The Brexit Political Risk and Global Financial Markets' Responses: A Brief Review of the Literature and Potential Research Directions

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Received August 16, 2024; **Revised** September 29, 2024; **Accepted** October 30, 2024

Abstract

Political risk, including political and economic uncertainty, has a significant negative impact on global economic activities. At the firm level, it is also one of the most significant uncertainty shocks, affects firms' future attitudes toward risks, and plays a crucial role in their decision-making. This article aimed to study the following research questions: 1) Does the danger posed by Brexit have an impact on global stock markets? 2) Does an escalation in the Brexit risk lead to a rise in the demand for safe haven assets? and 3) Does investor attention play a significant role in the financial market reaction to political risks, such as Brexit? Using text analysis methods and various financial data sources, the research findings were as follows:

1. Construction of a Brexit Risk Index: A new political risk index specific to Brexit was constructed, providing a data basis for studying the impact of political risks on global financial markets.

2. Investor Attention and Market Reactions: This study was the first to investigate the role of investor attention in financial market reactions to political risks. It revealed that investor attention significantly affects how political risks were incorporated into stock prices.

3. Cross-Market and Asset Analysis: Unlike prior research that focused on single events or markets, this study analyzed 14 major stock indexes and four major categories of financial assets. The cross-asset and international results enrich investors' understanding of global political risks.

4. Framework for Regulators: The project was expected to provide a framework for regulators of capital markets to identify, monitor, and prevent political risks.

The study concluded that Brexit, as a significant political risk, negatively affects stock prices globally, with China being one of the affected economies. Additionally, Brexit risk spills over to non–equity financial markets. These findings have implications for policymakers seeking to guide financial market recovery and establish corporate resilience strategies in the face of political uncertainties.

Keywords: Political Risk; Quality of Information Disclosure; Financial Market

Introduction

Political risk, encompassing both political and economic uncertainty, exerts a substantial adverse influence on global economic endeavors. The real option theory explains the correlation between uncertainty and economic activities as a "wait–and– see" phenomenon. When a company is faced with increased uncertainty, it will halt its investments and hiring, leading to an economic downturn (Bernanke, 1983).

High cancellation costs of investment projects and high employment and dismissal costs of employees lead to increased uncertainty, which in turn causes firms to postpone investment and recruiting. Additionally, this uncertainty also decreases the investment efficiency of enterprises. Simultaneously, the rise in uncertainty will result in higher bond premiums, and firms would see an increasing pressure on their financing costs. In order to prevent default, firms must decrease their investment (Pastor & Veronesi, 2012).

As uncertainty has grown, households have progressively decreased their spending, posing challenges for government policymakers in managing the economy and leading to a macroeconomic downturn. Political risk amplifies the instability of stock prices in different nations. During times of economic weakness, political risk increases the risk premium and amplifies the significance of the stock market (Baker et al., 2016).

However, conventional studies often view political risk as a driver of systematic but not idiosyncratic risk. Until the theory of spillovers by risks, the prevailing view was that political risk is idiosyncratic to countries. There is also extensive recent literature on firm–specific political betas. So, there is a need of a review of studies that can provide a more comprehensive look at the research question regarding the complicated relationship between political risks and firm performance.

The emerging field of political risk literature focuses primarily on analyzing political conflicts between nations as a distinct form of uncertainty. Prior research mostly focused on analyzing the effects of specific categories of political occurrences. An illustrative instance is a military confrontation that occurs between countries. This study focuses on Brexit, the United Kingdom's (UK) exit from the European Union (EU), as the primary event for examining the possible influence of political risk on global financial markets.

This article mainly discussed several questions: How does Brexit political risk impact global financial markets? What are the key mechanisms through which Brexit political risk propagates its effects to different segments of the financial system? What are the specific responses observed in global financial markets to Brexit political developments and uncertainties? How do existing theories and literature explain the financial market reactions to Brexit, and what gaps exist in the current understanding? What are the potential future research directions that can further illuminate the complex relationship between Brexit political risk and global financial markets?

