The strength of the Spanish economy is being challenged by an unstable geopolitical backdrop

Macro perspectives for Spain and the finances of its Regional Governments

2Q2025 **EXECUTIVE SUMMARY**

BFF INSIGHTS

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Executive Summary

Spain 2025-2026: macro scenario

The advance estimate of the Quarterly National Accounts (CNTR) for the first quarter of 2025 (0.6% QoQ) shows a slowdown mainly due to the sluggishness of consumption and a lower than estimated boost in investment; this figure represents a slowdown of one-tenth compared to the progress observed in the previous quarter.

In year-on-year terms, GDP growth moderated by 0.5 pp, reaching 2.8%. According to the INE's estimates, domestic demand contributed 0.4 pp to quarterly GDP growth, lower than expected, while on the other hand, external demand performed more favourably than expected, contributing 0.2 pp to quarterly growth, compared to the expectation of a slightly negative contribution. YoY, domestic demand added 3.2 pp to growth, while the net external balance subtracted 0.4 pp.

The Spanish economy has showed sustained growth in 2024. Real GDP growth was 3.2% in 2024, according to the estimates from the National Institute of Statistics (INE). This growth was higher than the one observed the previous year (2.7%), exceeding the forecasts of the Bank of Spain and the Government and well above the average for the euro area, excluding Spain and Ireland, which was 0.5% (0.9% if both countries are included). This evolution was supported by the performance of the main aggregates of demand and, in particular, the growth of private consumption, driven by the increase in population and employment, and public consumption, whose contribution to growth exceeded 0.8 points. Added to this is the expansion of non-residential investment and investment in transport material, which, with some volatility, exceeded the sluggishness of recent years, as well as the dynamism of services exports.

The transition towards a growth model based on Spanish household spending and to a lower extent on business investment is consolidated. Therefore, domestic demand contributed 2.8 percentage points to this growth, while the contribution of foreign demand was only 0.35 pp. Foreign demand contributed positively to GDP growth in 2024, albeit at a lower rate than in 2023.

The different indicators of the labour market continue to point to a greater capacity for growth of the Spanish economy. Job creation is widespread by nationality and age group, except among the Spanish population aged 35 to 44. Along the same lines, immigration continues to drive the growth of the labour force despite the contraction of its activity rate.

Compared to the euro area, the higher growth is explained by private consumption and, to a lesser extent, investment and net exports. The contribution of public consumption to growth was high and of similar magnitude in both cases. **The Spanish economy is on the verge of reaching the level of GDP that would have been reached if the pre-pandemic growth trend had continued.** This represents a differential behavior with respect to the one occurring in the rest of the euro area, where the recent stagnation is opening a gap. It also implies a more positive recovery than that observed after the global financial crisis of 2008 or in the years after the sovereign debt crisis in Europe. These examples put into context the recent good evolution of economic activity in Spain.

Our macroeconomic scenario for Spain continues to place the growth of the Spanish economy in 2025 at 2.5% (Figure 1), **unchanged from our last report in February,** while nominal GDP growth, particularly relevant for fiscal forecasts, stands at 4.8%, compared to 6.2% in the previous year. However, the lower-than-expected growth in the advance figures published by the INE for the first quarter of 2025, 0.6% QoQ, introduces an additional downward bias of approximately one tenth to our growth forecast for 2025 as a whole.

FIGURE 1 Macroeconomic picture for 2025

			AIReF		Government
		Apr-2025	Jan-2025	Oct-24	Jan-2025
Year on year variation rates	2024	2025	2025	2025	2025
Private National Final Consumption Expenditure	2.9	2.9	2.7	2.3	2.8
Final Consumption Expenditure of the Public Administrations	4.1	2.3	1.9	2.1	2.6
Gross Fixed Capital Formation	3.0	3.5	2.9	2.4	4.5
GFCF Capital goods and cultivated assets	2.9	4.2	1.7	1.8	-
GFCR construction and intellectual property	3.0	3.3	3.4	2.6	-
National Demand*	2.8	2.8	2.5	2.2	3.0
Exports of good and services	3.1	2.7	2.7	3.4	2.3
Imports of good and services	2.4	3.7	2.9	3.5	3.5
Foreign Balance*	0.3	-0.2	0.0	0.1	-0.3
Gross Domestic Product	3.2	2.5	2.5	2.3	2.6
National Gross Domestic Product	6.2	4.8	5.0	4.8	5.4
GDP deflator	3.0	2.2	2.4	2.4	2.6
CPI	2.8	2.5	2.1	2.1	-
Full-time equivalent employment	2.4	2.3	2.1	2.2	2.5
Hours actually worked	1.9	2.0	1.9	-	2.1
Unit Labor Cost	4	3.1	2.7	2.5	-
Productivity per full-time employee**	0.7	0.2	0.4	0.1	0.1
Salary earnings**	4.7	3.3	3.1	2.6	3.7
Unemployment rate (% active population)	11.3	10.4	10.8	10.9	10.4
Household savings rate and ISFLISH (% Gross Disponsable Income)	13.6	11.9	12.0	11.8	-

Source: INE, Ministry of Economy, Trade and Enterprise and AIReF
** contribution to GDP growth*
*** AIReF expressed in terms of full-time equivalent employment and in the Government in terms of people*

The recent revision of the **International Monetary Fund's** (IMF) **growth forecasts shows that Spain is one of the few advanced economies to escape a downward revision,** with an upward revision of two tenths of a percentage point compared to the GDP growth forecast for 2025 (to 2.5%, triple the growth forecast for the Eurozone of 0.8%), while the GDP growth figure forecast for 2026 remains at 1.8%.

The absence of revisions is supported by the strength of domestic demand and, in particular, private consumption projected for 2025, supported by employment growth, the high savings rates achieved - not seen since the outbreak of the global financial crisis -, the strength of economic activity at the start of the year and the improvement in financing conditions. The scenario also incorporates a recovery in business investment, which in the current context of uncertainty is subject to downside risks.

On the other hand, **the scenario does not yet incorporate the impact of the trade war unleashed by the United States, the outcome of which is difficult to foresee at the present time.** Nor do they incorporate the negative effects associated with the extraordinary increase in uncertainty about trade policy, which AIReF estimates **could subtract up to 0.5 percentage points from the growth of the Spanish economy as early as 2025 if it is not corrected quickly.** Uncertainty indicators have reached levels not seen since the pandemic.

The **Bank of Spain** has simulated the impact of a 10% increase in US tariffs on all its imports of goods (without increasing uncertainty), using both multi-regional and dynamic macroeconomic input-output models. Overall, this increase is estimated to have a negative impact on global GDP of about 0.3 percentage points. In the case of the euro area, the effect would be a decrease of 0.4 percentage points, while in Spain the impact would be approximately half, given the lower exposure of its exports of goods to the US economy. However, if the risk of a trade war materializes and all countries simultaneously increase tariffs by 10%, the global GDP would shrink by 4 percentage points.

