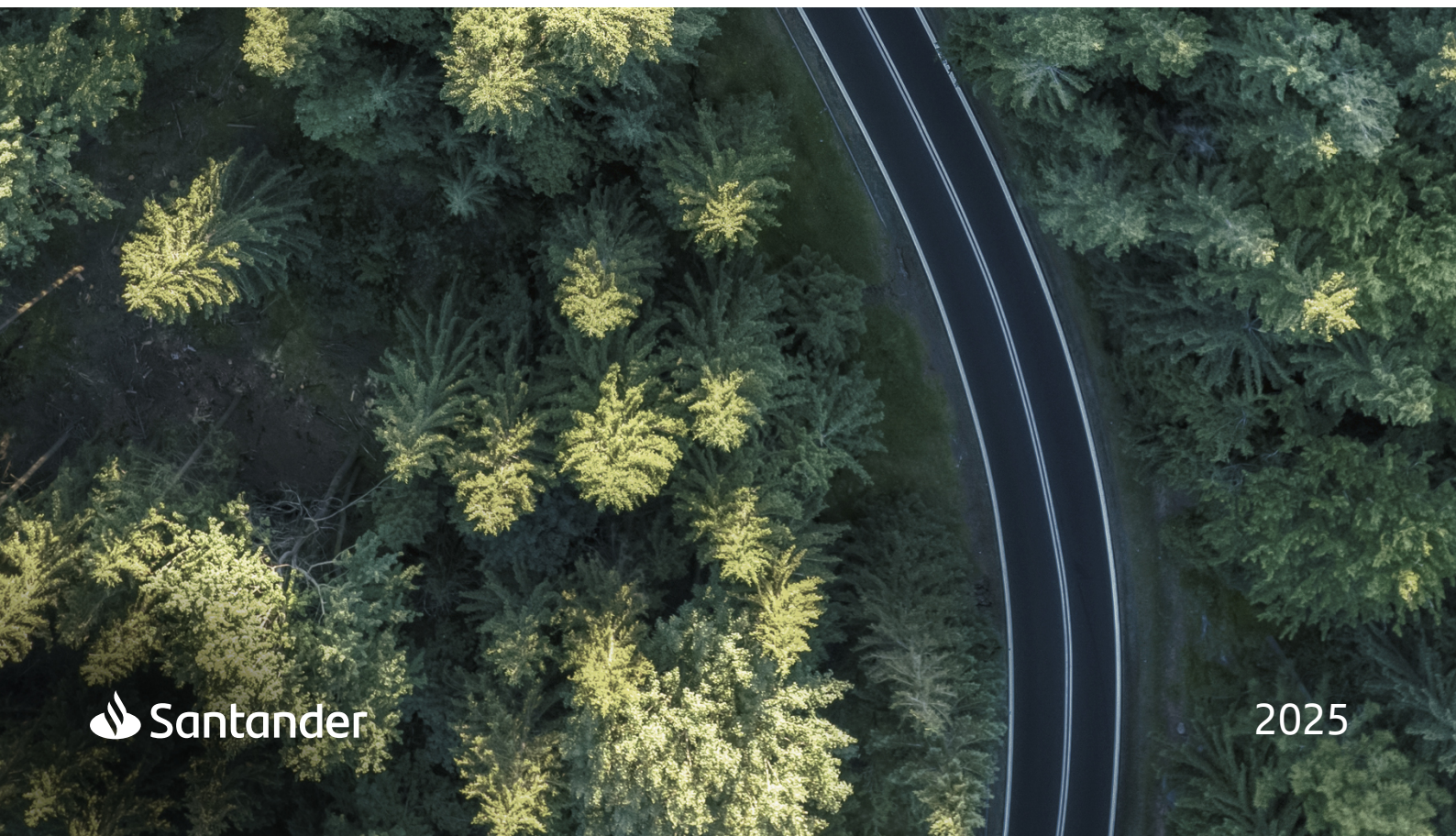
The Year Ahead

Resetting growth in a new geoeconomic era



Santander

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The statistical closing date for data and projections in this report is October 2025.

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Resetting growth in a new geoeconomic era

Editor's note

"I am interested in the future because I plan to spend the rest of my life there." The quote is attributed to Charles F. Kettering (1876–1958), an American inventor and engineer. It captures the spirit of this report, which we have called *The Year Ahead*, Santander Research's annual economic publication.

Here we share our outlook on the global economy, with special focus on the regions where Santander has a strong presence — spanning the United States, Europe, and our core markets in Latin America. We also focus on globally relevant topics, including the impact of artificial intelligence on the economy, the link between productivity and regulatory quality, the structural drivers of long-term interest rates, the EU-Mercosur agreement, and challenges in the housing and the automotive markets.

In recent years, heightened uncertainty and volatility have characterised the global economy. The world is undergoing unprecedented and disruptive changes due to short-term challenges and long-term structural trends. These are often intertwined and become difficult to distinguish. In today's landscape, the main challenge for a research department is to separate the signals from the noise. *The Year Ahead* is an attempt to identify these signals and to share conclusions that contribute to the public debate on the issues that are shaping the future of the world.

The global economy is in transition between two eras, moving from 'full globalisation' towards what is being called the 'age of strategic autonomies'. While pinpointing a single moment is not easy, among the main drivers of this structural shift are: the rising role of China in the global geopolitical and economic landscape; the Covid-19 pandemic in 2020; the subsequent Russian invasion of Ukraine in 2022; geopolitical tensions in the Middle East; and recent trade policies in the United States. All these events have led countries to recognise the fragility of global value chains, reconsider their international alliances and strategic agreements, and reassess their trade and industrial policies. Geopolitics — or more precisely, geoeconomics (the intersection of geopolitical events and their impacts on the global economy) — have taken centre stage in analysis like never before.

The challenges ahead are significant. According to the International Monetary Fund[1] (IMF), global economic fragmentation could reduce world economic output by 7% over the long term, which means some USD 7.4 trillion in lost output. That's roughly the equivalent of the combined size of France and Germany's economies. International cooperation is key to reversing geo-fragmentation. The world needs to 'new globalise' under more solid and stable pillars.

The current situation overlaps with long-term structural transformations such as demographic, climate-related, and technological change that will become increasingly evident in the next five to ten years. The renowned economist Rüdiger Dornbusch, noted for his influence on international macroeconomics used to say: "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could". A few data points help illustrate how much the world will change in the coming years. The United Nations forecasts[2] that by the mid-2030s there will be 265 million individuals aged 80 and older, outnumbering infants. Population ageing will have profound implications for pension systems, fiscal sustainability, and labour markets. On climate transition and countries development, according to UNCTAD,[3] the financing gap to reach the sustainable development investments is about USD 4 trillion per year. Finally, the emergence of generative artificial intelligence (AI) will significantly reshape the global economy. Though we still lack concrete data on its impact, some studies point to substantial productivity gains. McKinsey (2023)[4] estimates that generative AI could raise global labour productivity by 0.1 to 0.6 percentage points annually through 2040, depending on the pace of adoption. When combined with complementary technologies, the uplift could reach 0.2 to 3.3 percentage points per year, adding USD 2.6–4.4 trillion in annual economic value.

What will emerge from the intersection of all these demographic, climate, geopolitical, and technological trends? If someone claims to know the answer, be sceptical. The honest answer is we don't know. Rather than offering definitive answers, this report seeks to help ask the right questions, based on reliable data and evidence.

According to the World Bank,[5] around 1.5 billion people have been lifted out of extreme poverty worldwide since 1990 — equivalent to over 100,000 people per day on average, driven by strong and sound economic growth. However, the 'triple transition' — demographic, energy, and technological — will require the world to accelerate growth even further to generate sufficient resources to meet rising needs.

[1] International Monetary Fund (August, 2023), 'The High Cost of Global Economic Fragmentation', Washington D.C.

[2] United Nations (2024), 'World Population Prospects 2024: Summary of Results', New York.

[3] United Nations Conference on Trade and Development (September, 2023), 'SDG Investment Trends Monitor (Issue 4)'.

[4] McKinsey Global Institute (June, 2023), 'The economic potential of generative AI: The next productivity frontier', McKinsey & Company.

[5] World Bank (October, 2025), 'Poverty overview', Washington D.C

Unfortunately, the current five-year average global growth projection stands among the lowest in decades.

The world needs to 'reset' the growth pattern urgently. Accelerating long-term growth requires higher investment, and it can only increase with greater financing. That's why smart regulation that boosts this financing is essential, by channelling savings into investments, innovation and jobs. Several findings — included in this report — suggest that well-balanced regulation (which contemplates growth) has a significantly positive impact on productivity and, of course, long-term economic growth.

Today's world is full of risk and uncertainty. But beyond that, it is also full of transformation and opportunities. Because it is not about eliminating risk (which is impossible), but about building more resilient and inclusive economies that are capable of fully seizing the opportunities that lie ahead.

Welcome to *The Year Ahead*. We hope you enjoy it.

Juan Cerruti
Global Chief Economist

Madrid, November 2025

Acknowledgments

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Executive summary

Global growth outlook

Global economic growth is expected to stay at similar pace in 2026 as in 2025 (3.1%) , still affected by uncertainties related to global trade and the adaptation to new policies, while a modest rebound could occur in 2027 (3.2%). Although this would mark a mild recovery, it would still be well below the 3.7% average global growth observed in the early 2000s (pre-pandemic).

Challenges to sustained growth

This pace of growth is insufficient to meet looming global challenges. An ageing population and China's structural slowdown are weighing on the world's growth potential. Geopolitical uncertainty and fragmentation are further dampening economic momentum. Additionally, widening fiscal imbalances in many countries could pose significant risks in the coming years.

'Resetting' global growth

Resetting global growth will require a proactive structural reboot. In essence, the world must reignite growth by replacing its current engines with new ones. A possible roadmap that we present in this report involves three simultaneous initiatives:

- Re-globalising the world: Strengthening multilateralism on more solid foundations.
- A productivity revolution: Driven by transformative technologies such as AI.
- Growth-boosting smart regulation: Designed to unlock financing and stimulate investment.

Inflation and resilient labour markets

Global inflation is declining, albeit at different rates across regions. In the past few years, monetary policy tightening has largely achieved a 'soft landing' globally, and labour markets have proved remarkably resilient throughout.

Many central banks are now in the final stages of their easing cycles, though terminal interest rates remain significantly higher than those of the past decade — reflecting a new equilibrium level. Notably, these higher rates have so far coexisted with historically low unemployment in many major economies (the US, the euro area, the UK, etc.) as well as in key emerging markets (Brazil, Mexico, etc.).

Looking ahead, we expect unemployment to remain low in most countries where Santander operates through 2026 and 2027. For example, jobless rates are expected

to hold around 4% in the US, 6% in the euro area, less than 5% in the UK, and 6% across seven leading Latin American economies (LatAm7). This labour market strength gives central banks greater flexibility: they can maintain vigilance and even tighten policy again if needed, without necessarily derailing growth.

Market sentiment and asset valuations

The combination of early-stage, AI-driven business opportunities and the monetary-policy easing cycle is boosting equity valuations. At the same time, underlying geopolitical risks are creating a bifurcated market, which is mirrored in valuations: equities in several markets are at record highs even as gold and other traditional safe-haven assets also reach new peaks.

Regional growth outlook

Growth projections by region indicate a moderate recovery with some divergence:

- United States: GDP growth of roughly 1.8% in 2026, accelerating slightly to 1.9% in 2027.
- Euro area: Growth picking up from about 1.3% in 2026 to 1.7% in 2027. However, Spain's GDP will slow down to 2.0% and 1.7% over the next two years.
- United Kingdom: Modest growth of around 1% in 2026, improving to 1.4% in 2027.
- Brazil: Growth of approximately 1.5% in 2026, below its historical average, rising to 1.8% in 2027.
- Mexico: Growth of roughly 1.0% in 2026, climbing to 2.0% in 2027.

Special topics

From a structural and long-term perspective, this report also addresses several key questions in a section titled 'Special topics':

- What level will interest rates reach in the long term?
- What is the relationship between the quality of regulation and a country's productivity?
- How will AI impact the global economy?
- What is happening in housing markets around the world?
- What challenges is Europe's automotive industry facing?
- What could the EU-Mercosur agreement mean for these regions?

Global **overview**

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Global overview

Global growth is projected to remain at 3.1% in 2026 and pick up to 3.2% in 2027.

Global economic growth may be similar in 2026 to that recorded in 2025 (3.1%). However, from cyclical perspective we believe that a turning point toward a moderate recovery could occur over the course of the next year. In any case, 2027 will still show a mild expansion (3.2%), well below the historical average of 3.7% observed since the beginning of the century and up to the Covid-19 pandemic.

This growth rate remains insufficient to address the enormous challenges ahead. To put it in perspective: losing half a percentage point of global GDP growth implies USD 10 trillion less over just 5 years — equivalent to the combined nominal GDP of Germany and Japan, the world´s third and four largest economies.

Growth remains insufficient to address the enormous challenges ahead.

Geopolitical uncertainty and volatility remain powerful constraints on growth. Structural trends, such as the gradual reduction of the working-age population due to ageing, will also slow global growth in the mid-term. The world population growth rate has fallen from 2% annually to below 1% in just half a century. China's slowdown is another major factor: as its economy matures, growth will likely ease from around 8% annually 10 years ago to about 4% in the years ahead. Neither of these traditional 'growth engines' will be available in the future. The key question is: how can the world replace these engines and reignite global growth?

How do we 'reset' global growth?

A roadmap to speed up global growth should include 're-globalising the world', a productivity 'revolution' and growth-boosting smart regulation.