Research Objectives

1. The first goal of this study is to use textual analysis and investor survey to construct Brexit risk index and investigate how political risks affect stock prices across different countries in the context of Brexit.

2. The second goal of this study is to investigate how political risks affect non-equity financial markets, such as commodity, government bond and foreign exchange markets. The investigation across assets helps us to understand the well-known flight to quality phenomenon around high uncertainty periods.

3. The third goal is to explore the potential role of investor attention played in the process of the incorporation of political risk into stock prices. Whether the stock market reacts more strongly to political risk when investors pay high attention on political events.

Literature Review

1. Impact of political risks: Geopolitical risk refers to an unpredictable event or condition that has wide-ranging effects on politics, economy, society, culture, and other areas. Another term commonly used is political risk, which refers to a global risk that is systematic, cross-regional, and cross-industry. It encompasses violent conflicts between countries, civil unrest in significant nations, large-scale terrorist attacks, the spread of deadly weapons, and the breakdown of global

governance. Firstly, considering the matter from a political standpoint. Political events have a significant impact not only on domestic politics but also on international relations. The "Arab Spring" movement, which occurred in various Arab nations in 2010, serves as a prototypical illustration. The catastrophe resulted in infrastructure damages amounting to a staggering $900 billion, a death toll over 1.4 million, and a displacement of over 15 million individuals as refugees. Despite Tunisia's successful overthrow of its dictatorship and establishment of a democratically elected government, the country's economic growth has remained stagnant since 2010, with the per capita GDP declining from $4000 to $3600 annually. then, the movement resulted in a civil war in Syria, which then evolved into a geopolitical conflict between the US and Russia. This conflict has led to a significant influx of refugees into European nations, so adversely affecting these countries (Neacsu, 2016). Secondly, considering the matter from an economic standpoint. Political risks have detrimental effects on the economy, namely in terms of macroeconomic performance, foreign capital movement, international trade, and micro-enterprise operations. Small countries and emerging economies, due to their limited capacity to withstand risks and uncertainties, are particularly susceptible to political threats. The research findings from the Bank of England and the European Central Bank indicate that political risks exert a substantial adverse influence on the economies of the UK and the Netherlands. The implementation of sanctions by the US and the EU in 2012 resulted in a reduction of almost 50% in Iran's oil export earnings (Carney, 2016; Rivlin, 2018). Thirdly, considering the social and cultural domains. The escalation of political dangers will result in a corresponding rise in social instability and have a profound and detrimental effect on cultural resources. Using the Arab Spring as an illustration, this event caused significant social turmoil throughout the Middle East and North Africa, resulting in challenges for residents to maintain their daily lives and economic endeavors. Ultimately, it also prompted a large influx of migrants into EU countries. The influx of refugees also has an adverse effect on the social dynamics of European nations. Various aspects such as social employment, social welfare, and demographic structure have seen detrimental effects.

2. The Influence of Political Risks on Financial Markets: In this subsection, we specifically examine the influence of political risk on financial markets as part of our project's investigation into the correlation between political risk and stock prices. Initial research concentrated on examining the influence of certain political occurrences. According to Benhmad (2012), the presence of higher political risks will lead to a decrease in stock returns and an increase in stock market volatility. An illustrative instance is the occurrence of transnational military conflicts, such as the Iraq War in

2003, which significantly influenced worldwide stock markets. Bittlingmayer (1998) examined the intense political conflict in Germany during the First World War. He had the belief that political uncertainty would not only amplify the instability of equities but also precipitate the onset of a stock market slump. Rigobon and Sack (2005) discovered that in the presence of war risk, investors tend to move their investments from risky assets to assets that offer greater security or liquidity. The presence of war risk contributes to the decrease in stock prices and can account for the volatility observed in the stock market. Berkman (2011) conducted an analysis of 447 international political crises, rather than focusing on a single political event. Their findings indicate that, without any political upheaval, the yearly performance of global stock markets would rise by 3.6%. Wisniewski (2010) conducted a study on the US stock market and found that during years of conflict, such as World War II and the Korean War, the market value of stocks was lower than their fundamental value.

