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Book Reviews

Democratic Political Processes and Financial Markets: Pricing Politics
Bernhard, William and David Leblang
Cambridge: Cambridge University Press (2006), ix, 272 p.,
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Krieg, Kooperation, Kursverlauf: Die Internationale Politische Ökonomie von Finanzmärkten
Schneider, Gerald, Bechtel, Michael and Christian Fahrholz
VS Verlag für Sozialwissenschaften (2009), 178 p., ISBN 978-3-531-16509-7.

How do financial markets react to politics? This question is relevant for political scientists and political economy scholars for a number of reasons. First, the connection between politics and financial markets, such as stock or foreign exchange markets, is a crucial link in the causal chain implicitly or explicitly underlying most political science research on the consequences of economic globalization. Second, movements in financial markets in response to political events or decisions essentially reflect the distributional effects of domestic and international politics. These distributional effects are at the very heart of political competition and conflict between interest groups, political parties or governments, but they often are difficult to nail down empirically. Third, financial market responses to politics allow us to gauge the economic costs that arise from political processes and events, e.g. political violence or electoral uncertainty, and thus reflect the welfare consequences of politics.

Two recent books, *Democratic Processes and Financial Markets* by William Bernhard and David Leblang, and *Krieg, Kooperation und Kursverlauf* by Gerald Schneider, Michael Bechtel and Christian Fahrholz, address these important issues. They contribute to the young, but quickly growing literature in political economy that has examined the interaction between politics and finance during the last few years. The two books represent the most encompassing efforts in this research area so far and complement each other well. The former is a collection that examines how domestic political processes, e.g. cabinet dissolutions, coalition bargaining and national elections, affect different types of financial markets, specifically bond, stock and foreign exchange markets. The latter mostly addresses the effect of international politics on finance and assesses the consequences of European integration, international conflicts and economic globalization.

Both books view financial markets as efficient institutions that constantly process information about future profitability of short-term investments (Schneider et al., chapter 2). This implies that market participants monitor political developments because government policies, such as regulations and fiscal spending, or political events, such as cabinet dissolutions and international wars, seriously affect investments and therefore lead to domestic and international reallocations of capital. The underlying theoretical framework of financial markets, however, also implies that the financial effects of politics can only be observed during a short period of time when market participants receive new information about future political developments and revise their political expectations. The study of politics and financial markets thus requires sophisticated empirical strategies. Both studies use an impressive arsenal of empirical methods that range from event studies of a large number of political events to the use of high frequency financial data that are analyzed with advanced time-series models.

The natural starting point of an analysis of domestic politics and financial markets is the classic theories of opportunistic and partisan business cycles. These theories appear in both books, but the studies move far beyond these traditional approaches and combine them with more sophisticated political theories, e.g. models of government formation and cabinet dissolutions. Bernhard and Leblang rely on these political theories to assess the financial consequences of democratic politics, especially the political uncertainty during periods of political change. Such periods, which are not only pre- and post-election periods, but also episodes of government negotiations and increased risk of government breakdown, can have serious economic costs (chapters 2 through 5). When political predictability decreases and therefore political risk increases, market participants demand a greater risk premium for holding a country's currency or higher interest rates on government debt (chapters 2 and 5). Abnormal market behavior is mediated by political constellations that facilitate the anticipation of political outcomes. Drawing on theories of government formation, Bernhard and Leblang show that stock and bond markets respond less to political processes if government negotiations are easily predictable, e.g. by the presence of a strong party (chapters 3 and 4). The cross-country analyses are complemented by interesting case studies that examine in greater detail how market participants process political information during these periods of uncertainty e.g. the formation of the first ÖVP/FPÖ government in Austria in 1999 (chapter 6) or the U.S. presidential election in 2000 when Bush ran against Gore (chapter 7).

