

Letter from the Editors

As the world economy continues to navigate the complexities of 2025, economic fragmentation and geopolitical tensions have become defining features of the global landscape. The return of Donald Trump to the U.S. presidency has intensified protectionist sentiments, deepening rifts between the United States and Europe at a time when economic resilience and strategic cohesion are more critical than ever. Amid this decoupling, the U.S. continues to demonstrate robust growth, albeit tempered by persistent inflation, while Europe struggles to regain economic momentum despite aggressive monetary stimulus. The resulting divergence in monetary policies between the Federal Reserve and the European Central Bank is amplifying financial instability and currency volatility, posing serious challenges for policymakers across the eurozone. This broader context of political discord and economic disparity frames the March issue of *Spanish and International Economic and Financial Outlook (SEFO)*, as we explore key issues shaping the economic outlook for Spain and Europe.

Within this context, the March *SEFO* begins with a discussion of ECB-Fed monetary policy divergence, framing the global conditions affecting the eurozone and Spain. The divergence in monetary policy between the Federal Reserve and the European Central Bank is raising concerns about financial stability and growth in a fragmented global economy. While the Fed maintains stable

interest rates amid strong U.S. economic performance, the ECB is continuing its strategy of rate cuts to combat weak eurozone growth. This discrepancy is strengthening the dollar and attracting capital flows to the U.S., although the dollar's appreciation has been inconsistent in recent weeks. Meanwhile, geopolitical fragmentation and protectionism are exacerbating these issues, weakening global policy coordination and generating bond market volatility. The future of European monetary policy will depend heavily on how trade tensions with the U.S., increased European defense spending, and Germany's expansive fiscal package will influence inflation and growth. While additional rate cuts remain an option, there is growing pressure on the ECB to reconsider its strategy for economic reactivation, especially if inflation accelerates due to fiscal expansion or higher imported inflation from a weaker euro. Balancing these factors will be critical to maintaining financial stability and supporting economic growth in the eurozone.

Along these lines, we provide an analysis of the eurozone periphery's economic resilience. Once heavily impacted by the EMU sovereign debt crisis, the economies of southern Europe, or the peripheral countries, have shown significant economic resilience in recent years, growing faster than the bloc's largest economies. While this momentum has been partially driven by post-pandemic recovery and external factors like energy market shifts,

structural improvements –including labour market reforms, banking sector restructuring, and fiscal adjustments– have played a key role in narrowing the gap with core eurozone peers. Foreign investment flows and sovereign risk premiums reflect renewed investor confidence in the periphery, reinforcing the perception that these economies have gained stability. However, sustaining this convergence will depend on continued productivity gains and the ability to withstand global economic uncertainties.

Next, we cover housing market issues and the knowledge economy, illustrating structural challenges and reform opportunities. Spain’s housing market faces mounting pressures, with demand consistently outstripping supply, particularly in major urban areas. In 2022, only one new home was built for every seven new households, exacerbating affordability challenges. While housing policy in the EU varies widely, key initiatives—such as Vienna’s strategic land management, the Netherlands’ social housing financing model, and Ireland’s rental guarantee scheme that integrates private properties into the social housing stock through long-term agreements and tax incentives—offer valuable lessons for Spain. Addressing the country’s housing shortfall requires cutting excessive red tape, improving land-use policies, and fostering public-private partnerships. A coordinated approach across government levels and targeted incentives for affordable housing will be essential to ensuring long-term stability in the Spanish housing market.

Spain’s knowledge economy has experienced mixed progress since 2019, according to the European Innovation Scoreboard (EIS). Notable improvements include increased R&D investment, public-private partnerships and sales derived from product innovation, especially among SMEs, suggesting positive impacts from Spain’s Recovery Plan – the government’s main mechanism for implementation of NGEU funding. However, critical challenges remain, including declining STEM talent, insufficient ICT training across firms, and a weakening focus on

environmental sustainability. Of the Recovery Plan’s almost 80 billion euros, allocations directly linked to the knowledge economy represent just under 12% of the total budget, indicating a need for more targeted support to strengthen Spain’s competitive position in the knowledge economy through enhanced structural reforms, increased investment in digitalization, strengthening of the regulatory environment and prioritizing sustainability within innovation policies.

Moving on to the financial sector, we provide an examination of Spain’s banking sector efficiency, evidencing how the financial sector is adjusting to broader economic trends. Despite driving considerable improvement in margins over the last three years, the rapid increase in interest rates since 2021 has also contributed to rising operating expenses across the Spanish banking sector, prompting banks to prioritize cost efficiency. With little additional upside for margins, the banks now need to focus hard on streamlining their operating expenses. Within this context, an examination of the trends in operating expenses over the past three years based on the financial statements of both significant institutions (SIs) and less significant institutions (LSIs) shows that while LSIs have faced more pronounced cost growth—especially in staff expenses—their efficiency metrics have improved more than those of SIs, reflecting a combination of business expansion, technology investments, and shifts in their cost structures. Despite these gains, both types of institutions now face the challenge of sustaining efficiency in a period of slowing income growth, requiring a focus on productivity, digitalization, and alternative revenue streams.

We then explore fiscal issues, providing an analysis of fiscal drag and tax policy, highlighting challenges for middle-income households. Spain’s tax system has been heavily impacted by inflation, which has increased the tax burden by pushing taxpayers into higher brackets and eroding the real value of allowances and deductions. Spain lacks a systematic indexation mechanism, leading to a “hidden” tax increase that disproportionately

affects middle-income earners. Between 2021 and 2024, this phenomenon raised tax revenue by an estimated €9.7 billion, with middle-income households shouldering the largest share of the additional burden. Indeed, the increase in tax bills was an estimated 311 euros for low-income taxpayers, 458 euros for middle-income taxpayers, and 622 euros for high-income taxpayers, with bracket creep alone increasing middle-income taxpayer bills by a further 225 to 450 euros. While targeted relief measures have been introduced, such as higher deductions for low-income earners, these adjustments are insufficient to address the broader issue. The persistence of fiscal drag poses risks to economic growth and equity, highlighting the need for a transparent and consistent policy approach to prevent unfair increases in the tax burden.

We conclude with a sectoral view at the institutional level of economic activity in Spain, providing a broader perspective on Spain's economic evolution. Spain's institutional sectors have shown divergent growth patterns over the last 25 years, coinciding with the euro's introduction. Non-financial corporations (NFCs) have remained the largest contributors to gross value added (GVA), employment, and investment, despite setbacks from the 2008 financial crisis and the COVID-19 pandemic. By contrast, the household sector has experienced persistent underperformance, with output in 2024 still 20% below its potential had it consistently grown at a rate of 2% per year. Meanwhile, public sector investment has frequently trailed capital consumption, particularly during austerity periods. While recent improvements in gross fixed capital formation (GFCF) have occurred in the public sector, current net capital investment in the NFC sector is less than one-third of its 2000 value. The lagging recovery in the capital formation of NFCs in the post-pandemic era raises concerns about the dynamics of growth in productive capacity of the Spanish corporate sector.