The composition of the growth forecast in our baseline scenario reflects robust domestic demand, driven by private consumption and investment, and a negative contribution from the external sector. In particular, private consumption is expected to increase in the same way as in 2024 (2.9%), which will make it the main support for growth. The growth in private consumption is supported by the increase in real disposable income associated with the good performance of employment - supported by immigration - and by the high savings rates accumulated by Spanish households. Likewise, the cost of credit has decreased in recent months, boosting household demand for financing.

Inflation, in year-on-year terms, stood at 2.2% in April 2025, eight tenths less than in February, while core inflation increased four tenths to 2.4%. The downward resistance in inflation that has been seen since the end of 2024 as a result of higher energy prices appears to have ended and cheaper commodity prices in futures markets could contribute to a moderation in inflation in the coming months.

Risks around the macroeconomic scenario.

The downside risks around this growth scenario are high. The global economy showed remarkable resilience during the severe shocks of the past four years and still bears significant scars. Now it is being tested once again, especially in emerging market and developing economies with more limited room for manoeuvre.

Uncertainty has risen to such heights that it poses downside risks to global growth. The likelihood of a recession in the United States is rising and the increase in tariffs has been so high that inflation expectations have risen markedly in this economy. The expulsion of immigrants puts greater strain on their labour market given the shortage of labour, which could lead to wage increases. In the rest of the countries, the increase in uncertainty is an obstacle to investment and exports. In this context, institutions are revising global growth downwards.

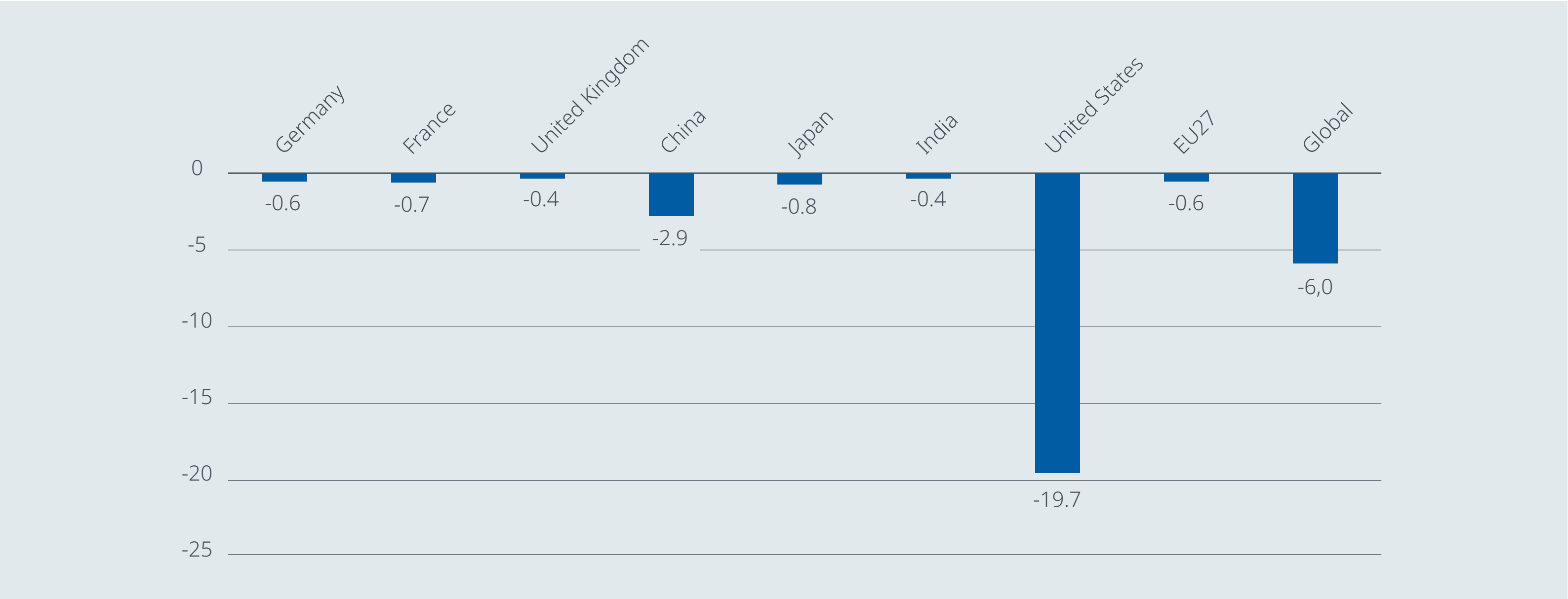
Financial conditions could tighten further, perhaps abruptly, if markets react negatively to the declining growth outlook and increased uncertainty. While banks remain well capitalized overall, and market movements have been relatively orderly so far, they can be tested in the event of a full-blown risk-off episode. However, there is also a **positive scenario:** if countries move away from their current tariff position and coordinate to provide clarity and stability in trade policy, the outlook could improve immediately.

On April 2, the U.S. moved to apply a universal non-negotiable additional tariff of 10% on almost all imports (with the exception of copper, semiconductors, wood, pharmaceuticals, critical raw materials, and energy and energy products), maintaining 25% for cars and components, steel, and aluminium. In addition, the so-called reciprocal tariffs were established (provisionally suspended since April 9 for a period of 90 days with the exception of China) among which the application of an additional tariff of 34% on Chinese products stands out, which accumulating the increases of recent years would face a 70% tariff on sales to the United States. The previous figure has subsequently been increased to reach a figure of 145% except for the semiconductor and electronics sector, pending the definition of sectoral tariffs on these, while China for its part would now apply a 125% tariff on imports of goods from the United States and a 20% tariff on imports from the EU.

The average effective tariff applied to U.S. imports would go from 2.4% to between 16.5% and 22.5%, highs not seen since the Great Recession in 1930. The Trump administration has left open the possibility of renegotiating these tariff increases, but has also announced new measures for countries that retaliate.

