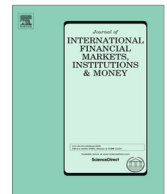


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Empirical analysis of market reactions to the UK's referendum results – How strong will Brexit be?

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ABSTRACT

This paper studies the effects of the June 2016 United Kingdom European Union membership referendum and the subsequently triggered article 50 on 43 major developed and emerging stock markets. Specifically, on a bivariate basis, we use dependence dynamics through copulas with regime switching of Silva Filho et al. (2012) using intraday data returns to identify contagion among stock markets. The empirical results add significant evidence to the literature on the financial contagion from the Brexit to other countries for a very large sample thus far. Evidence shows that the methodology identified immediate financial contagion produced from the referendum results. However, the contagion was not sufficiently significant given the short duration. In general, results showed instant financial contagion due to the shock and increased uncertainty from the referendum results; however, the shock and uncertainty were very limited, because a few days after the polling day, most stock exchange markets had fully recovered their losses. The approach provides significant information not only to policymakers but also to investors about the stock market's reaction to the expected Brexit.

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1. Introduction

The United Kingdom European Union membership referendum, also known as the EU referendum, occurred on Thursday, 23 June 2016, in the United Kingdom to decide on the country's continued membership in the European Union. The United Kingdom (UK) decided to leave the European Union (EU) in a process commonly known as Brexit, due to the referendum in which 51.9% of participating voters voted in favor of leaving the EU. The term Brexit is a blending of "British exit". On the morning of 24 June, the pound sterling fell to its lowest level against the US dollar since 1985, marking the pound down 10% against the US dollar and 7% against the euro. The drop from \$1.50 to \$1.37 was the largest move for the currency in any two-hour period in history. Internationally, more than US\$2 trillion of wealth in equities markets was lost. By June 27, the FTSE 100 index had lost nearly £85 billion and fallen more than 500 points (see Fig. 1). Near the end of trading on the same day, the domestically focused FTSE 250 Index was down approximately 14% compared with June 23, before the referendum results were published.

The Euro fell almost 4% against the US dollar, whereas gold and the Japanese Yen surged. Additionally, crude oil prices fell, and the CAC 40 and DAX fell by over 10% upon opening. Likewise, the IBEX 35, Greek ATHEX, Dutch AEX index, Czech PX

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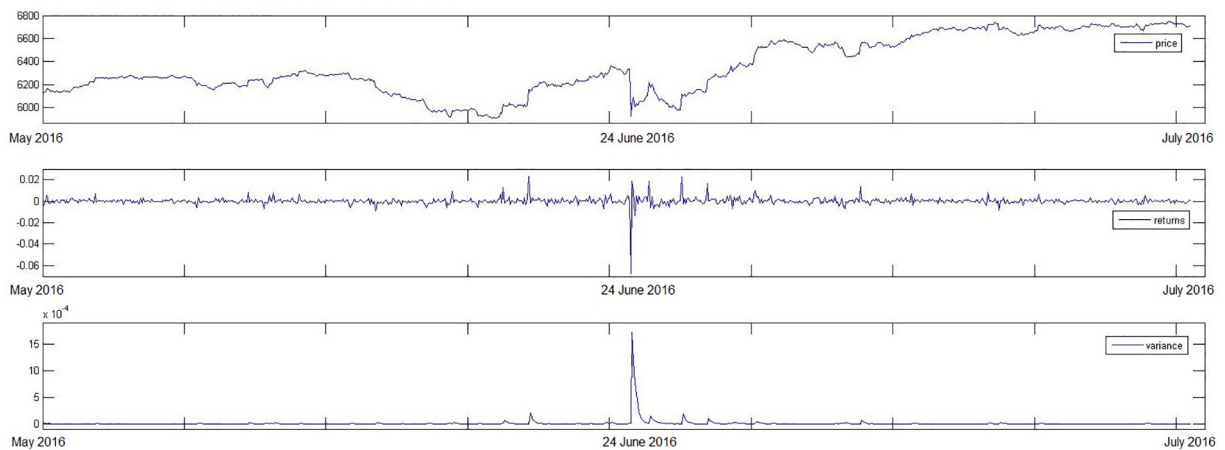


Fig. 1. FTSE 100, one month before and after referendum.

