Letter from the Editors

As 2025 unfolds, the global economic environment remains defined by heightened fiscal uncertainty, diverging policy trajectories, and deepening geopolitical fault lines. The growing asymmetry between U.S. and European fiscal and monetary responses initially reinforced capital flows toward the United States, but this trend has since reversed amid rising policy instability and geopolitical risk. Across Europe, concerns over fiscal sustainability have re-emerged as high public debt levels, rising interest costs, and shifting political priorities complicate compliance with the EU's new budgetary rules. Meanwhile, financial markets remain sensitive to changing macroeconomic expectations, and strategic sectors —most notably defence— are entering a new phase of consolidation and repositioning as security imperatives reshape national investment priorities.

Within this context, we begin the May issue of *Spanish and International Economic and Financial Outlook (SEFO)*, with the global macro picture and U.S. dynamics, especially given the pivotal impact of U.S. policy changes on global economic conditions and financial markets.

Until the end of last year the U.S. economy was performing better than most other advanced economies, and the prospects were for robust economic growth, moderate inflation and low unemployment. However, the recent policy changes driven by the new administration have generated a significant adverse shock, whose magnitude, if unaddressed, will be amplified both over time and internationally. Import tariffs will impose a serious short-term squeeze on real personal incomes, consumer spending, profit margins and business investment, even assuming no retribution from trading partners. And they will eventually blunt incentives to innovate, invest and improve product quality. It is no surprise that financial markets are reacting in such a violent fashion, further aggravating the outlook. Moreover, the on-again-off-again process that has been used to impose tariffs has exacerbated uncertainty, with powerful effects on investment and consumption of durable goods. Additional uncertainty has been generated by: i) talk of encouraging (or even forcing) foreign holders to extend maturity of their U.S. bonds; ii) deportation of both illegal immigrants and critics of administration policies; iii) firing of many federal government and agency employees; iv) perceived erosion of the rule of law; and v) territorial threats against allies, resulting in growing boycotts against U.S. goods and tourism. In such a context, the risk of stagflation or worse has increased considerably.

Beyond the domestic impact, the tariff measures announced by Washington on 2 April ushered in a period of heightened uncertainty for the global economy, while simultaneously signaling a potential inflection point for the multilateral trading system. Although the direct impact of the tariffs on the Spanish economy is relatively limited —with an estimated GDP loss of 0.2 to 0.3 percentage points— the burden is disproportionately borne by a small number of sectors. Moreover, the indirect effects are expected to be more pronounced. First, countries heavily affected by the tariffs, such as China, are likely to redirect exports toward alternative markets, potentially increasing competitive pressure on European imports. Second —and most critically— the adverse effects on U.S. economic activity, financial markets, and particularly investment, which is closely tied to trade flows, will play a significant role as the escalation of tariffs and retaliatory measures persists. Under relatively benign assumptions, the Spanish economy is projected to grow by 2.3% in 2025 —0.3 percentage points below pre-conflict estimates— and by 1.6% in 2026, reflecting a 0.4-point downward revision.

We then move into eurozone-level public finance issues, highlighting sovereign debt challenges, banking exposures, and fiscal policy dilemmas.

Transatlantic divergence on fiscal and monetary policies have underpinned recent tensions in both the U.S. and eurozone sovereign debt markets. In addition to exhibiting high volatility, in May 2025, 10-year U.S. Treasury yields remained above 4.3%, driven by a high fiscal deficit and rising public debt, accentuated by an exodus by traditional institutional investors and higher activity by price-sensitive players. In the eurozone, the expansionary shift in German fiscal policy —particularly the €100 billion increase in defence spending— has pushed Bund yields to around 2.5% while peripheral country risk premiums had risen somewhat: the Italian risk premium stood at over 100 basis points and the Spanish spread stood at around 65bs. Meanwhile, the ECB has lowered its deposit rate to 2.25%, following six consecutive cuts since mid-2024, and faces the challenge of supporting growth without importing inflation. This combination of factors initially reinforced capital flows to the U.S., strengthening the dollar and increasing global financial fragmentation, but tariffs and uncertainty have ultimately reversed these capital flows and weakened the dollar. Going forward, the lack of economic policy coordination could continue to generate episodes of instability in international financial markets.

