

Letter from the Editors

After several years marked by overlapping shocks— including the pandemic and the energy crisis triggered by Russia’s invasion of Ukraine and the resulting cycle of monetary tightening—the global economy had begun to move toward a phase of relative stabilisation. Inflation pressures were easing and financial conditions were gradually normalising. Yet the eruption of conflict involving Iran has once again highlighted the fragility of this environment. Energy markets remain the most immediate transmission channel through which geopolitical tensions affect inflation and economic activity in Europe, raising the risk that renewed price pressures could complicate the path toward price stability and economic growth, even as other sources of financial market volatility—such as stresses emerging in segments of private credit—remain present.

Within this context, the March issue of *Spanish and International Economic & Financial Outlook (SEFO)* examines several structural forces shaping the European and Spanish economies, ranging from geopolitical developments and fiscal governance to housing market dynamics and the growing pressures facing younger households.

The issue begins by examining Europe’s rearmament effort and the economic implications of the continent’s changing security environment. With a combined GDP of roughly €20 trillion and an industrial base

comparable in scale to that of the United States, Europe has the economic capacity to sustain a strong defence posture. Defence spending is rising rapidly, particularly in Germany, Poland, and the Nordic countries, but investment is unequal across the Union and remains predominantly national, limiting its overall effectiveness. Despite higher budgets, critical capability gaps persist in areas such as air and missile defence, spacebased assets, and cybersecurity. The preference for *juste retour* (fair return) arrangements and national champions has undermined collaborative projects, leading to production inefficiencies, delays, and weak incentives to scale proven systems, as illustrated by the slow ramp-up of platforms such as SAMP/T. Achieving NATO-level spending targets—potentially lifting European defence outlays toward €700 billion annually—will not translate into effective military power either, unless spending is redirected toward genuinely joint capabilities. Closing Europe’s most acute gaps will require prioritizing a small number of high-impact projects, reducing industrial fragmentation, and refocusing flagship initiatives such as Iris2 on defence-driven common assets rather than national interests.

The next contribution turns to developments in the European banking sector and the implications of excess capital for bank valuations. European banking has entered a new phase in which the policy focus has shifted from strengthening resilience to

simplifying an increasingly complex regulatory framework. Banks continue to hold capital levels well above minimum requirements, raising the question of whether excess capital acts as a buffer that enhances stability or as a drag on profitability and shareholder value. From a valuation perspective, bank market performance depends on the spread between return on equity and the cost of equity, making capital accumulation without a corresponding increase in profits potentially dilutive. Empirical analysis of large euro area banks shows a negative relationship between capital levels and valuation multiples, which becomes more pronounced when focusing specifically on capital held above regulatory and supervisory thresholds. The evidence suggests that markets distinguish between required capital, which underpins resilience, and excess capital, which carries an opportunity cost unless it reduces risk or supports sustainable growth. As such, holding capital beyond prudential needs may weigh on returns and valuations, particularly when it does not translate into lower funding costs or higher earnings.

Turning to Spain, the remainder of this issue examines several structural challenges shaping the country's economic outlook. The next article assesses the outlook for the Spanish economy in the coming years and the risks posed by the current geopolitical environment. The Spanish economy has shown remarkable resilience in recent years, maintaining strong growth despite a succession of external shocks. This performance has been supported primarily by robust domestic demand and strong population growth, while the contribution from foreign trade has weakened. Under the baseline scenario, economic activity is expected to continue expanding at a solid pace over the next two years, although gradually slowing as the effects of immigration, tourism and the European recovery funds begin to fade. GDP growth is forecast at around 2.4% in 2026 and 1.8% in 2027, still above the eurozone average but increasingly reliant on internal demand. This growth pattern is also likely to keep inflation somewhat higher than in the rest

of the euro area. The main downside risk to this outlook stems from the outbreak of a new conflict in the Middle East and its potential impact on energy prices. A sustained increase in oil and gas prices would push inflation higher and erode household purchasing power, weakening private consumption, the main engine of current growth. Under such a scenario, the economic slowdown would be more pronounced than expected, demonstrating the vulnerability of the current expansion to external energy shocks.

Fiscal institutions also remain central to Spain's economic outlook. The following contribution analyses proposals to reform the regional financing framework. Spain's latest proposal for reforming the regional financing system marks a shift away from more disruptive, bilateral models towards a more standardized federal framework. The reform aims to meet a range of regional demands, including calls from some territories to increase resources for underfunded regions, to address disparities in per-capita funding, and to expand total revenues for the regional fiscal tier. The proposal also introduces several new funding mechanisms, which add complexity and raise questions about transparency, fiscal co-responsibility and the overall distribution of resources across territories. The reform would generate close to 21 billion euros in additional resources for the regions in 2027. However, the increase relative to a no-reform scenario would be significantly lower, as part of this amount reflects taxes already being collected and revenue growth that would occur under the current system. Even so, the fiscal impact would constrain the central government's room for manoeuvre under increasing spending pressures for pensions, defence, and debt servicing. Simulations show that the distribution of additional funding benefits both territories that have argued they are under-financed and regions with stronger fiscal capacity. However, the combination of high fiscal cost, uneven distributional effects, and the need for an absolute majority in Congress makes the political path to reform and its ultimate viability uncertain.