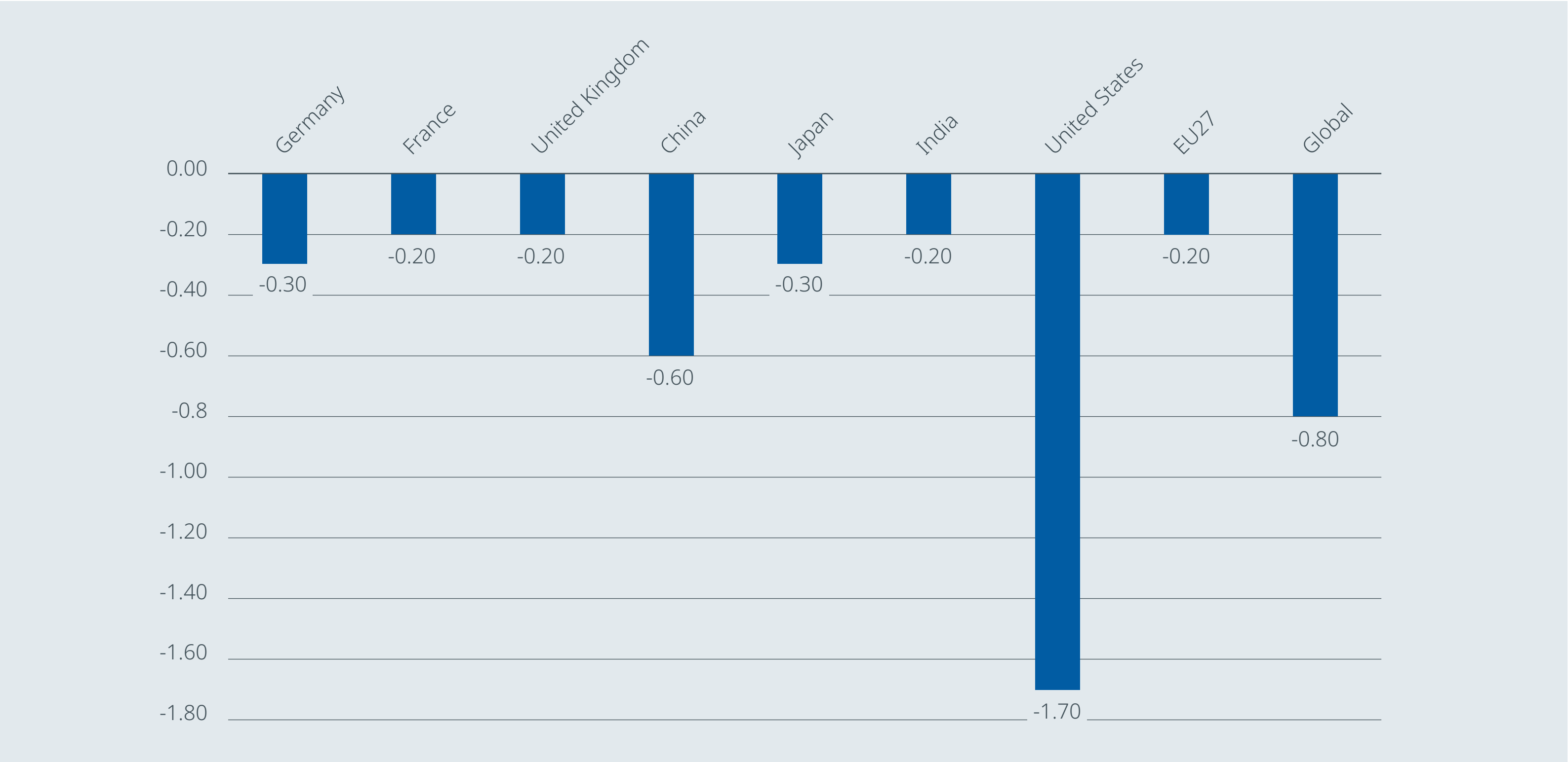
The common denominator, however, is that tariffs are a negative supply shock (Figures 2 and 3) for the economy that imposes them, as resources are reallocated towards the production of non-competitive goods, with the consequent loss of aggregate productivity, lower activity, and higher costs and prices of production.

FIGURE 2 Short-term impact of tariffs on exports (%)



Source: IfW (April 4, 2025)

FIGURE 3 Short-term impact of tariffs on real output (%)



Source: IfW (April 4, 2025)

On the one hand, **the United States has left open the possibility of negotiating reciprocal tariffs and has decreed a temporary suspension of their application for 90 days from April 9 to open a period of negotiation with the affected countries.** On the other hand, the increase in tariffs has been so intense and widespread that the risk of a trade war is high.

There is also uncertainty about the impact of the tariffs. On this occasion, the trade diversion effects may be significant. In the previous China-US protectionist wave of 2018-2019, China managed to channel part of its trade with the US through third countries in Southeast Asia, containing the fall in its sales in the North American market. On this occasion, the imposition of a universal tariff of 10% and the high tariffs that are generally applied to the Asian region, raise the odds that China will divert its trade to EU countries. European countries could also occupy the space left by American products in Southeast Asia. In this context, the impact of the US tariffs on Europe and Asia could be less than that derived from direct and indirect exposure.

The IMF also expects the rapid escalation of trade tensions and extremely high levels of political uncertainty to have a significant impact on global economic activity. According to the IMF's baseline forecast that incorporates information as of April 4, global growth is projected to fall to 2.8% in 2025 and 3% in 2026, compared to 3.3% for both years in the January 2025 WEO update, which corresponds to a cumulative downgrade of 0.8 percentage points. and well below the historical average (2000–19) of 3.7%. In the baseline forecast, growth in advanced economies is projected to be 1.4 percent in 2025.

In European economies, two factors could cushion the negative impact of the trade war, although its effects may be postponed until 2026: the increase in defence spending, the impact of which is difficult to gauge at the time of writing, and Germany's expansionary fiscal policy.

In the geopolitical sphere, the announcements and decisions of the new US administration have led the EU to prioritise defence and security spending through the ReArm Europe Plan/ Readiness 2030 programme. In response to the deteriorating geopolitical environment and the need to strengthen the European Union's strategic autonomy, the European Commission presented the ReArm Europe Plan/Readiness 2030 in March 2025, which aims to mobilise up to EUR800 billion in defence spending and investment over the next decade.

In Germany, there has been a historic shift in fiscal policy, which is reflected in an ambitious investment programme accompanied by a relaxation of the debt brake. Germany has launched a comprehensive fiscal stimulus package that will take effect immediately after being ratified by the Bundesrat. The plan contemplates the creation of a EUR500 billion infrastructure investment vehicle over ten years, focused on strategic sectors such as transport, energy, digitalisation and education. This programme is combined with a relaxation of the fiscal discipline framework by amending the constitutional debt brake ("Schuldenbremse").

In the area of financial conditions, the European Central Bank continues with the progressive monetary easing, as the stabilization of inflation allows it to have a monetary policy more focused on cushioning the consequences of the current geopolitical uncertainty, while the Federal Reserve maintained its interest rates. Headline and core inflation remained relatively stable since the end of 2024 due to the downward resistance of services and some rebound in energy and food prices. Even so, the ECB expects price increases to converge to 2% at the beginning of 2026 in a context of weak economic activity in some member states, which has allowed it to continue advancing in the monetary normalisation process.

The risks to price developments associated with tariffs are mostly to the downside. The increase in tariffs by the United States does not in principle have a direct impact on consumer prices in Spain or other European countries. If anything, slower global growth and the need to seek new markets by the most affected Southeast Asian countries could have a deflationary impact. However, if retaliatory measures are adopted by the EU, this negative impact could be mitigated. Finally, a potential breakdown of value chains can have effects on business costs that are difficult to foresee.

Some institutions had already begun to incorporate into their macroeconomic tables a negative impact associated with uncertainty about trade policies. Among the most recent analyses incorporating the tariffs announced on 2 April, the Kiel Institute for the World Economy (IfW) stands out, estimating that as a result of the tariff measures adopted up to 4 April, the EU's real GDP, in the absence of EU retaliation, would contract by 0.2% in the first year and by 1.7% in the US.

