UNITED KINGDOM

A POOR START

No sooner had the divorce agreement with the European Union been signed than the UK started disputing its terms. On 16 March, the British government was formally notified by the European Union for breaches of the Protocol on Ireland and Northern Ireland and violation of the duty of good faith. The final outcome, which can include sanctions, is yet to be decided. The fact remains that Brexit, described as a "historic mistake" by the remaining 27 members of the EU, appears as nothing more or less than what it is: a clear break. Admittedly, it will not stop the UK economy from recovering. Having managed to avoid tariffs, become a convert to "whatever it takes" and now being well on the way to winning out over Covid-19, the United Kingdom, like other countries, is enjoying euphoric economic conditions. Yet beyond the short term outlook, the benefits it could get from its decision to go its own way are still to be proved.

DEALS: NO SOONER SIGNED THAN BREACHED

Although it has reached a wide range of bilateral deals with trading partners (70 or so since Brexit, the most recent and by far the most important being that with Australia), the United Kingdom has presented its former European Union partners with something much less palatable. Looking strictly at data flows, the country is already visibly more distant. Having fallen to historically low levels in January 2021, the UK's trade with the EU has only partially recovered since its redeployment outside the single market has started (chart 2). On the political and diplomatic front, mistrust has become the order of the day. In early March, without prior discussion or consultation, Boris Johnson's government decided to postpone (to 1 October 2021) the implementation of checks on British exports to the EU passing through Northern Ireland, thus failing in its legal duties (see Box).

In response the EU issued the UK government with two formal notices for breaches of its agreement, one on breaches of the Protocol on Ireland and Northern Ireland and the other for a violation of the duty of good faith. The UK's response to these has been received and is being considered in Brussels. The next steps remain to be decided. If it remains unsatisfied, the Commission may issue a 'reasoned opinion', detailing the UK's failures to respect the withdrawal agreement. Ultimately, the European Court of Justice would be able to impose a fine or other penalty on the UK, or, in the event of a refusal to implement any ruling, could suspend the application of all or part of the Brexit treaties.

Although it has not triggered any official process, the issue of fishing rights has been another flashpoint that has pushed a wedge into the cracks in the trade and cooperation agreement between the UK and EU. Under this deal, the UK agreed to authorise European boats to fish in its waters in return for a 25% reduction in their catch quotas over the next five years. In the event, the few licences that have been issued suggest a much more restrictive policy, particularly for the waters around the island of Jersey, which is virtually off-limits to EU boats. French fishermen have been hit hard by this (70% of the catch in Brittany comes from British waters), and France is now putting pressure on the European Commission to enforce the terms of the agreement.

The list of on-going disputes is further swelled by the UK's policy for investment in offshore wind power, which favours UK companies and thus contravenes the 'level playing field' rules agreed with the EU (The Guardian, 2021)[1].

Vice President of the European Commission Maroš Šefčovič has stated that *"unilateral decisions and international law violations by the UK defeat [the Protocol's] very purpose and undermine trust between us."*

1 The Guardian (2021) 'Wind turbine clash adds to UK-EU post-Brexit tensions', June 17.

GROWTH AND INFLATION (%)

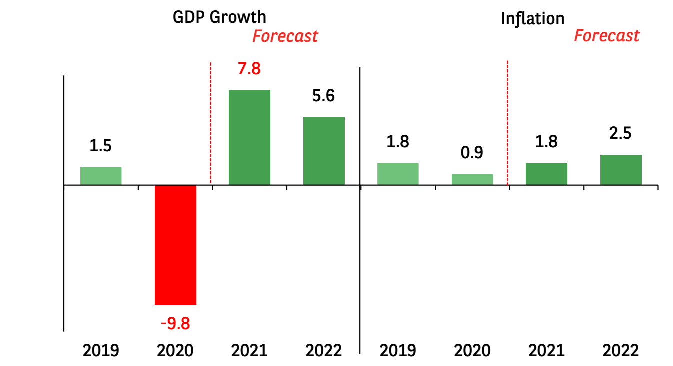

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

TRADE, THE START OF REDISTRIBUTION
AVERAGE OF MONTHLY EXPORTS AND IMPORTS, GBP BILLION, AT 2018 PRICES

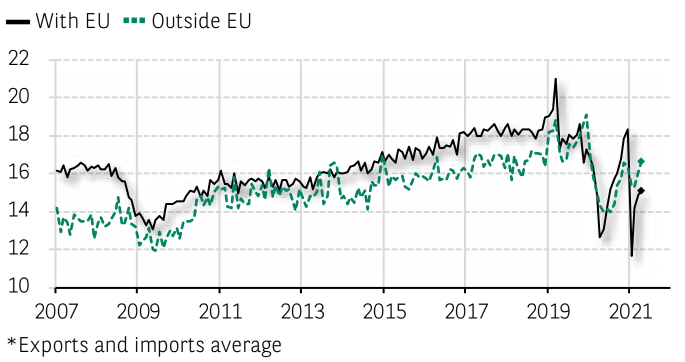

CHART 2 SOURCE: ONS

Despite all efforts to manage it, the post-divorce relationship between the UK and the EU looks strained, and divergence inevitable.