Housing pressures, however, represent one of the most significant structural challenges currently facing the Spanish economy. The next article analyses whether recent price increases signal the emergence of a new housing bubble. The sharp increase in house prices in 2024 and 2025 has reignited concerns about the possible emergence of a new housing bubble in Spain. A comparison with the early-2000s cycle shows that, despite strong price growth and high transaction volumes, the current macroeconomic context differs substantially from the period preceding the financial crisis. Credit expansion remains far more contained, and housing construction is well below the levels seen during the previous boom, resulting in a cumulative deficit of nearly 700,000 homes since 2020. However, household expectations about future house prices remain very strong. Evidence from the 2025 Home Price Expectations Survey indicates that buyers overestimate recent price increases by nearly double and anticipate substantial future revaluations. These beliefs play an important role in shaping purchasing decisions and can reinforce demand pressures in tight housing markets. The coexistence of relatively solid fundamentals with highly optimistic expectations highlights the importance of monitoring the latter as a potential source of market overheating. Incorporating expectations into housing market surveillance may therefore be crucial for anticipating emerging risks and designing effective housing policies.

Housing affordability pressures are particularly acute among younger households, many of whom now rely on rental markets. In Spain, renting has become the default option for young adults leaving the parental home, with nearly 50% of under-35s now living in rental housing. Large urban areas host the largest share of young renters, accounting for six out of ten households. At the same time, rental costs, including service charges and utilities, have risen sharply, absorbing roughly 35% of household expenditure and leaving many young adults financially stretched. Non-European immigrant households have also grown to represent more than 40% of young renters

over the past decade and are often exposed to the highest levels of financial strain. Additionally, rent overburdening varies significantly based on autonomous community, generally affecting densely populated, wealthy, or touristic regions such as Catalonia, the Basque Country and the Balearic Islands more than less dense and lower-demand regions. Taken together, close to 60% of young renters nationwide continue to devote more than 30% of their spending to housing, highlighting the depth and persistence of Spain's rental affordability problem.

Housing dynamics are also closely linked to broader patterns of wealth accumulation and inequality across generations. Wealth inequality in Spain has increased markedly since the early 2000s, with divergence both across age groups and within generations. Older households have consolidated their position through asset revaluation, while younger cohorts face lower homeownership rates and weaker income growth, limiting their capacity to accumulate wealth. Housing plays a central role in this process, amplifying disparities between owners and non-owners and reinforcing differences across generational cohorts. At the same time, intragenerational inequality has intensified, particularly among younger households, where wealth is increasingly concentrated at the top of the distribution. Intergenerational transfers are set to become more significant as population ageing progresses and cohort sizes shift, raising average inheritance per capita. However, these transfers are unevenly distributed and closely tied to existing wealth concentration. As a result, inheritance may reinforce rather than reduce intragenerational disparities.

The housing affordability challenge also has a broader structural dimension across Europe. Since the mid-2010s, housing affordability has re-emerged as a central policy challenge across Europe, including in Spain, with rents in large Spanish cities rising by 50–70% in nominal terms between 2015 and 2025. Comparative evidence indicates that widely used policy instruments, such as rent controls and demand-

side subsidies, tend to reduce supply or translate into higher prices when housing construction is inelastic, while large-scale social housing models have stabilised markets only under specific institutional and historical conditions that are difficult to replicate. Spain's structural weakness lies in its historically ownership-focused model and the automatic expiration of protection on subsidised housing, which has left a social rental stock of just 1.5–2% of total housing, far below the EU average. At the same time, homeownership among 30- to 34-year-olds has fallen by more than 20 percentage points since 2002, emphasizing the intergenerational dimension of the problem. Spain's effort to improve housing accessibility, the 2023 Right to Housing Law, follows the European pattern of short-term relief combined with risks of reduced formal rental supply. The accumulated evidence suggests that sustained affordability ultimately depends on expanding effective supply through more flexible zoning, faster licensing and greater legal certainty for tenants and landlords.

Finally, this issue of SEFO examines the relationship between tourism activity and housing pressures in destinations experiencing strong visitor flows. Overtourism has re-emerged as a major challenge for many European destinations since the end of the pandemic, generating pressure on local infrastructure, housing markets and natural resources. Beyond its social and environmental impacts, excessive tourism can also undermine the visitor experience and weaken a destination's long-term competitiveness. Tourist taxes are frequently criticised for raising costs and discouraging demand, yet the author argues that economic theory suggests that a carefully calibrated tax can help correct the externalities associated with tourism activity. From this perspective, by increasing the cost of visiting congested destinations, such taxes can moderate demand and reduce pressure on common resources. If properly designed, the author suggests they may also encourage a shift in demand towards visitors who place greater value on quality. In practice, this tends

to attract tourists who are less sensitive to higher prices. The article points to evidence from the Balearic Islands, one of Europe's most mature and tourism-intensive destinations, to demonstrate this logic. That said, simulations based on tourism demand elasticities suggest that the existing tax would need to increase by between 15 to 20 euros to generate a meaningful reduction in peak-season demand. The author concludes that, while not a standalone solution, a stronger tourist tax could play an important role in managing tourism pressure while reinforcing the long-term competitiveness of the destination.