The agreement for the State to absorb part of the debt of the regional governments should be accompanied by a reform of regional financing, of the conditions of access and exit from the Regional Liquidity Fund and be dependent on compliance with reforms to ensure the sustainability of the regional debt. Without eliminating the structural imbalance shown by the finances of some autonomous communities, the underlying problem will persist. In addition, the absorption by the State of part of the indebtedness of regional governments, without clear conditions or a reform of the financing mechanism itself, could encourage irresponsible fiscal behaviour in the future.

Spain and the impact of Trump's tariffs

Foreign trade is a fundamental engine for the growth of the Spanish economy, an economy with a high and growing degree of openness. The weight of real exports in GDP has gone from 26% in 2008 to 34.9% in 2024. That is why the impact of a trade war can be particularly intense.

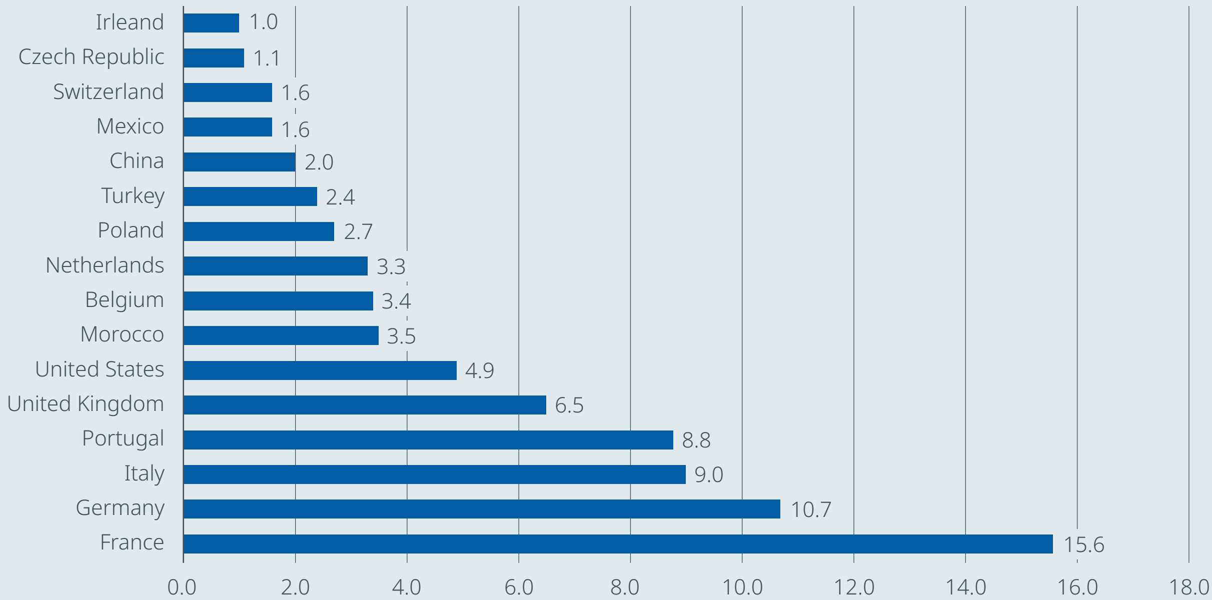
There are many channels through which tariffs and uncertainty about trade policy can affect the Spanish economy. The announcement of an increase in tariffs of a universal nature, such as the one implemented by the Trump administration, may lead the affected country to increase its imports to anticipate future price increases. But most importantly, it represents a supply shock for the country that imposes tariffs that entails negative effects on growth and an increase in inflation. For the country facing new tariffs, there is a decrease in exports whose amount will depend on: a) the price increase associated with the new tariffs, b) the elasticity of demand for the products affected with respect to the increase in prices, and c(the importance of exports to the U.S. in total exports.

The ultimate impact on this economy will depend on its ability to diversify its sales into new markets. In a context where a large part of trade is carried out by large multinational companies that have relocated the different phases of production of goods according to the comparative advantages of each country, the recomposition of value chains is difficult to anticipate.

The reaction of monetary and fiscal policy is also a relevant factor. On the other hand, the Trump administration's way of acting has brought uncertainty about trade policy to levels never seen before, creating an unsuitable breeding ground for new investment projects in the most exposed companies.

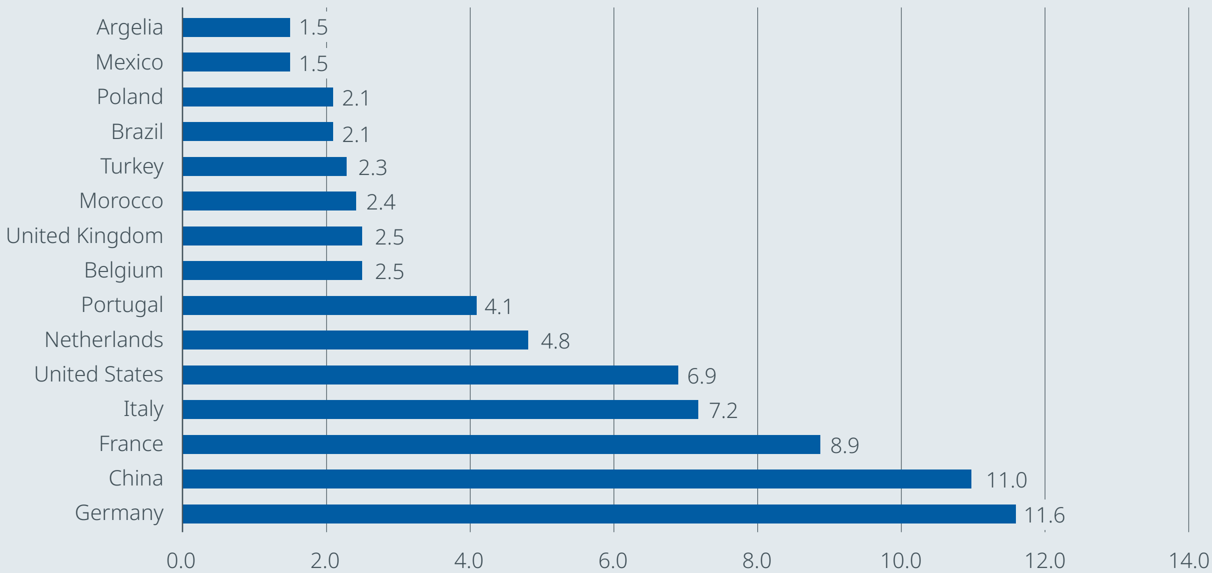
In the case of Spain, **direct and indirect exposure to the US market is relatively low** (Figures 4 and 5). Direct exposure is measured by the weight of each sector in exports and the change in the effective tariff. The indirect one is due to the exposure of trading partners to the United States, which depends both on the proportion of Spanish inputs that incorporate the exports of its trading partners to the United States, and through the potential effects on growth associated with tariffs.

