Letter from the Editors

Fiscal sustainability has moved back to the centre of the European economic policy debate. The return of binding fiscal rules comes at a time when governments face rising demands on public resources—from defence and the green and digital transitions to ageing, infrastructure and climate-related risks—while debt levels and financing costs continue to constrain fiscal space. For Spain, these pressures are compounded by a prolonged period of budget roll-overs and expenditure growth that has tested the adjustment path agreed under the new EU framework.

Against this backdrop, the September issue of *Spanish and International Economic & Financial Outlook* (*SEFO*) examines the choices confronting Spain and Europe as they seek to reconcile new spending priorities with fiscal sustainability. The issue begins with Spain's economic and budgetary outlook, before examining the country's fiscal consolidation and expenditure trajectory. It then broadens to the European fiscal framework and the debate over the appropriate scale and design of common fiscal capacity, before turning to the corporate and financial-sector challenges shaping the wider economic environment.

We begin with an assessment of Spain's fiscal policy after three years of budget roll-overs. The Spanish Congress has not approved a new budget since 2023, which means that the same accounts have been extended in nominal terms for the past three years. However, allocation adjustments, supplementary appropriations, and credit injections have made it possible to increase actual expenditure far above what the rollover implies. Central government and Social Security spending now run 14% and 20% above their initial budgeted levels, respectively, a gap worth 78 billion euros. Moreover, regional governments, unaffected by the freeze, have kept expanding their own budgets, compounding the divergence between formal budgetary limits and actual fiscal behaviour. Revenue has grown even faster than spending, up close to 24% across all levels of government, driven by economic growth and the decision not to index personal income tax schedules on inflation. Yet, spending increases have outpaced this windfall enough to leave fiscal policy broadly expansionary. Adjustments have also skewed budgetary priorities, favouring defence, industry, and economic affairs, while education and housing lag behind despite mounting social pressure. The result is a fiscal framework that avoids the contractionary drag typically associated with budget freezes but sacrifices the coherence and targeting a properly negotiated budget would provide.

The discussion then turns to Spain's fiscal consolidation under the new EU

framework, examining whether the adjustment is keeping pace with the country's economic momentum. Net primary expenditure growth reached the upper limit permitted under the new EU fiscal framework in 2025, after taking into account the additional flexibility provided by the national escape clause for higher defence spending. Recalculating the fiscal adjustment using the updated potential growth and GDP deflator estimates contained in Spain's Annual Progress Report suggests that the structural primary deficit should have been reduced by around 0.72% of GDP, more than twice the 0.3% adjustment actually achieved. This discrepancy highlights an asymmetry in the new fiscal framework: while adverse economic developments are accommodated through stress scenarios and escape clauses, stronger-than-expected economic performance does not result in a corresponding tightening of the expenditure path. Although the government envisages a larger structural adjustment in 2026, projections from the Independent Authority for Fiscal Responsibility (AIReF) and the European Commission point to significant implementation challenges, particularly given spending pressures at the regional, local and Social Security levels. These challenges are compounded by the absence of an approved 2026 budget, a draft budgetary plan submitted to Brussels or binding fiscal discipline agreements with subnational governments. Against this backdrop, Spain's current economic momentum provides an opportunity to accelerate structural fiscal consolidation and build greater fiscal space ahead of a future slowdown and mounting expenditure pressures.

We then look more closely at Spain's expenditure overshoot and the fiscal adjustment pressures building for 2027. In 2025, Spain cut its public deficit to 2.4% and brought debt down to 100.7% of GDP, continuing compliance with its European targets. Underneath those headline numbers, net primary expenditure, the control variable under the new EU fiscal framework, has grown faster than promised in every year but 2024, eroding the buffer Spain had built through strong post-pandemic growth. A defence spending escape clause and a pending energy-crisis exemption keep 2026 growth within bounds, but both are accounting adjustments that leave the underlying spending trajectory unchanged, and AIReF projects Spain breaching its permitted deviation from 2027 onward. Compounding the problem, the government has not passed a budget since 2023, governing instead through budgetary modifications that have grown to an unusually large share of total state spending, with the draft 2027 budget setting a record spending ceiling. As expenditure still outruns the fiscal plan's pathway, the 2027 adjustment is expected to fall on the revenue side, driven overwhelmingly by personal income tax and social security contributions. That reliance on labour taxation runs against the European Commission's repeated recommendation that Spain shift its tax base toward consumption, property and environmental levies.

