

# Letter from the Editors

Just as inflation pressures had begun to moderate and markets were increasingly anticipating a more stable monetary environment, renewed tensions involving Iran have once again exposed the fragility of the global economy. Rising uncertainty surrounding energy prices and trade flows has complicated the outlook for growth and inflation at a moment when Europe was already struggling with weak productivity, industrial pressures, and growing geopolitical fragmentation.

At the same time, the rapid acceleration of artificial intelligence is beginning to reshape labor markets and business models at a speed that increasingly challenges the ability of firms, workers, and institutions to adapt. Together, these developments are reinforcing a broader reality confronting Europe: the next phase of economic adjustment will be shaped not only by geopolitical instability, but also by uneven technological transformation and intensifying competition across sectors and regions.

Against this backdrop, the May issue of *Spanish and International Economic & Financial Outlook* (SEFO) examines how these overlapping transitions are beginning to reshape the European and Spanish economies, financial systems, and labor markets.

We begin with an assessment of the economic impact of tensions in the Middle East on Spain. The conflict in the Persian Gulf

has delivered a renewed supply-side shock to the Spanish economy at a time when growth remained relatively strong, unemployment was falling, and the effects of the tariff war were beginning to ease. Energy markets are the main transmission channel: following the sharp rise in oil and gas prices, the passthrough to fuel and food prices is already visible, while futures markets suggest elevated costs could persist well into 2027. Unlike the 2022 shock following Russia's invasion of Ukraine, however, this episode is not being driven by excess demand. Household savings are more limited, and domestic consumption, while resilient, is not overheating, reducing the risk of a sustained inflationary spiral. Under the baseline scenario—in which the Strait of Hormuz gradually reopens before the summer—Funcas projects GDP growth of 2.2% in 2026, with inflation averaging 3.3% this year. Tourism flows redirected toward Spain as a perceived safe destination may partially offset weaker goods exports and softer private consumption. The more serious risk lies in a prolonged closure of the Strait of Hormuz. Under that scenario, inflation would rise to 4% and GDP growth would slow to 1.8% in 2026, while Europe would move close to recession in the second half of the year.

We then turn to trade and the growing strategic importance of the European Union's expanding network of trade agreements at a time of intensifying geopolitical fragmentation and mounting pressure on global supply

chains. The EU has accelerated its trade agreement agenda in recent years, yet the effects of those agreements have not been uniform across member states. Spain's trade profile is distinctive: exports account for 37% of GDP, the country records a goods surplus with EU partners but a deficit with the rest of the world, and its trade with third countries is particularly concentrated in markets with historical or linguistic ties. This distinctiveness raises the question of whether EU trade agreements are associated with differentiated effects on Spanish goods exports, and whether they widen the basket of exported products or instead intensify existing flows. Spanish goods exports to agreement partners exhibit greater responsiveness than those of other large EU economies, with cumulative growth reaching 23.5% in *Neighbouring* partner markets, compared with 10.1% for Germany and 7.7% for France over the same horizon. Moreover, the deepening of existing trade flows explains most of that performance, particularly in markets where historical ties already lower entry costs. In more distant markets without such ties, Spain activates the extensive margin more intensively than its European peers, expanding its export basket through the addition of new products at a comparatively faster rate. The pipeline of agreements now entering into force—including Mercosur, the modernised agreements with Mexico and Chile, and prospective agreements with India and Indonesia—aligns closely with these patterns in ways that carry distinct implications for Spanish exporters. Realising that potential, however, will depend not only on the agreements themselves, but also on the depth of their provisions, firms' effective utilisation of trade preferences, and the availability of institutional support at the point of market entry.