Terrorism is an increasingly prevalent issue that is closely linked to political threats, alongside warfare. Following the 9/11 attacks, terrorism has garnered significant attention from both the media and the general population. Karolyi and Martell (2006) and Brounen and Derwall (2010) examined the fluctuations in stock market indices in nations that experienced terrorist attacks. Following the strike, there will be a substantial decrease in the stock price. Moreover, the response of the stock market to terrorist activity differs across different sectors. Carter and Simkins (2004) and Chesney et al. (2011) have substantiated in their literature on airline share prices that airline share prices exhibit greater susceptibility to terrorism. This is unsurprising considering, at the time of its occurrence, the destruction of the World Trade Center in New York held the record for being the most significant event in terms of insurance losses.

Caldara and Iacoviello (2018) utilized a quantitative approach to measure political risks by conducting text searches of mainstream publications. Their objective was to demonstrate the detrimental effect of these risks on the returns of US stocks. In their study, Balcilar et al. (2016) examined the influence of political risk on the stock markets of the BRIC countries and South Africa. They discovered that Russia has the highest vulnerability to political risk, which has a substantial effect on its stock market. On the other hand, India's stock market exhibits the greatest responsiveness. Apergis et al. (2018) established a connection between political risk and the stock prices of 24 global military corporations. Their findings suggest that political risk does not have a substantial effect on the returns of these companies. Pan (2018) employed the political risk index to examine the influence of political risk on asset markets in 17 industrialized nations spanning the

years 1899 to 2016. The stock return rate is more responsive to changes in political risk compared to the return rate of the real estate market. Furthermore, a significant degree of political risk will result in the transmission of high– risk effects to the stock market, causing alterations in the discount rate. This, in turn, would adversely affect the GDP, particularly in terms of private consumption and private investment. Murray (2018) examined the correlation between political risk and commodity prices to determine the influence of political risk on other asset prices. He believes that while this relationship is ambiguous, in certain instances, commodity prices maybe the primary determinant of political risks. Antonakakis et al. (2017) demonstrated that political risk had a diminishing effect on both oil returns and volatility. As a result, the correlation between the stock market and the oil market was diminished. Baur and Smales (2018) discovered that gold has a distinct behavior compared to other precious metals. The revenue generated from gold is strongly and positively associated with political risk, although fluctuations in the price of gold do not react to political events. Simultaneously, political uncertainties did not result in any additional escalation in the volatility of gold yields. These findings offer fresh evidence supporting the distinct role of gold as a worldwide hedge asset.

3. Political Risk and Behavioral Finance: Recently, there has been a growing interest among researchers in studying investor behavior, leading to the recognition of the significant influence of behavioral finance elements on asset pricing. Specifically, investor attentiveness and investor sentiment have emerged as key areas of focus in this discipline. According to the standard asset pricing model, the market is efficient, meaning that any public information will be quickly incorporated into stock price movements. As a result, there are no further returns available in the market. Investors possess a finite amount of attention, meaning their capacity to digest information or engage in many tasks is restricted. As a result, attention becomes a precious resource in the cognitive process. When confronted with many information or tasks, individuals must distribute their limited attention. Thus, a greater focus on one event signifies a decrease in attention towards another event. Investors have a limited capacity to process information in the market and so make investment decisions based on a subset of that information. Hence, fluctuations in stock prices do not encompass all available information. Investors that have a restricted capacity to pay attention may rely on uncomplicated decision–making strategies, such as categorization, or concentrate solely on companies that capture their attention (Peng & Xiong, 2006). When examining the influence of limited attention on the economy, numerous studies concentrate on the correlation between attention given to a particular stock and the fluctuations in stock prices. The information

can only be incorporated into the price when investors give it their attention. Furthermore, according to the attention hypothesis put forth by Barber and Odean (2008), individual investors tend to purchase stocks that draw attention. This trading behavior, based on seeking attention, results in brief price pressure and subsequent reversals in stock prices.

