Book Review

Christina L. Davis, Princeton University

The Company States Keep: International Economic Organizations and Investor Perceptions. By Julia Gray. Cambridge: Cambridge University Press, 2013.

How do countries establish a reputation for being creditworthy? Previous research focuses on the economic fundamentals, policy reforms, political environment, and past behavior. Julia Gray posits a new mechanism—peer effects. Through close association with low-risk countries, a government can improve its own reputation among investors. Likewise, the reputation of a country worsens when it hangs out in the wrong crowd. Membership in regional economic organizations provides the key forum for establishing a peer group in Gray's book, and she presents comprehensive evidence that documents the impact of membership on sovereign credit risk. The argument is original and compelling, with profound implications for rethinking investor decisions and the informational role of international institutions. The deft use of evidence that ranges from sophisticated statistical analysis of bond yields to interviews of government officials sets a model for scholarship.

In a novel twist, *The Company States Keep* highlights a role for institutions to provide information beyond the specific reforms that are demanded of entrants. In contrast to theories that argue that institutions help states make credible commitments to policy reforms, for Gray the partners in the organization are more important than the policies—a state with a high risk profile can in effect borrow credibility by virtue of its shared membership in an organization with other states that are low risk irrespective of whether the state implements extensive reforms. This argument relies on a view of investors who are flooded with information and seek cues to inform their credit valuations. Accession to regional economic organizations leads investors to place a government into a new category of risk level based on what they know about the other members of the organization. Is this an irrational investor decision? Not necessarily. Certainly the argument suggests informational shortcuts within a bounded rationality framework. But it also presents logical steps in which investors infer information from the judgment of "known" states that reveal their confidence in the new member by letting them into their club.

Using statistical analysis of spreads on sovereign debt to assess investor perceptions of risk across 129 emerging markets over 28 years, Gray finds a significant impact of the interaction between the average risk rating of member states (measured by International Crisis and Risk Group ratings) and the proposed level of integration. Controlling for benchmark measures of economic performance in the country, she finds an independent peer effect triggered by clearing the final hurdle of negotiations to enter the organization. As expected, her argument applies in both directions, such that countries joining an organization with high-risk states will experience higher interest rates as a surcharge for keeping poor company, while entry into an organization like the European Union with low-risk states brings lower interest rates. Case study analysis indicates that governments anticipate borrowed credibility from their entry into the organization. Even more surprising is the resilience of the borrowed reputation in the face of contrary facts; one year after Hungary joined the European Union it was revealed to have misled negotiators on its budget figures such that its actual government deficit was in violation of the Stability and Growth Pact, but neither the European Union nor markets punished Hungary with fines or increased its cost for borrowing. Gray cites an interview with a Hungarian ministry of finance official that "markets [were] giving Hungary a break because of the membership in the EU" (112). It would take years of excessive spending before Hungary's credit rating fell.

Chapter 5 offers the most interesting evidence in support of peer effects, with its analysis of what happens to emerging markets that join up with "bad company." For Honduras, the decision of a newly elected leftist government in 2008 to join Hugo Chavez's Bolivarian Alternative for the

The Journal of Politics, volume 77, number 4.

Americas (ALBA) brought access to substantial financial resources from Venezuela and an immediate increase in risk measured by sovereign spreads on Honduran debt for the 30 days following the membership announcement. This risk fell when the next government chose to exit ALBA. The book's case studies nicely integrate quantitative and qualitative evidence showing that decisions on membership had an impact on markets despite the absence of economic reforms.

The Company States Keep leaves open some important questions. First, the focus on regional economic organizations such as the North American Free Trade Agreement and the European Union sets aside the question of whether joining other international institutions such as the World Trade Organization or the International Monetary Fund would have an equivalent effect. The evidence in chapter 6 on international organization (IO) expansion shows that enlargement begins to dilute reputation effects, which suggests that the larger multilateral institutions would be too big and heterogeneous in membership to carry weight among investors. It would have been nice to see this comparison shown explicitly in a broader comparative analysis of IO accession effects on investor perceptions. In a related point, an interesting extension would explore how investors weigh information across overlapping memberships. Even within a region there can often be multiple economic organizations, and does each one simply have an additive effect on the country's reputation? If not, what leads one organization to rise to the forefront as the de facto category by which investors sort countries into groups of different company? Second, Gray deliberately leaves aside the question of why states choose to join the organization. She makes the distinction that her theory is not a form of signaling argument whereby states join as part of a strategy to convey information about their type; instead, she attributes the reputational effect of membership as "unintended consequence of entry into trade agreements" (36). The complex motives for joining international organizations merit further research and could hold implications for understanding the impact of membership decisions.

The book offers rigorous empirical testing of a new and important set of hypotheses about international institutions. If anything, Gray undersells the implications of the book—the idea that peer effects trump the nature of reforms challenges the focus on institutional design that is so prevalent in the literature. Similar to Michael Tomz's *Reputation and International Cooperation:* (2007), Gray uses sovereign debt as a window for developing theory and empirical tests to understand how reputations are formed and affect economic outcomes. She shows a new role for institutions to define the profile of members–for better or worse–by the states they join in cooperation within an institutional forum. The book should be widely read by those interested in understanding international relations and international political economy.

REFERENCE

Tomz, MIchael. 2007. *Reputation and International Cooperation: Sovereign Debt across Three Centuries.* Princeton, NJ: Princeton University Press.