From Spain, the issue broadens to the European fiscal framework. Within this context, we assess the implications of the new rules and the additional flexibility granted for higher defence spending. Euro area countries entered the COVID-19 crisis with markedly more fiscal restraint than the United States or United Kingdom. Since 2022, the bloc's average deficit has stabilized near 3% of GDP even as deficits diverge sharply while the gulf in debt levels between Germany and the region's more indebted members remains. Against this backdrop, the 2025 decision to accommodate rearmament through the National Escape Clause allows countries to raise spending by up to 1.5% of GDP a year for four years without breaching their agreed adjustment paths. A synthesis of the official debt sustainability framework demonstrates that full use of this flexibility would raise debt ratios only marginally and require a correspondingly small additional improvement in primary balances once the adjustment period ends in 2031. The greater vulnerability lies in the

interest-rate projections set in 2024 that remain the baseline for the Commission's debt sustainability analysis; but that have already been overtaken by market developments, with French borrowing costs now close to two percentage points higher. Because the rules keep this baseline fixed unless a government formally requests a recalculation, the gap between assumed and actual financing costs is likely to persist rather than correct itself. The fiscal cost of accommodating defence spending appears manageable, but the framework's credibility will depend on how it is enforced once interest-rate assumptions catch up with reality.

This *SEFO* also includes a longer-term reflection on the creation of a European treasury, written from the perspective of greater fiscal integration in the EU—something that, under current circumstances, appears distant for both political reasons and because of the weak fiscal position of some EU countries.

The issue then turns to the corporate sector, examining the characteristics of Spain's fastest-growing medium-sized firms. Medium-sized enterprises occupy a distinctive position in Spain's corporate landscape, combining sufficient scale to shape economic activity with the flexibility to keep adapting and growing. Among this group, a subset of 100 firms that already qualified as medium-sized in 2008 went on to record the highest cumulative growth rates in the sample through 2024. These firms expanded without diluting their productivity: their revenue per employee grew at an annual rate of 10.7% between 2019 and 2024, roughly twice the pace of the broader sample since 2008. Investment kept pace with that growth, and their return on assets reached 8.5% in 2024, the highest level in the series. Labour costs per employee rose too, but more slowly than revenue, showing that their competitiveness has not come from holding down wages. They also grew without leaning more heavily on debt, financing their expansion mainly through funds generated internally. These patterns point to investment, productivity and financial prudence as the traits that distinguish firms capable of sustained growth from those whose expansion proves temporary.

Attention then shifts to the financial sector, where we analyse the growing importance of cyber risk for European banks and the ways in which artificial intelligence is changing both the threat landscape and banks' defences. European banks absorb the majority of cyberattacks recorded across the region's financial system, accounting for 56.5% of incidents and making them the sector's principal target. Their exposure stems from managing extensive digital infrastructure and services, whose disruption is immediately visible and costly. The entry into force of DORA (Digital Operational Resilience Act) has tightened incident reporting, stress testing and oversight of external technology providers, formalizing obligations that previously varied widely across institutions. Artificial intelligence is reshaping this landscape from the defensive side, enabling faster anomaly detection, alert triage and vulnerability remediation, as demonstrated by initiatives such as Anthropic's Project Glasswing. However, the same capabilities lower the barrier to sophisticated attacks, with 82.4% of banks identifying AI-enabled social engineering, deepfakes and credential theft as their foremost concern. Durable resilience will depend less on any single control than on governance frameworks that treat AI simultaneously as a defensive asset and a source of concentrated, supplier-linked risk.

Finally, we close this issue with an examination of the European Banking Authority's revised SREP Guidelines and the new supervisory risks that banks will need to address from 2027. The European Banking Authority's (EBA's) revised SREP Guidelines consolidate previously dispersed provisions into a single supervisory framework and incorporate developments in the EU banking regulatory landscape since the last major update. The review retains the core SREP

architecture while reorganising the treatment of risks, institutions and supervisory measures to improve consistency and flexibility. Among the most significant changes are the integration of ESG factors, emerging risks and operational resilience, alongside new provisions covering third-country branches and subsidiaries, the output floor limiting reductions in capital requirements from banks' internal models, the Digital Operational Resilience Act (DORA) and credit spread risk in the banking book. The Guidelines also introduce a more flexible escalation framework for supervisory measures and expand proportionality for Category 4 institutions—small and non-complex banks with lower-risk profiles—including the possibility of extending the minimum cycle for a full SREP assessment from three to five years for qualifying institutions. For banks, the revised framework does not change their underlying regulatory obligations but will affect how those obligations are assessed and translated into supervisory requirements. With the Guidelines due to apply from 1 January 2027, institutions should prepare in advance for greater supervisory scrutiny of next-generation risks and ensure that the relevant documentation, metrics and risk management frameworks are in place.