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INTRODUCTION

Institutional changes and economic dynamics of international capital markets in the context of BREXIT

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BREXIT is a complex political project that has many economic effects – not only for the UK and the EU27, but also for the US and beyond. The effects in capital markets and institutional changes are among the key aspects of the historical Brexit project: The first such disintegration project in post-1945 Western economic history. The majority in favor of leaving the EU in 2016 came as somewhat of a surprise; the promises of the pro-Leave Brexiteers were quite "generous": More money for the National Health System, more policy autonomy for the UK, and considerable economic benefits. For most economists, such promises sound like wishful thinking; the theoretical case that free trade brings major economic benefits is too well established and the empirical evidence is overwhelming. However, one cannot really assess the trade liberalization benefits without also taking into account the benefits from foreign direct investment and portfolio capital flows as these three pillars are interlinked: Some of these crucial links become visible in this special issue.

The special issue brings together an interesting forum with a view from capital markets - contributions (presented at the Frankfurt workshop) by Badiani/Gerhard, Heise/Boata, Clausen and Mullineux, followed by the contributions of Eichengreen, Welfens/Xiong and Jerger/Körner as well as the papers from the team of the European Institute for International Economic Relations (EIIW) where five researchers (Welfens, Baier, Kadiric, Korus and Xiong) have worked for two years on a project sponsored by Deutsche Bundesbank. Two individual papers – by Welfens/Baier and by Welfens/Baier/Kadiric/Korus/Xiong - have been published in other journals; but the core of the

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research findings is presented here so that the reader gets a broad overview as well as new insights into the capital market related dynamics and the institutional changes and challenges associated with BREXIT. The EIIW papers as well as the Jerger/Körner paper have been presented at international workshops in Wuppertal and Frankfurt as well as in Athens and Rome in 2018, and we appreciate very much the feedback from all conference participants. The paper presenters are all very grateful to the many useful and fruitful comments obtained from commentators.

The paper by Eichengreen looks into the impact of BREXIT on the Bretton Woods Institutions and points out the importance of EU membership for UK portfolio inflows and the respective inward stock. BREXIT could have major implications for London's status as a global financial center. Post-BREXIT there could be a large adjustment process which would naturally bring about a Pound depreciation and considerable global reallocation effects, respectively. Moreover, the international financial architecture (IMF, World Bank, G7, G20, Basel Committee and the Financial Stability Board) is also analyzed by Eichengreen.

As regards the focus of the paper of Welfens/Xiong, the emphasis is on the nature and size of welfare losses from BREXIT, aspects of potential overshooting and Branson model effects, as well as the issue of lower long run growth. Moreover, a first time empirical explanation of barriers to capital inflows in the financial sector in Western countries is considered. From a theoretical perspective, it is argued that BREXIT amounts to an implicit rise of EU import tariffs and such an increase of tariffs could have a negative effect on both the level of the growth path and the trend growth rate.

The contribution by Jerger/Körner considers BREXIT dynamics and macroprudential supervision in a DSGE perspective: The dynamics of shocks associated with BREXIT are analyzed, namely in a setting with flexible macroprudential regulation on the one hand and a second case with no flexibility on the other. Hence, the usefulness of flexible macroprudential regulation can be analyzed and the simulation results of the DSGE model gives new insights into adjustment dynamics.

Kadiric/Korus analyze risk premiums – for selected maturities – in the UK and the Eurozone in the context of BREXIT and emphasize the different responses of financial and non-financial sectors, including the non-tradable sector. A battery of economic variables plus a BREXIT event variable are used in order to explain corporate risk premiums where the BREXIT referendum statistically affects the financials stronger than non-financials, and the UK more than the Eurozone.

The paper by Welfens looks at institutional aspects of macroprudential supervision and changes in EU and international financial markets in the context of BREXIT. It seems doubtful that there is adequate cooperation within the framework of the European Systemic Risk Board (ESRB) which is an EU28 institution (until March 29, 2019), but post-BREXIT cooperation between the UK and the EU27, plus countries with ESRB observer status, is and will continue to be crucial; however, thus far, such cooperation not does not appear well organized in all fields. There seems to be a lack of macroprudential risk management in the EU28. One can also raise the question of whether it is adequate to leave a large extent of the euro-denominated derivatives business based in the UK for an additional year – for the UK, the major instability problem might not be so much its economic system – which is considered to be rather flexible – but rather its political system. Political

instability could bring considerable economic volatility and this would be a significant problem for the EU and the Eurozone, respectively, as the EU27 wholesale market is largely based in the City of London. The institutional setting would radically change with BREXIT.

Korus/Celebi analyze the impact of BREXIT news on British pound exchange rates. They find that 'bad' BREXIT news is associated with a depreciation of the British pound against the euro and the US dollar, whereas 'good' BREXIT news appreciates the British pound against the euro. Furthermore, they show that that the BREXIT referendum and other BREXIT-related events have a significant impact on the volatility of the British pound/euro exchange rate. Thus, they recommend that the outcome of the BREXIT negotiations between the UK and the EU should be well communicated to market participants in order to avoid a sudden and strong rise of the exchange rate volatility of the British pound/euro exchange rate and hence an increase of economic uncertainty.

The paper by Baier/Welfens looks into a quasi-FDI perspective of British banks. Since bilateral banking FDI data are not available, the focus is more on international asset positions in the banking and non-banking sectors. While the British pound depreciation stimulated buy-outs in the industrial sector, we find an overall negative effect that is mainly driven by the investment slump in the banking sector. Controversially, while global banks seem to prepare for several BREXIT scenarios, we find no adaption in the investment patterns of UK banks outside Europe.

As regards the effects of a hard BREXIT on output, a two year recession in the UK and also a downward economic development in the Netherlands would have to be expected according to the Rabobank model (https://economics.rabobank.com/publications/2017/october/the-permanent-damage-of-brexit/) where the trade channel is one crucial element of real economy linkages (and Germany's exports to the Netherlands would certainly also be negatively affected). It is not clear at the time of writing whether or not a hard BREXIT will happen but if that should indeed be the case, it would come with only a few weeks of advance warning and hence many SMEs are unlikely to be adequately prepared and hasty adjustment will often bring pitfalls and additional cost.

At the bottom line, this special issue offers innovative and market-relevant research, but also presents suggestions for policy reform. We have emphasized links between financial markets and the real economy, which thus far have not been adequately considered, and highlight new theoretical and policy aspects.

Finally, one may note that during the intense and impassioned political debate between pro-BREXIT and REMAIN camps in the UK, one should not overlook the quote from Adam Smith on the British 20 pound note – that reinforcing the international division of labor is advantageous. The dimension of capital markets also has to be considered. While international integration has slowed down in the post-Transatlantic Banking Crisis era, one should not overlook that financial markets' responses will be the first and partly also the most dramatic adjustment signals in the context of the historical BREXIT.

The EIIW gratefully acknowledges project funding from Deutsche Bundesbank and would also like to express its gratitude to IHS Markit in Frankfurt for the hosting of our workshop. We are confident that some of the new ideas and research findings will be quite useful for investors, central banks and other researchers; and that the

approaches presented here lend themselves to be applied to other capital-market related research focusing on integration areas around the globe.

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