

Letter from the Editors

As we start off 2025, the global economic landscape finds itself in the midst of profound transformation, with the return of Donald Trump to the U.S. presidency marking a pivotal moment for transatlantic relations. Europe is navigating an increasingly complex environment shaped by divergent economic trajectories: while the U.S. enjoys robust economic growth, albeit alongside persistent inflation, Europe is facing lacklustre growth rates with greater price stability, albeit given the appreciation of the dollar *versus* the euro, EU inflation may increase in the near-term. This decoupling, together with trade tensions, defence spending burdens, and divergent central bank policies, underscores the urgency for Europe to redefine its role in the new global economic order. In this issue of *Spanish and International Economic & Financial Outlook (SEFO)*, we explore these dynamics, assessing how Europe, and Spain in particular, can adapt to the challenges of U.S. trade policy, intensifying competitiveness, and the ongoing drive for economic integration and strategic autonomy.

Within this context, we first explore how the new Trump administration will impact transatlantic trade and investment. The second Trump administration moved quickly to use tariffs and other trade policy instruments to push commercial partners of the United States to offer more favourable deals for American firms and to encourage manufacturers to

invest in the United States. The European response to this move is to contemplate buying more American liquefied natural gas and military equipment, while threatening a tit-for-tat retaliation with trade instruments. There is still more to do. Europeans could also take the opportunity to negotiate a limited free trade agreement with the United States alongside an agreement for greater mutual recognition of regulatory equivalence. And Europe could strengthen that response over the longer-term by shifting its growth model away from a dependence on exports and greater autonomy in military procurement. Such longer-term responses not only offer the promise of rebalancing economic relations across the Atlantic but also strengthening the transatlantic partnership.

Delving into the topic of EU investment, we focus on the recent findings of the Draghi report, and of course, what these findings mean for Spain. The Draghi report, published at a pivotal moment for the European Union, identifies structural weaknesses in Europe's economic model and proposes comprehensive reforms to secure its future. With public and private investment needs estimated at €800 billion annually, the report calls for productivity-boosting measures, enhanced strategic autonomy, and a focus on the green and digital transitions. It highlights the importance of industrial policy, regulatory simplification, and improved governance to foster innovation and competitiveness.

However, implementation faces hurdles, including political fragmentation, limited fiscal space, and resistance to deeper integration, underscoring the urgency of prioritizing achievable reforms and embracing a multi-speed Europe.

As regards Spain, addressing the risk of a structural decline in the European economy, Mario Draghi's report on competitiveness presents two complementary solutions, namely: (i) the rollout of a common economic policy along with public investment incentives; and (ii) completion of the Single European Market. While both solutions are particularly relevant for Spain, further European integration would bring greater benefits in the short-term and is also the more feasible solution, considering the state of much of the EU's public finances. This is because, first of all, greater integration would provide Spain with better access to EU capital markets, thus addressing the current investment deficit, which stems largely from the private sector and a weak public-private investment multiplier. Secondly, more integration could help Spain further improve its competitive positioning within the EU, which has already seen significant gains, driven by relatively cheaper labour and energy costs. This could help offset the lost ground in global markets, particularly in the technology sector. While greater integration would channel European savings into Spain's productive sector, the biggest risk remains fragmentation among Member States amid the rising tide of protectionism.

The following section of this *SEFO* takes a closer look at financial sector issues. First, we look at access to finance in Europe and Spain, with a critical lens on the role of size. Spanish companies benefit from lower bank borrowing costs than other Eurozone enterprises, irrespective of loan size. Loan costs are higher on smaller-sized loans, which are more commonly applied for by smaller companies. However, the extra cost paid by smaller enterprises relative to their larger counterparts is very small and much lower in Spain than in the Eurozone. Moreover, only a very

low percentage of Spanish companies (4.53%) view access to finance as their main problem and even though that percentage rises among small enterprises (4.91%), the difference with large companies (4.43%) is narrow. Elsewhere, the percentage of companies that face obstacles in obtaining a bank loan is similar in Spain to that observed in the Eurozone (7.9% vs. 7.3%), the main impediment being fear of rejection. Micro enterprises perceive more obstacles although in Spain, this size penalty is virtually negligible. As a result, size counts, but very little in Spain.

The next financial sector topic relates to liability management for Spanish banks in a low interest rate environment. Indeed, more than six months after the ECB started to cut rates, and almost one year since the market (Euribor) began to discount those cuts, unit margins (the difference between the return on credit and cost of deposits) have started to contract, partially offset by the slight growth in credit volumes observed for much of 2024. Notwithstanding this recent increase in new credit, the new scenario of falling rates, which is expected to continue for the next couple of years, forces the banks to focus on managing customer funds (striking the right balance between off-balance sheet assets and deposits and within the latter source of funding, between overnight deposits and deposits with agreed maturity) while controlling costs to unlock efficiency gains. Within this context, retail deposit funding costs have proven to be a key competitive advantage for certain banks, especially those with significant exposure to savers in smaller municipalities where deposit pass-through has been more contained. Banks that have managed these funding costs effectively are better positioned to preserve profitability as net interest margins continue to decline, particularly by shifting savings into time deposits and offering tailored advice to retain customers and maintain deposit stability.

Next, we explore a more theoretical topic: how digitalisation has transformed banking interactions, with 94% of customers using digital channels for everyday transactions. Younger users

are reliant predominantly on mobile applications while older cohorts demonstrate a preference for web platforms. AI excels in its ability to enhance security, particularly through its role in fraud detection, but has generated scepticism around autonomous decision-making in the areas of lending and investing. Satisfaction levels are high with the basic digital tasks but there is room for improvement with respect to more complex matters, such as incident resolution. Going forward, successful application within the financial sector lies in blending AI's capabilities with customer-centric strategies that address generational and technological divides, enabling banks to strengthen relationships and maintain competitiveness in an evolving market.

We close this *SEFO* with two additional topics. Firstly, we examine the weakness in overall construction sector profitability and how low productivity is being exacerbated by labour shortages. Secondly, we analyze the recent evolution of the bancassurance business in Spain.

On construction, the sector survived the rout ushered in by the Great Recession, recording steady growth up until the pandemic. As of 2023, its contribution to GDP was around 5.0%, close to the EU-27 average of 5.2%. After the health crisis, the rebound in demand for housing coupled with price growth paved the way for a sharp recovery in sector profitability. However, monetary policy tightening then stalled the trend of expanding margins. The sector has since overcome this difficulty but the shortage of qualified labour is becoming an increasingly pressing issue, undermining aggregate sector productivity particularly for smaller firms, as labour shortages persist despite a structural improvement in employment conditions. Although the Next Generation EU funds are enormously beneficial for the construction sector, it is vital to search for solutions for the shortage of human capital. Failure to do so could seriously jeopardise the firms' profitability and impede (urgently-needed) growth in the supply of housing.

As for bancassurance, of the roughly 176 insurance providers doing business in Spain, 29 have ties to the main banking groups. Their weight in the country's insurance business, especially the life insurance segment, and their contribution to their parent banks' domestic earnings are very significant. This contribution has been key to propping up the banks' financial statements during periods in which they had to recognise significant loan-impairment provisions and/or navigate ultra-low margins as a result of low market interest rates. Today, the bancassurance business accounts for nearly 14% of banks' domestic earnings directly, with the life insurance segment generating the bulk of that profit. Although traditional banking profits have surged due to rising interest rates, bancassurance remains a key revenue stream, with its contribution expected to grow further, driven by premium repricing and increased non-life insurance activity.