The broad range of topics is extended in Schneider et al. by shifting the focus towards international politics. They document the importance of international organizations, as represented by the European Union, for welfare and the international allocation of financial resources (Schneider et al., chapter 4). For instance, when the EU decided to impose stricter regulations of genetically modified products, the prices for American soybean and corn products dropped while the price for equivalent European products increased. Simultaneously, the inability to comply with the EMU budgetary standards has costly consequences because governments violating the rules have to pay higher interests on their debt. Compared to the distributive consequences of international integration, the financial effects of political disintegration as reflected by political violence, especially the gains of the defense industry and the loss of the tourism-related sectors in response to suicide bombings and interstate wars, seem less non-obvious (chapter 5). Quite interesting is the finding that the Iraq war had only small effects on oil prices. This contradicts the common view that consumers all over the world had to shoulder a large share of the economic burden that this conflict generated. The third empirical section directly connects to the book by Bernhard and Leblang and documents the role of domestic politics for international markets (chapter 6). Indications of greater authoritarianism in Russia led to greater distress and volatility in the Russian stock market illustrating the importance of stable democratic institutions for liberal emerging market economies. In consolidated Western democracies, stocks mainly respond to the prospect of more or less market-friendly policies after an election. Political institutions mediate this effect because a greater number of veto players reduce the risk of a policy change.

A nice feature of both books is the combination of single case studies with broader cross-country analyses. The focused analyses of few cases give detailed insights into the continuous interplay of politics and markets, while the broader studies also uncover when we should *not* expect a strong relationship between politics and financial markets. The latter studies are particularly important because the study of well-chosen cases, often the United States and the United Kingdom, where we should see particularly strong effects of politics on finance has taken a prominent place in the existing literature. This is a bit unfortunate because structured comparisons of cases with strong and little financial effects of politics would be even more interesting than the common, but narrow focus on cases where strong effects can be easily demonstrated. The two books make a big step into this direction, but there is room for more comparative case studies that are guided by a careful selection and combination of interesting cases that cover greater variation with respect to the impact of politics on financial markets.

In general, both books would gain if the welfare effects of politics were discussed more explicitly and extensively. The distributional effects of policy choices, such as EU regulations, or the costly impact of political processes, such as electoral uncertainty, are mentioned repeatedly throughout both books, but it would be desirable to see more explicit discussions of the size of the estimated effects and their implication for politics. Although the relationship between politics and financial markets is interesting in itself, the welfare effects of politics are of interest to a broader audience and in fact are one of the greatest concerns of political science. In other words, we should not only care about the *existence* of systematic effects, but also about their *magnitude*. The ability to exactly quantify these distributional effects is one of the advantages of the financial analyses and could be exploited more thoroughly.

In some parts, the great potential of political theories has not been fully exploited, for instance with respect to analyses of political conflict. The literature on political violence and conflict is very comprehensive and allows for more refined hypotheses about financial market responses to conflicts than the ones analyzed. While the economic effects of terrorism on selected economic sectors are interesting, the political science literature yields even more elaborate and relevant hypotheses, e.g. about the role of political institutions. To name just one, financial markets should respond less to terrorist attacks in political systems that are able to better integrate domestic groups and mediate political violence, but they should respond more in systems that are less integrative or more fragile. There are many such interesting, normatively highly important theories that wait to be applied to financial markets. Following much of the existing literature, the authors also refrain from comparing financial market reactions in open and closed economies. Most research on the political economy of financial markets examines the link between politics and markets during the last few decades when economies were fairly open to international financial flows. Most theories, however, also yield implications about the differences between open and closed economies that are rarely addressed empirically.

Building on the study of domestic and international politics and financial markets in the two books discussed here, the logical next step would be to link the domestic and international arena by further examining financial spill-over effects across countries in response to political developments (see also Bernhard and Leblang, chapter 4). These can be negative spill-over effects when political failures lead to an international financial crisis as we see it today, or positive spill-overs when a country experiences a capital inflow in response to political destabilization in another. The effects of regulation of financial markets in response to the current crisis, and the relationship between politics and finance in developing and emerging market countries, which has received little attention so far (see also Schneider et al., chapter 6), are other important topics that should be addressed. The books by Bernhard and Leblang and by Schneider et al. not only provide the ground for this future research, but also are a great starting point for students of political economy that have not yet been exposed to research in this area.

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Les sentinelles de l'argent sale : Les banques aux prises avec l'antiblanchiment
Favarel-Garrigues, Gilles, Godefroy, Thierry et Pierre Lascoumes
Paris : La Découverte (2009), 312 p., ISBN 978-2-7071-5421-7.

Durant ces dernières années, la législation antiblanchiment s'est imposée comme un des éléments clés de la régulation financière internationale, en termes d'activisme des pouvoirs publics, d'attention médiatique, et en ce qui concerne les moyens administratifs et l'effort déployé par les professionnels du secteur. La nécessité de lutter contre l'argent sale fait désormais l'objet d'un consensus de principe presque absolu au niveau national