These broader trends are mirrored in the financial sector, particularly through the evolving composition of banks' balance sheets. The share of public debt in the Spanish banks' asset mix has been increasing in recent years, reaching 15.4% in 2024, in tandem with the run-up in interest rates. That is 2.5pp above the EU average. Forty-eight percent of this debt is Spanish public debt. This share is below the European average, reflecting the Spanish banks' strong international footprint. A point in favour of the Spanish banks is the growing volume of public debt carried at amortised cost (67.2% *vs.* 58.6% in the EU), ring-fencing it from market fluctuations. In the Spanish banks' domestic businesses, public debt has increased its share of total assets from 6.66% in 2019 to 7.79% in 2024, and from 76.4% of total fixed-income holdings to 90.7%, with the interest earned on these investments multiplying 2.5x.

Beyond the banking sector, attention turns to Spain's fiscal position, where cyclical gains have masked deeper structural challenges. Spain's fiscal performance in 2024 benefited from strong economic growth and buoyant revenues, helping to reduce the headline deficit to 2.8% of GDP. However, this improvement largely reflected cyclical dynamics, with the structural deficit decreasing only slightly to remain above 3%. Budget planning for 2025 has been clouded by political uncertainty, resulting in a sharp divergence in medium-term consolidation scenarios between the government and independent institutions. At the subcentral level, regional governments posted near-balanced budgets thanks to sharp growth in tax collections and the national strategy of sheltering them during the pandemic years, while local governments registered a surplus, supported by relatively flat spending. Looking ahead, demographic change, climate-related spending, defence requirements, and external shocks are expected to add further strain. In this context, fiscal sustainability will depend on rebuilding consensus, strengthening institutions, and adapting Spain's budgetary framework to emerging risks and long-term demands.

A closer look at the composition of tax revenues helps explain the underlying fiscal trends. The bulk of tax revenue in Spain comes, in descending order, from personal income tax (PIT), value added tax (VAT), corporate income tax (CIT) and excise duties. Revenue from these four taxes increased by 8.1%, or €21.17 billion, in 2024. As a result, their share of GDP increased from 17.4% to 17.7%. Around four out of every 10 euros of that increase corresponded to PIT, 3 to VAT, 1.8 euros to CIT and 0.6 euros to excise duties. As in prior years, PIT was that key source of growth in tax receipts. In 2024, the indexed average real PIT burden borne by Spanish households was well above the value of 100 in 2008, at 114.4. In contrast, indexed average net income stood at 95.7 in 2024. This means that Spanish households' take-home pay was lower in 2024 than it was in 2008. In other words, in real terms, they paid more PIT than in 2008. The failure to index PIT to inflation since the pandemic explains a substantial part of the divergence between the net income and PIT indices in 2024.

Following on the sovereign-bank discussion, we look at recent financial sector performance. The Spanish and European banks have long traded at lower valuations than their U.S. peers, trading at significant discounts to book value. The fact that they traded at price-to-book ratios of less than 1x for 2022, 2023 and much of 2024 was hard to explain in light of the fact that the Spanish and European banks were reporting returns on equity (ROE) clearly above their cost of capital, as estimated by the supervisors, the entities themselves and market analysts. Possible explanations for this anomaly included a higher cost of capital than estimated by the sector itself or doubts about the sustainability of the ROE levels reported in 2022 and 2023. This situation has reversed since the end of 2024, with most of the Spanish and European banks currently trading above book value. Improved margins have supported a strong recovery in valuations, but structural and regulatory differences continue to explain the persistent valuation gap etween European and U.S. banks. That said, margin gains have been priced in, and future margin stability is now expected, making sustaining fundamentals the key challenge going forward amid an increasingly uncertain global geopolitical environment.

Finally, we transition to the corporate landscape, exploring how macro-fiscal trends are influencing strategic investment decisions. Europe's long-standing investment gap relative to the U.S. has been especially pronounced in the defence sector, where fragmented demand, limited interoperability, and dependence on foreign technology have constrained competitiveness. Recent geopolitical developments and the ReArm Europe initiative have shifted the focus toward scaling and consolidating defence capabilities, supported by policy incentives and multilateral coordination. Past consolidation trends in the U.S. and Europe reveal a growing role for cross-border transactions, alliances, and dual-use technologies in today's defence M&A environment. Despite global M&A activity weakening in 2025, the defence sector has remained resilient, with transaction volumes rising in Europe and supported by investor interest, margin expansion, and limited sensitivity to interest rates. While structural and regulatory barriers persist, the sector's strong fundamentals and strategic relevance are expected to sustain momentum in consolidation and investment going forward.