As Giuseppe Tomasi di Lampedusa wrote in *The Leopard*: "If we want things to stay as they are, everything must change". Today, a large share of humanity enjoys the highest living standards in history. Yet what got us here will not necessarily take us forward over the next 10 to 20 years. The current global growth outlook is among the weakest in many years. None of the world's challenges that lie ahead can be solved without concrete actions and consensus on how to 'reset' the global growth model. A possible roadmap would be to 'replace' the previous drivers with three new growth 'engines' for the coming decades:

1) '**Re-globalising the world':** Geopolitical fragmentation risks leading the world into a less efficient equilibrium. Reversing this requires incentives that generate win-win dynamics, strengthen multilateralism, and reinforce global governance. The world must 'new globalise' on more stable and solid foundations.

2) **A productivity revolution:** Transformative technologies, led by AI, could help reverse the economic growth slowdown. This also requires structural reforms to labour markets and education, alongside major investments in re-skilling the workforce and better allocation of resources. According to the IMF, AI-induced

productivity gains could lift global GDP by up to 4 percent over the next decade[1] (see Special topic: "The macroeconomic effects of artificial intelligence").

3) **Growth-boosting smart regulation:** Designed to unlock financing and stimulate investment. Weak capital accumulation has led to a sharp decline in real investment since the 2008 crisis. Recovery after this year was modest, investment contracted again during the pandemic, and aggregate real investment today remains around 20% below trend in advanced economies and around 30% below in emerging markets.[2] Reigniting investment is essential: Europe alone requires an additional EUR 800 billion per year to regain competitiveness.[3] This demands a regulatory and financing framework that fosters growth and balances financial stability with pro-growth incentives. Evidence increasingly confirms the close link between high-quality regulation and productivity growth (see Special topic: "Regulation and productivity: In search of the optimal balance").

Unemployment rates proved highly resistant to increases, which was crucial in sustaining growth despite higher interest rates.

Resetting global growth requires building consensus to reverse economic fragmentation, designing smarter regulations, and accelerating technology adoption to raise productivity. Additionally, in several regions and countries, addressing fiscal imbalance is key to tackling persistent public deficits and stabilising debt ratios.

Lessons from recent shocks

The world has experienced two major disruptive exogenous shocks in recent years: first, the Covid-19 pandemic in 2020, and second, Russia's invasion of Ukraine in 2022. Together, these events strained global value chains and triggered the highest inflation rates in four decades across most regions. The joint action of central banks — in 2022, a record eight out of ten raised interest rates simultaneously — helped bring inflation back close to pre-crisis levels within two years. This was achieved through a 'soft landing', with only a moderate negative impact on economic activity. A key feature of this was the resilience of labour markets worldwide. Unemployment rates proved highly resistant to increases, even during the economic slowdown, which was crucial in sustaining growth despite higher interest rates over the past few years.

New equilibrium levels of interest rates appear compatible with today's low unemployment rates.

Today, most central banks have either completed or are close to completing their interest rate-cutting cycles. However, terminal rates remain significantly higher than in the previous decade. These new equilibrium levels of interest rates appear compatible with today's low unemployment rates (see Special topic: "The 'equilibrium' interest rate: A review of the main drivers"). In many cases, jobless rates are at or near historical lows, as seen in the euro area, the United States, the United Kingdom, Poland, Brazil and Mexico — among countries where Santander operates. This resilience also provides central banks with greater room for manoeuvre should they need to tighten policy again to keep inflation under control in the future.

[1] International Monetary Fund, World Economic Outlook (October, 2025), 'Global Economy in Flux, Prospects Remain Dim', Washington DC.

[2] Organisation for Economic Co-operation and Development (2025), 'OECD Economic Outlook, Volume 2025 Issue 1: Tackling Uncertainty, Reviving Growth, Paris, 2025

[3] Draghi, M. (2024). 'The future of European competitiveness: Report for the European Commission'. Brussels: European Commission.

Declining interest rates and record-high markets

Despite lower interest rates, the global geopolitical situation and the fiscal imbalances will be headwinds to growth.

With interest rates declining and nearing their floor in many countries and regions, the global economic cycle should accelerate growth going forward. However, as we have anticipated, forecasts point to only a mild hastening over the next two to three years and at a different pace by region. Common factors — such as uncertainty surrounding the global geopolitical situation and worsening fiscal imbalances — are acting as headwinds to growth. These come on top of the structural trends already noted, including population ageing globally and China's economic slowdown.

On the other hand, certain factors could push growth above current projections. For instance, a faster-than-expected de-escalation of ongoing armed conflicts, coupled with strengthened global coordination and multilateralism, would provide upside momentum. Similarly, a more rapid and widespread adoption of AI than currently anticipated would boost productivity and economic growth. According to the IMF, a marked decline in global economic policy uncertainty — stemming from clearer and more stable bilateral and multilateral trade agreements — could raise global output by around 0.4%. Reducing tariffs within these agreements would add roughly another 0.3% to growth. In addition productivity gains from artificial intelligence could further increase global output by about 0.4% in the near term.

Global markets reflect the current dichotomous scenario: stock markets and safe-haven assets, such as gold, are simultaneously at record highs.

Global markets are perhaps the clearest reflection of the dichotomous economic scenario at present, in which stock markets at record highs (usually associated with periods of economic expansion) coexist with traditional safe-haven assets such as gold (also at record levels). This unusual asset dynamic highlights the complexity of today's environment. Historically, equities and gold have thrived under opposing conditions, but since late 2023 both have reached record highs simultaneously. This rare occurrence reflects the dual nature of the current cycle: optimism about growth and productivity (driven mainly by the optimism about AI and expectations of monetary policy easing), and heightened demand for safe-haven assets amid geopolitical risks. Meanwhile, the emergence of technological innovations in finance — such as stablecoins, which have expanded rapidly over a short period — deserves further analysis and understanding.

Regional and country outlook

In the US, the effective tariff rate rose from 2% to nearly 17% — its highest level in almost 90 years.

The **United States** has undoubtedly been at the centre of global attention in recent months. In 2025, the US administration pursued a trade policy aimed at reshaping the world trade map and reducing its goods trade deficit. The effective tariff rate rose from 2% to nearly 17% — its highest level in almost 90 years. However, so far the tariff war appears to have had a moderate impact on the global economy, thanks to the swift response of the private sector — which front-loaded imports — and the absence of significant retaliatory measures from most countries. The economic agenda of the current US administration also include deregulation measures, an extension of tax cuts, and tighter immigration policies.

We expect US economic growth to bottom out between the second half of 2025 and early 2026, before gradually accelerating in the following years. Nevertheless, growth will remain below the average of recent decades (slightly above 2%). At the same time, inflation is projected to converge gradually towards the Federal Reserve's target, approaching that level by 2027/28, while the unemployment rate should stay low, in the 4.2%–4.5% range. Medium- and long-term fiscal sustainability remains as a challenge for the US economy. Meanwhile, the US dollar is expected to continue weakening gradually against other currencies, such as the euro.

Growth in the euro area is set to accelerate.

The **euro area** — which in recent years has seen southern countries replacing northern ones as the main growth drivers — will move toward a more balanced contribution. Growth is set to accelerate from around 1.2% in 2025 to 1.7% in 2027, supported by fiscal stimulus in countries such as Germany and by the sustained expansion of economies like Spain and Portugal. Joint infrastructure projects in national security spending are also expected to deliver positive effects on growth. In addition, there is growing consensus on the need to boost competitiveness by simplifying bureaucracy through a 'smart regulation' approach that also focuses on strengthening the single market as a driver of growth and scale economies. At the same time, the fiscal position of some countries will need to be closely monitored.

Unemployment will remain near historic lows (around 6%) in the euro area, constrained by an ageing population only partly offset by higher immigration. Inflation is already close to the European Central Bank's 2% target.

In the United Kingdom, economic growth will remain close to 1% in 2026.

In the **United Kingdom**, growth will remain close to 1% in 2026, with unemployment rising only slightly. Inflation, meanwhile, will move gradually towards the 2% target. Looking ahead, the UK faces the challenge of stimulating growth with a constrained labour supply, without significantly increasing labour costs or inflation, while continuing to restore fiscal discipline.

On the other side of the world, **China**'s economy continues along a path of gradual slowdown. We project growth of 4.6% in 2026 and 4.3% in 2027. Its trajectory will depend heavily on its ability to address key structural vulnerabilities, including an ageing population, environmental sustainability, and financial stability.

Latin America's growth is still weighed down by past monetary tightening, with clearer recovery expected from mid-2026.

In **Latin America**, regional growth is still absorbing the lagged effects of the monetary tightening cycles that central banks have implemented in recent years. From mid-2026 onwards, recovery in GDP growth among Latin America's largest economies will become more evident, driven by the full impact of interest rate cuts. At the same time, though the need for fiscal adjustment in Brazil and Mexico could limit economic expansion, progress on this front will strengthen confidence, attract capital inflows and boost investment. However, regional challenges remain: reducing high inequality and poverty; improving access to basic infrastructure; and strengthening the export profile of many economies among others. Progress on the European Union-Mercosur agreement is undoubtedly a major step in the right direction (see Special topic: "The EU–Mercosur agreement: A strategic alliance for the 21st century").

This should not overshadow the fact that Latin America — historically vulnerable to episodes of economic and financial stress whenever the United States and other major economies raise interest rates — has successfully navigated and overcome this challenge recently. This resilience reflects both the professional management of regional central banks and structural reforms undertaken in recent decades, such as deeper and more liquid domestic capital markets, which have significantly reduced risks such as currency mismatches.

Mexico has so far weathered the tariff changes imposed by the United States relatively well. However, challenges lie ahead with the renegotiation of the United States Mexico-Canada Agreement (USMCA) in 2026 and the need for fiscal consolidation. In turn, Brazil faces a decisive presidential election year in 2026 that will shape its economic outlook. Its central bank is expected to begin cutting rates in the first half of 2026, while fiscal consolidation remains a key priority for investors.

Chile, meanwhile, holds presidential elections this year. Economic growth is expected to slow in 2026 to just below 2%, before recovering to 2.3% in 2027. Over the medium term, sustaining stronger growth will require structural reforms to boost productivity and investment.

Commodities

Global commodity markets face mixed conditions entering 2026.

Global commodity markets are entering 2026 under mixed conditions. Overall, the S&P GSCI composite is forecast to fall by 3.3% next year. Slower economic growth is expected to temper demand, yet certain tailwinds remain in place. Chief among these is the sustained weakening of the US dollar, which enhances the purchasing power of non-US buyers. As most commodities are priced in US dollars, a softer greenback typically reduces costs for importers and stimulates consumption.

Even so, the broader commodity complex is unlikely to move in unison. Fundamentals vary substantially across categories, meaning their price trajectories could diverge significantly over the medium term. While the headline S&P GSCI index is still expected to follow a slight downward path, underlying stories in precious metals, base metals, energy and agriculture will likely evolve in contrasting ways.

Gold is reinforcing its role as a safe haven.

Precious metals stand out, with prices expected to rise by more than 4% in 2026. Gold remains the key anchor within the commodity universe. Central banks, particularly in emerging markets, remain eager to diversify their reserves away from the dollar, sustaining robust institutional demand. Beyond official purchases, macroeconomic and geopolitical uncertainty are reinforcing gold's traditional role as a safe haven. These dynamics underpin a constructive outlook for the price of gold.

Base metals paint a more nuanced picture, though they are forecast to edge up by around 2% in 2026. On one hand, subdued manufacturing activity worldwide weighs on short-term demand and China's property market remains under pressure, keeping price momentum in check.

Base metals are forecast to edge up by around 2% in 2026.

On the other hand, longer-term structural drivers remain intact. Metals such as copper, nickel and lithium are indispensable for the energy transition, serving as core inputs in the production of electric vehicles, batteries and energy transmission networks. A further source of structural demand comes from the digital economy. Artificial intelligence, with its growing appetite for electricity and advanced infrastructure, adds a new layer of support to base metals. Data centres, semiconductor fabrication and next-generation communication networks are all highly resource-intensive.

Over the medium term, additional stimulus is likely to come from Europe, where the EU Rearmament Plan and Germany's infrastructure modernisation agenda are expected to boost demand for critical materials. This long-term structural necessity positions base metals as one of the most strategically important commodity classes.

On the supply side, notable divergences emerge across metals. Lithium and nickel enjoy relatively favourable production prospects, and lithium in particular can be scaled up relatively quickly. By contrast, copper production remains limited, with no significant new projects expected to come on stream in the near term that could materially expand output. As a result, the market is projected to remain in deficit over the medium term, adding pressure on copper prices, which are expected to rise by just over 3% in 2026.

Energy prices could remain under downward pressure.

Energy prices according to market expectations are set to decline by more than 6% next year, with Brent crude projected to drop even more in 2026. Oil markets are entering a period of sustained surplus, exerting further downward pressure on prices.

Global demand growth is undergoing a structural slowdown, reflecting technological advances that improve energy efficiency as well as the accelerating adoption of electric vehicles.

On the supply side, OPEC+ is gradually unwinding the voluntary production cuts announced in late 2023, restoring additional barrels to the market. While lower prices may discourage further US drilling activity and cap future production growth, overall supply conditions remain comfortable. However, risks to this outlook remain. Escalating tensions in the Middle East or fresh sanctions on energy exporters could disrupt supply and push prices higher.

Natural gas tells a different story. In the US, domestic demand and resilient industrial use should maintain some price strength. In Europe, meanwhile, the diversification of supply sources has created a more stable environment despite ongoing geopolitical risks, particularly concerning Russian gas flows.

Agricultural commodities are set to ease in 2026.