FIGURE 4 Main destinations for Spanish exports in 2024 (weight in the total)



Source: Datacomex, 2025

FIGURE 5 Origin by country of Spanish imports in 2024 (% GDP)



Source: Datacomex, 2025

The Government has approved financial measures in response to the tariff crisis for a total amount of EUR 7,220 million, as part of the Trade Response and Relaunch Plan, which is expected to reach an amount of 14,100 million euros. Royal Decree-Law 4/2025, of 8 April, establishes measures that are articulated around three axes: promotion of productive investment, provision of liquidity for companies and promotion of export activity.

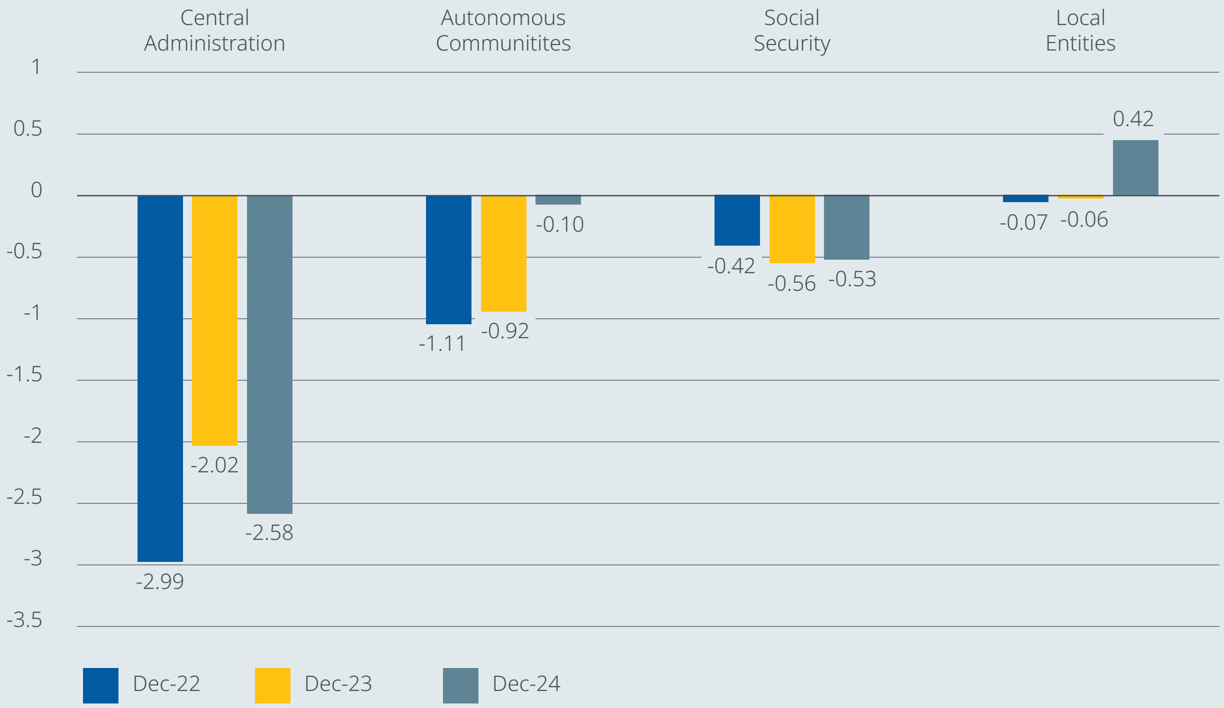
To this end, a new line of guarantees worth 5,000 million euros is established to guarantee the financing of affected companies. The Fund for the Internationalisation of Business (FIEM) is also strengthened, with an increase in its budget of an additional 200 million, to 700 million euros, and an additional 20 million euros are included to finance non-reimbursable operations. Likewise, 2,000 million euros are allocated from CESCE, the Spanish Export Credit Insurance Company, for coverage for international projects affected by the new tariffs. Finally, the Reciprocal Interest Adjustment Agreement (CARI) is amended to maintain protection against interest rate volatility and facilitate access to bank financing. **All of these are financial measures, so that, except for the estimated impact of defaults by the guarantee line, they would have no impact on the deficit.**

Spain: fiscal scenario in 2025

We maintain **the deficit forecast in 2025 for the general government as a whole at 2.7%, excluding the impact of the DANA[1],** therefore a reduction of five tenths compared to the 2024 figure (Figure 6). In 2024 the public deficit was reduced by three tenths (seven tenths if we exclude the impact of the DANA). Despite an increase in the deficit due to non-recurring operations and the cost of the DANA measures by four tenths of a percentage point for each and an additional tenth for the other revenue measures, the evolution of the rest of revenues and expenditure and the withdrawal of the measures to alleviate the price and energy crisis pushed the deficit down by 1.2 points. ending the year at 3.2% of GDP.

1 The measures approved to mitigate the effects of the DANA will have an impact on national accounts of 0.7% of GDP in the general government as a whole, which will be distributed mainly between 2024 and 2025. The Public Administrations have approved a set of measures to respond to the damage caused by the DANA, between October 28 and November 4, 2024. The Government approved measures for an announced amount of 20,379 million through three royal decree laws: Royal Decree-Law 6/2024, of 5 November; Royal Decree-Law 7/2024, of 11 November; and Royal Decree-Law 8/2024, of 28 November. Overall, the measures to mitigate the effects of the DANA have had an impact of 0.4% of GDP in 2024 and AIReF estimates an impact of 0.3% of GDP in 2025.

FIGURE 6 **Evolution of the deficit by Public Administration (% GDP, 2022-2024)**



Source: Ministry of Finance, 2025

In 2025, a reduction in the deficit of five tenths is therefore expected, as we have mentioned above. In this year, the entry into force of various revenue measures, the reduction in the cost of non-recurring operations, the almost complete withdrawal of the measures due to the energy and price crisis and a slight reduction in the cost of the measures to alleviate the effects of the DANA will push the deficit down by seven tenths of a percentage point. On the other hand, the evolution of other income and expenditure will increase the deficit by two tenths, ending the year with a deficit of 2.7%.

Finally, we recall that the European Commission has recently communicated the possibility to Member States of requesting the activation of the national escape clause, so that the increase in defence spending of up to 1.5% of GDP compared to the level recorded in 2021 is not considered for the purposes of the European spending rule. In addition, the Government has recently announced the possible approval of aid aimed at protecting the most vulnerable economic sectors in the event of a possible tariff war.

Autonomous Communities and Local Entities: Tax situation

The deficit of the Autonomous Communities will increase in 2025 to 0.5% of GDP, 0.4% not including the impact of the DANA (the regional deficit in 2024 would have stood at 0.2% of GDP, 0.1% without the DANA measures). This represents an improvement in the forecast of one tenth since our previous report, which is mainly explained by the partial transfer to 2025 of the better-than-expected fiscal performance in 2024. The deterioration of the deficit in 2025 is mainly explained by the decline in revenue from the liquidation of the regional financing system which, after the extraordinary increase in 2024, recovers its usual levels. This means that, although payments on account grew by 9.5%, the income of the regional financing system grew by only 2.5%. On the other hand, expenditure excluding RTRP will grow by 4.8%.