LESS ATTRACTIVE?

After all, this was the goal of Brexit. As for its economic effects, these are hard to read in a situation still shaken by the health crisis. As with most countries that are on the road to vaccination (65% of the UK population has received at least one dose) and thus gaining some control over the pandemic, the UK is enjoying euphoric economic conditions. After a marked contraction in 2020 (9.8%, the largest since 1920) and a further fall in the first quarter of 2021, the economy is picking up again. The Organisation for Economic Cooperation and Development (OECD) predicts growth of 7.2% this year. The return to pre-pandemic levels of economic activity is expected to come in early 2022, at around the same time as in the eurozone. However, this seemingly favourable picture needs qualification on two points.

The first is that it has been accompanied by an exceptional increase in the "twin" fiscal and current account deficits. As an experienced practitioner of 'stop and go' policies, the UK government was one of the first to apply a 'whatever it takes' approach, and then to announce that this would be coming to an end in 2023. In 2021, the UK primary structural deficit (i.e. excluding interest payments) was more than 7% of GDP, making it the highest of all developed nations (Chart 3).

The second point is that investment is clearly lagging behind the recovery. According to the OECD, household spending, particularly the consumption of services, will be the first area to recover from the crisis, with business spending taking much longer[2]. In this area, therefore, both Covid-19 and Brexit could leave their scaring effects. Having left the European Union, the United Kingdom will not have access to the Next Generation EU programme to accelerate the green transition and promote infrastructure investment. To do this, the country will have to rely on its own resources and on its ability to attract capital, which for a long time has not been a problem. In 2019, however, the country lost its position as Europe's top destination for foreign direct investment to France (The Guardian, 2021[3]). Net capital inflows have been falling since 2016 (the year of the Brexit referendum), and the latest figures from the Office for National Statistics (ONS) show no reversal of this trend.

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THE PROTOCOL ON IRELAND AND NORTHERN IRELAND

The Protocol on Ireland and Northern Ireland, which came into force on 1 February 2020, is an integral part of the withdrawal agreement and is therefore legally binding on its signatories, the UK and the EU. Designed to avoid a hard border on the island of Ireland, whilst also protecting the integrity of the EU single market, it creates a hybrid status for Northern Ireland, which remains in the UK customs union for goods not destined for the EU, but is aligned with European regulations (tariffs, VAT, state aid, etc.) for those goods liable to enter the EU. This requires the introduction of checks, including physical inspections (health and phytosanitary) on goods entering Northern Ireland from the rest of the United Kingdom, which it is the UK's responsibility to carry out. Monitoring of the protocol is the responsibility of an EU-UK Joint Committee, set up to supervise and facilitate the implementation of the withdrawal agreement. For the European side, Slovakian Maroš Šefčovič (also Vice President of the European Commission) acts as co-Chairman of the Joint Committee. Since the beginning of March 2021, his British counterpart is the former chief Brexit negotiator, David Frost.

The consent mechanism

The Protocol on Ireland and Northern Ireland is neither fixed nor irrevocable. The EU and UK agreed the so-called 'consent mechanism', which gives the Northern Ireland Assembly the deciding vote on the continuation of the Protocol's provisions. Four years after the end of the transition period (i.e. on 1 January 2025), the Assembly can decide, by simple majority, whether or not to terminate the Protocol. If it does, the UK will notify the EU that the Protocol will lapse two years later. Subsequently, the Assembly may vote every four years on the continued application of 'relevant EU legislation'.

SOURCE: EUROPEAN COMMISSION

TWIN DEFICITS (2021, % OF GDP)

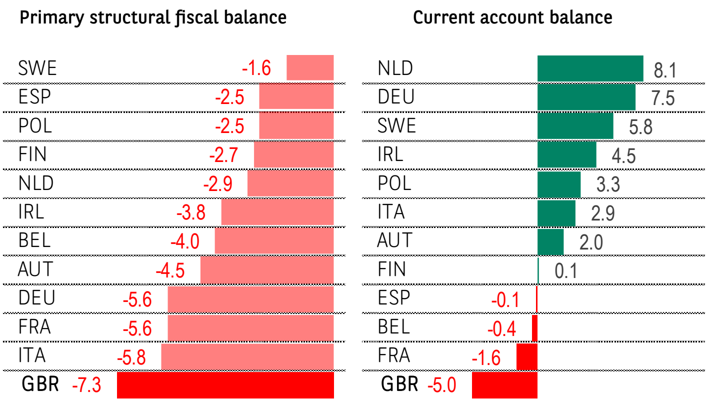

CHART 3

SOURCE: AMECO (ISO COUNTRY CODES)

2 At the end of 2022, private gross fixed capital formation is still expected to be 5 percentage points (in volume terms) below its pre-pandemic levels. See: OECD (2021) Economic Outlook, May.
3 The Guardian (2021) 'UK second to France again for attracting foreign investment in Europe', June 7.