Index and Polish WIG30 all fell by 8 to 15%. Yields on European sovereign bonds spiked, with 10-year bonds in Spain and Italy rising as much as 0.40% in early trades. In the Asian-Pacific region, markets also fell. Officials from South Korea, India and China stated that they tried to minimize the effect of the result and address the excess volatility. The Australian dollar, which has usually been sold off in times of market uncertainty, fell strongly against the US dollar and the yen, and the Chinese Yuan fell to its weakest level against the US dollar since January 2011. When American markets opened on June 24, there was a dramatic fall from Canada to Brazil.

On 24 June 2016, based on the result of the referendum, Moody's downgraded the UK's debt rating outlook from "stable" to "negative". Fitch Ratings degraded the credit rating from AA + to AA, and Standard & Poor's cut the UK's rating to AA. The referendum result also had an immediate economic effect on a number of other countries. The South African rand experienced its largest single-day decline since 2008, dropping in value by over 8% against the US dollar. Other negatively affected currencies included those of Canada, Nigeria and Kenya, due to concerns about how the UK's withdrawal from the EU would affect the economies and trade relations of countries with close economic links to the United Kingdom.

Generally, stock markets faced severe turmoil the day after the referendum, with extreme volatility and central bankers expressing their support to maintain stability. Following the referendum, the International Monetary Fund (IMF) forecast reduced world economic growth by 0.1% and greater reductions in UK economic growth. In addition, the British government triggered article 50 for withdrawal from the European Union on 3/29/2017. The process will set a course for the UK to leave the EU by the end of March 2019. Although the British PM promised to implement the current law at a domestic level, the relevant terms of withdrawal have not been established to date. Currently, the UK remains a full member of the European Union. In this paper, we investigate possible financial contagion from the UK to emerging and developed countries that is related to the Brexit referendum and the subsequently triggered article 50.

Forbes and Rigobon (2002) argued that contagion is a significant increase in market spillovers after a substantial shock to one channel of an economy. More specifically, contagion refers to the case in which we observe a spread of stock market disturbances from one country to others. However, if two countries exhibit an increased level of co-movement during tranquil periods and remain highly correlated after the shock, this co-movement might not constitute financial contagion. Conversely, other studies define contagion as an excessive increase in the correlations among the countries causing the crisis with all other countries (Corsetti et al., 2005; Samitas and Tsakalos, 2013). Other authors, such as Dornbusch et al. (2000), Bekaert et al. (2005) and Sachs et al. (1996), describe contagion as the dissemination of market disturbances, primarily with negative consequences, from one market to another with simultaneous observations of significant increases in cross-country correlations of stock market returns and volatilities.

Considering the methodological approach, a dependence structure among stock markets was the core of the approach in several studies in the literature. Many studies proposed multivariate models as an appropriate method for quantifying the transmission mechanism, volatility and correlation dynamics among stock markets. The first attempts were made by Bollerslev (1990), who developed the constant conditional correlation (CCC). Later, Engle and Kroner (1995) proposed the unpublished BEKK model, which has the ability to measure time-varying correlations. Engle (2002) evolved the CCC model and introduced the dynamic conditional correlation (DCC) model, which could detect time-varying correlations and capture the changes over time. Conversely, copula functions have been seen in several studies measuring the financial contagion phenomenon (Rodriguez, 2007; Bhatti and Nguyen, 2012; Durante and Jaworski, 2010). Other techniques in the literature include the structural break and Markov regime-switching models, which are also useful tools to detect changes in the behavior of time series.

A solution to reduce the probability of financial contagion is to strictly increase the financial supervision. On domestic and international levels, organizations and institutions should effectively plan the financial architecture. Strictly tying implied

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