The Autonomous Communities closed 2024 with a deficit of 0.1%, while local entities once again recorded a strong surplus

The Autonomous Communities closed 2024 with a deficit of one tenth, which represents a budgetary consolidation of one point of GDP in two years (2022 to 2024). The exceptional increase in the revenues of the Regional Financing System (SFA) this year of 20,493 million euros, together with a very positive evolution of payments on account (8.3% YoY), have raised the level of the System's total resources to 14.5% YoY. Even so, the situation between the different autonomous communities has been very heterogeneous, with eleven communities maintaining a surplus and only two registering a slight deterioration over the end of 2023.

FIGURE 7 **Budget deficit (-)/surplus (+) of the Spanish Autonomous Communities**

	2023		2024		Variation		
Autonomous Communities	**Euro Millions**	**GDP %**	**Euro Millions**	**GDP %**	**Euro Millions**	**%**	**p.p. GDP**
Andalusia	-2,149	-1.07	1,581	0.74	3,730	-173.6	1.81
Aragon	-326	-0.70	131	0.36	457	-140.2	0.96
Asturias	85	0.30	258	0.86	173	203.5	0.56
Balearic Islands	140	0.33	114	0.26	-26	-18.6	-0.07
Canary Islands	194	0.36	537	0.93	343	176.8	0.57
Cantabria	11	0.07	135	0.76	124	1,127.3	0.69
Castile La Mancha	-591	-1.10	76	0.13	667	-112.9	1.23
Castile Leon	-510	-0.72	23	0.03	533	-104.5	0.75
Catalonia	-3,875	-1.37	-1,227	-0.41	2,648	-68.3	0.96
Extremadura	-273	-1.10	420	1.59	693	-253.8	2.69
Galicia	-88	-0.11	202	0.25	290	-329.5	0.36
Madrid	-2,176	-0.74	-585	-0.19	1,591	-73.1	0.55
Murcia	-908	-2.25	-478	-1.11	430	-47.4	1.14
Navarra	235	0.94	259	0.97	24	10.2	0.03
Rioja	-68	-0.64	-4	-0.04	64	-94.1	0.60
Valencia	-3,321	-2.38	-2,782	-1.88	539	-16.2	0.50
Basque Country	-106	-0.12	-585	-0.63	-479	451.9	-0.51
Total CCAA	-13,726	-0.92	-1,925	-0.12	11,801	-86.0	0.80

Source: Ministry of Finance

Local Corporations as a whole once again register a large surplus balance amounting to more than four tenths of GDP (6,642 million euros), after the slight deficit in 2023. This result is due to the combination of a growth in non-financial income of 7.8% YoY with a modest increase in Non-Financial Expenditure, 0.6% YoY, which is well below the target of the expenditure rule (2.6% YoY). The activation of fiscal rules after the pandemic has once again highlighted the high degree of compliance with the objectives by this subsector.

We estimate that eleven Autonomous Communities will close with a surplus, balance or deficits close to balance in 2025. Compared to the previous year, however, in all the regions of the common system, a deterioration in the balance is expected, conditioned by a trend in employment accompanied by a moderate growth in the resources of the financing system and those from European funds outside the RTRP.

Challenges for the sustainability of public finances

Our baseline scenario envisages a further reduction in the debt-to-GDP ratio of one point by 2025, placing it at 100.8% compared to 101.8% at the end of 2024 (Figure 8), where the ratio fell by 3.3 points in the year, with an increase of 4.2 points compared to the pre-pandemic level; our forecast would be in line with the projections presented by the Government in the PFEMP, as well as by the European Commission and the IMF, which estimate decreases of 1.1 points, 1 point and 1.6 points respectively. Although the public deficit will continue to contribute to the increase in debt, its impact will be more moderate than in previous years. At the same time, the contribution of economic growth to the reduction in the debt ratio will be lower this year, in addition to a foreseeable increase in the stock-flow adjustment derived from European loans. All this will result in a slowdown in the rate of debt reduction, which will go from a fall of 3.3 points to just one point.

FIGURE 8 Evolution of Spain's debt-to-GDP ratio 2012-2024 (%GDP)

Source: Bank of Spain

The cumulative reduction from the ceiling reached in the first quarter of 2021 (124.2%) is 22.4 points. In 2024, public debt has increased by 45,224 million euros to reach 1.62 trillion, which represents a year-on-year growth rate of 2.9%. This growth rate has been notably lower than the 6.2% growth of nominal GDP, the denominator of the ratio.

The rate of reduction in the ratio has been slowing down in line with a more moderate evolution of nominal GDP. Economic growth has been the main driver of the decline in the ratio after the initial increase during the pandemic. In the period 2020-2024, the contribution of growth to the reduction of the debt ratio has been 37 percentage points of GDP. A public deficit with a downward trend, despite the slight upturn in the financial burden, has helped to consolidate this reduction.

Regional debt in the spotlight after the forgiveness proposal

The regional debt, as a whole, exceeds 335 billion euros (+EUR 10,736 mn in the year). In relative terms, the debt-to-GDP ratio fell by 0.6 p.p. due to strong nominal growth, to 21.1% of GDP. This behaviour is common in all regions except Murcia (+1.4 p.p.), with Cantabria (-1.7 p.p.), Navarra (-1.5 p.p.) and Asturias (-1.5 p.p.) standing out for greater intensity of the fall.

With regard to the autonomous communities and under a regulatory scenario, **we expect the Autonomous Communities to reduce their level of indebtedness by 1.3 points in 2025, reaching 19.8% of GDP.** The proposed regulatory scenario does not contemplate any effect of the regional debt forgiveness that has been announced, on the understanding that, in any case, it would not have an impact in 2025. In any case, and given its importance, in the following section we will analyse in detail the debt forgiveness proposal and its implications.

The reduction in the debt ratio of the Autonomous Regions by 2025 is due to the generation in 2024, in several regions, of surpluses and excess financing above what was initially expected. This forecast is conditioned by the estimation of the excess financing from previous years pending application and by the assumption of strict compliance with the regulations, which would imply that in 2025 the surpluses not applied and the excess financing pending from previous years should be used to reduce net indebtedness, and does not contemplate any effect from the forgiveness of regional debt that has been announced. These positive factors are only partially offset by the deficit forecast for 2025 (0.4% of GDP) and by the effect on debt of the financing of the DANA expenditure in 2024 and 2025, of up to just over one tenth of GDP.

