

Letter from the Editors

As 2025 draws to a close, Europe finds itself navigating a complex economic landscape marked by slowing growth, a cautious central bank, and intensifying fiscal pressures. The European Central Bank's pause after a series of rate cuts reflects the tension between fading inflationary pressures and the need to preserve policy flexibility in an uncertain global environment. Spain, by contrast, continues to outperform its peers, combining solid growth while avoiding macroeconomic imbalances—but faces growing constraints, which could undermine the long-term sustainability of its recovery. In this issue of *Spanish and International Economic & Financial Outlook (SEFO)*, we explore these dynamics through the lens of Spain's macroeconomic performance, evolving fiscal strategy, and financial sector resilience.

We begin with an analysis of Spain's growth dynamics, which are among the most robust in Europe. Spain remains Europe's leading growth engine, with GDP now 10% above its pre-pandemic level and expanding at nearly twice the eurozone average; all without generating macroeconomic imbalances. However, the current cycle, resilient through successive global shocks, is now driven almost entirely by domestic demand, supported by household consumption and a buoyant labour market. Foreign-born workers have accounted for 65% of new net jobs over the past three years, yet their integration is increasingly constrained by acute housing shortages.

Private investment also remains subdued, still 5% below pre-pandemic levels in real terms, weighing on productivity. Meanwhile, European funds, which have fuelled public investment, are expected to taper off as the Next Generation programme approaches its end. Under this scenario, Funcas projects GDP growth of 2.9% in 2025, moderating to 1.9% in 2026 and 1.7% in 2027, underscoring the need to boost residential construction and corporate investment to sustain long-term growth momentum.

Next, we turn to the monetary policy outlook, as the ECB recalibrates its stance following a period of rapid normalization. After the most intense tightening in its recent history, the European Central Bank (ECB) reduced its deposit rate eight times between 2024 and 2025, from 3.75% to 2.00%, and has since entered a cautious pause. Inflation has converged toward 2%, while core inflation remains at 2.4% and GDP growth hovers around 1%. Bank lending, which had contracted for five consecutive quarters, has stabilized, and excess liquidity has been reduced from €4.7 trillion to €2.6 trillion. However, the resilience of service inflation and wage growth above 3% suggest that the scope for further rate cuts is exhausted. Instead, monetary policy has shifted its focus toward balance sheet normalization, with the ECB reducing its Asset Purchase Program (APP) by roughly €30 billion per month. In the medium term maintaining rates around

2% would be reasonable, supporting activity while remaining consistent with the ECB's price-stability mandate. Should core inflation remain sticky, a modest rate hike could reassert control and anchor expectations without disrupting recovery dynamics.

The focus of this issue then shifts to fiscal sustainability and consolidation, where several contributions examine the evolving trade-offs between discipline, growth, and structural reform.

Public debt ratios across advanced economies remain well above pre-pandemic levels, but Spain stands out as an exception within the euro area. After peaking at 120% of GDP in 2020, Spain's debt ratio declined to 107.5% in 2024—almost five percentage points below the EU average and nearly ten points lower than in France or Italy. This improvement reflects a favorable interest rate-growth differential, strong labor market performance, and robust immigration inflows that expanded the tax base. Interest payments have fallen to just 2% of GDP, half their 1990s level, allowing debt reduction without major fiscal consolidation. Yet this benign dynamic is unlikely to persist. Demographic projections indicate that age-related spending will rise by over five percentage points of GDP by 2070, while potential growth remains constrained by low productivity and a maturing labor force. Ensuring fiscal sustainability will therefore require structural reforms to boost growth and preserve the credibility of Spain's public finances in a less forgiving macroeconomic environment.

Spain's central government remains mired in budgetary paralysis, with the 2023 General State Budget still in force and no new draft budget likely to pass given the current political fragmentation. Nevertheless, fiscal performance in 2025 has been encouraging: as of August, the deficit fell by half a percentage point of GDP, driven by a 10% increase in tax revenue, outpacing nominal GDP growth. The improvement stems largely from favourable cyclical conditions, including strong job creation and the expiration of temporary tax

relief. Looking ahead, AIREF and the Bank of Spain expect further fiscal consolidation in 2026, projecting deficits of 2.0%–2.3% and a debt ratio near 100% of GDP. However, underlying structural imbalances remain, and most of the deficit reduction has been cyclical rather than permanent. From 2027 onwards, Spain will likely face pressure to curb expenditure growth and introduce structural reforms to comply with new EU fiscal rules. Sustaining fiscal discipline amid political uncertainty will require difficult choices, particularly in defence, housing, and public investment.

Spain's public revenue continues to post robust gains, with 2024 marking another year of exceptional tax and social security receipts. Growth in 2025 remains dynamic, driven by employment, wages, and corporate profitability, although underpinned by the fiscal drag effect rather than structural reform. Despite these tailwinds, the persistence of a “stopgap” fiscal strategy has delayed the long-recommended shift toward higher indirect and environmental taxation. Looking ahead, demographic forces are becoming an increasingly important constraint: population ageing is changing the composition of taxable income and eroding personal income tax buoyancy. Immigration has cushioned the decline but cannot fully offset it. Indeed, Spain would need at least one immigrant worker for every new pensioner in order to prop up tax revenue. Moreover, most immigrant workers earn below-average wages and will eventually become pensioners themselves. Without a sustained increase in higher-wage employment or structural tax reform, ageing could weigh heavily on revenue growth and threaten fiscal sustainability in the coming decades.

The final section of this issue turns to Spain's financial sector, where both banks and insurers continue to act as anchors of stability in a volatile environment.

Spanish banks have become increasingly active and reliable players in fixed-income markets, consolidating the progress achieved

since the financial crisis. Recent issuance patterns show that refinancing operations and regulatory adaptation, particularly to meet MREL requirements, have replaced the liquidity-driven issuance of previous years. The funding mix has shifted decisively toward unsecured instruments, signaling both restored market trust and improved capitalization. Smaller and medium-sized institutions have also expanded their footprint, achieving a level of market access that was previously reserved for the largest entities. The decline in spreads across senior and subordinated debt confirms the sector's regained credibility, though continued reliance on wholesale funding underscores the importance of maintaining high profitability and resilient balance sheets in an environment of still-elevated rates and evolving regulation.

Spain's insurance sector remains one of the most robust segments of the financial system, combining sustained profitability with exceptionally strong solvency positions. Capital ratios comfortably exceed European averages, supported by prudent asset allocation and limited exposure to market risk. Premium growth continues across both life and non-life segments, with the latter showing particular dynamism driven by auto and health lines. While the low-interest rate legacy still constrains returns on older portfolios, higher yields are gradually improving investment income and supporting new product growth. The sector's cautious risk management and focus on long-term stability have made it a key stabilizing force within Spain's financial landscape, underpinning confidence among policyholders, regulators, and investors alike.