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Hard or soft Brexit: The impact

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When the U.K. finally leaves the European Union, it potentially faces two extremes: a hard or soft Brexit. What will each scenario look like?

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In its 45-year membership of the European Union, the U.K. has benefited economically on several levels: the EU currently serves as the U.K.'s main trading partner (53% of its imports and 44% of exports[1]) and its single market characteristics have allowed for the free movement of goods and people. Brexit now threatens to fracture this setup.

Following the vote to leave the EU, March 29, 2019 was set as the date when the U.K. would cease its membership. But the inability to secure a deal has extended the deadline, with the potential for further delays or even the cancellation of the U.K.'s intention to leave.

Brexit means Brexit — but what form will it take?

Putting aside the uncertainty over whether the U.K. actually leaves the union or not, the consensus is that Brexit will result in either a "hard" or "soft" exit of the EU — although these terms are still fairly undefined.

- A **soft Brexit** describes a situation where the U.K. maintains relatively close economic ties with the EU, continues to provide budgetary contributions and potentially allows for the free movement of people.
- A **hard Brexit,** on the other hand, generally refers to a large-step change in the U.K.'s formal ties with the EU. The U.K. would likely leave the customs union and the single market, and it will end the free movement of people. Under this scenario, the U.K. would be bound by trading rules set out by the World Trade Organization, which would be renegotiated with the U.K. as an individual body.

Assuming the U.K. does leave the EU, it would likely be either a hard or soft exit — but what will be the repercussions of each option?

Trade

In the U.K., a hard Brexit would be especially disruptive to trade given that exports to the EU amounted to £274 billion — 44% of all U.K. exports — in 2017.[2] European regions with industries and sectors exporting to, or importing from, the U.K. would be particularly

1 House of Commons Briefing Paper 7851, "Statistics on UK-EU Trade," (November 2018).
2 Ibid.

exposed to a disorderly Brexit. For example, Benelux countries import a high proportion of U.K. goods, and Ireland would be particularly susceptible due to its common land border. Uncertainty continues to hinder business confidence, and some manufacturers like BMW have stated that it could be forced to close its U.K. operations if Brexit makes trading more difficult.

Growth and investment

Analysis by the U.K. government predicts that under a hard Brexit scenario, U.K. economic growth compared with current forecasts would be reduced by 8% over the next 15 years.[3] The National Institute of Economic and Social Research echoes this: research shows that in comparison with a soft Brexit scenario, a hard Brexit would cause annual input to be 5.3% smaller over 10 years. U.K. economic growth would only be 0.3% in both 2019 and 2020, compared with 1.9% and 1.6% in a soft Brexit scenario.[4]

Investment is a key component of economic growth and would come under pressure, particularly in the form of foreign direct investment (FDI) — an investment made into overseas countries. It raises national productivity, and therefore output and wages, because multinational firms bring in better technological and managerial know-how. It also stimulates improvement among domestic firms as a result of stronger supply chains and tougher competition. Approximately half of the U.K.'s FDI stock of more than £1 trillion comes from EU countries because the prospect of easy access to the EU is a key attraction for foreign investors. A soft Brexit could mean continued investment from abroad, while a hard Brexit could mean reduction in FDI inflows by 22%.[5]

Markets

Market watchers believe many larger U.K. stocks are better sheltered from a hard Brexit than their smaller competitors because they generate more of their earnings globally and outside the EU. More domestically focused U.K. shares, which have underperformed since the referendum, are expected to be harder hit, and investors should expect U.K. stock markets to remain volatile.

In the U.K. government bond market, a hard Brexit scenario could mean base rates would be cut to 0.25% (and potentially even lower), which would prompt a significant rally in gilts. However, if sterling was to slide further, as is expected from its already low position, this would not leave the central bank with much room to maneuver. It's also important to note that a weakness in sterling could actually benefit U.K. companies that derive their money overseas. In fact, more than 70% of the revenue earned from the FTSE 100 comes from outside the U.K.[6]

Bottom line

Regardless of the type of deal that's eventually secured, Brexit has had, and will continue to have, a far and wide-ranging impact economically and socially both in and outside of the U.K. With a soft Brexit we would expect a relatively positive outcome in terms of the impact on the economy because existing ties would remain relatively unaltered. In the case of a hard Brexit, we would expect to see a more drastic change from the current situation with disruption to trade, reduced FDI and a loss of subsidies. The difficulties with bureaucratic

3 EU exit long-term economic analysis. (November 2018). 1-90.
4 Press Release: Prospects for the UK Economy. The National Institute Economic Review. (November 2018).
5 Dhingra, S., Ottaviano, G., Sampson, T., & Reenen, J. V. (n.d.). The impact of Brexit on foreign investment in the UK. The London School of Economics and Political Science, The Centre for Economic Performance. (March 2019.

6 FactSet, FTSE 100 geographical revenue exposure, March 2019.

checks at borders will slow the movement of goods and people, incurring additional costs.

While the scale of the effects of the U.K.'s withdrawal will depend on individual countries' exposure to the U.K., the general consensus is that a hard Brexit will result in far more disruption to the economic environment than a soft variant.

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