Five Autonomous Communities would have a debt-to-GDP ratio of less than 13% in 2025, while two would still be above 30%. Thus, in five Autonomous Communities (Navarre, the Canary Islands, the Basque Country, Madrid and Asturias), the debt would be below 13% of GDP, always under the assumptions of the application of surpluses and excess financing from previous years. Two other communities (Valencian Community and Region of Murcia), on the other hand, would maintain a debt ratio above 30%. Compared to the previous report, Catalonia and Castile-La Mancha would leave this group, as their debt is slightly below 30% of their regional GDP.

Financing mechanisms increase their weight in the composition of the regional debt. According to data as of December 2024 from the Bank of Spain, the State's financing mechanisms would continue to be the main source of financing for the Autonomous Communities as a whole, although three regions (Navarre, the Basque Country and Madrid) would not have any debt for this resource. The financing mechanisms would represent 63% of the debt of the regions, which represents an increase of two percentage points compared to 2023. In five regions (Region of Murcia, Cantabria, Valencian Community, Catalonia and Castile-La Mancha), the liquidity mechanisms account for more than 80% of the total debt of the regional administration.

Therefore, **the Financing Fund for Autonomous Communities remains the main financing instrument and increases its weight to 62.8% from 60.9% the previous year.** In terms of volume, it increased by EUR12,873 million in 2024, with the increase in Q4 being more limited (+€2,202 million). However, if the forgiveness materializes, this percentage would be considerably reduced, although it would continue to be the main source of financing.

The balance of loans with national banks fell in 2024 (-2,159 million euros), as there was a significant volume of repayments that have not been offset by new banks' loans. Despite continuing to be the main source of financing for those regions that have been financed outside the FFCA, they represent only 15.4% of the total, 1.2 percentage points less than at the end of 2023. Loans with non-residents continue their downward trend, as activity with these entities has fallen considerably in recent years.

Finally, the capital market has acquired a little more dynamism in 2024 compared to 2023 (+15% YoY), with 4,528 million euros in bonds being issued, although still far from the maximum recorded in the last decade (7,120 million euros in 2021). This growth has allowed this instrument to maintain a weight above 14% of total debt.

As we analyse in the next section, **if the announced forgiveness of 83,252 million euros occurs, the regional debt would be reduced to 252,725 million euros.** With the data at the end of 2024, the global debt-to-GDP ratio would experience a reduction of 5.2 p.p. to 15.9%. The communities with the worst ratio (Valencia, Murcia and Catalonia) would be reduced by 7.6, 7.7 and 5.7 percentage points, respectively. Likewise, Andalusia (-8.9 p.p.) and Castilla-La Mancha (-8.6 p.p.) are the autonomous communities that would reduce their debt-to-GDP ratio the most, remaining at 10.2% and 20.5%, respectively.

In terms of debt over current income, the impact on the regions is heterogeneous. While in Murcia this ratio would be reduced by almost 56 p.p., in Cantabria it would only be 27.4 p.p. However, the regions with the highest level of indebtedness would continue to maintain high levels (Murcia would continue to have a debt of 171% of current income, Catalonia would remain at 174% and Valencia would continue to be above 200%). We should highlight that rating agencies consider that a debt level above 175% of current income is considered a situation of over-indebtedness.

In any case, the medium- and long-term risks to the sustainability of public finances remain worrying. AIReF projects an unfavourable evolution of the debt-to-GDP ratio in the medium and long term. Based on growth projections, fiscal variables and medium- and long-term interest rates, **AIReF projects a rising debt ratio after an initial period of some stabilisation, reaching 181% of GDP in 2070.** The foreseeable increase in expenditure on pensions, health expenditure and long-term care as a result of the ageing of the population is one of the main challenges for the sustainability of public finances in the medium and long term. Higher structural expenditure that is not covered by additional revenues will lead to a very significant increase in indebtedness from historically very high levels. The high stock of debt will generate a financial burden that will accelerate even considering contained types of financing.

Implications of the proposal for partial debt forgiveness of the Autonomous Communities under the common regime

After the meeting of the Fiscal and Financial Policy Council (CPFF) on 26 February, the Spanish Government has presented a proposal for an agreement on the outstanding debt **(83,252 million euros)** of the autonomous communities under the common regime[2] that the State has offered to assume, as well as the criteria for the distribution of the amounts corresponding to each of them. The aim is to strengthen the financial independence of the autonomous communities by reducing their level of indebtedness and facilitating their ability to obtain financing through the financial markets.

[2] The Basque Country and Navarre are not included in the central government's debt relief plan because they are under a different institutional framework than other regions under the common regime.

The initial message of a possible debt forgiveness for the autonomous communities arose from the PSOE's agreement with ERC for the investiture of the current president of the government after the July 2023 elections. This included the partial forgiveness of Catalonia's debt to the State, with a cut of 15 billion euros representing around 20% of Catalonia's total financial debt, implying debt relief of 1,980 euros per capita adjusted. The agreement provided for the generalization of these reductions to the rest of the regions of the common system.

The aforementioned 83,252 million euros will be distributed among the autonomous communities **through a complicated procedure in several phases.** Firstly, 75% of the available resources (60,233 million euros) will be distributed by adjusted population. Then, the remaining 25% will be distributed in tranches that give priority, respectively, to the autonomous communities with the highest adjusted per capita debt, then to those with below-average adjusted per capita debt and, finally, to those that, on average, have made use of their regulatory capacity to increase Personal Income Tax (IRPF). A major problem with the procedure is that **the premium allocated to underfunded regions does not necessarily reflect the accumulated underfunding.**

As shown in Figure 9, a group of **five regions would receive the highest adjusted per capita debt forgiveness amount** (Valencia, Andalusia, Catalonia, Murcia and the Balearic Islands) and six other regions would receive the **lowest adjusted per capita amount** (Asturias, Castilla y León, Galicia, Madrid, Cantabria and Rioja).

FIGURE 9 Adjusted per-capita debt forgiveness (EUR)

Region	Debt-relief per capita adjusted (euros)
VAL	2,284
MUR	2,284
CLM	2,284
AND	2,284
CAT	2,284
BAL	1,551
ARA	1,505
AST	1,498
CAN	1,369
CNT	1,369
CYL	1,369
EXT	1,369
GAL	1,369
RIO	1,369
MAD	1,369

Source: Ministry of Finance

The Basque Country and Navarre are not included in the central government's debt relief plan because they are under a different institutional framework than other regions under the common regime.

Impact on regional debt portfolios

The impact on the debt ratios of the autonomous communities will be uneven, as can be seen in Figure 10. The following conclusions should be highlighted:

- **There are five autonomous communities** (Madrid, Galicia, Castilla y León, the Canary Islands and Asturias) that would not have a sufficient balance with the FFCA, and the forgiveness would be carried out, either totally or partially, through the amortization of debts with third-party creditors, although this point is not entirely clear today. Bank loans generally do not incur cancellation penalties, but bond issues often have penalties if they are written off before maturity.
- In terms of GDP, **the greatest reduction in debt will be seen in Andalusia.** This ratio would be reduced by 9pp compared to 2.8pp in the Community of Madrid. In any case, together with these two autonomous communities, Galicia, the Canary Islands, Asturias and La Rioja would remain below the 13% reference set by the Stability Law. The island region stands out, which would be left with a debt of just 5.7% of GDP.
- As for **debt to current income,** while in Murcia this ratio would be reduced by almost 56 pp, in Cantabria it would only fall by 27.4 pp. However, Murcia would still have a debt of 159% of its current income, Catalonia would remain at 174% and Valencia above 200%. As we commented before, for rating agencies, a level of indebtedness greater than 175% is considered over-indebtedness.