According to Da et al. (2011), there is a correlation between the growth in Google's search volume and the short-term gain in stock price, followed by a long-term reversal. This finding aligns with the attention theory. In contrast to the classical theory, there exist irrational investors in the market. The variations in stock cross-sectional returns, which are produced by cognitive biases of these investors such as overconfidence, over-optimism, and response, have also gained significant attention as a research topic in recent years. Investor sentiment adversely affects the anticipated returns of stocks, with the extent of the adverse impact varying based on the specific attributes of the companies. According to Baker and Wurgler (2006), equities with small market capitalization, high volatility of returns, and high opacity of corporate information are more influenced by investor mood in terms of their returns. Investor attention and investor sentiment are more challenging to quantify compared to conventional earnings measures such as book value and dividend indicators. Conventional research mostly relies on stock trading data and financial statements to indirectly assess attention and sentiment markers. The utilization of online big data in the economic and financial domain has led to the emergence of more precise assessment techniques. Presently, the prevailing techniques encompass the utilization of online news data, search engine data, social networking data, online forum data, and so forth. Through the utilization of online big data, numerous research investigations have developed diverse indexes to measure investor attention and investment sentiment. Studies indicate that investors' pessimistic outlook has a detrimental effect on stock prices, whereas reports of improving company performance can enhance stock returns (Tetlock et al., 2007; Heston & Sinha, 2015). Imposing limitations on short selling will diminish the market's ability to automatically adapt and react. The influence of investor sentiment on stock prices is a worldwide phenomenon with sentiment measure serving as a contrarian predictor of country-level market returns, as stated by Gao et al. (2020). Stocks that receive less attention from investors tend to have a greater imbalance of information and hence have a higher level of risk. This higher risk necessitates greater compensation for taking on that risk, which supports the information risk hypothesis proposed by Antweiler and Frank (2004).

Conceptual Framework

Based on the above analysis of the key concepts about political risks and economic outcomes and their potential linkages, this section provides a conceptual framework that can highlights the three research questions we would like to find answers in the existing literature.