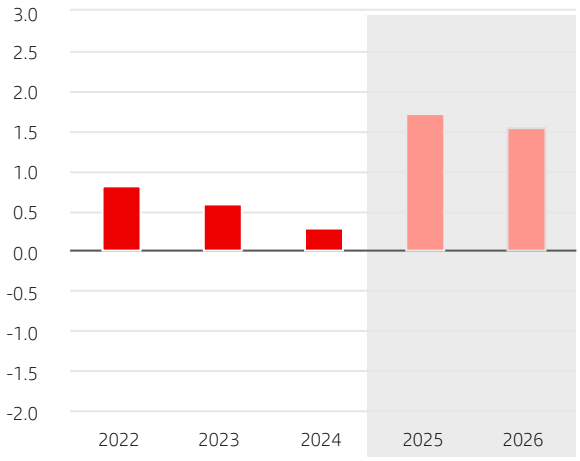
Agricultural commodities present a subdued outlook. They are projected to ease by around 2% in 2026. Gains in productivity and steady improvements in yields are expected to curb price pressures for grains. Indeed, global grain output is projected to rise in 2025/26 thanks to abundant harvests in several key producing regions. This

surplus will likely push prices lower but could simultaneously accelerate consumption, particularly in feedstock and industrial applications.

Soybeans follow a similar pattern. With record harvests anticipated in South America, global output is on track to reach new highs, resulting in downward pressure on prices, which are forecast to retreat by nearly 4%.

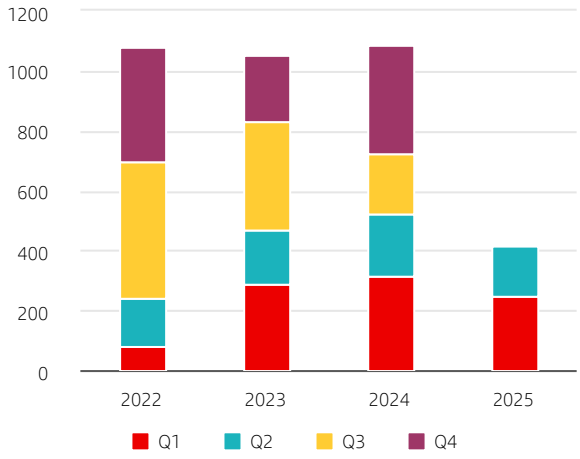
Nevertheless, this relatively benign outlook masks significant upside risks. Climate change is amplifying the frequency of extreme weather events — droughts, floods, and heatwaves — that can swiftly disrupt supply and reverse downward price trends.

Oil market surplus (+) / deficit (-)
(million barrels per day)



Source: U.S. Energy Information Administration (EIA).

Quarterly gold demand by central banks
(tonnes)



Source: World Gold Council.

Commodity price forecasts

S&P GSCI index components	2025	2026	2027
Agriculture	350	343	336
Energy	214	201	205
Base metals	497	509	519
Precious metals	5,198	5,425	5,612
All commodities	545	527	534

Selected commodities	2025	2026	2027
Soybeans (USD/bushel)	9.7	9.3	9.1
Brent oil (USD/bbl)	61	55	57
Copper (USD/MT)	10,780	11,117	11,445

End of period

Sources: Refinitiv, S&P GSCI and Santander Research.

Regions **and countries**

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United States

Navigating policy changes: higher tariffs and deregulation

In the US, higher tariffs and tighter immigration policies weighed on 2025 activity, though less than expected. In 2026, growth should benefit from fiscal and monetary stimulus, deregulation and reduced trade-policy uncertainty. In the meantime, the Fed will ease monetary policy gradually amid a weaker labour market.

The US economy decelerated throughout 2025, reflecting the significant increase in tariffs, lower immigration and restrictive monetary policy. Economic activity expanded by around 1.5% annualised in the first half of 2025, while final sales to private domestic purchasers — which exclude government spending, net exports and change in private inventories — grew by 2.4% annualised. Supportive financial market conditions, tariff exemptions for key supply chain products and strong AI-related investment helped prevent a sharper slowdown.

While the scale of tariff increases is becoming clearer, their overall impact remains uncertain. Employment data suggest that domestic demand will expand at modest rates for the rest of the year. Weaker labour demand, subdued sentiment and higher prices arising from tariffs are expected to weigh on private consumption. Private investment could be constrained by margin compression and the normalisation of trade flows. Growth is projected to recover gradually through 2026, driven by tax cuts and business provisions enacted under the "One Big Beautiful Bill", monetary policy easing, deregulation and a decline in trade-policy uncertainty.

Labour market conditions have softened, with workers' perceptions of job availability deteriorating. Payroll employment growth has been particularly weak in recent months. Reduced immigration has lowered labour supply and may account for part of the weakness, but other factors may also be weighing on labour demand, including heightened policy- and demand-related uncertainty, and a contraction in public-sector employment. These factors are unlikely to reverse in the near term. Accordingly, the unemployment rate is projected to rise to around 4.5% in the first half of 2026, before gradually declining thereafter.

Inflation is expected to remain sticky. Progress towards the 2% target has stalled, reflecting the impact of tariffs. While core services inflation has moderated, rising goods prices have kept headline inflation high. Inflation is projected to hover around 3% in both 2025 and 2026. The tariff-driven impact on inflation is expected to be temporary. Medium- and longer-term inflation expectations remain well anchored, with no evidence of additional pressures from

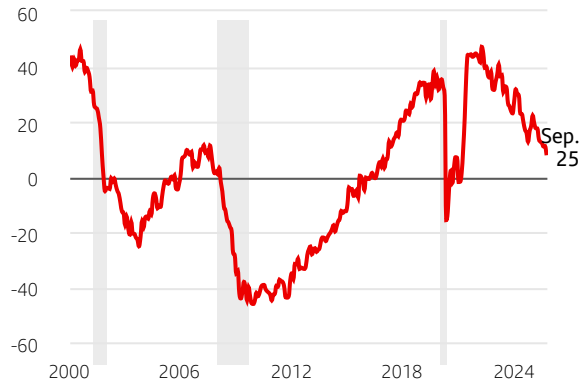
United States

global supply chains, while the weaker labour market limits the risk of second-round wage effects. Inflation is, therefore, expected to resume its convergence towards the 2% target in the second half of 2026.

The Federal Reserve is gradually moving towards its neutral rate. Concerns over downside risks in the labour market have reinforced a more dovish approach. With policy still restrictive, further gradual easing is expected. We anticipate further rate cuts that will bring the target range down to 3.00–3.25%. Estimates of the neutral rate have risen in recent years. In the absence of warning signs of recession or a rapid return of inflation to target, the Fed is unlikely to reduce rates much further.

Significant uncertainty still surrounds the outlook. The impact of tariffs on unemployment and prices is still unclear. Policy uncertainty could persist for longer than expected in the event of renewed tariff threats or legal challenges. Concerns about public debt, together with doubts about the sustainability of tariff revenues as a long-term funding source, may put upward pressure on long-term yields. On a more positive note, advances in artificial intelligence and pro-business policies aimed at reducing regulatory burdens and stimulating investment could lift productivity and potential growth beyond current expectations.

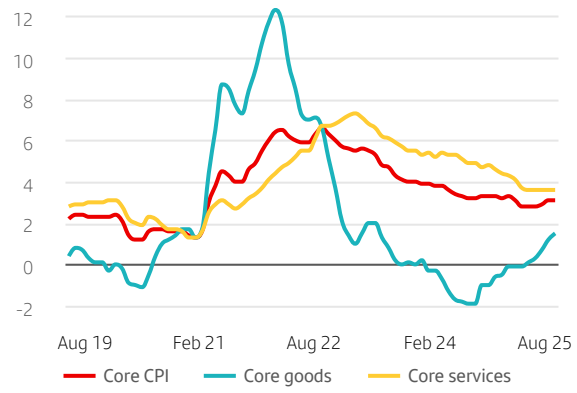
US: Consumer sentiment around the labour market has deteriorated further



Net balance of consumers reporting jobs plentiful minus those reporting jobs hard to find. In shading, the recessions according to the NBER.
Sources: Conference Board and Refinitiv.

US: Rising prices of goods have kept core inflation persistently high

(%, y/y)



Source: Refinitiv.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	1.8	1.8	1.9
Unemployment rate	4.3	4.4	4.2
CPI inflation	2.8	2.8	2.3

Source: Santander Research.

United States: In focus

The medium- and long-term fiscal challenge

The fiscal position of the United States faces challenges due to rising healthcare, social security, and debt-service costs, which are projected to increase further. This could heighten pressure on debt levels over the medium and long term. On the other hand, an eventual stronger-than-expected economic growth — boosted by AI and other factors — would help improve this fiscal outlook.

Deficits, interest costs, and the debt burden

The federal budget deficit has been in the range of 6%–7% of GDP in recent years, with the primary deficit (excluding interest payments) much wider than in comparable cyclical conditions. Interest payments on the debt, which have doubled since 2022, already amount to USD 1 trillion, equivalent to 3.2% of GDP. This now exceeds some of the largest categories of federal expenditure, such as national defence. The ratio of federal debt held by the public to GDP, which was already on an upward trajectory, surged at the onset of the pandemic and now stands at close to 100% of GDP.

Outlook and policy assumptions

Projections indicate that, under current revenue and expenditure policies, the public debt-to-GDP ratio will continue to rise in the medium and long term. Healthcare and social security spending are expected to accelerate as the population ages. Debt service costs would absorb an increasing share of the budget, reflecting both the expansion of the debt stock and the rise in interest rates relative to pre-pandemic levels. Rising mandatory spending (including healthcare and pensions) together with growing interest expenditure is expected to outpace public revenue growth over the next 10 years.

Reversing the structural imbalance between revenue and expenditure requires additional measures. The increase in tariff revenues appears to have the potential to offset the additional challenges of fiscal side that would otherwise have resulted from the 'One Big Beautiful Bill' (OBBB).[1] However, the combined effect of both measures does not improve the fiscal trajectory that was previously projected.[2] As such, the budget deficit is expected to remain in the coming years at around 6% of GDP. These projections depend on several factors.

[1] According to the latest estimates by the Congressional Budget Office (CBO), if tariffs remain at their current levels, the total deficit would be reduced by USD 4 trillion over the period 2025–2035. This figure is very similar to the estimated increase in the deficit of USD 4.1 trillion over the period 2025–2034 resulting from the OBBB. These estimates do not take into account the effect that both measures may have on the economy. Congressional Budget Office (August, 2025), 'An Update About CBO's Projections of the Budgetary Effects of Tariffs', CBO blog post.

[2] If anything, they introduce an additional degree of uncertainty. Projections of the long-term impact of higher tariffs are particularly uncertain, given the possibility of changes and exemptions in tariffs, as well as the lack of empirical evidence on how firms and households might respond to tariff increases of this magnitude over both the short and long term.

United States: In focus

They assume that currently approved policies remain in place over the forecast horizon. If spending increases or revenue reductions initially introduced as temporary become permanent without offsetting measures, the deficit might rise. This pattern has been common over the past two decades and explains much of the increase in the structural deficit. According to the Congressional Budget Office (CBO), if some of the temporary tax provisions in the OBBB were made permanent, the budget shortfall could expand by nearly USD 1 trillion over the next decade. Economic growth and interest rate projections are also key inputs in debt sustainability assessments.

Rates, growth, and debt dynamics

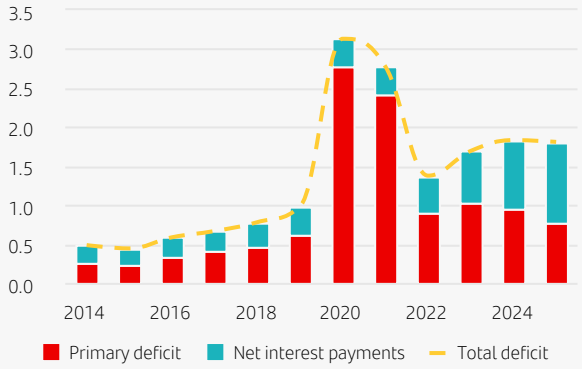
Higher real interest rates generally make debt convergence more challenging, as they increase interest costs and reduce fiscal space for adjustment. They also worsen the primary deficit owing to their contractionary effect on activity. It is estimated that a one percentage point increase in interest rates above current projections could lead to an additional increase of around 10 percentage points in the debt-to-GDP ratio over a 10-year horizon.

By contrast, stronger-than-expected economic growth would improve the fiscal outlook by raising tax revenue and reducing the denominator in the ratios used to assess fiscal sustainability. Sustained higher real growth would ease the control of debt dynamics. But will a productivity boost from the AI revolution be sufficient? To reverse the current debt trend, the increase would need to be substantial.

US: Public debt to GDP ratio

Source: CBO.

US: public deficit breakdown (USD trillion)



Source: CBO.

Euro area

In transition to a cyclical recovery

Euro area growth is expected to accelerate in 2026, supported by monetary and fiscal policies. In the medium term, restoring competitiveness and lifting potential growth will keep the spotlight on structural reforms, regulatory simplification, and deeper integration within the EU. The labour market has remained robust, with unemployment at historical lows.

In 2025, the euro area showed resilience despite US tariffs and global trade uncertainty. Economic activity grew at an annualised 1.4% in the first half of the year. Yet the composition of growth was fragile, with the first quarter boosted by pre-tariff exports and the second quarter by inventory accumulation. Investment proved volatile, while household consumption has yet to gain traction.

The EU–US Trade Agreement is positive insofar as it reduces the risk of a trade war and lowers overall uncertainty. Yet, the terms of the agreement put pressure on the competitiveness of euro area firms relative to their US peers, at a time when the euro has strengthened considerably.

Looking ahead to 2026, the euro area is set to overcome recent external shocks and enter cyclical recovery. Monetary easing will gradually filter through, supported by a more expansionary fiscal stance. Private sector fundamentals remain solid: deleveraging has advanced, households maintain high savings, and firms retain financing capacity — enabling them to benefit from lower rates. We forecast GDP growth of 1.2% in 2025 and 1.3% in 2026, with a steady upward trajectory in quarterly activity next year. For 2027, economic activity will accelerate to 1.7%.

At a structural level, the euro area needs to shift its growth model from external demand to a more domestically driven pattern, centred on investment and supported by higher national security spending. The Draghi Report offers a roadmap for enhancing EU competitiveness vis-à-vis major economies, boosting productivity while advancing energy and digital transformation. This approach places particular emphasis on strengthening the internal market, simplifying regulation, and deepening capital markets as central public policy priorities in the years ahead.

