169	4065	4065	4065	4365	4365	4365
R2 Adj.	0.886	0.887	0.900	0.954	0.955	0.954	0.933	0.934	0.934	0.957	0.957	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment. For FDI, portfolio equity, and portfolio debt, the sample is restricted to those source and destination countries that are included in the BIS dataset for banking assets. Since the BIS dataset has a significantly smaller country coverage compared to the other three asset types, this restriction ensures comparability across asset classes while reducing discrepancies due to sample differences.

Table A12: Climate Policy Effects by Financial Development (IMF Index)

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Financial Development - Destination)	-0.060	-0.042	-0.024	0.318	0.293	0.287
	(0.288)	(0.277)	(0.278)	(0.292)	(0.283)	(0.277)
L.Climate Policy - Destination x D(High Financial Development - Destination)	1.102***	0.958***	0.931***	0.852*	0.859**	0.821**
	(0.364)	(0.342)	(0.339)	(0.439)	(0.417)	(0.410)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	11396	11396	11396	4365	4365	4365
R2 Adj.	0.912	0.912	0.911	0.958	0.958	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. Financial development is measured using the IMF Financial Development Index.

Table A13: Climate Policy Effects by Financial Development (Credit-to-GDP)

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination x D(Low Financial Development - Destination)	0.226	0.105	0.144	0.187	0.082	0.092
	(0.194)	(0.201)	(0.203)	(0.268)	(0.289)	(0.291)
L.Climate Policy - Destination x D(High Financial Development - Destination)	0.964***	0.835**	0.798**	0.973**	0.962**	0.945**
	(0.347)	(0.334)	(0.329)	(0.459)	(0.447)	(0.442)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	10747	10747	10747	4144	4144	4144
R2 Adj.	0.911	0.912	0.911	0.957	0.957	0.956

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. Financial development is measured using domestic credit to GDP as an alternative measure.

Table A14: OECD-EPS: all subcategories

	FDI			Equity			Debt			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Market based Policies												
L.CO2 Certificates - Destination	0.070	-0.005	-0.014	0.075	0.080	0.075	0.008	0.008	0.016	0.145***	0.165***	0.158***
	(0.057)	(0.056)	(0.055)	(0.066)	(0.063)	(0.063)	(0.066)	(0.070)	(0.068)	(0.054)	(0.053)	(0.053)
L.Renewable Energy Certificates - Destination	0.087	0.042	0.034	0.103	0.119	0.122	-0.084	-0.064	-0.066	-0.174*	-0.134	-0.127
	(0.128)	(0.125)	(0.122)	(0.105)	(0.110)	(0.110)	(0.095)	(0.095)	(0.094)	(0.100)	(0.092)	(0.092)
L.CO2 Tax - Destination	0.086	0.089	0.102	-0.099	-0.108	-0.102	-0.062	-0.072	-0.079	0.091	0.073	0.061
	(0.098)	(0.098)	(0.096)	(0.075)	(0.076)	(0.074)	(0.084)	(0.087)	(0.085)	(0.076)	(0.077)	(0.080)
L.NOx Tax - Destination	-0.049	-0.053	-0.053	-0.015	-0.014	-0.007	0.064	0.063	0.069	-0.057	-0.036	-0.023
	(0.060)	(0.060)	(0.059)	(0.042)	(0.043)	(0.044)	(0.058)	(0.059)	(0.060)	(0.094)	(0.098)	(0.100)
L.SOx Tax - Destination	-0.006	-0.044	-0.075	0.148	0.145	0.129	-0.007	-0.005	-0.010	0.202	0.209	0.203
	(0.138)	(0.145)	(0.143)	(0.154)	(0.152)	(0.151)	(0.132)	(0.141)	(0.142)	(0.193)	(0.197)	(0.198)
L.Diesel Tax - Destination	0.044	0.015	0.031	0.100	0.132*	0.113	0.022	0.065	0.069	-0.001	0.003	-0.012
	(0.063)	(0.054)	(0.056)	(0.067)	(0.073)	(0.072)	(0.065)	(0.067)	(0.065)	(0.039)	(0.040)	(0.039)
Non-Market based Policies												
L.NOx Emission Limit - Destination	-0.029	0.002	-0.023	0.067	0.027	0.039	-0.323**	-0.388***	-0.417***	0.225**	0.122	0.080
	(0.100)	(0.094)	(0.090)	(0.110)	(0.119)	(0.125)	(0.128)	(0.132)	(0.134)	(0.098)	(0.103)	(0.104)
L.SOx Emission Limit - Destination	0.231	0.151	0.155	0.505***	0.574***	0.578***	0.536***	0.635***	0.656***	0.183	0.313**	0.347**
	(0.143)	(0.150)	(0.149)	(0.117)	(0.124)	(0.129)	(0.160)	(0.166)	(0.166)	(0.120)	(0.140)	(0.152)
L.PM Emission Limit - Destination	0.129	0.098	0.126	0.077	0.078	0.075	0.186**	0.193**	0.190**	-0.067	-0.042	-0.037
	(0.091)	(0.088)	(0.083)	(0.091)	(0.095)	(0.093)	(0.083)	(0.087)	(0.089)	(0.060)	(0.062)	(0.061)
L.Sulphur Emission Limit - Destination	-0.083	-0.079	-0.066	-0.147***	-0.096*	-0.098**	0.052	0.086	0.108**	0.109	0.159*	0.190*
	(0.053)	(0.051)	(0.048)	(0.051)	(0.049)	(0.049)	(0.052)	(0.053)	(0.054)	(0.093)	(0.092)	(0.098)
Technology Support												
L.R&D Expenditure - Destination	0.034	0.021	0.003	-0.054	-0.064	-0.066	-0.000	-0.013	-0.014	-0.262***	-0.242***	-0.229***
	(0.050)	(0.048)	(0.052)	(0.057)	(0.059)	(0.060)	(0.046)	(0.048)	(0.048)	(0.059)	(0.057)	(0.054)
L.Adoption support Solar - Destination	-0.037	-0.056	-0.056	0.021	0.023	0.021	0.067**	0.077**	0.077**	0.003	0.024	0.032
	(0.047)	(0.048)	(0.046)	(0.033)	(0.032)	(0.032)	(0.033)	(0.035)	(0.035)	(0.030)	(0.034)	(0.034)
L.Adoption support Wind - Destination	0.024	0.019	0.014	0.013	0.015	0.016	-0.078*	-0.078*	-0.080*	-0.018	-0.018	-0.023
	(0.048)	(0.047)	(0.044)	(0.039)	(0.039)	(0.039)	(0.044)	(0.045)	(0.044)	(0.047)	(0.048)	(0.047)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	7451	7451	7451	8130	8130	8130	8094	8094	8094	3953	3953	3953
R2 Adj.	0.889	0.889	0.892	0.914	0.914	0.914	0.861	0.861	0.859	0.958	0.958	0.957

