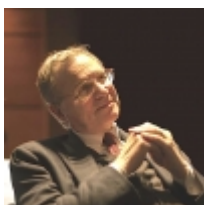


Europe's challenges after Brexit



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The UK's referendum vote against remaining in the European Union - Brexit - has created an unprecedented situation in the history of European integration. In the short term, the actions taken by the monetary authorities have mitigated the impact on foreign exchange and financial markets, while it is the UK economy that is expected to suffer the most in terms of slower growth. Concerns are much greater as regards Brexit's longer-term repercussions, as they are set to depend on complex negotiations whose outcome is inevitably surrounded by uncertainty.

Brexit reflects concerns raised by heightened geopolitical risks but it is first and foremost the product of a sentiment of mistrust that has been gripping Europe since the aftermath of the crisis. For this reason, Brexit presents policymakers with challenges that go well beyond the economic and financial spheres: it may ultimately cast a long shadow over the political strength of the European construction that might also obscure the will to complete the Economic and Monetary Union (EMU).

For Brexit not to undermine the European project, the primary response is to foster integration by means of common responses - supported by adequate tools - to the challenges that today are critical for the definition of a true European citizenship: migration, defence and security. Finding unity on these fundamental issues could also pave the way to achieving a genuine EMU, with more action at an economic and financial level to be accompanied by parallel action at an institutional and political one. This approach would replace the piecemeal attitude to EMU integration followed so far, which despite major achievements - the progressive establishment of a Banking Union being the most important - generates reform fatigue that makes subsequent steps towards integration even more difficult to take.

Uncertainty about the process of European integration is also among the factors that hold back investment and prevent a stronger recovery in the euro area. A combination of still modest real growth and very low - if not negative - inflation raises macro-financial risks for both sovereigns and banks: it makes fiscal consolidation more difficult while calling for record-low interest rates that can hit the profitability of banks and other financial intermediaries. Uncertainty is compounded by concerns over the area's capacity to use fiscal policy to support economic activity should the recovery be undermined.

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Strengthening the euro area's recovery remains paramount. It requires a combination of policies on both the supply and demand side: structural reforms need to be facilitated and complemented by measures that support aggregate demand so as to take full advantage of the favourable financing conditions ushered in by the monetary policy of the ECB. Equally important, the reform of the European economic governance that began with the measures to tackle the crisis must be completed. A gradual transfer of economic and financial sovereignty needs to be matched by supranational institutions that offset the limitations in the use of national policy levers.