The labour market has remained robust, with unemployment at historical lows (6.2%). This reflects both supply-side constraints, linked to demographic ageing, and sustained job creation. While labour market conditions have softened somewhat in large economies such as Germany and France, cooling has been modest and offset by gains in countries with strong service-sector specialisation, notably in tourism (e.g. Spain and Portugal). The expected recovery in 2026 will reinforce the downward trend in unemployment, which we expect to move towards 6%.

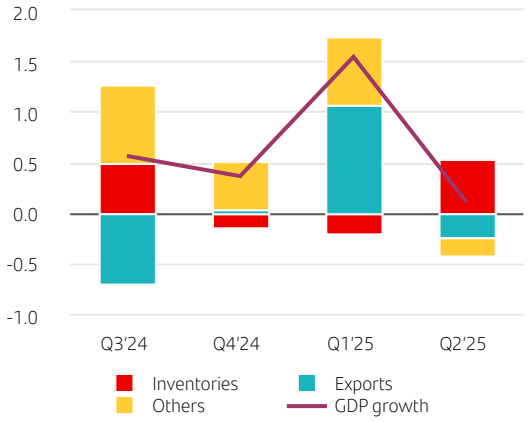
Euro area

In 2025, inflation returned to the ECB's 2% target, enabling the Governing Council to lower policy rates. For 2026, we expect inflation to remain aligned with the ECB's price stability objective, albeit with the possibility of temporarily undershooting 2%. While euro appreciation may exert some downward pressure, cyclical recovery will help close the current negative output gap and we expect wage growth to converge towards 2.5%. Once adjusted for productivity gains, this would be consistent with the ECB's inflation target.

The ECB has lowered its key interest rates to 2%, a level considered neutral for the real economy. Given the lag in monetary policy transmission, we expect this to support growth in 2026, particularly through stronger household consumption and corporate investment. Policy rates are expected to remain stable through 2026.

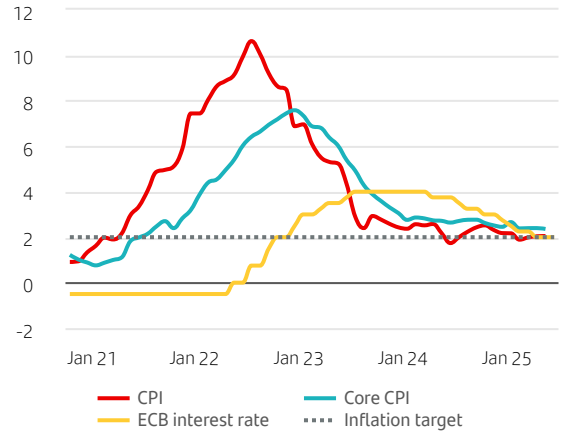
Fiscal policy will turn expansionary in 2026, reflecting strategic decisions taken the previous year. The EU has prioritised higher defence spending, while Germany is launching an ambitious infrastructure renewal programme. A final boost is also expected from investment projects under the NextGenerationEU funds, given the approaching disbursement deadline. As a result, the general government deficit in the euro area is expected to rise moderately, from 2.9% of GDP in 2025 to slightly above 3% in 2026. This increase will, however, be contained by differentiated fiscal space across countries, with high-debt economies likely to reallocate expenditure towards national security to safeguard debt sustainability.

Euro area: GDP growth breakdown
(%, y/y)



Source: Eurostat.

Euro area: inflation is at ECB target
(%, y/y)



Sources: ECB and Santander Research.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	1.2	1.3	1.7
Unemployment rate	6.3	6.2	6.0
CPI inflation	2.1	1.9	2.0

Source: Santander Research.

Euro Area: In focus

Towards a common safe asset in the euro area

There is a new opportunity to advance the creation of a common safe asset in the euro area: eurobonds, which would be key in strengthening European financial integration and strategic autonomy.

One of the defining features of the euro area — as a monetary union without a fiscal union — is that its sovereign debt market is fragmented, which has resulted in a limited supply of euro-denominated financial instruments that can function as safe assets.

This fragmentation stems from the fact that each Member State has its own creditworthiness (determined by its fiscal position) and because of substantial differences in market depth and liquidity across national sovereign bond markets. In particular, the outstanding volume of bonds issued by euro area treasuries amounts to nearly EUR 12 trillion. Of this, one quarter is rated AAA, another quarter is rated AA, and the remainder is rated A or below. Furthermore, the relatively small size of many sovereign issues has often hindered the development of organised derivatives markets. For instance, Eurex offers futures contracts on government debt from Germany, France, Italy and Spain. Among them, only German futures, which account for over 70% of the fixed income futures traded every day, have real depth and liquidity. Consequently, only German sovereign debt currently meets the quality and liquidity standards expected from a world-class safe asset. Reshaping this financial structure requires regional political agreement and an appropriate technical solution.

The emerging opportunity

The absence of such political agreement stems from the fact that fiscal sovereignty remains with Member States, which have historically shown varying degrees of commitment to fiscal discipline. Moreover, the Maastricht Treaty includes the prohibition of mutualising Member States' sovereign debt. Despite this, the possibility of creating a common safe asset has been seriously considered on several occasions.

The first discussions emerged during the sovereign debt crisis triggered by the Great Financial Crisis, where the aim was to break the vicious circle between sovereign and banking sector solvency. However, those proposals failed to progress due to divergences in countries' fiscal positions, which led to distrust of the more austere states and their refusal to issue debt instruments that would involve risk sharing, due to moral hazard concerns.

Euro Area: In focus

The second major opportunity came with the pandemic, where the aim was to provide the EU with the fiscal capacity to respond to the systemic shock. On this occasion, joint debt issuance was agreed upon, but only as an exceptional and time-limited measure — linked to the NextGenerationEU programme and SURE — as these bonds were to be amortised within a specific timeframe.

A third opportunity is now emerging. Geopolitical shifts — particularly those driven by the United States — have prompted international capital flows into the euro, leading public institutions in the euro area to reconsider the international role of the euro. This time, the rationale for creating a common safe asset — eurobonds — lies in progressing European capital market integration, enhancing resilience to external shocks, and reinforcing Europe's strategic autonomy.

Proposals for a common safe asset

Two main proposals have been put forward to quickly establish a eurobond market with sufficient volume and credit quality to function as a safe asset, while avoiding mutualisation of sovereign risk.

One approach, put forth by economists Olivier Blanchard and Ángel Ubide,[1] reformulates the earlier proposal by Delpla and von Weizsäcker (2010)[2] during the sovereign debt crisis. It involves the European Commission issuing eurobonds and using the proceeds to purchase part of the national sovereign debt. These eurobonds would be senior to the Member States' remaining sovereign debt — thus minimising the risk of joint liability — and interest payments would be backed by specific national fiscal revenues. As a result, public debt would be segmented into two tiers: high-quality 'blue bonds' (the eurobonds) that function as safe assets, and lower-tier 'red bonds' that account for the remaining national debt.

The alternative proposal is to create synthetic eurobonds via the securitisation of a diversified portfolio of sovereign bonds, known as the sovereign bond backed securities (SBBS) proposal. The senior tranche of such securitisation would serve as the European safe asset. This technical solution also dates back to the sovereign debt crisis,and has been revised several times,[3] even culminating in a draft legislative proposal presented to the European Parliament in 2018.[4]

[1] Blanchard O. and Ubide, Á. (2025), 'Now is the time for Eurobonds: A specific proposal, Peterson Institute for International Economics', Real-time Economics Blog.

[2] Delpla, J., and von Weizsäcker, J. (May, 2010), 'The blue bond proposal', Bruegel Policy Brief No. 2010/03.

[3] Brunnermeier, M. K., Garicano, L., Lane, P. R., Pagano, M., Reis, R., Santos, T., Thesmar, D., Van Nieuwerburgh, S., & Vayanos, D. (September, 2011), 'European Safe Bonds (ESBies)' and Brunnermeier, M. K., Garicano, L., Lane, P. R., Pagano, M., Reis, R., Santos, T., Thesmar, D., Van Nieuwerburgh, S., & Vayanos, D. (May, 2016), 'The Sovereign-Bank Diabolic Loop and ESBies', American Economic Review, 106(5), 508–512.

[4] European Commission, Directorate General for Financial Stability, Financial Services and Capital Markets Union (May, 2018), 'Proposal for a regulation on sovereign bond backed securities' (COM/2018/339 final).

Euro Area: In focus

From creation to global relevance

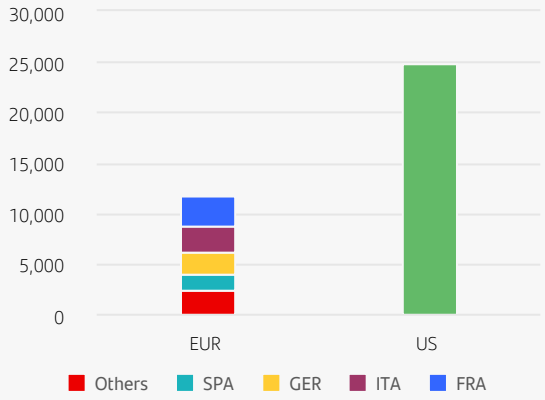
Even if political consensus is ultimately achieved and a technically sound solution is implemented, significant progress would still be required for eurobonds to rival US treasuries. Eurobonds would meet the first key requirement for a safe asset: providing a high-quality financial instrument. The proposals outlined envisage an outstanding volume of at least EUR 5 trillion — double Germany's outstanding debt — but still only one-fifth the size of the US treasury market.

The second requirement is liquidity, which necessitates the development of derivatives instruments and market infrastructure. The benchmark set by the US treasury market in terms of depth and liquidity is considerably higher. For example, in 2024, daily secondary market trading in US treasuries reached USD 1 trillion, 30 times the daily turnover in German government bonds (EUR 27 billion).

Conclusion

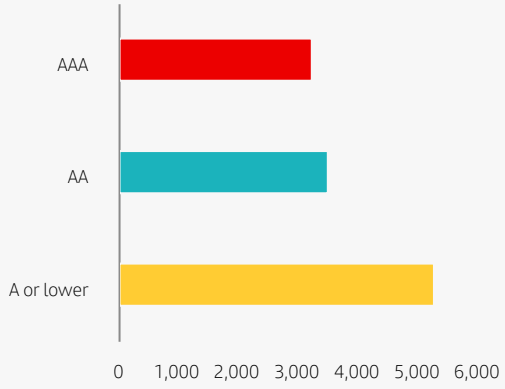
The current geopolitical environment has created an opportunity to develop a common safe asset — eurobonds — that would be a cornerstone of deeper capital market integration in Europe. While political and technical challenges remain, the prospect of improving financing conditions across the euro area (and, more broadly, the EU) justifies the effort.

Euro area versus US sovereign bonds total outstanding in 2025 (EUR bn)



Sources: ECB and US Treasury; Including EU bonds.

Euro area sovereign debt by rating (EUR bn)



Sources: ECB and S&P.

Portugal

Strength today, confidence tomorrow

Portugal stands out as a top performer in the euro area. Looking ahead, growth is expected to moderate, as the economy is transitioning from rapid recovery to stable, sustainable growth — underpinned by strong fundamentals and forward-looking policies.

Economic landscape: Resilience amid global headwinds. Portugal's economy continues to grow steadily, powered by strong domestic demand, a robust labour market, and solid public finances — even as external challenges mount.

In the second quarter of 2025, GDP rose 0.6% quarter-on-quarter and 1.9% year-on-year, driven by private consumption and supported by rising real wages and record employment. Unemployment rate fell to 5.8%, with 202,000 more people employed than a year ago. Investment grew modestly. National Recovery and Resilience Plan (RRP) execution reached 32%, with reprogrammed EU funds now targeting high-impact sectors like health and research, replacing slower-moving public works. But external trade remains a weak link. Net exports dragged on growth due to soft global demand and a dip in service exports. Tourism shines, with 18 million guests (3.7%) and EUR 3.9 billion in revenue (8.4%) in the first seven months, with the US gaining market share.

Still, US tariffs (15%) on EU goods threaten key Portuguese exports. Pharmaceuticals, making up over a third of exports to the US, face reduced competitiveness. Other vulnerable sectors include transport equipment, textiles, footwear, and wine. Inflation rose to 2.8% in August, driven by food prices (7.0%), while core inflation held steady at 2.5%. Falling unit prices suggest disinflation may be underway.

Despite volatility, consumer confidence remains strong, and the economic climate is improving across services, manufacturing and trade, though construction shows signs of softening. The housing market remains dynamic, with median prices at EUR 1,945 per m^2 (18.7%). However, recent legal reforms — ending the Golden Visa and tightening naturalisation rules — may cool foreign investor interest.

Outlook: Steady growth anchored to resilience and strategic opportunity. Portugal is poised for moderate yet stable economic growth, projected to average 1.6% annually through 2027. This trajectory is supported by resilient domestic demand, a robust labour market and sound fiscal management, positioning the country as a resilient performer within the euro area.

Portugal

Private consumption is expected to moderate but remain positive, driven by rising real incomes and fiscal stimulus, while household savings should remain high. Investment activity is expected to expand at a healthy pace — around 4% annually — underpinned by strategic public funding programmes such as the RRP and Portugal 2030, as well as declining interest rates. Exports may face short-term headwinds in 2025, reflecting global economic uncertainty and geopolitical risk. However, gradual recovery is anticipated from 2026 onward, supported by diversification efforts and competitive sectors. Tourism will remain a pillar of external demand, bolstering services exports and contributing to real estate activity, where house price growth is forecast to slow to 5% in 2025, then stabilise around 3.5% in 2026.