Notes: *** $p<0.01$, ** $p<0.05$, * $p<0.1$. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is the share of total external assets that a source country has allocated in a destination country whereas we consider the following assets: foreign direct investment, portfolio equity, portfolio debt, and banking investment.

Table A15: Climate Policies and Substitution Effects Between Different Types of Assets

	FDI/Total Assets			Equity/Total Assets			Debt/Total Assets			Bank/Total Assets		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L.Climate Policy - Destination	-2.011	-1.380	-1.251	0.716	0.713	0.635	0.220	0.089	-0.176	2.429	1.662	1.658
	(1.649)	(1.601)	(1.474)	(0.912)	(0.945)	(0.866)	(1.092)	(1.009)	(1.049)	(1.530)	(1.432)	(1.304)
L.Climate Policy - Source	-1.348	-0.522		-2.473*	-2.110*		-0.836	-1.271		5.129***	4.319**	
	(1.953)	(1.784)		(1.361)	(1.132)		(1.469)	(1.416)		(1.804)	(1.790)	
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES	NO	YES	YES	NO	YES	YES
Num.Obs.	3595	3595	3595	3608	3608	3608	3595	3595	3595	3595	3595	3595
R2 Adj.	0.810	0.813	0.827	0.893	0.896	0.902	0.865	0.867	0.872	0.802	0.806	0.829

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. The dependent variable is a source country's respective external asset which is allocated in a destination as share of its combined external assets in this destination.

Table A16: Mechanism Investigation: Green Awareness (Continuous Interaction)

	Equity			Bank		
	(1)	(2)	(3)	(4)	(5)	(6)
L.Climate Policy - Destination	0.205	0.166	0.101	1.066***	1.032***	0.967***
	(0.227)	(0.217)	(0.230)	(0.323)	(0.317)	(0.334)
L.Share Green Party - Source	-0.040	-0.040		0.012	0.010	
	(0.027)	(0.027)		(0.050)	(0.051)	
L.Climate Policy - Destination x L.Share Green Party - Source	0.081**	0.081**	0.098**	-0.017	-0.024	-0.010
	(0.034)	(0.033)	(0.041)	(0.054)	(0.055)	(0.067)
Source-Destination Pair FE	YES	YES	YES	YES	YES	YES
Source Country-Year FE	NO	NO	YES	NO	NO	YES
Year FE	YES	YES	-	YES	YES	-
Controls	NO	YES	YES	NO	YES	YES
Num.Obs.	8323	8323	8323	3534	3534	3534
R2 Adj.	0.944	0.945	0.943	0.959	0.959	0.958

Notes: *** p<0.01, ** p<0.05, * p<0.1. Standard errors are clustered at the country-pair and source country-year level. We use a source country's share of Green Parties in the national parliament as continuous variable in this setting.

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