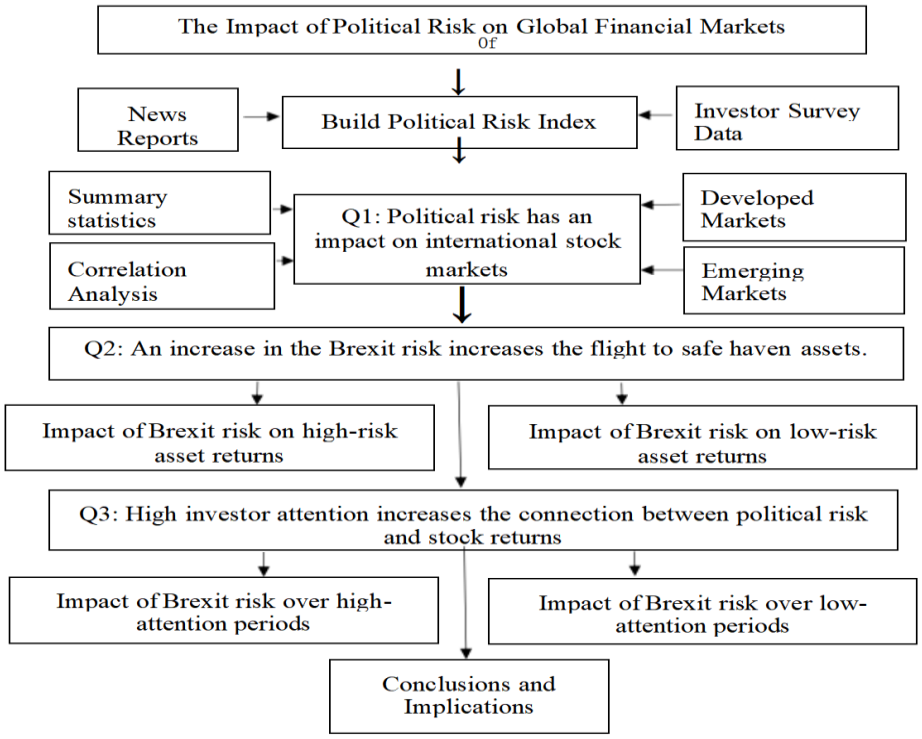

Fig.1 Conceptual Framework

Research Methodology

The monthly Brexit risk data are based on news from Access World News and Brexit risk index from SENTIX. Use Google trend service to measure investor attention on Brexit. 1 4 international stock indices and 9 different financial assets will be examined. For each international stock market, we construct one sample data set, which contains three main variables: index return, the Brexit risk, and investor attention, and several market-level control variables. The study uses all observations and doesn't draw any sample from the population. Specifically, the monthly Brexit risk data are based on news reports downloaded from Access World News. SENTIX provides a survey-based measure of Brexit risk. We measure investor attention using Google trend service. 14 international stock indices return, 9 categories of asset prices and other market-level financial variables are collected from Wharton Research Data Services (WRDS) and Bloomberg. This research is designed for investigating how political risks affect global financial markets in the

context of Brexit, and the respective role of investor attention played in the process of the stock price reaction to the political risks. The study starts from the key variable construction and then runs OLS regression to investigate the impact of Brexit risk on future stock returns.

Research Results

Objective 1. The results showed that it is possible to build a firm-specific Brexit risk index and political risks will negatively affect stock prices in China.

Objective 2. The results showed that. political risks can also affect non-equity financial markets, such as commodity, government bond and foreign exchange markets. The investigation across assets helps us to understand the well-known flight to quality phenomenon around high uncertainty periods

Objective 3. The results showed that investor attention played an important role in the process of the incorporation of political risk into stock prices. Take China as an example, the Chinese investors react more strongly to political risk when investors pay a higher attention on political events such as the Brexit. Discussions

Discussions

The purpose of this paper is to explore how investor attention affects financial market performance in the context of political risk with the regression specification (1). The first and second column of Table 2 summarize the results, respectively with and without controlling for firm governance structure, financial status, growth, firm ownership, and industry/provincial fixed effects. Our estimated statistically positive coefficients show that investor attention consistently mitigates the negative association between the Brexit political shock and the contemporaneous Chinese firms' financial market performance as measured by CAR.

Knowledge from Research

Given the profound effects of the Brexit, our study utilizes the initial Brexit outbreak as a natural experimental setting to investigate the impact of the Brexit shock on financial markets in emerging countries, aiming to partly fill the above knowledge gap. Furthermore, we concentrate on the significance of investor attention and investigate its impact on firms' stock return responses to Brexit-induced political risk, particularly in the face of uncertainty. In the analysis, we use an

event study and a panel regression to examine the short–term effects of investor attention on the relationship between political risk and stock return changes in response to the impacts of Brexit. This study selects Brexit as the major event to investigate the potential impact of political risk because this shock caused complex, long–standing, and worldwide stock market reactions due to investors' interests in Brexit. Our findings show that investor attention exerts a mitigating effect on the negative relationship between the Brexit shock and financial market performance in China. The above finding provides policymakers with insights into how to guide financial market recovery in the context of political risk. It also sheds light on establishing a corporate resilient business model. Thus, we broaden the scope of research on the nexus between firm–level political risk and financial markets.