Portugal's labour market is expected to remain resilient, with unemployment holding well below the estimated natural rate. Wage growth will be supported by tax reforms, disinflation and workforce mobility, including immigration flows that help address demographic challenges and skill gaps. Productivity is projected to grow by approximately 1.5% annually, driven by digital transformation, automation, and a highly skilled workforce. Inflation is expected to stabilise around 2%, aligned with ECB targets. However, short-term volatility may persist due to energy price fluctuations, tourism-related seasonal effects, and global supply chain adjustments.

Portugal's fiscal position remains strong, with the budget expected to stay close to balance and a primary surplus of 2% of GDP. This should support a sustained reduction in the public debt ratio, projected to fall below 90% by 2027. Investor confidence remains high, with sovereign bond spreads over German benchmarks continuing to narrow. This reflects fiscal prudence and political stability, and is reinforced by recent rating upgrades by S&P and Fitch, both raising Portugal to A.

Conclusion. Portugal enters 2026 with a resilient economy and a stable growth outlook. Global risks and domestic shifts present challenges, but the country's strong labour market, disciplined fiscal policy, and EU-backed investments provide a solid buffer. By staying agile and building on its strengths, Portugal is well-positioned to maintain confidence and drive progress in the years ahead.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	1.6	1.9	1.6
Unemployment rate	6.4	6.4	6.5
CPI inflation	2.2	2.1	2.1

Source: Santander Research.

Portugal: In focus

The Lusitanian swan: The economic transformation of an ugly duckling

Portugal has undergone a profound structural transformation over the past two decades. From macroeconomic fragility and structural imbalances in the early 2000s, it implemented a series of ambitious reforms in response to the sovereign debt crisis. These efforts, combined with a favourable external environment and disciplined fiscal management, enabled Portugal to restore investor confidence, stabilise public finances and get back on a sustainable growth path.

An unbalanced but apparently healthy economy

Portugal experienced a period of clear economic stability between 2000 and 2007, driven by strong credit-fuelled consumption. However, this growth masked deep structural imbalances: low R&D investment (0.3% of GDP), excessive reliance on construction (70% of total investment), high indebtedness (310% of GDP by 2008), persistent job market fragilities (8% unemployment, 17% youth unemployment), and a high dependence on imported, non-renewable energy (85%). These structural imbalances created the conditions for a deep crisis, which was triggered by the 2008 financial crisis.

The pains of transformation during the adjustment period (2010-2014)

The international crisis of 2008 exposed the fragility of Portugal's economy. In 2010, a sharp deterioration in investor confidence caused Portuguese sovereign debt interest rates to exceed 14%, signalling a looming liquidity crisis. In response, the government requested external assistance from the European Commission, ECB and IMF ('Troika'), securing a EUR 78 billion bailout package.

The adjustment came with deep austerity:

- **Reduction of the wage bill:** Cuts to public sector salaries, reduction of pensions and social benefits, redundancies.
- **Increased tax burden:** Increased taxes (such as VAT and IRS surcharges).
- **Reduction of public investment.**

These measures, while necessary to restore external confidence, deepened the economic recession. Between 2011 and 2012, GDP contracted by more than 4% and unemployment reached historic levels (17% in 2013, with youth unemployment around 40%).

Portugal: In focus

Nonetheless, the period also saw the implementation of major structural reforms:

- **Greater job market flexibility:** Reduction of redundancy payments and simplification of hiring and dismissal procedures.
- **Public administration modernisation and cost efficiency.**
- **Tax system:** Simplification and gradual reduction of corporate income tax.
- **New competition and regulation framework.**
- **Streamlining in healthcare and local government.**

Early signs of recovery emerged from 2014: unemployment dropped to 12% in 2015, exports surpassed 40% of GDP, and the current account turned positive. Debt spreads narrowed from over 1,200 basis points in 2012 to 150 in 2015. Energy dependence also improved, with renewables reaching 43% of production.

The path of value generation, but in a favourable economic landscape (2015–2019)

After exiting the financial assistance programme in 2014, Portugal entered a phase of sustained economic recovery, marked by balanced growth and fiscal discipline.

Despite a significant recapitalisation of Caixa Geral de Depósitos (EUR 4.9 billion) in 2017, Portugal maintained fiscal control, reducing its budget deficit to 0.3% of GDP by 2018 and achieving a slight surplus (~0.1%) in 2019 — the first surplus in over 40 years.

This strong fiscal performance was underpinned by increased tax revenues, a notable decline in debt interest payments (from 4.5% of GDP in 2015 to 3% in 2019), and sustained containment of public expenditure. Public debt also declined from 130% of GDP to approximately 117% in 2019, prompting rating agencies to restore Portugal's investment-grade status by 2018.

Investor confidence improved significantly, reflected in the narrowing of bond spreads against German benchmarks from 12 percentage points in 2012 to approximately 0.7 points in 2020, placing Portugal on par with economies like Spain.

By late 2019, Portugal exhibited strong economic fundamentals, including diversified growth drivers, a falling unemployment rate (~6.5%), consistent budget surpluses, and a clear trajectory of debt reduction, which helped it withstand subsequent challenges such as the Covid-19 pandemic and monetary tightening.

Portugal: In focus

The challenges to the resilience of Portugal's economic model (2020-2023)

Between 2020 and 2023, Portugal's economic resilience was tested by significant external shocks, including the Covid-19 pandemic, rising inflation, and higher interest rates. In 2020, GDP contracted by 8.4%, one of the steepest declines in the EU, highlighting vulnerabilities related to dependence on tourism and external shocks. The fiscal deficit increased sharply to approximately 5.8% of GDP, and public debt rose again above 130%.

European policy responses — including suspending fiscal rules, ECB asset purchases, and the Recovery and Resilience Plan — helped stabilise financial markets and mitigate the economic impact.

However, global inflationary pressures intensified from 2021 due to supply-chain disruptions, energy price shocks, and geopolitical instability stemming from Russia's invasion of Ukraine in 2022. The ECB responded with a rapid tightening of monetary policy, raising interest rates from 0% to 4.5%, which increased financing costs significantly.

Despite these challenges, Portugal demonstrated notable economic resilience:

- **Economic growth**: 4.8% in 2021 and 5.8% in 2022, exceeding the pre-pandemic trend. In 2023, it moderated to 2.5%, but remained above the euro area average.
- **Enhanced financial autonomy:** Less debt, greater capitalisation, and liquidity.
- **Ability for continuous investment,** despite high global volatility.
- **Strong commitment to innovation, geographic diversification, and energy autonomy**.
- **Public finances**: The deficit fell below 3% in 2022, with a surplus of 1.2% of GDP and public debt at 97.7% of GDP in 2023.

The starting point shapes the trajectory and confidence

Portugal, starting from a more vulnerable position, achieved structural transformation that brought it closer to the most stable economies in the euro area. The convergence of Portuguese debt spreads with those of Spain — and at times even below those of Italy — is a testimony to the effectiveness of the reforms and the credibility regained.

The importance of the starting point lies precisely in the ability to overcome: the more challenging the beginning, the more significant the achievement.

Spain

Solid growth amid shifting drivers

Spain's growth, stronger than the euro area's in recent years, could reach 2.8% in 2025 and stay solid thereafter, though at a slower pace. Drivers are expected to shift from external demand — key to post-pandemic recovery — to household consumption and investment. Boosting productivity and continuing fiscal consolidation are the main challenges ahead.

Domestic demand is becoming the driver of growth. Household consumption has been stronger than expected in 2025, supported by a robust labour market, real wage growth and population gains due to migration flows. For 2026, it will be the main driver of the economy, together with investment, which is also improving, though still has ground to cover. We expect construction to gain strength as housing demand exceeds current supply. Business investment remains constrained by global trade frictions, but performance in the first half of 2025 was encouraging so further progress is expected.

The external sector will be behind the deceleration of Spain's economy in 2026. Services exports are still growing, albeit at a slower pace. Tourism, which led the post-pandemic recovery, continues to expand but more moderately, with foreign tourism slowing further while domestic tourism has likely peaked. Goods exports have been affected by global trade uncertainty in recent months and a still weak euro area. At the same time, imports of both goods and services are strengthening.

Despite this strong performance, the economy faces challenges. Spain's recent economic expansion has been characterised by strong job creation, rather than increased productivity that has barely contributed to GDP growth and has underperformed compared to the euro area. Several factors explain the gap: the small size of firms, their level of innovation, and a slow pace of investment (even with the NextGenerationEU funds).

The labour market will continue to perform well. In 2026, we expect the unemployment rate to keep falling, dropping below 10%, even as the labour force grows due to immigration. Though this unemployment rate is high compared to other euro area economies, it has also been a level at which companies begin to struggle to find workers. At the same time, job creation will remain positive, though at a more moderate pace.

Inflation, on the right track but slow. After reaching 2%, inflation has been erratic due to energy price fluctuations. For 2025, we expect an average inflation rate of 2.5% (3.1% in 2024) and a year-end figure above 2%. Core inflation will decline more slowly, since services remain stuck above 3% and have less room to fall, as wage increases agreed in collective bargaining stabilised in 2025.

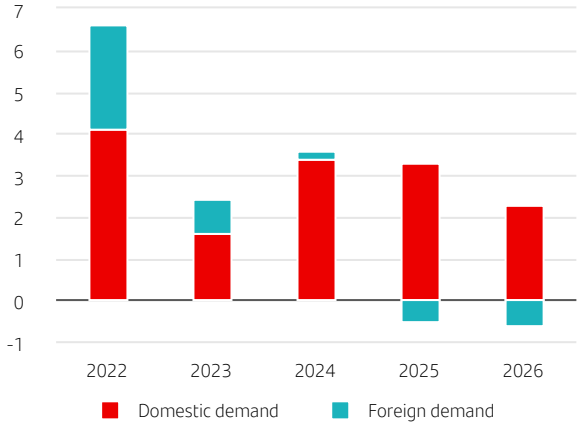
Spain

Demand for housing exceeds supply. Residential demand has continued to increase, supported by improved affordability stemming from lower mortgage rates. However, the end of the rate-cutting cycle, together with the sharp increase in prices, has led to a gradual moderation in the growth rate, which is expected to persist over the coming quarters. At the same time, supply has grown at a double-digit (13%) rate but remains behind covering underlying demographic demand: housing starts are running at around 130,000 units per year, compared with a net household formation of 250,000. This gap continues to widen the housing shortage in the most dynamic areas. Upward pressures on prices persist (12.7% in Q2'25) and are likely to continue, albeit at a more moderate pace.

Debt and public deficit is still challenging, but have improved in 2025. The reduction of the deficit to 2.5% in 2025 (excluding flood-related measures) is largely explained by three key factors: higher revenues from the reversal of tax discounts on electricity, gas and food; moderate public spending growth; and a favourable macroeconomic outlook. Therefore, the government's target of reducing the debt-to-GDP ratio to 101.7% by the end of 2025 and to 100% thereafter appears feasible. Over the longer term, fiscal policy remains one of Spain's main challenges and will need to address the fiscal pressures of an ageing population, particularly in pensions and healthcare.

Spain: GDP growth breakdown

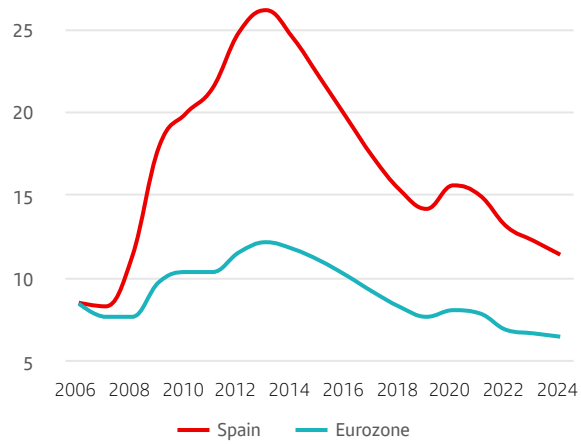
(contributions to GDP growth, %)



Sources: Spanish National Statistics Institute (INE) and Santander Research.

Spanish unemployment rate will keep on falling

(%)



Sources: ECB and Spanish National Statistics Institute (INE).

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	2.8	2.0	1.7
Unemployment rate	10.3	9.8	9.6
CPI inflation	2.5	2.0	2.1

Source: Santander Research.

Spain: In focus

Labour supply under pressure: the impact of demographic change

Robust job creation has supported Spain's post-pandemic recovery, but labour supply pressures from low birth rates and retiring baby boomers challenge its employment-intensive growth model.

Spain's workforce is changing

Demographic shifts, together with wider socio-economic and educational changes, are reshaping Spain's workforce. Two forces drive this transformation: immigration and greater participation of older workers, especially women and the higher-educated.

First, immigration has been central to Spain's cyclical recovery. Since the beginning of 2022 through the first quarter of 2025, 1.6 million jobs have been created, with 1.2 million taken by immigrants and 400,000 by native-born Spaniards. Over the same period, the labour force grew by 1.2 million, entirely due to foreign workers, raising their share to 19% of the population and 28% of the active workforce. Latin America accounts for the largest inflow, with cultural ties and a shared language facilitating labour market integration.

Second, the rising participation of elderly workers reflects a structural trend shared by ageing economies. It is primarily driven by reforms aimed at improving the sustainability of defined-benefit public pension systems (such as raising the statutory retirement age, discouraging early retirement, and/or reducing expected pension benefits). Individuals with higher educational attainment are typically more likely to extend their working lives, which contributes to an overall increase in the average qualification level of the workforce.

Spain is exhibiting both dynamics, further amplified by the delayed entry into the labour market in the early 21st century of young women, who are now transitioning into older age cohorts. As a result, while the national labour force has remained stable since early 2022, the number of individuals over 55 has gone up by nearly 500,000, two-thirds of whom are women. Moreover, the number of tertiary-educated workers has grown by 400,000 in the same period.

Implications for Spain's growth model

In the medium term, labour supply will come under pressure due to declining birth rates and the retirement of the 'baby boom' generation born in the 1960s and 70s. The gap between the cohorts entering and exiting the workforce is expected to reduce the working-age population by an average of 100,000 people annually over the next five years.[1]

[1] Spanish National Institute of Statistics (June, 2024), 'Population projections: 2024-2074'.

