Since the last *Financial Stability Report* (FSR) was published, the vulnerabilities and risks identified then have evolved unevenly.

Notably, risks linked to high inflation have decreased significantly across all geographical areas. In this setting, the projections continue to point to inflation moving towards the 2% target in the medium term, both in the euro area as a whole and in Spain. Among the upside risks, persistent services inflation and dynamism in wages stand out, although the latter have moderated slightly and their contribution to these risks has tempered.

The risk of lower short-term growth in Spain has also declined. The Spanish economy remained highly dynamic in the first half of the year, with growth clearly above the European average. In addition, global economic activity remained positive, although some signs of weakness persist, such as the low growth of the euro area as a whole and the slowdown of activity in China.

Amid this more favourable macroeconomic setting, the escalation of geopolitical tensions remains the main risk to financial stability, compounded by the intensification of the conflicts in eastern Europe and the Middle East. Other geopolitical risks, such as those relating to the trade tensions between China and the United States and also the European Union remain relatively stable, but high. These tensions are especially significant since they affect particularly certain technological products which are key for long-term economic growth.

In the same vein, the outcome of the US presidential elections will be the most important geopolitical event in the coming months given the global reach of US policies. In Europe, the results of the elections in some countries, such as France, are also generating uncertainty about the economic policy stance.

Also, the high valuations of some risky financial assets and other factors, such as the concentration of equity market value in only a few technology firms, increase the risk of abrupt financial market corrections.

Persistently high valuations of risky financial assets with the current level of uncertainty may make investors' perceptions fragile. In this type of environment, limited changes in the information on macro-financial conditions may trigger more pessimistic investor sentiment, as was illustrated by the bout of turmoil in early August. This turmoil was very short-lived, but more persistent corrections could prompt a tightening of global financial conditions.

In any event, it is worth noting that the different risks identified interact with each other and that the materialisation of any of them may exacerbate others. In particular, both the materialisation of geopolitical risks and the tightening of global financial conditions would impact negatively the growth of activity.

The government debt-to-GDP ratio has continued to decline in Spain, although it remains at a high level, clearly above the European average. This limits the fiscal space to absorb future shocks and makes the cost of financing of government debt more sensitive to a potential tightening of financial market conditions. Against this background, an adequate and strict implementation of the recently announced medium-term fiscal-structural plan is necessary to make progress in the application of the new European fiscal rules, reduce the level of structural deficit and ensure the fiscal consolidation process in Spain.

The favourable performance of the income of households and non-financial corporations has continued, as has the process of decreasing their debt ratios, helping to reduce their degree of financial vulnerability.

The Spanish banking sector's financial position remains favourable, with high profitability underpinned by the growth of net interest income and, to a lesser extent, other items, such as net fee and commission income. This has not resulted in a significant strengthening of their solvency ratios, with the CET1 ratio remaining comparatively lower than that of other European banking systems.

The results of the stress tests conducted by the Banco de España point to notable aggregate resilience on the part of the Spanish banking sector under adverse macro-financial scenarios. However, there is some cross-bank heterogeneity and, under the most severe scenarios, capital depletion and less credit flowing to the economy should be expected. By contrast, under the forecast scenarios, the sector would retain its profit generation capacity, helping to both strengthen its solvency and comply with new regulatory requirements, such as the activation of the countercyclical capital buffer (CCyB), which is discussed below.

Globally, there is still concern over the high leverage and build-up of liquidity risks at some non-bank financial intermediaries.

Housing market activity has picked up and house price growth has accelerated since 2023 Q4, as the moderating effects of the rise in interest rates have tailed off. High demand, tight supply and an increasingly higher proportion of properties used as holiday rentals have all contributed to these developments. However, the rise in household income has prevented the emergence of significant house price imbalances and loose credit standards are not being observed, limiting the adverse effects on financial stability. The Banco de España will continue to monitor developments in this sector closely.

The Banco de España has approved a CCyB requirement of 0.5% of exposures located in Spain from 2024 Q4 (applicable from 2025 Q4). This tool was activated as a result of a revision of the framework for setting the CCyB approved in 2024 Q4, and its activation is consistent with the identification of an intermediate level of cyclical systemic risks. These risks will likely remain at this level in 2025, and the CCyB requirement will be increased to 1% in 2025 Q4 (applicable from 2026 Q4).

The Banco de España has also activated the systemic risk buffer for credit exposures located in Portugal and Italy, reciprocating the measures adopted by the authorities of those countries.