

EDITORIAL

FRAGILITY

The most recent figures on the Spanish economy point to activity stabilising with a slight upswing over the coming quarters. Fragility is acute, however. The extent of the imbalances still suffered by the economy means that it is highly vulnerable, especially in the case of adverse developments in international financial markets.

Perhaps the most significant risk comes from the USA, a country immersed in a complex process of draining liquidity that, given the importance of the US financial market for the international economy, is bound to have huge consequences across the planet.

The USA's return to growth after the international financial crisis of 2008-09 is the result of several factors but undoubtedly the most important has been the huge monetary boost provided by the successive rounds of quantitative easing. Undoing this unorthodox expansionary monetary policy will be no easy task. The mere announcement, last May, that this process would begin a few months later (the famous *tapering*) had a huge effect throughout the summer on many financial markets and particularly on long-term interest rates and emerging foreign exchange markets. It has forced monetary and fiscal authorities in many countries to adjust their economic policies to ensure the impact of changes in international capital flows do not alter the fundamental course of their economies. What will happen when this strategy to withdraw unorthodox monetary policy actually begins?

For the moment, the Federal Reserve has postponed tapering. In part, alarmed by the adverse and rapid reaction of the markets at the mere mention of a reduction in its rate of debt purchases. But also due to inconclusive data regarding the strength of the economic recovery and the complex budget negotiations that the Obama administration is facing this autumn.

However, the decision to reduce and possibly withdraw monetary stimuli must be taken and we need to gauge the risks involved. If the exit strategy is implemented too quickly, there is the risk of cutting short an economic recovery that is still weak, leading to relapse into recession. This is the stance taken by the Fed in its September decision, surprising the financial markets. Delaying tapering, although this may only be for a few weeks, has led to stock market gains and pushed down the long-term interest rates of benchmark economies. Capital flows have also returned to emerging economies.

On the other hand, there are equally substantial risks should this monetary injection be withdrawn too late. If the recovery picks up enough speed, inflationary pressures may grow and consolidate. This could also lead to new financial bubbles. Within this scenario, interest rates would probably have to be increased significantly, which would be difficult to bear even for an economy that has reached cruising speed. In any case, the high degree of volatility caused by reducing monetary stimuli is going to be inevitable.

This US monetary policy dilemma is going to be crucial for the Spanish economy. Early tapering will pass on high interest rates to the euro area, tending to slow up the rate of recovery in our monetary area. The slowdown will be even greater if this tapering derails the recovery in the USA, a very important trading partner for the euro area.

Late tapering could ultimately lead to even higher interest rates and these would be more difficult for Europe to avoid although, by way of compensation, this adverse impact would occur in a more benign environment, with the recovery somewhat more consolidated in the euro area.

Early or late, the withdrawal of loose monetary policy in the USA is a threat to Spain's fragile economy and the country desperately needs to continue reducing its imbalances and thereby be in a stronger position to withstand the buffeting emanating from international financial markets.

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