Spain: In focus

These trends pose challenges to a growth model that relies on job creation. So far, frictions have been limited, as Spain's unemployment rate started from a high level (close to 14% in 2022) and immigration has largely met labour demand. Today, though unemployment is still high (at around 10%), there are significant disparities across population groups and certain sectors are already facing labour shortages.

Limited room for labour supply expansion

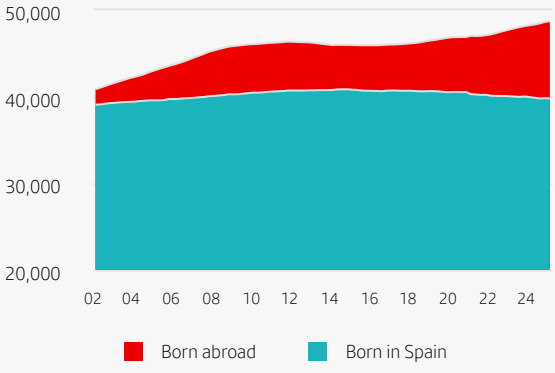
Given such challenging demographic trends, the potential for further increases in labour supply is limited. Immigration may continue in the short and medium term, but it is inherently cyclical and is expected to gradually slowdown in the years ahead.

There remains some room to raise labour force participation among older age groups and also among the youth, whose participation rate is among the lowest in Europe. However, health-related issues — particularly chronic illnesses — become more prevalent with age. In Spain, absence due to temporary disability has increased by 60% since 2019 (rising from 2.9% of the active population in 2019 to 4.1% in 2024), and some studies suggest a possible link to the ageing of the labour force.[2] Finally, ageing job markets may become less dynamic as market turnover slows among older workers compared to their younger counterparts.[3]

Conclusion

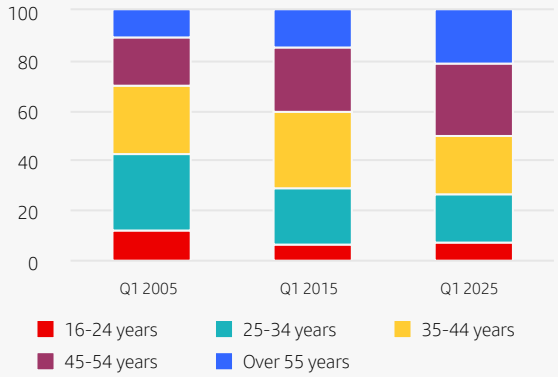
Spain's economy has benefited from a temporary demographic dividend that is unlikely to last. In the medium term, to offset its adverse demographic outlook, Spain must prioritise youth education and adult reskilling, especially to prepare for the transformation brought about by digitalisation, the adoption of artificial intelligence and other technologies, while also increasing productivity.

Spanish population increases due to immigration (thousands of people)



Source: Spanish National Statistics Institute (INE).

Spanish labour force is ageing (share by age as a percentage of labour force)



Source: Spanish National Statistics Institute (INE).

[2] Bank of Spain (2025), Annual Report 2024, 'A first analysis of the increase in sick leave due to temporary disability in Spain' (pp. 172–175).

[3] Anghel, B., & Puente, S. (August, 2024), 'The impact of population ageing on inflows and outflows in the Spanish labour market'. Economic Bulletin of the Bank of Spain, 2024/Q3(07).

Poland

Economic momentum with fiscal consolidation still pending

Poland's economy is showing resilience, with growth stabilising above 3% in 2025 and expected to accelerate further in 2026 on the back of investment and strong household consumption. Inflation is converging towards target, and monetary policy is gradually easing. However, persistent fiscal deficits, rising public debt and high national security spending weigh on the outlook, keeping investor confidence dependent on policy decisions.

In 2025, Poland remained on a path of moderate recovery after the 2022 energy price shock and Russia's invasion of Ukraine. GDP grew 2.9% in 2024, stabilised above 3.0% year on year in the first half of 2025, and is expected to average 3.5% this year. We see growth accelerating to 3.7% in 2026, above consensus, reflecting a stronger euro area outlook and a delayed domestic investment cycle that should gain full momentum next year.

Absorption of Recovery and Resilience Fund (RRF) money has been slow, shifting the investment impulse to 2026. Still, early signs are visible in higher spending by local governments and large firms. Slightly weaker investment in 2025 should be offset by stronger household consumption, supported by real income gains, credit revival and a normalisation of savings from the exceptionally high levels of 2024.

The labour market is performing well. Demand for labour remains solid, and the recent rise in registered unemployment mainly reflects regulatory changes rather than weakening conditions. Wage growth remains high but should slow to 6.0–7.0% year on year in the coming quarters. With productivity gains of 3.0–4.0% year on year, conditions should become increasingly favourable for inflation to stabilise near target.

Inflation has decelerated towards 3% year on year and is expected to stabilise slightly above this level in late 2025, partly due to higher housing costs (heating, waste management). CPI may dip below 3.0% in 2026 but should stay within the tolerance band around the 2.5% target. We assume electricity price caps will remain in place through 2025 year-end and that new energy tariffs for 2026 will not raise household costs.

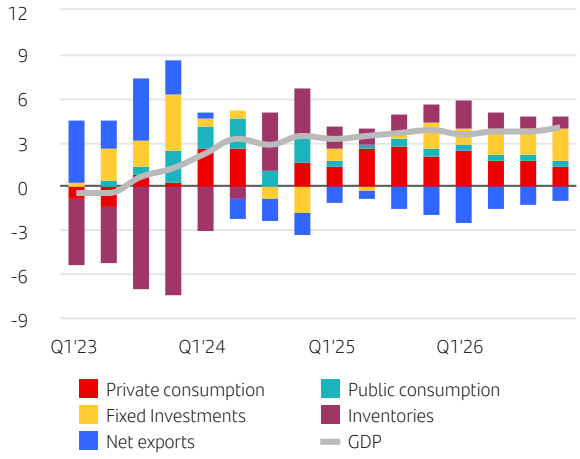
This outlook still allows for further monetary policy easing. In 2025, the National Bank of Poland (NBP) continued to normalise policy, cutting rates to 4.5%, that remains above our estimated neutral rate of 4.0%. We expect the NBP to move more cautiously, given loose fiscal policy and solid GDP growth.

Poland

Fiscal deficits remain high. The 2026 draft budget sets the public sector deficit (GG) at 6.5% of GDP, down slightly from 6.9% in 2025 and 6.6% in 2024. Public debt, according to EU methodology, is expected to rise to 66.8% of GDP in 2026. Room for fiscal consolidation is constrained by the political cycle and the need for higher defence spending. This deterioration has already led Fitch Ratings and Moody's to shift Poland's rating outlook to negative, and other agencies may follow. We believe the European Commission is unlikely to react strongly, as its assessment focuses mainly on the expenditure path, which does not exceed the set targets.

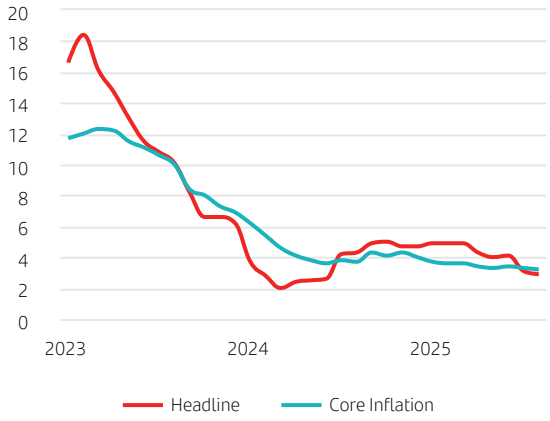
The zloty has been stable, trading between 4.24 and 4.28 against the euro since April 2025. We expect it to remain slightly below 4.30/euro, supported by resilience and EU fund inflows, but weighed down by persistent fiscal uncertainty and the proximity of the ongoing war in Ukraine.

Poland: GDP growth breakdown
(%, y/y)



Sources: Central Statistics Office (GUS) and Santander Research.

Poland: CPI
(%, y/y)



Sources: Refinitiv and Central Statistics Office (GUS).

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	3.5	3.7	3.4
Unemployment rate	3.2	3.2	3.2
CPI inflation	3.9	3.0	2.6

Source: Santander Research.

Poland: In focus

How do EU funds affect business loan sales in Poland?

The 2021–2027 Cohesion Policy is beginning to deliver tangible results. For banks, a key question raised: are EU funds crowding out traditional loans, or do they complement them by enabling companies to launch larger projects? This analysis looks at the data, the economic impact, and the policy implications.

What does the data show?

We use two sources: National Bank of Poland (NBP) data on new loan contracts for non-financial companies, and Ministry of Funds and Regional Policy (MFiPR) figures on EU funding granted under the 2014–2020 and 2021–2027 frameworks. At first glance, the numbers may seem unrelated, especially given the inflation-driven rise in loan volumes after the pandemic. But closer examination reveals a clear positive correlation: when EU funding rises, so do business loan sales.

What is the economic impact?

Regression models, controlling for macroeconomic factors that can affect both the volume of loan sales and the volume of granted EU funding, confirm the link. Every PLN 1 billion of EU funding is associated with an additional PLN 0.5–0.6 billion in loan sales. This relationship is statistically robust, holding at the 1% significance level. Interestingly, there is a temporary dip in loan sales two months after a funding spike, but quarterly data confirms the overall positive trend. Notably, none of the models suggest that EU funds crowd out bank loans.

Why are EU funds and bank loans complementary?

EU funds rarely cover the full cost of a project. By May 2025, Polish companies had launched PLN 234 billion in projects under the 2014–2020 Cohesion Policy, but only PLN 128 billion came from EU sources — just 55% of the total. Our analysis suggests that roughly half of the gap was filled with business loans, showing how EU funds and loans work together.

What are the policy implications?

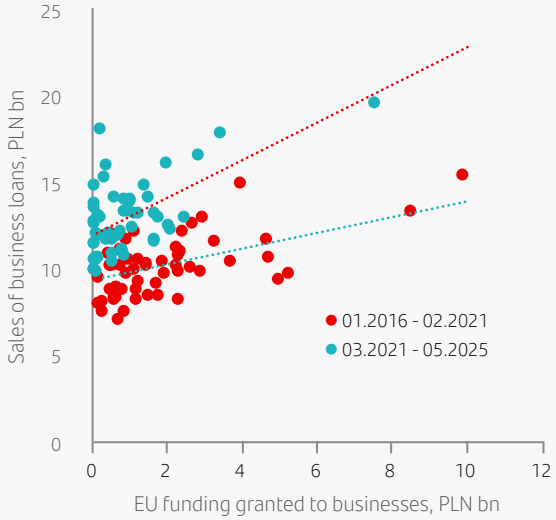
Looking ahead, the 2021–2027 Cohesion Policy should moderately boost loan demand. In 2024, PLN 23 billion in funding contracts were signed, potentially driving PLN 9 billion in loans. In 2025, PLN 25 billion in funding could generate over PLN 10 billion in new loans. Compared with total outstanding business loans, this is just over 0.1% year on year. Since business loans overall are expected to grow around 7% year on year, the effect is positive but moderate. From 2026, the impact may fade, and the role of the Recovery and Resilience Facility (RRF) remains uncertain.

Poland: In focus

Conclusion

EU funds and bank loans are not substitutes — they are partners. Because EU funds only partially cover project costs, companies turn to loans to bridge the gap. Together, they strengthen investment and business growth in Poland.

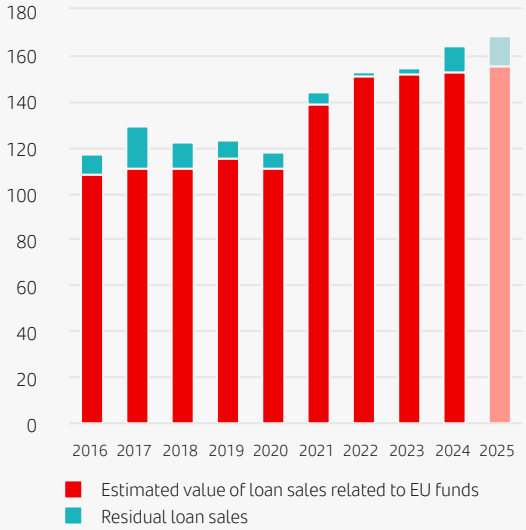
The relationship between corporate loan sales and EU funding for companies



Sources: National Bank of Poland, Ministry of Funds and Regional Policy, and Santander Research.

Poland: Business loan sales

(PLN bn)



Sources: National Bank of Poland and Santander Research.

United Kingdom

Growth slows amid inflation and fiscal strain

The UK economy recovered in the first half of 2025. But high inflation, labour market weakness and fiscal strains are set to weigh on growth. Inflation above target limits rate cuts. Fiscal pressures persist due to high debt, rising servicing costs and doubts over sustainability.

It was a positive start to 2025 for economic growth in the UK. GDP grew 0.7% in the first three months of the year and 0.3% in the following quarter, despite headwinds from new US tariffs and an uncertain geopolitical outlook. However, the second quarter breakdown shows that the boost to the economy was driven largely by higher government expenditure, while household spending rose just 0.1% quarter on quarter and business investment contracted.

Looking forward, quarterly growth is expected to slow in the second half of 2025. This partly reflects the pattern seen in recent years, with stronger growth in the first half and softer outcomes in the second. Beyond that, quarterly growth is likely to remain at trend pace (0.3%–0.4%) unless productivity can be raised.

There are currently issues with the labour market data provided by the Office for National Statistics (ONS). This means it is hard to rely on these statistics alone to assess labour market conditions. Since they were announced in the Autumn 2024 Budget, changes to employer National Insurance contributions (NICs) and the increase in the minimum wage at the start of April 2025 have affected the labour market, alongside the higher cost of living, and have resulted in falling numbers of payrolled employees. Vacancies have also been declining since the peak in 2022 and the Labour Force Survey (LFS) published by the ONS has unemployment at 4.7%, up from 4.4% at the end of last year. It is likely that unemployment will continue to trend up and peak around 5% in 2026.

