

# UC San Diego

## UC San Diego Previously Published Works

### Title

Julia Gray. 2013. The Company States Keep: International Economic Organizations and Investor Perceptions (New York: Cambridge University Press)

### Permalink

<https://escholarship.org/uc/item/6021m697>

### Journal

The Review of International Organizations, 9(3)

### ISSN

1559-7431

### Author

Broz, J Lawrence

### Publication Date

2014-09-01

### DOI

10.1007/s11558-014-9191-7

Peer reviewed

Book Review of Julia Gray. 2013. *The Company States Keep: International Economic Organizations and Investor Perceptions* (New York: Cambridge University Press)

J. Lawrence Broz

*The Review of International Organizations*. Published online 10 April 2014

This excellent book is about the impact of membership in international economic organizations (IEOs) on sovereign credit risk. Gray's key intuition is that membership changes in organizations like the European Union (EU) and Mercosur are public events; therefore, when the professional investment community observes such changes, they reassess the creditworthiness of sovereign borrowers. When, for example, a high risk country joins an organization composed primarily of low risk members, the entrant will be viewed more favorably by the investment community. In Gray's terms, the entrant has joined a more prestigious "peer group" and is rewarded for this status upgrade with a lower interest rate. By the same token, the existing members of the organization, having added a riskier member into their ranks, will see an increase in their costs of borrowing, as investors sense that the peer group has been "diluted" by the new member. Sovereign credit risk is thus affected by "The Company States Keep."

There's more to it that, however. Gray's most remarkable claim is that the effect of membership on sovereign risk is *independent* of anything that the organization does or demands of its members. Organizations like the EU have rigorous accession requirements that aspiring entrants must meet. Such organizations also have laws and institutions that constrain their members' policy flexibility, as well as enforcement mechanisms to ensure that members stay within the rules. Scholars of international organizations have studied these features in depth under the "legalism" and "rational design" frameworks. But Gray argues that institutional factors matter less to investor perceptions than the reputations of the national governments that populate international institutions. In this sense, Gray brings "the state" into the study of international organizations for the first time.

To support the claim that the character of member states affects sovereign risk independently of institutional or other factors, Gray addresses a host of alternative arguments in her regressions. She controls for prior domestic reforms enacted as part of the requirements for entry, as well as for policy reforms made after a nation enters an organization. She also addresses selection bias and endogeneity, as well as the institutional features of IEOs that are commonly associated with rule enforcement and constraints on behavior.

Remarkably, Gray finds that state membership matters above and beyond these other covariates. Her results imply that membership in international economic organizations is something like a brand name. If two countries were identical in every way except that one of them is a member of a "high-quality" international organization and the other is not, the former country would enjoy a lower interest rate than the other. Importantly, "high quality" refers not to the norms, laws, and institutions of the international economic organization. In the limit, the organization could be nothing but a meaningless placeholder. Instead, "high quality" refers to the reputations of the other members of the organization.

The mechanism behind this membership effect involves the professional investment community and the informational short-cuts its members use to gauge sovereign risks. Gray is fairly cynical about the capacity of investors to accurately assess political risk, defined as a borrower's willingness to repay, on the grounds that being right is less important to investors than being caught out on the wrong side of market sentiment. To avoid being burned by herd behavior, investors rely on simple heuristics that are widely observed and easily understood by other investors. Changes in the membership of international organizations are of this caliber and thus help to coordinate the expectations of the investment community.

The book contains four excellent empirical chapters in addition to an introduction, theory chapter, and conclusion. While her research design relies primarily on quantitative techniques, Gray peppers the book with original supporting quotations derived from first-hand interviews with dozens of policymakers and investment professionals. This qualitative evidence really nails down the causal mechanism. For example, she quotes a Peruvian trade minister who said, "trade agreements are part of our brand... The right kind of trade agreement can send a signal that policies will continue as expected" (p. 34). But, according to an equities fund manager in Botswana, an agreement with the wrong type of trade partners works in the other direction: "Getting into bed with a bunch of weaker trading partners could widen spreads for the group" (p. 34).

Each empirical chapter is absorbing in its own right. But the chapters are also designed to complement one another so that the overall effect is very powerful: the evidence en masse is very persuasive.

