Since the last *Financial Stability Report* was published in spring of this year, the risks to financial stability have intensified, aganinst a backdrop in which some elements of vulnerability for the Spanish economy have eased.

First, geopolitical tensions have increased from their already high level due to the new conflict in the Middle East. These could have an adverse impact on global growth and inflation, particularly through potential energy market shocks, and could erode agents' confidence and lead to sharp falls in the prices of risk-bearing assets.

The fall in energy prices since the second half of 2022 and monetary policy tightening have contained inflation notably in the euro area and in other regions during 2023. Indeed, under the baseline projection scenario, the current level of interest rates set by the European Central Bank (ECB), if maintained for a sufficiently long duration, would succeed in bringing inflation back to the 2% target in the medium term.

However, strongly persistent underlying inflation and the above-mentioned geopolitical tensions are an important source of upside risks to price developments. In addition, a higher than expected increase in wages and profit margins could drive inflation up further. In any event, the ECB will adjust its monetary policy on the basis of the incoming data to ensure price stability.

At international level, the Federal Reserve is expected to keep its interest rates high, and above those of other advanced economies, for longer. This could prompt a more prolonged tightening of global financial conditions, given the United States' central position in the international financial system.

The risk premia on financial instruments remain at historically low levels, despite the current uncertain environment and an outlook characterised by still relatively high inflation and weak growth. In this setting, an increase in economic agents' risk aversion could cause borrowing costs to rise and consumption and investment plans to be scaled down for precautionary reasons. The existence of relatively high financial market valuations could increase the fragility of sentiment over the course of macro-financial developments and lead to a sharper and deeper price correction should it turn more pessimistic still.

The projections for 2023-2025 envisage average growth for the Spanish economy of around 2%. The latest Banco de España projections, however, revised down growth for 2024 and 2025, owing to lower external demand, further tightening of financial conditions and higher oil prices. Should the risks identified materialise, the growth slowdown in Spain may be steeper. That would have a negative impact on the income of households and firms, and their ability to meet their financial obligations.

Spain's government debt-to-GDP ratio and budget deficit declined further to June 2023. However, according to the Banco de España's projections, government debt would still stand at very high levels in 2025 (over 100% of GDP). This, coupled with higher interest rates, would drive up Spain's public debt burden through to 2025, draining funds that could be used elsewhere. Furthermore, it would reduce the fiscal space to cushion any additional shock to the Spanish economy, leaving it vulnerable to changes in agents' risk sentiment.

In light of all of the above, fiscal policy should comply with the European Union recommendations, reducing the debt and structural budget deficit by means of a programme geared towards lasting fiscal consolidation.

Non-financial corporations recorded healthy profits in the first half of 2023, which tempered the impact of higher interest rates on their financial position. However, they face considerable profitability risks over the coming quarters, owing to weaker demand, upward pressure on labour and energy input costs and the gradual increase in the average cost of corporate debt as higher interest rates are passed through.

The recovery in households' income has cushioned the adverse impact of higher inflation and interest rates on their purchasing power and ability to meet payment obligations. Rising interest rates, however, continue to exert upward pressure on indebted households' interest burden and the average cost of debt. In addition, a stronger pass-through of rate increases to the cost of households' outstanding debt can be expected, which would contribute to driving up the proportion of indebted households with a high debt burden.

The recent recovery of some of their purchasing power, to a certain extent due to a robust labour market, appears to have sustained households' servicing capacity, thus reducing the need for credit risk management measures, such as those envisaged under the reformed Code of Good Practice (CGP) framework established by Royal Decree-Law 19/2022. That said, a relatively high number of applications for measures under the CGPs was received in 2023 H1, compared to those submitted in equivalent periods under the CGP introduced by Royal Decree-Law 6/2012.

The Spanish banking system has proved to be resilient in 2023 to date. Indeed, its profitability and solvency performed favourably in the first part of the year, with no signs of significant deterioration in credit quality. Moreover, the conditions on wholesale bank funding markets quickly returned to normal following the turmoil in March.

However, with interest rates remaining higher for longer, the cost of banks' liabilities, which had been contained until now, is gradually rising and will also contribute to some deterioration in credit quality. Based on the results of the stress tests conducted by the European Banking Authority and the Banco de España, although the banking sector has sufficient overall resilience, the materialisation of the risks identified could give rise to the need to absorb losses.

Therefore, it is still necessary for banks to use the current favourable profitability situation to build up resilience to adverse scenarios. Indeed, under the macroeconomic projections baseline scenario, the results of the stress tests show that generating capital organically and maintaining a sound liquidity position is feasible.

On this occasion, the build-up of real estate imbalances, some incipient signs of which were observed in 2022, has been excluded from the list of vulnerabilities. The contraction both in activity and credit on the housing market, which began in 2022 Q3, has continued to intensify in 2023. Also noteworthy is the slowdown in house price growth with respect to 2022.

That said, both the volume of house purchases and new mortgage loans are still above their pre-pandemic levels, and house price growth headed up again in 2023 Q2. This sector will therefore continue to be monitored closely, although no build-up of vulnerabilities is currently observed.

The impact of the minimum buffer rates for O-SIIs set by the ECB has been passed through to capital requirements in the Spanish banking sector, leading to an increase of 25 basis points in the minimum buffer rates required of Spain’s two most systemically important institutions. The current contraction in credit, which owes partly to a further tightening of credit standards, and the uncertainty surrounding macro-financial developments, make it advisable to hold the countercyclical capital buffer (CCyB) at 0% for now and to refrain from activating other macroprudential measures.