The UK has struggled to reduce inflation back to its target — 3.8% in August — and it remains higher than in the US and euro area. Contributing factors include regulatory price increases (e.g. water prices rose 26% month on month in April) and higher food and rental inflation. As a result, UK inflation expectations have risen. This is feeding through to continued strength in wage growth, despite a loosening labour market. Though some surveys suggest wage growth may slowdown c.3.5% next year, current pay growth is nearer c.5%. As inflation has started rising again, real-wage growth has fallen, which may explain why household spending has not grown as strongly as hoped. While inflation is

United Kingdom

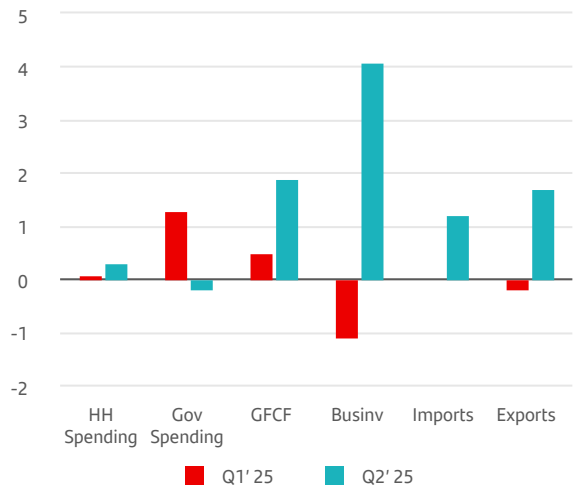
expected to fall over the next 18 months, it will struggle to reach the official 2% target in that time.

Bank Rate has fallen from its 5.25% peak to 4% over the past year. However, rising inflation (and inflation expectations) may limit further cuts, particularly in the near term. Though it is considered that Bank Rate remains in restrictive territory, how restrictive it remains a crucial question. Further cuts are predicted, but how quickly they come will depend on how inflation and wage growth evolve.

The fiscal position remains a major concern. The UK is struggling with elevated government borrowing — with debt-interest spending hitting £16.4 billion in June — and a high peacetime debt-to-GDP ratio of 96.1%. The gilt market shows record-high yields (30-year gilts yields at their highest since 1998), reflecting investor concerns over inflation, borrowing, and fiscal credibility. This has led to increased scrutiny ahead of the Autumn Budget amid speculation about a sizeable fiscal shortfall and what tax measures will be taken to fill it.

UK: Quarterly GDP growth by expenditure component

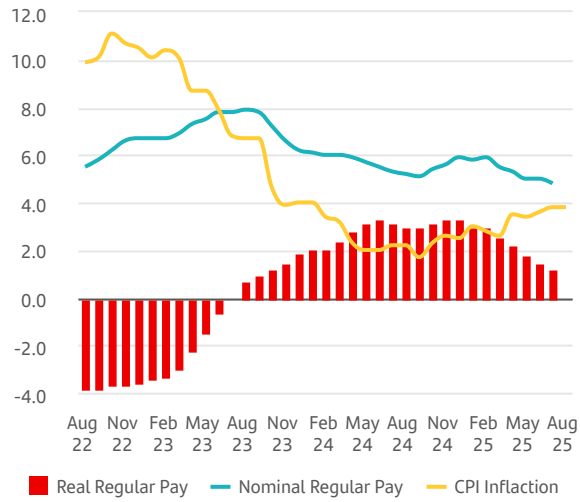
(%, y/y)



Source: ONS.

UK: Real regular pay growth

(%, y/y)



Source: ONS.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	1.3	1.0	1.4
Unemployment rate	4.6	4.8	4.8
CPI inflation	3.3	2.4	2.3

Source: Santander Research.

United Kingdom: In focus

Why are UK industrial electricity prices so high?

The United Kingdom is facing an energy dilemma. Its industries pay far more for electricity than their international competitors, a disadvantage that erodes competitiveness and threatens to accelerate deindustrialisation. This analysis explains why prices are so high, what effects are already being felt in the economy, and what real options exist to address the problem.

The government published the Modern Industrial Strategy[1] in June 2025, outlining a new economic approach that focuses on the UK's strengths. In it, the government said it would make it "easier and simpler for companies to do business". One of the key ways to do this was to tackle the high industrial electricity costs that UK businesses face.

Industrial electricity prices in the UK are significantly higher compared to other advanced economies, a cost businesses say makes it difficult to compete internationally and risks further deindustrialising the UK. Across all member countries of the International Energy Agency (IEA), industrial electricity prices in the UK were around 50% more expensive than Germany and France and four times as expensive as in the US. Over the past decade, prices have ranged from 17% above to 49% above the IEA median. India and China are not members of the IEA, but data for 2024 shows UK firms paid around three times as much for electricity as these two countries.

What is driving higher prices?

The UK's exposure to wholesale gas markets has significantly increased industrial electricity prices. The UK uses a marginal pricing system, meaning the price is set by the last and, therefore, most expensive unit of power required to meet demand at any time. Gas underpins the UK electricity grid and fills the gaps renewables and other sources of energy are unable to fill. It means that gas prices end up setting prices in the electricity market even when it is not the primary source of energy.

An article published in the Energy Journal Reports[2] found that in 2021 gas-fired power stations generated 43% of UK electricity but set the system price 97% of the time. This compares to gas setting the marginal price for electricity in the EU 36% of the time and in France, with its large nuclear capacity, just 7%. The UK could use its natural gas resources to back up renewables like Germany did when it reactivated several coal-fired power plants in response to energy shortages, but

[1] Department for Business and Trade (June, 2025), 'The UK's modern industrial strategy' (CP 1337).

[2] Zakeri, B., Staffell, I., Dodds, P. E., Grubb, M., Ekins, P., Jääskeläinen, J., Cross, S., Helin, K., & Castagneto Gissey, G. (2023), 'The role of natural gas in setting electricity prices in Europe', Energy Reports, 10, 2778–2792.

United Kingdom: In focus

successive governments have backed away from offshore oil and gas leasing and recently closed the last coal plant in its pursuit of decarbonising all sectors of the UK economy to reach the target of net zero by 2050.

The UK's exposure to global gas price swings is exacerbated by its limited gas storage capacity and makes diversifying its energy mix all the more important as renewables like solar and wind are far less reliable than other sources of energy. Renewables accounted for just over half of all electricity production in the UK last year; but while the technology has become cheaper, bills have not fallen. There are several reasons why this could be the case. First, previously expensive costs are still being paid for by consumers and industry. Second, for renewable producers, the major costs remain land, labour and capital — all of which have risen.

What is the economic impact?

Higher UK electricity prices have probably been one of the main factors being the reduced export volumes, as foreign competitors have a competitive edge in terms of pricing and production. Between the end of 2022 and the end of 2024, UK export volumes fell 9.6% compared to a 5.6% decline in Germany, and 4.1% and 5.1% increases in France and the US, respectively. Of this near 10% decline in UK export volumes, services exports have actually risen 11.6%, meaning the overall decline has been driven by goods exports, which have fallen 28.8%.

To cope with these higher energy costs, firms can (in principle) reallocate operational budgets from growth initiatives. They can delay capital investment or expansion plans or even reduce operational output to manage operations in the face of high energy prices, particularly in energy-intensive sectors. The leader of a major business lobbying group recently said that 40% of firms were holding back investment due to high energy bills, while a well-known figure in the UK's chemical industry said energy prices were killing the sector.

As mentioned, this has been a major problem for energy-intensive industries that operate in international markets and include companies that manufacture paper products, petrochemicals, metals and other inorganic products like glass. The combined output of these sectors is estimated to have fallen by one-third between the start of 2021 and the end of 2024, leaving its output level lower than at any time since 1990. This means the UK is becoming ever-more reliant on the service sector to drive economic growth and leaves it with an ever-worsening trade imbalance and more vulnerable to global shocks. High industrial electricity costs threaten the future of the industrial sector in the UK and a failure to act could lead to job losses, decreased competitiveness and slower economic growth.

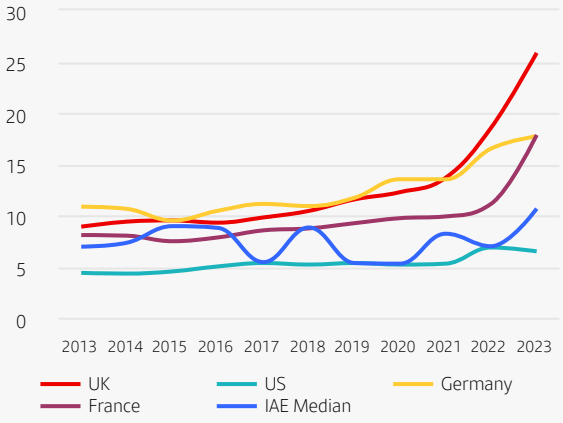
United Kingdom: In focus

What can be done?

The UK government recently committing to building a new nuclear power station (Sizewell C), the first in over three decades, shows the government wants a diverse energy portfolio to enhance energy security. The government has set out some policies designed to reduce costs for some industrial users of electricity. In July 2025, plans to cut electricity network costs for energy-intensive businesses by 90% were set in motion, with around 500 of the UK's most energy-intensive firms set to save up to GBP 420,000 a year when the current 60% discount on network charging costs increases to 90% from 2026. In 2027, the government also plans to exempt around 7,000 energy-intensive businesses from some green levies as well.

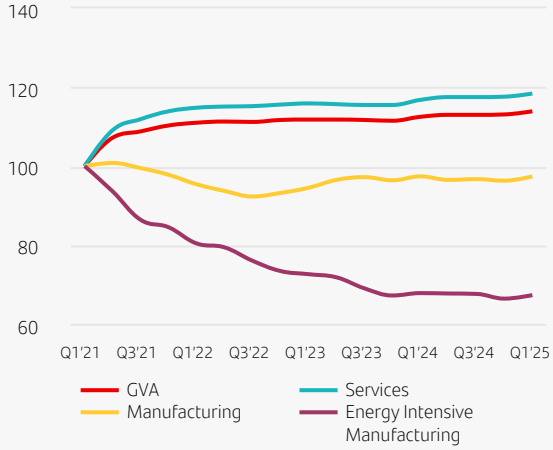
But in reality, these measures are only shifting higher electricity costs onto other energy consumers or to taxpayers and are not a permanent cure to the problem. Time may provide a solution, particularly if gas prices fall further and if technology for renewables and battery storage becomes significantly cheaper. Renewables could still become the cheapest and most secure energy source, but achieving that will require significant capital investment in the UK's energy system — and it will not be a quick fix.

Industrial electricity prices
(pence/kWh)



Sources: International Energy Agency and DESNZ.

UK: Gross Value Added
(Index, Q1'21=100)



Sources: Office for National Statistics and Santander Research.

Latin America

Challenges and opportunities in a volatile global landscape

Current geopolitical and trade tensions pose challenges but also create opportunities for Latin America's economies. Santander's Latin American markets[1] exhibit remarkable diversity in both trade — ranging from close ties with the US or China to more diversified relations — and in their productive structures, which span manufacturing and the competitive use of natural resources, including agribusiness, mining, and energy.

Most countries were expected to slow at the start of 2025. The main uncertainties came from US trade and economic policies, directly and indirectly, through their impact on Latin America's key trading partners. In addition, shifts in investor sentiment — affecting financing conditions and international capital flows — would also be key determinants of economic performance.

So far this year, the economic activity slowdown has been milder than anticipated, prompting upward revisions for 2025 and 2026 growth forecasts. While some investment decisions were postponed — reflected in a slowdown in investment this year — we expect a gradual recovery as the outlook becomes clearer, supported by progress in trade negotiations and lower uncertainty.

A positive surprise has come from stronger-than-expected exports — partly as an advanced response to tariff tensions and partly by capitalising on more favourable than anticipated tariff treatment. Private consumption has also proved more resilient, driven by robust labour markets, falling unemployment, and rising real wages.

Inflation, which had been slowing over the past year and a half, has now stabilised at around 4.5% (excluding Argentina). Some countries remain outside their central banks' tolerance ranges, while others are already showing signs of convergence. This heterogeneity has led central banks to differing monetary stances: in Brazil, the central bank maintains high policy rates and signalled they will remain high for an extended period, while Mexico and Chile have cautiously begun cutting rates and are closely monitoring the risk of inflationary resurgence. Inflation rates are expected to resume converging in 2026 and 2027 towards more moderate levels and closer to official targets. This would enable the more hawkish central banks to begin cutting rates, while those that are already easing could move more decisively toward neutrality.

[1] Latin America - 7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay.

Latin America

Financial markets, which experienced heightened volatility in late 2024 and early 2025, have shown notable recovery in recent months. Currencies have appreciated against the US dollar, long-term yields have declined despite restrictive monetary policies — reflecting a flattening yield curve — and equity markets remain close to record highs, mirroring Wall Street's performance and supported by strong international investor appetite.

Latin America's external position remains solid. Though the current account deficit has begun to widen, it remains moderate (1.7% of GDP on average for Lat-7) and is comfortably financed by stable capital inflows, with foreign direct investment close to 2.5% of GDP and modest portfolio inflows (0.5%). Furthermore, international reserves are high, nearly USD 840 billion (14.3% of GDP), providing a solid buffer against potentially adverse external shocks.

While fiscal accounts are undergoing consolidation, they are doing so unevenly and, in some cases, insufficiently to reduce public debt ratios. Public debt sustainability requires restoring the primary surpluses of the late 2000s. This is a complex task amid growing social demands. Without it, medium-term growth prospects will stay weak and financial risks will persist. In this regard, projections for 2026–2027 suggest that fiscal policies are moving in the right direction but require faster consolidation to firmly anchor the process.