FIGURE 10 Impact of the debt forgiveness proposal on regional debt portfolios

Region	Total debt 3Q24	Debt-relief amount	Total debt after debt-relief	Debt-relief through FFCA	Debt-relief through extraordinary transfers	Debt/GDP ratio	Debt/ GDP ratio after debt-relief	Change in debt/GDP ratio	Debt/ current revenues ratio	Debt/current revenues ratio after debt-relief	Change in debt/ current revenues ratio
AND	39,842	18,791	21,051	18,791	-	19.0%	10.0%	-9.0%	103.8%	54.8%	-49.0%
CAT	88,917	17,104	71,813	17,104	-	30.1%	24.3%	-5.8%	215.5%	174.0%	-41.4%
CVA	59,498	11,210	48,288	11,210	-	40.8%	33.1%	-7.7%	275.6%	223.7%	-51.9%
MAD	36,915	8,644	28,271	-	8,644	12.0%	9.2%	-2.8%	141.0%	108.0%	-33.0%
CLM	16,473	4,927	11,546	4,927	-	29.2%	20.5%	-8.7%	172.9%	121.2%	-51.7%
GAL	12,154	4,010	8,144	2,089	1,921	15.0%	10.1%	-4.9%	97.7%	65.5%	-32.2%
CYL	14,006	3,643	10,363	1,774	1,869	18.9%	14.0%	-4.9%	118.7%	87.8%	-30.9%
MUR	12,802	3,318	9,484	3,318	-	30.3%	22.4%	-7.9%	215.0%	159.3%	-55.7%
CAN	6,467	3,259	3,208	1,286	1,973	11.4%	5.7%	-5.7%	64.2%	31.9%	-32.4%
ARA	9,365	2,124	7,241	2,124	-	19.2%	14.8%	-4.4%	142.1%	109.9%	-32.2%
BAL	8,661	1,741	6,920	1,741	-	19.7%	15.7%	-4.0%	154.6%	123.6%	-31.1%
EXT	5,453	1,718	3,735	1,718	-	20.9%	14.3%	-6.6%	90.5%	62.0%	-28.5%
AST	4,096	1,508	2,588	586	922	13.8%	8.7%	-5.1%	80.4%	50.8%	-29.6%
CNT	3,248	809	2,439	809	-	18.5%	13.9%	-4.6%	109.9%	82.5%	-27.4%
RIO	1,632	448	1,184	448	-	14.7%	10.7%	-4.0%	102.7%	74.5%	-28.2%
TOTAL	**319,528**	**83,252**	**236,274**	**67,925**	**15,327**	**22.1%**	**16.3%**	**-5.8%**	**155.8%**	**115.2%**	**-40.6%**

Source: AIReF

Our opinion: a decision that continues to cast more doubts than certainties in the event of an unconditional debt forgiveness

Once the proposal of the Ministry of Finance was approved by the CPFF on February 26, which only had the support of one autonomous community (Asturias and Castilla-La Mancha approved it), the legislative process was launched. This will require both the **modification of the Organic Law on the Financing of the Autonomous Communities** (LOFCA), which does not contemplate mechanisms for unilateral debt forgiveness, and the support of the majority in Parliament where the legislative proposal will be presented, **foreseeably at the end of the year,** at the discretion of the Minister of Finance himself.

In short, **we believe that the ultimate goal of this process should be the return to financing in the financial markets.** In this way, the State liquidity mechanisms should continue to be only a way of access for those autonomous communities that, even after this process, may not have full autonomy in the financial markets under the financial conditions established in the Financial Prudence Resolution, although **this conditionality, which we consider necessary, does not yet appear in the Ministry's initial proposal voted by the CPFF.**

In the event that this conditionality is not included, and taking into account that the reform of the financing system (SFA) continues to be delayed in time, when the ideal would be for it to take place in parallel to the debt forgiveness procedure, it is only a matter of time before we see a situation of **over-indebtedness** in some Spanish autonomous communities. In addition, **the debt forgiveness that is proposed is not enough to end the permanent provisionality of these mechanisms that were born as extraordinary measures and only later became permanent.** In our opinion, the reform of the extraordinary financing mechanisms should go hand in hand with the reform of the regional financing system and the guarantee of compliance with the relevant fiscal rules.

The absence of any conditionality associated with forgiveness, in addition to the obvious **"moral hazard",** creates a negative incentive for the autonomous communities to meet their fiscal and debt stability objectives in the future if they perceive that, after a few years, the State will once again assume part of their financial debt and that compliance with the principles of budgetary stability is not associated with any reward.

This could lead in the long term to a structural increase in the cost of financing for the State if investors assume **a structural situation of over-indebtedness of the autonomous communities as a whole,** derived from the questioning of their ability to manage their debt.

Moreover, the justification of this proposal as **a posteriori compensation for the adverse effects of a financial shock makes it a free insurance against cyclical downside risk** that will eliminate any temptation that regions may have to meet their fiscal and debt targets in good times, as well as increase public spending. Therefore, there is no point in forgiving debt if it is not guaranteed that it will not continue to accumulate in the future beyond what fiscal rules allow.

As for the possible actions of the rating agencies, **S&P,** in a note published on February 26, maintained that **they do not plan to act in the short term, as the Ministry of Finance's proposal is not yet legal and binding,** but that the credit metrics of the autonomous communities will be adjusted as there is more clarity on the timing and final impact. In any case, if the measures are implemented, the impact will be neutral to positive for the ratings of those regions that the agency rates.

However, S&P insists on the same critical points that we have already mentioned, in the sense that the measure presented by the Ministry of Finance focuses on the accumulation of budget deficits of the past, but that in the absence of progress in a new financing model for the autonomous communities, **the current debt forgiveness would only temporarily improve their situation and would not prevent the accumulation of new deficits in the autonomous communities in the future,** in addition to the moral hazard that would be incurred by reducing the incentives for the autonomous communities to undertake prudent management from a financial point of view in the face of the precedent that new forgiveness may occur in the future.

Similarly, **Moody's also sees the positives of debt relief,** as it will reduce the regions' debt burden and interest costs, which in turn will reduce their budget deficits, which is positive for their credit position. However, like S&P, **the agency will not act until the law is voted on in parliament and is binding.**

On the other hand, **the agency is concerned about moral hazard issues.** If debt cancellation were to discourage prudent fiscal policies at the regional level, this would weigh on the general government's finances and have an adverse impact on the government's fiscal strength. For this reason, the agency sees this decision as a negative credit for the Spanish sovereign.

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