Press Release 24/2016

Halle (Saale), 20th June 2016

Financial market reaction to poll data suggests strong effects of a Brexit on exchange rates and the banking system both in the UK and in the EU

On 23 June 2016, there will be a referendum in the United Kingdom (UK) on the question of whether or not the country should remain in the European Union (EU). We use the polls as a measure of the likelihood of an exit to examine the likely effect of a Brexit on financial markets. "Whenever the probability in the polls of a Brexit moves above 50%, we observe a substantial depreciation of the UK pound with respect to most major currencies (including the euro), and strong decline in bank stock prices, suggesting that markets feel the financial sector (both in the UK and the EU) will be most severely affected by a Brexit", IWH President Reint E. Gropp says. There is little effect on the euro/US Dollar exchange rate. "A huge concern is that overall market volatility both in the UK and the EU are on record highs since last Thursday, reflecting the higher uncertainty associated with Brexit and how exactly, if it happened, it would come about." Within the UK, we see some evidence for a flight to safety into UK government bonds, but no effects for German bonds.

Using high frequency financial data and poll data measuring the share of supporters of the UK leaving the EU (from whatukthinks.org), the IWH obtains first estimates of the likely short term consequences of a Brexit on financial markets. Figure 1 shows the time series pattern of the poll results regarding the question about whether a UK exit from the EU is supported (see Figure 1, next page).

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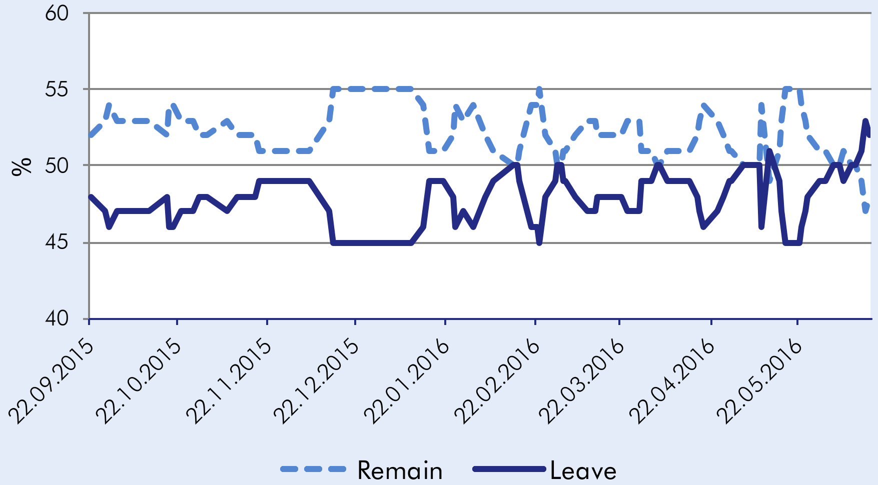
Figure 1

Poll results on the question "Should the United Kingdom remain a member of the European Union or leave the European Union?"



The figure shows the average opinion about whether the UK should remain or leave the EU across the six most recently conducted polls.

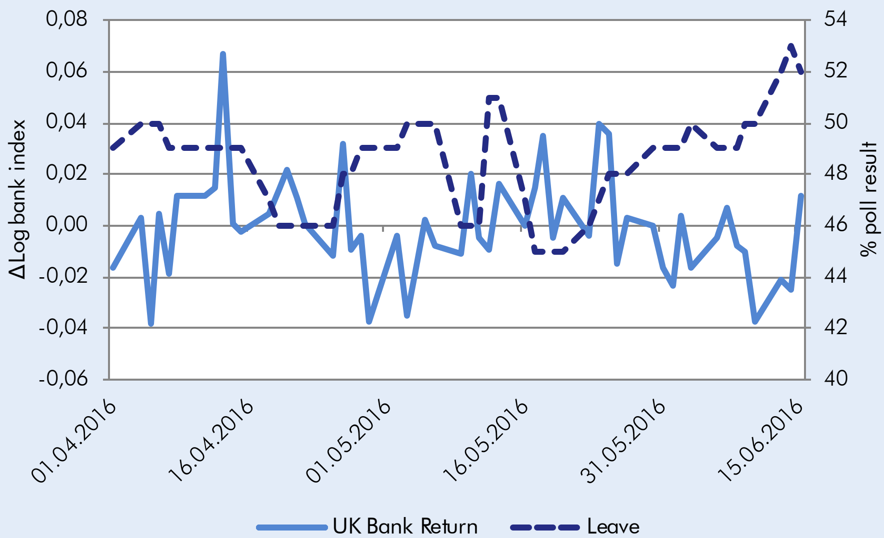
Source: whatukthinks.org.

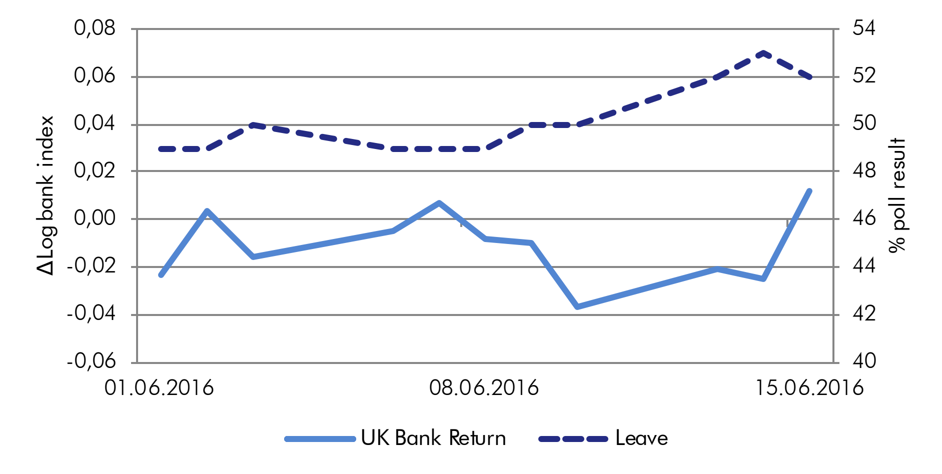
Formal empirical analysis (see IWH Online 5/2016) supports the patterns depicted in Figure 2. The figure shows that an increase of the share of supporters of leaving the EU is associated with declining returns of bank indices (panel a) and a depreciating UK Pound with respect to the Euro (panel b) and other currencies (not shown). We also find record levels of volatility in European stock markets, not seen even during the Greek debt crisis (panel c).

