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The distant echo of Brexit: Did exporters suffer the most?

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ABSTRACT

This study investigates price adjustments on the Warsaw Stock Exchange after the referendum on Brexit. Contrary to our expectations, we found that investors' reactions were uniform with regard to the firms' dependence on European markets or reliance on export activities in general. Other fundamental factors only moderately influenced investors' decisions.

1. Introduction

The result of the Brexit referendum held in the United Kingdom (UK) on Thursday, June 23, 2016, appeared to surprise the media, general public, politicians, and financial market participants despite several preceding polls indicating increasing support for the "leave" vote. In the days that followed, the mass media expressed their astonishment and underscored the general feeling of uncertainty that resulted from the referendum outcome linked to the process of the UK's removal from the European Union (EU). Perhaps the most emblematic was The New Yorker cover page that presented a traditionally dressed English gentleman taking a giant step into an abyss.

The financial markets also reacted nervously to the referendum results. On June 24, the main indexes of the equity markets in both North America and Europe fell sharply. London's FTSE dropped by 3.15%, New York's DJI dropped by 3.39%, and Frankfurt's DAX dropped by 6.82%. The selling wave also reached post-transitional Central European countries. The stock exchanges in Budapest, Prague, and Warsaw on that same day recorded losses of 4.45%, 4.17%, and 4.38%, respectively.

With respect to the general public, the referendum triggered an unprecedented and, unfortunately, a rather belated increase in interest in the consequences of the UK's decision to leave the EU. In June 2016, the number of queries concerning Brexit in the Google search engine exceeded 4 million in the UK, whereas the average number of similar questions during the preceding six months was only 209 thousand. Similarly, the number of people from Poland seeking information on Brexit in Google increased 20 times in June in comparison with the number in May.

The referendum on Brexit, however, also created a unique opportunity to study investors' reactions when they are confronted with consequential and largely unanticipated events. Two recently published studies have already exploited this

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opportunity. First, Tielmann and Schiereck (2016) found an overall negative value effect of the Brexit referendum on European logistics companies. Second, Schiereck et al. (2016) established that the reaction of bank stock prices to the Brexit announcement was more severe than the reaction to Lehman's bankruptcy, while the response of the CDS market was far more subdued.

In this study, we analyze whether the investors' reactions to the results of the Brexit referendum were driven by fundamentals, particularly firms' dependence on export activities. In contrast to Tielmann and Schiereck's (2016) and Schiereck et al. (2016) studies, we opt for a single country framework and concentrate on a post-transitional emerging stock market. We choose the Warsaw Stock Exchange (WSE). We believe that the WSE constitutes an interesting and appropriate laboratory for analyzing investors' reactions for three reasons. First, despite the WSE's relative sophistication, it is still perceived as an emerging market. Second, the WSE is significantly larger by market capitalization and the number of listed firms compared to the stock markets in other post-transition European countries.[1] Third, the WSE is potentially vulnerable to short-term capital flows because, on one hand, foreign investors account for approximately 50% of the transactions on the WSE and, on the other hand, mutual funds with assets equivalent to almost 15% of Poland's GDP are active market participants.

To test whether exporters suffered the most after the Brexit referendum, we hand-collected data on the export activities of firms listed on the WSE. Contrary to our expectations, we found that investors' reactions were unaffected by the variables that illustrate the dependence of companies on European markets. This research outcome was robust to the changes in event study methodology.

The remainder of this paper is organized as follows: In Section 2, we review the relevant literature and formulate our hypothesis. In Section 3, we describe the methodology and characterize the dataset. Section 4 provides the research outcomes. Section 5 contains concluding remarks.

2. Research hypothesis

The British people's decision to leave the EU worsened the economic prospects for both the United Kingdom and other members of the EU. Ebell et al. (2016) estimated that 15 years after the decision to leave the EU, the British GDP would be lower by 2.7% than what the baseline forecast would have been if the UK had remained in the EU. The impact on households is projected to be larger: real consumer wages are anticipated to fall by 4.6%, while consumption is estimated to drop by 4.0%. For Central European countries, the referendum outcome signifies lower demand for goods exported to the UK and greater uncertainty about future benefits from the EU membership (Cumming and Zahra, 2016). Although Brexit is expected to impact all shares in Poland negatively under these circumstances, we conjecture that price adjustment would be strongest for firms dependent on European markets. Therefore, we formulate our research hypothesis as follows:

Hypothesis. The price decline caused by the referendum was most severe for firms dependent on European markets.

However, such a selective, informed, and at least theoretically rational reaction might not occur for two reasons, both of which relate to the specificity of emerging markets. First, the literature emphasizes the role of portfolio capital flows for returns on financial markets. Froot et al. (2001) found that portfolio inflows have positive forecasting power for future equity returns after considering past returns, especially in the emerging economies. Moreover, this effect is particularly prominent during periods of financial turmoil. In the same line of thought, Jotikasthira et al. (2012) showed that shocks are transmitted across international markets by mutual funds that have been domiciled in the developed markets. These, forced by investment flows, then make significant changes in their portfolio allocations to the emerging markets. Such changes affect both equity returns and correlations in the emerging markets. Additionally, Raddatz and Schmukler (2012) underlined the role of mutual funds in amplifying crises and transmitting shocks because these funds tend to retrench from countries in bad times and make more investments during good times. Second, the emerging markets are particularly prone to herd behavior because of the relative scarcity of rapid and accurate firm-specific information that may cause investors to focus more attention on information regarding macro tendencies (Chang et al., 2000; Demirer et al., 2010; Goodfellow et al., 2009). Herding in emerging markets seems to be most acute during downturn periods (Demirer et al., 2010; Goodfellow et al., 2009). Ormos and Timotity (2016) reached similar conclusions in a slightly different empirical setting. Specifically, relying on data from the Budapest Stock Exchange, they established that the probability of informed trading decreased after the global plunge in stock prices in September 2008. They also concluded that in periods of uncertainty when prices are volatile, rational and value-focused investors tend to stay away from the market.

Considering the role of portfolio flows and herding behavior for the emerging markets, particularly after an unanticipated and adverse event from the perspective of Central European countries, it is possible that capital outflows from the WSE and mimetic reactions by domestic investors resulted in uniform price changes. Consequently, from a theoretical point of view, both positive and negative verification of our hypothesis is conceivable.

[1] The global capitalization of all other stock exchanges in the post-transition countries that joined the EU is below 50% of the WSE capitalization.