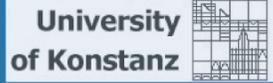


# Eliciting Substance from 'Hot Air': Financial Market Responses to EU Summit Decisions on European Defense



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## 1. Are Multilateral Fora "Talk Shops"?

- The results of deliberations in multilateral fora are often considered as ineffective. Decision making in the European Union (EU) and in particular its key intergovernmental body, the European Council, poses no exception. Interviewed by the International Herald Tribune, Daniel Gros from the Center of European Policy Studies, described these gatherings as a "waste of time".
- The skeptical view is nurtured by the realist perception that national interests prevent states from being able to agree on and credibly commit to lasting cooperation. It is especially suited to multilateral decision making in the area of security and defense, which directly concerns states' primary objective of securing a maximum of political power and autarky.
- In this paper, we take issue with the claim that multilateral summits merely result in "hot air".

## 2. European Defense Policy Outcomes Matter

- We focus on the domain of foreign and security affairs (European Security and Defense Policy, ESDP) and thus an area of cooperation for which some early observers never expected the European integration to encroach upon.
- We argue that investors react positively to a successful strengthening of Europe's military component – a vital part of the intensified cooperation within the European Security and Defense Policy (ESDP) – since such decisions increase the demand for military products and raise the expected profits in the European defense industry.
- We expect that investors carefully evaluate the outcome of EU council meetings. Thus, in our view, some of these intergovernmental meetings are not a "waste of time", but provide crucial information about crucial economic decisions.

## 3. Strengthening the ESDP: EU Summits, 1993-2005

Summit	Defense Policy Outcome
Amsterdam 16.06.97	Treaty signals progressive framing of a common security and defense policy based on the Petersberg tasks.
Cologne 03.06.99	Leaders reach agreement in that EU needs own military capacity to tackle regional crises in Europe (including sources of intelligence and capabilities for analysis and strategic planning)
Helsinki 10.12.99	"European headline goal": Specifies need for rapid response capability, adding a security and defense arm to the EU (60,000 soldiers for peace-keeping operations).
Brussels 12.12.03	Summit approves European security strategy („A Secure Europe In A Better World“), formulating for the first time a common security strategy for Europe
Brussels 17.06.04	European Battlegroup (EUBG) concept: EU military forces under direct control of Council, each consisting of appr. 1500 combat-ready soldiers deployable within 15 days of approval from the European Council

## 4. Do Summit Outcomes Matter?

- We argue that traders will identify Council meetings which have been concerned with the ESDP and which actually resulted in decisions to build up military capabilities and to strengthen the defense and security component of the EU.
- Efficient Markets will reflect available political information. Thus, an increase in expected profitability of defense industry leads to an increase in defense returns.
- Hypothesis:** Summits which resulted in a strengthening of the EU's military capabilities and an increase in defense cooperation increase the stock return performance of the European defense sector.
- Summits which merely put defense issues on the agenda should be inconsequential for defense firms.

## 5. Research Strategy: Event Study Approach

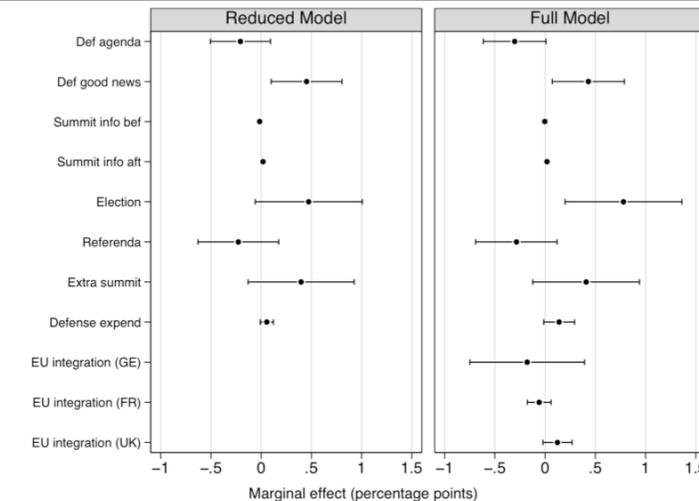
### Step 1: Comparing Observed and Expected Returns

- Comparison of observed defense returns and expected returns (normal performance)
- Generate synthetic defense return series (normal performance) based on asset pricing model
- Difference between observed and synthetic return (counterfactual) is abnormal return

### Step 2: Explaining Variance in Abnormal Returns

- Regress abnormal defense returns on indicator variable "Def good news" (equals 1 for summits in table above and is 0 otherwise)
- Include "Def agenda" indicator (equals 1 for summits which put ESDP on agenda but failed to change the status quo)
- Control variables: Press coverage ("Summit info bef" and "Summit info aft"), "election" and "Referenda" (indicates whether election/referendum upcoming in one of the three largest member states (Germany, France, United Kingdom), EU integration preferences

## 6. Evidence: Regression results for abnormal defense returns (N=222)



GLS point estimates (with random effects), 90 percent confidence intervals computed from Huber/White standard errors. Constant included but not reported.

## 7. The Market Discriminates between Substance and "Hot Air"

### Findings

- Council meetings which result in deeper ESDP cooperation ("Def good news") trigger positive abnormal returns of about 0.5 percentage points on average.
- Data on the market capitalization of the European defense sector suggests that each of these summit decisions is worth about 4 (+/-1.4) billion Euros on average.
- Summits which merely put ESDP on the agenda but failed to change the status quo have no significant effect. This suggests that the market carefully discriminates between summit outcomes, i.e. between substance and "hot air".

### Conclusion

- The evidence contradicts the view that EU council meetings are just "talk shops" which lack any informational value and therefore are ignored by financial markets.
- The skeptical view many hold about the effectiveness of international institutions, diplomacy and their relevance for the economy is in need of qualification; potential for effective decision-making within international institutions relevant for markets may be underestimated, because we lack systematic evidence on when and how these matter.
- Our study constitutes a first step in learning more about these phenomena and at the same time encourages future research to further examine the economic effects of international diplomacy.

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