Figure 2

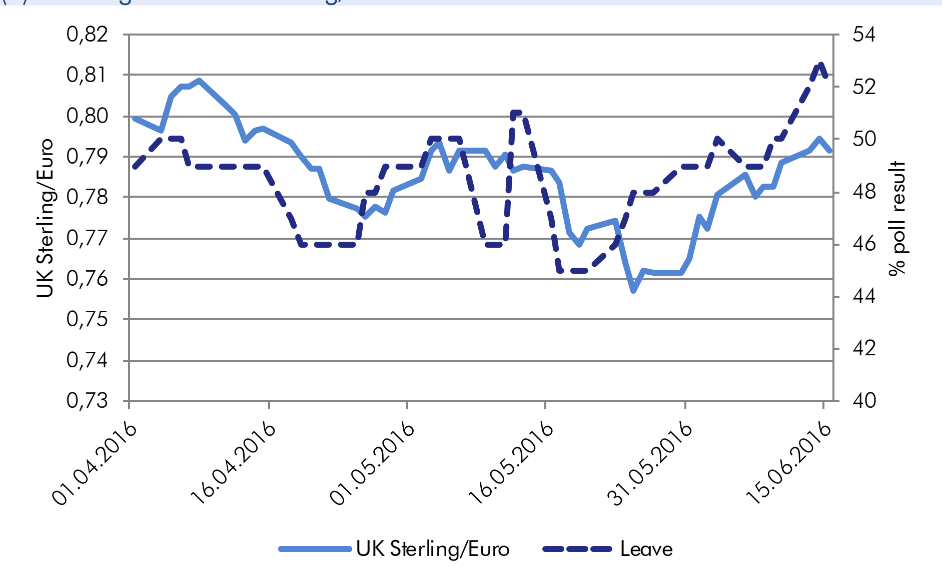
Poll result and financial market indicator

(a) UK bank index return

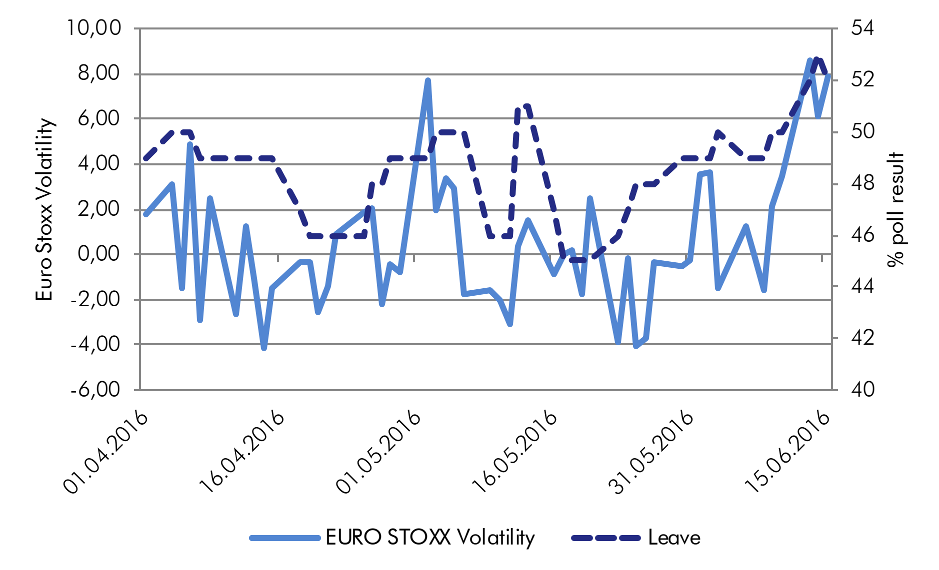




(b) Exchange rate UK Sterling/euro



(c) EURO STOXX volatility



The figure shows the share of respondents supporting the exit of the UK from the EU (right axis) and the time series pattern of a financial market indicator (left axis).

Source: whatukthinks.org; Datastream.

The note also presents a number of other interesting results. One, there are significant market reactions on days when poll results in favor of the UK leaving the EU are above 50%; compared to poll results below the 50% threshold. Second, we show a flight to safety effect into UK government bonds. Markets do not expect the UK budget to be negatively affected by a Brexit. No flight to safety effects into other countries are found, including no effect on German government bonds. Third, the absence of an effect on the euro dollar exchange rate is surprising, as it suggests that market participants do not see a potential Brexit as a threat to the common currency. They seem to carefully differentiate between the UK exiting from the EU, rather than the euro, which the UK was never part of.

Publication

Krause, Thomas; Noth, Felix; Tonzer, Lena: Brexit (Probability) and Effects on Financial Market Stability. IWH Online 5/2016. Halle (Saale) 2016.

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IWH List of Experts

The IWH List of Experts gives an overview of the IWH research themes. The institute's press office will be pleased to establish contact to the respective experts.

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