

Since the last *Financial Stability Report* was published, there has, on balance, been some containment of the risks identified and the vulnerabilities have eased.

The drop in headline and underlying inflation in the euro area and other advanced economies has reinforced financial market expectations of looser monetary policy and lower short and long-term interest rates.

However, these expectations of lower rates have partially corrected upwards since the start of 2024, reflecting uncertainty over the disinflationary process. In this respect, inflation in the United States has recently surprised on the upside. Given this country's key position in the international financial system, this could affect expectations about global financial conditions.

In 2023 GDP grew by 2.5% in Spain, a higher than expected rate that also outpaced euro area GDP growth (0.4%), which was relatively weak by global standards amid deteriorating growth expectations for this region. The economic momentum in Spain was driven by external demand and the recovery in household consumption. Some moderation is expected in 2024, given the signs of weakness among Spain's main trading partners, but GDP is still expected to grow above potential in the period 2024-2026.

In this setting, a potential escalation of the geopolitical tensions, associated in particular with the war in Ukraine and the conflict in the Middle East, remains the main risk to economic activity – tilting the balance of risks to growth to the downside – and to the stability of the Spanish financial system. Several elections are set to take place in 2024, adding a further layer of uncertainty to the geopolitical context.

The possibility of an intensification of cyber attacks worldwide also remains a specific risk linked to geopolitical tensions. This report includes a special feature on the bank-level and systemic implications of cyber risk, a concept that is broader than cyber attacks and includes non-malicious events. The special feature also looks at the European and global regulatory and supervisory initiatives to enhance the financial system's cyber resilience.

The possibility of a pick-up in risk aversion is also gaining ground. Risk premia currently stand at low levels. A sharp correction could lead to a tightening of global financial conditions and to a correction in the valuation of risky financial assets, which show signs of standing at high levels, particularly in the United States.

Meanwhile, positive income developments and deleveraging in Spain's private non-financial sector have helped to improve its financial position. That said, the country's high government debt remains a significant vulnerability. This debt has declined recently, driven by nominal

GDP growth. However, in the absence of measures to reduce the structural budget deficit, no further significant reductions can be expected. Therefore, a fiscal consolidation process must get under way in 2024, one that complies strictly with the new EU fiscal rules and is designed to boost the economy's potential growth as much as possible.

The vulnerabilities in the banking sector's intermediation capacity eased in 2023, supported by stronger bank profits, alongside a limited deterioration in credit quality, and by liquidity ratios that remain high. Solvency ratios improved only very moderately. However, this improvement did not prevent the gap between Spain's CET1 ratio and the higher ratios seen in other major European banking systems from widening. On the whole, banks would remain well advised to use their current strong earnings to strengthen their capacity to absorb potential macro-financial shocks in the future, particularly in light of the persisting downside risks to economic growth.

The main driver of bank profits in 2023 was growth in net interest income, above all due to the faster pass-through of policy interest rate hikes to asset rates than to liability rates, particularly in business in Spain. The different speeds of pass-through help to explain the increase in loan repayments, in both mortgages and loans to non-financial corporations. This, together with the drop in new lending, caused the stock of credit to the Spanish non-financial sector to decline again in 2023. However, the latest data suggest that it is stabilising.

The non-performing ratio for bank loans to Spain's private non-financial sector stood at 3.4% in December 2023, largely unchanged from a year earlier. This ratio improved slightly for non-financial corporations, but deteriorated somewhat for households. The Stage 2 loan ratio rose for both households and non-financial corporations.

The systemic risk indicators stand at neutral levels, indicating neither high nor low risk. Only in the real estate sector are there moderate signs of upward house price imbalances, partly due to prices accelerating in the second half of 2023 compared with the first half. The macroprudential policy stance is in line with this macro-financial context.