Chapter 3 provides the broadest test of the theory by drawing on a sample of 129 countries and using both quarterly (1993:Q1-2008:Q4) and annual (1980-2008) panels. The dependent variable is "political risk" measured as logged spreads over the three-year U.S. Treasury Bill. The key independent variable is called "Company," short for "The Company States Keep." More precisely, this variable measures the political quality of all members in the international organizations to which a country belongs. Gray turns to the International Country Risk Guide (ICRG) to construct this variable, since its 12-component weighted index of political risk aligns reasonable well with Gray's concept of "political quality." Results from her OLS regressions with fixed period and region effects suggest that political risk decreases when countries are members of international organizations with high-quality members. The results appear robust even when controlling for IEO constraints on behavior, prior reforms, and a host of other factors associated with sovereign risk.

Chapter 4 is a statistical case study of the European Union (EU), whose enlargement in recent years demonstrates the effects of "good company" on risk spreads. The EU has expanded its borders in waves over the years and Gray tests to see if new members enjoy a reduction in spreads over and above reductions associated with EU entry requirements, policy changes, institutional constraints and so on. Gray also takes pains to address endogeneity and selection by way of a two-stage instrumental variable approach. The chapter is based on a Gray's 2009 journal article in the *American Journal of Political Science*, which attests to its high quality and careful econometrics.

Chapter 5 complements the “good company” context of EU enlargement with its mirror image: “bad company” cases where states join organizations with low-quality members. The argument is symmetrical so the expectation is that when states join IEOs with members that have poor reputations, investors downgrade the entrant’s reputation and raise its spreads. The cases are fascinating. They include the *Bolivarian Alliance for the Peoples of Our America* (ALBA), which was promoted by Venezuela under Hugo Chavez as a foil to US-sponsored economic integration in Latin America; the Eurasian Union advanced by Russia to integrate Eastern Europe and Central Asia; and the *Common Market for Eastern and Southern Africa* (COMESA).

This chapter focuses on ALBA, which was a regional trade agreement with little content—other than anti-capitalist rhetoric. Using event studies that look for abnormal stock market returns around the timing of membership changes, Gray shows that states with ideologies similar to Chavez’s—Bolivia under Ivo Morales and Nicaragua under Daniel Ortega—saw no abnormal returns when they entered ALBA. This is expected since investors already knew the character of these states. But for entrants that were less well known in world markets, such as Honduras under Manuel Zeyaya, Gray shows that markets responded very negatively.

As a counterpoint to the previous chapters, Chapter 6 investigates the effects of new entrants on existing members in an IEO. Here, again, the argument is symmetrical: just as a high-risk entrant’s reputation is enhanced by the better reputations of other members of the IEO, so too should the entrance of a risky member diminish the reputations of the existing members. The key case here is the expansion of the European Union to include members with weaker reputations than the core members. Gray reports a number of interesting findings. First, and as expected, every round of EU enlargement has brought a slight increase in Germany’s risk premium. Second, and more surprising, the entrance benefit of joining the EU, as measured by the decline in the risk premium, has diminished over time as the EU absorbed larger numbers of higher risk countries. Needless to say, these results have important implications for debates about the *enlargement* of IEOs, which Gray discusses in the concluding chapter of the book.

There are a few weaknesses worth noting. First, Gray claims to derive her arguments from sociology, management theory, and constructivism. These claims are not substantiated in the text, which is odd, but more importantly there is little reason to invoke these approaches at all. When investors employ informational short-cuts to anticipate the actions of other investors, they are merely operating under informational constraints. Imperfect information is entirely consistent with the rational actor approach to social phenomena.

Second, Gray’s analyses omit the possibility that *implicit bailout guarantees* are driving her results. When a high risk country enters the EU, investors may consider that country a better risk simply because they anticipate political pressure for bailouts from Germany and other core members should the new member face a debt crisis down the road. By the same token, Germany and other low risk nations in the EU may experience higher spreads when risky members enter the union simply because investors recognize that Germany will be on the hook in the event of a debt crisis in the periphery. Indeed, scholars of the Eurozone crisis usually interpret market reactions in this manner.

While Gray is conscious of this alternative explanation she does not control for implicit bailout guarantees in her analyses. One way to do so would be to include the loan exposure of core-country banks to new entrants (data on bank exposures are available from the Bank for International Settlements). When banks are highly exposed to a new member, it implies bailout insurance to the new member because a default could spark a financial crisis in the core.

Despite these minor issues, this book is clearly a “must read” for serious students of international organizations. Gray develops a novel argument about the effects of international organizations and persuasively defends her position against alternatives suggested by the dominant theories of international institutions. She builds her case systematically, utilizing a combination of statistics and first-hand interviews, and testing the implications of her argument across a range of contexts and regions. You will learn a great deal from this book.