The issue then broadens its focus to the evolving international monetary and geopolitical landscape through an analysis of the dollar's uncertain hegemony. For decades, the dollar's dominance rested on a set of durable foundations: deep capital markets, credible monetary institutions, and the implicit guarantee that the U.S. would not weaponize its currency against allies. That compact is fraying, as the

Trump administration has recast the dollar as an instrument of geopolitical leverage. The cost of doing so is already visible in currency markets: the greenback weakened through 2025 even as tariff hikes should, by conventional logic, have pushed it higher. In response, central banks and sovereign wealth funds have begun accelerating reserve diversification and driving gold to historic highs as an alternative reserve asset. The dollar's structural position, anchoring 56% of global reserves and the bulk of international trade finance, remains intact, and the "there is no alternative" (TINA) argument still holds in the short run. However, the incentive to reduce dollar dependence grows with each new sanction deployed and each threat of financial exclusion. Whether the current weakness reflects a transient risk premium or the early phase of a more durable erosion is a crucial uncertainty.

Following the analysis of the dollar, we then examine how financial risk itself is increasingly migrating across the global financial system through the rapid expansion of private credit and non-bank financial intermediation. The rapid expansion of non-bank financial intermediation since 2008 has reshaped the global credit landscape, with private credit growing from roughly \$400 billion in 2020 to nearly \$1.8 trillion today. This segment now concentrates many of the tensions shaping the current cycle: opaque valuations, liquidity mismatches, continued reliance on bank funding, and rising exposure to sectors facing refinancing pressure and technological disruption. Recent stress points in U.S. evergreen business development companies (BDCs)—publicly listed vehicles that provide financing to mid-sized firms—and the acceleration of synthetic risk transfers (SRTs)—transactions through which banks transfer credit risk to investors without selling the underlying loans—in Europe illustrate how these vulnerabilities are manifesting. In the United States, liquidity promises attached to illiquid loans have been tested by valuation gaps and rising redemption pressure. In Europe, banks have used SRTs to release regulatory capital while often retaining the underlying exposures, raising questions about how much risk is actually

being transferred and how incentives to monitor borrowers evolve after the transfer. The picture is not one of imminent systemic crisis, but of mounting friction within an increasingly complex financial architecture. Credit risk has shifted into structures with different transparency, governance, and loss-absorption dynamics, while remaining closely interconnected with the banking system. Understanding where that risk ultimately resides, and how it would behave under stress, has become central to assessing financial stability in this cycle.

Geopolitical tensions are also increasingly shaping financial markets and banking dynamics more directly. Geopolitical risk is playing an increasingly visible role in the valuation of banks and their operating conditions. Evidence from the IBEX-35 Banks index shows that immediate and persistent equity declines follow major geopolitical events, such as Russia's invasion of Ukraine, escalating tensions in the Middle East, and protectionist policy announcements. These episodes reflect a combination of weaker macroeconomic expectations, tighter financing conditions, and rising risk premiums. At the same time, the Spanish banking sector stands out for its high level of internationalization, with nearly 56% of total activity linked to foreign markets as of the end of 2025. This geographic diversification allows banks to offset adverse shocks in some regions with stronger performance in others, acting as a stabilizing mechanism for earnings and valuations. However, the effectiveness of this buffer depends not only on the extent of internationalization but also on the composition of exposure across economies with different risk profiles and cycles. The findings suggest that geopolitical risk is now a structural feature of the global banking environment, requiring more systematic integration into banks' strategic planning and risk management frameworks.

The May SEFO then turns to the European insurance sector through an assessment of the Solvency II framework ten years after its implementation. A decade after its implementation, Solvency II has consolidated itself as an international benchmark for risk-

based regulation, having delivered higher average solvency, more rigorous internal governance, and greater supervisory convergence across the EU. Practical experience, however, has also exposed structural limitations: the framework's technical complexity has imposed a heavy regulatory burden, particularly on smaller insurers and notably in Spain, whose compliance costs are disproportionate to their actual risk profiles. The short-term sensitivity of the solvency capital requirement to market movements has likewise sat in persistent tension with the long-term nature of insurance liabilities, generating procyclical pressures and constraining the sector's ability to channel savings into illiquid and long-term assets — precisely the kind of patient financing that Europe's green and digital transitions require. The review now underway addresses these imbalances along several axes: a recalibrated extrapolation of the risk-free curve, a redesigned and more entity-specific volatility adjustment, proportionality provisions for Small and Non-Complex Undertakings (SNCUs), and a reduction in the risk margin's cost-of-capital rate from 6% to 4.75%. The SCR itself is also refined, with preferential treatment for long-term equity investments and a more accurate capture of interest rate risk, including negative rates. Complementing these technical changes, the reform formally embeds ESG and climate risks into governance and reporting, equips supervisors with new macroprudential tools, and updates the rules for cross-border groups. The intent is to preserve the prudential solidity the framework has built while removing the constraints that have prevented insurance from fully functioning as a stable, long-term source of financing for the real economy.