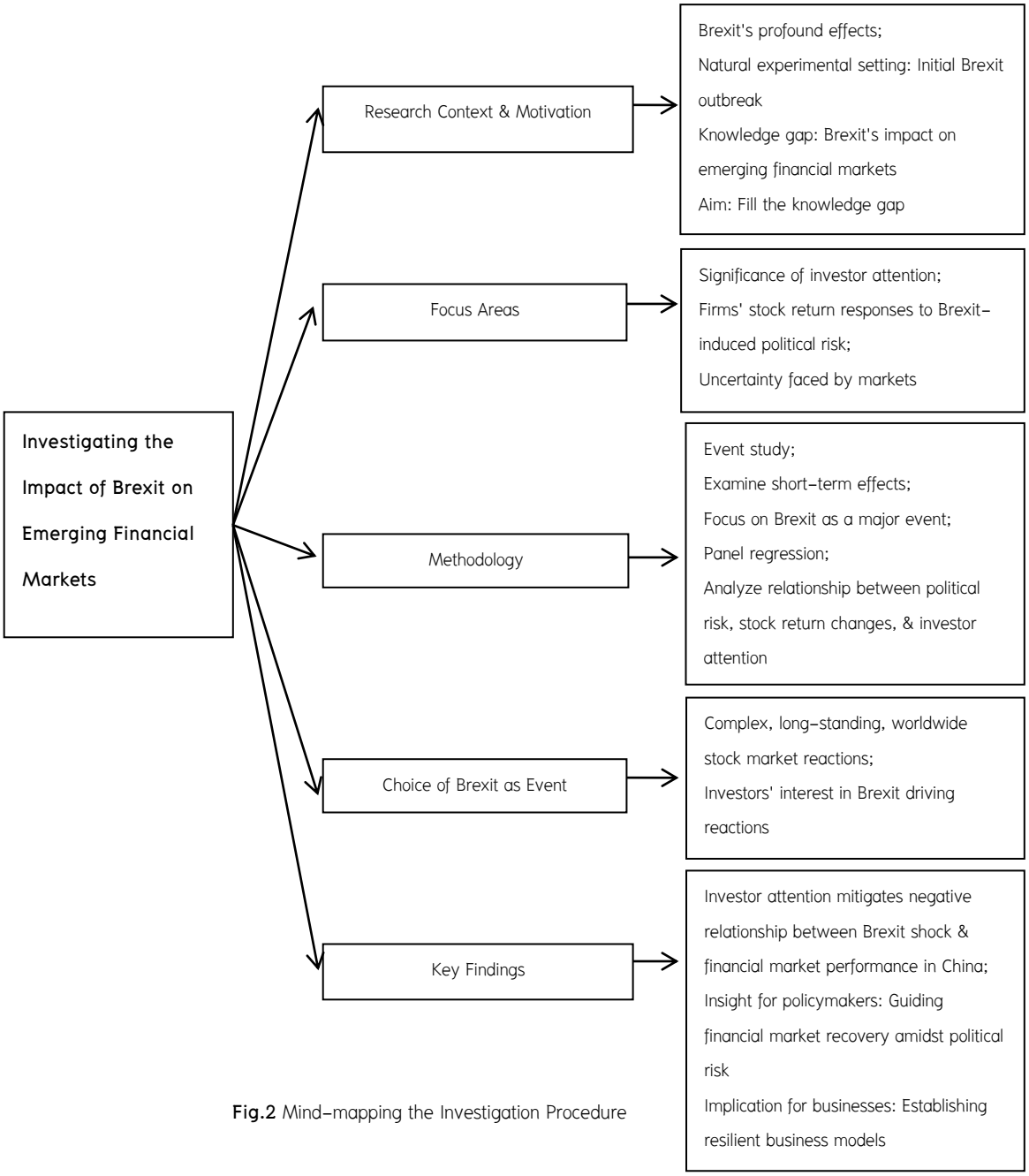

Fig.2 Mind-mapping the Investigation Procedure

Conclusion

In conclusion, concern over how financial markets can swiftly rebound from the adverse effects of Brexit has risen to the forefront of discussions among entrepreneurs and policymakers. Leveraging the Brexit shock as a real-world test, this paper delves into how investor attention shapes financial market performance during political risk.

Suggestions

Our research indicates that investor attention mitigates the negative correlation between political risk (specifically, the Brexit shock) and financial market performance. These revelations provide policymakers with valuable insights into how to steer the recovery of financial markets in the context of political risk. Future studies can aim at revealing the patterns that how political involvement mitigates the positive effect of firm–level political risk on the outcomes of economic activities. Our findings offer several implications of practical value. First, investors and shareholders learn from our research that firm–level political risks are critical in determining stock price, volatilities, and other economic performance indicators. With this information, they can form an effective financial market risk management policy. Second, policymakers benefit from our findings as they can mitigate the political risk that firms face, which may significantly reduce financial market risk and foster stability. Overall, our research has important implications for both practitioners and policymakers, since it offers an in–depth investigation of the influence of the political risk endured by enterprises on financial market environment, as represented by the events of equity price changes and adjustments in corporate finance factors.

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