The remainder of this issue focuses on artificial intelligence and the increasingly uneven nature of technological transformation across Europe. Assessments of AI's economic impact are often distorted by a flawed understanding of intelligence — one that conflates pattern recognition with reasoning, and imitation with creativity. AI excels at the former, defining both its power and its limits: it can outperform humans in structured, repetitive cognitive tasks

while remaining incapable of original inquiry or genuine creativity. Early productivity data support this distinction. In the United States, a 10 percentage point increase in AI adoption between 2019 and 2025 is associated with a cumulative productivity gain of 2.9 percentage points, meaningful but far from transformative. The more consequential divergence, however, is geographic. In 2026, 43% of U.S. employees used AI compared with 32% in the EU, while adoption gaps within Europe continue to follow familiar divides between Northern and Central Europe on the one hand, and Southern and Eastern Europe on the other, rooted more in management practices than in access to technology. Europe's combination of strong employment protection, precautionary regulation, and hierarchical corporate cultures is likely to slow the labour reallocation required for AI-driven productivity gains to materialise. The distributional effects also challenge conventional assumptions. Evidence suggests that AI may disproportionately augment lower-educated workers while putting pressure on structured mid-level roles, reversing the pattern observed during earlier technological transitions. AI will destroy some jobs and create others, but countries with more rigid labour markets are likely to absorb the transition more slowly, deferring the productivity dividend rather than avoiding the disruption itself.

Artificial intelligence is also exposing deeper structural divisions within Europe itself. The economic impact of artificial intelligence will depend not only on how firms use the technology, but also on how widely adoption spreads across Europe. While AI adoption among EU firms has risen sharply—from 7.6% in 2021 to around 20% in 2025—the pace of diffusion remains highly uneven, ranging from more than 35% in Scandinavia to below 10% in parts of Southern and Eastern Europe. Drawing on EU-ICT-Firm Survey data and diffusion of innovation theory, this study finds that GDP per capita, R&D intensity, and workplace digitalisation are key drivers of firm-level AI adoption, whereas general human capital appears less significant. Yet even after accounting for these factors, a persistent divide remains between the Central-Northern and Southern-

Eastern blocs, pointing to deeper differences in institutional quality and management practices. Even as the experience of early adopters facilitates the subsequent diffusion of AI across lagging regions, the continuous evolution of these technologies nevertheless risks turning existing adoption gaps into a more persistent source of economic divergence within the EU.

Finally, the implications for employment are explored further in the following article on artificial intelligence and the labor market in Spain. The relationship between artificial intelligence and employment has shifted substantially since Frey and Osborne's 2017 estimate that 47% of U.S. jobs faced high automation risk, a figure now subject to methodological revision. Second-generation indices, built on task-level analysis rather than occupational categories, find that exposure to generative AI is concentrated among educated, higher-wage workers, not the routine manual jobs of the previous paradigm. Experimental evidence reinforces this picture: productivity gains are significant, but benefit less experienced workers the most, while aggregate TFP gains over a ten-year horizon are estimated at under 1%. Applying an adapted version of the AI Occupation Exposure index to Spain's CNO-11 occupational classification, the model projects gross job displacement of between 1.7 and 2.3 million positions over 2025–2035, with a central estimate of 2.0 million concentrated in administrative, technical support, and scientific professional roles. Against this, complementarity effects benefit an estimated 3.1 million workers in services and manufacturing, and new occupation creation is projected at 1.61 million, placing the net loss at around 400,000 jobs in the baseline scenario. The distribution of that loss across geography, sector, and educational level is highly uneven, and the transition window depends critically on the pace at which displaced workers can access reskilling. Spain's position at a historic employment peak as AI adoption accelerates represents an opportunity to manage that transition from a position of relative strength.