Latin America - 7: Exports by destination countries

	Destination country			
	USA	CHINA	EUROPEAN UNION	ARGENTINA and/or BRAZIL
Origin country				
ARGENTINA	9%	6%	10%	18%
BRAZIL	12%	27%	15%	5%
CHILE	17%	37%	9%	6%
COLOMBIA	30%	4%	12%	5%
MEXICO	83%	2%	4%	1%
PERU	12%	31%	10%	3%
URUGUAY	11%	13%	8%	25%

12 months cumulative figures to May 2025. Red lights mean main destination by country.
Sources: IMF, World Trade directions and Refinitiv.

Latin America - 7: Exports by sector

	Exporting sector			
	AGRICULTURE	MINING	ENERGY	INDUSTRIAL MANUFACTURES
Country				
ARGENTINA	60%	8%	13%	19%
BRAZIL	43%	14%	17%	27%
CHILE	10%	57%	0,4%	33%
COLOMBIA	32%	14%	33%	21%
MEXICO	3,7%	2,0%	3,5%	91%
PERU	21%	65%	5%	9%
URUGUAY	81%	1%	0,6%	18%

Data accumulated year to date, up to the latest available data (July-25 or August-25). Red lights mean main sector by country.
Sources: Ministries of Economy, trade and industry, statistical institutes and central banks of each country.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	1.8	1.8	2.2
Unemployment rate	5.7	5.9	5.9
CPI inflation	7.5	5.4	4.4

Source: Santander Research.

Argentina

From stabilisation to the growth test

In 2025, a firm fiscal anchor, sustained disinflation and a new IMF agreement supported economic conditions, though some volatility weighed on activity in the second half of the year. Growth is expected to hold firm in 2026, supported by continued macro stability, higher investment inflows under the RIGI framework, and a gradual rebound in private consumption. If structural reforms advance and the political environment remains constructive, Argentina could move closer to unlocking its medium-term growth potential.

After the fast rebound seen since mid-2024, the economy lost some momentum from the second half of 2025 and entered a mild contraction. The combination of a very tight monetary stance and high real interest rates slowed investment and domestic demand, as well as impacting on credit growth. We view this setback as temporary and largely linked to the political environment ahead of the mid-term elections of 26 October, among other factors such as tight financial conditions and delayed investment decisions. With a clearer political mandate after December (new Congress composition), expectations could reset given the favourable electoral outcome for the government, unlocking both local and RIGI-related investment and supporting a rebound in consumption. This would set the stage for a solid recovery in 2026, with GDP growth projected to be around 3%.

Monetary policy remained restrictive in 2025, with the shift to a monetary aggregates framework reinforcing the fiscal anchor and limiting money issuance. The elimination of central bank instruments such as the Lefis and higher bank reserve requirements further tightened liquidity. Market interest rates adjusted endogenously to reach historically high real levels. This stance, together with fiscal consolidation, was key to sustained disinflation, though it weighed on credit and activity. At the same time, the financial system began to rebalance: banks continued to reduce their exposure to the public sector and increased lending to households and firms, albeit from a low base of comparison. Credit quality remains sound despite a mild rise in non-performing loans, while deposits continued to recover, particularly in foreign currency. Looking towards 2026, monetary conditions are expected to remain prudent but with substantially lower real interest rates, creating space for a gradual recovery in private sector credit and supporting investment, while preserving overall stability.

Monthly inflation readings remained in the 2% area by mid-2025, supported by the fiscal anchor, a restrictive monetary stance, and a liberalisation of the FX

Argentina

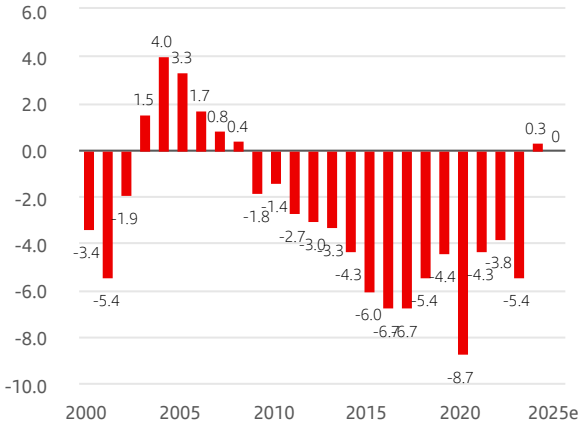
market with limited pass-through. The sharp reduction in subsidies and utility rates adjustments had initially added pressure on regulated prices, but overall disinflation advanced steadily, with headline CPI projected at around 30% for 2025. Core inflation also dropped to multi-year lows, underscoring stronger policy credibility. Looking ahead, inflation is expected to continue its downward path, converging toward 16% in 2026 and moving into single digit by 2027. The pace of this process will hinge on sustaining fiscal discipline, preserving prudent monetary conditions, and anchoring expectations within a more competitive exchange rate framework.

Fiscal policy remained the cornerstone of Argentina's stabilisation programme in 2025. The government upheld strict discipline, delivering a primary surplus of about 1.6% of GDP despite political tensions and repeated attempts in Congress to raise government expenditure. The adjustment came mainly through a sharp cut in subsidies, tighter control of transfers, and a strong contraction in capital expenditure, while social programmes maintained adequate coverage. The zero-deficit rule, embedded in the International Monetary Fund (IMF) agreement, was the centrepiece of credibility and cut monetary financing from Central Bank of Argentina (BCRA). Looking ahead, fiscal consolidation will continue in 2026, supported by reforms in taxation, pensions, and revenue-sharing to strengthen long-term sustainability.

In 2025, stronger agricultural exports and a notable improvement in the energy balance supported the trade account, while the easing of import restrictions and high demand for services widened the current account deficit to about 1.6% of GDP, according to our estimates (a manageable level compared to 2017). On the financial side, inflows from multilaterals and corporates contrasted with higher household dollarisation after the FX market unification in April. The adoption of a band-based exchange rate scheme in that month improved price discovery and narrowed gaps between official and parallel rates. Looking ahead, confidence will depend on a credible reserve accumulation plan and regaining access to international dollar markets at sustainable rates. The 2026 outlook is more optimistic: stronger financial inflows, a combined energy and mining surplus of around USD 16 billion, together with agricultural exports and the first RIGI projects, should bolster the trade balance, rebuild reserves, and strengthen external resilience. Sustaining fiscal discipline and preventing an overly appreciated real exchange rate will also be critical to maintain solid financial conditions, support real activity, and ensure durable market access.

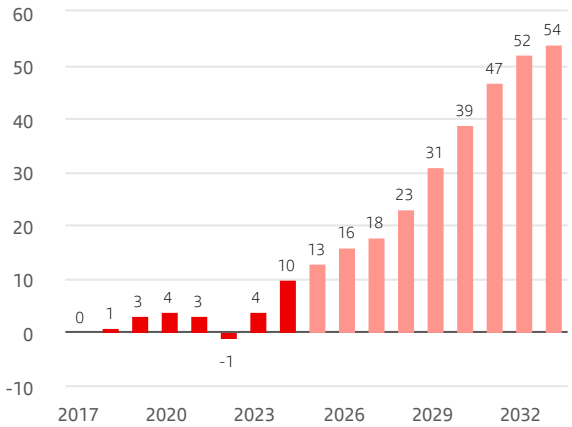
Argentina

Argentina preserves fiscal equilibrium in 2025
(% of GDP)



Sources: IMF, Ministerio de Economía and Santander Research.

Trade balance for energy and mining will double by 2029
(USD billion)



Source: Ministerio de Economía.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	3.5	3.7	3.7
Unemployment rate	6.3	6.0	5.6
CPI inflation	30.0	16.0	8.7

Source: Santander Research.

Argentina: In focus

Argentina's key structural reform

Tax, labour market and pension reform are necessary to improve Argentina's business environment and set the path for growth.

1. Tax reform

Over the past decades, the public sector's footprint in Argentina's economy has expanded significantly across national, provincial and municipal levels. This growth was financed by a sharp increase in the tax burden. According to the Ministry of Economy, the consolidated tax pressure rose from 21% of GDP in the early 1990s and peaked at 32.2% in 2015. It then fell to 28.2% of GDP in 2024.

This tax structure has created competitiveness issues, given the prevalence of highly distortionary taxes—such as the *Tasa de Seguridad e Higiene* at the municipal level, *Ingresos Brutos* at the provincial level, and the tax on bank debits and credits nationally. Argentina shifted from a tax burden 2.7 percentage points below the regional average in 2001–2003 to one 5 percentage points above it today.

Comprehensive tax reform is urgent. Key priorities include eliminating distortionary taxes, cutting tax expenditures, and simplifying the system. Notably, just 10% of the more than 160 existing taxes account for 90% of total revenue. Reforming the federal tax-sharing arrangement (*coparticipación*) should also be on the agenda, though it presents greater legal and political complexities.

2. Labour market reform

Informality remains structurally high in Argentina, reaching 42% in Q1 2025 (INDEC). This is partly due to the high cost of formal employment: hiring a registered worker costs on average 1.35x the gross wage, compared to a regional average of 1.22x. Low productivity and excessive labour litigation compound the problem.

According to the Union of Occupational Risk Insurers, 25,472 labour lawsuits were filed in the first quarter of 2025, with a projected total of 130,000 for the year. As of March, there were 301,735 unresolved cases. These conditions deter formal hiring and contribute to persistent informality.

Policy efforts should focus on lowering the cost of formal employment and reducing litigation incentives. While growth is necessary to improve employment quality, it is not sufficient without structural changes.

Argentina: In focus

3. Pension reform

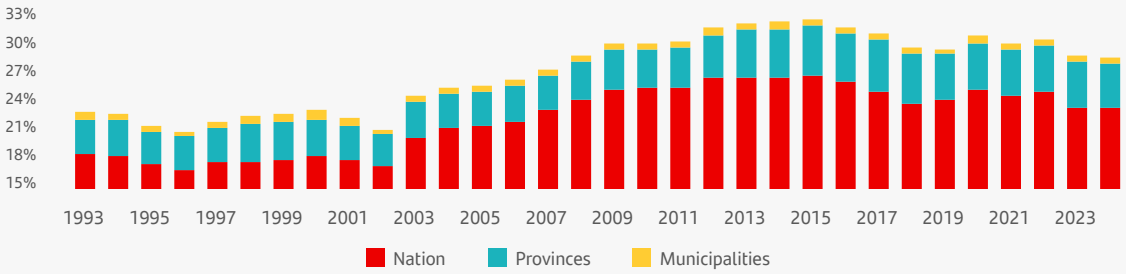
Pension reform is critical to ensure the sustainability of the fiscal consolidation path. In the absence of changes, the pension system represents a structural deficit of approximately 2% of GDP.

Measures to boost formal employment — via lower labour costs and fewer lawsuits — would support pension revenues. In parallel, demographic trends are eroding the system's sustainability: since 2014, the birth rate has fallen 40%, and the demographic bonus is fading.

Raising the retirement age would help contain long-term liabilities. Since April 2024, pension adjustments have followed an inflation-linked formula (via decree), shielding benefits from economic cycles and helping preserve purchasing power. However, disparities in access remain: 74% of new pensions in 2024 relied on moratoriums, up from less than 0.3% in 2005. Moving towards a system that clearly distinguishes between contributory and non-contributory benefits — and phasing out special regimes — would enhance fairness and transparency.

Tax pressure

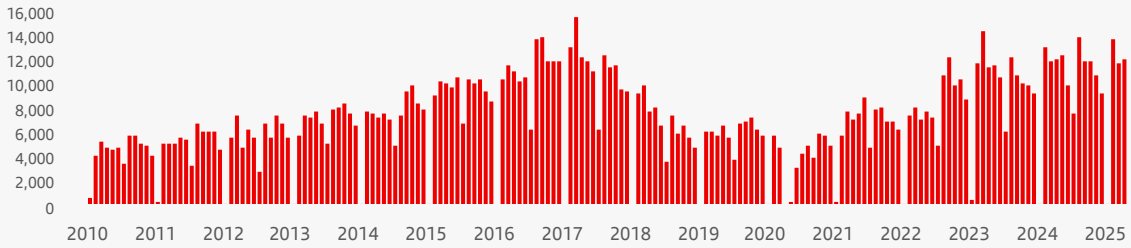
% GDP



Sources: Ministerio de Economía de Argentina and Santander Research.

Lawsuits filed by workers

Monthly data



Source: Superintendencia de Riesgos de Trabajo.

Brazil

Growth above expectations amid fiscal challenges

In 2025, Brazil's economy is performing above expectations, driven by fiscal stimulus, rising household income, and a resilient labour market. Economic activity is expected to slow in 2026, reflecting restrictive monetary policy and fiscal challenges. Still, the labour market will remain firm and Brazil's economy has demonstrated notable resilience due to the socioeconomic reforms implemented in recent years.

Brazil's economy expanded at an average annual rate of 3.2% from 2022 to 2024. Based on an estimated potential growth of around 2.0% per year — while acknowledging the inherent uncertainty in such estimates —, this performance suggests that the economy has been operating above its capacity during this period. Within the same time frame, inflation remained above the 3.0% target (with a 1.5 percentage point band) for all three years, reaching 5.8%, 4.6%, and 4.8%, respectively. Concurrently, the unemployment rate decreased significantly, from 11.2% in December 2022 to 6.2% in December 2024, reaching 5.6% in August 2025. Real gross disposable household income grew at an annual average rate of 5% between 2022 and 2024, decelerating to 4.1% so far in 2025. Some of the strong growth was offset by increased imports, particularly in 2024. This, along with lower commodity prices, contributed to a widening of the current account deficit, though it continues to be financed by stable capital inflows, and international reserves remain at comfortable levels, providing an indication of the solid external position.

These indicators point to demand pressures that may have pushed the economy above its potential, partly due to fiscal and quasi-fiscal impulses over the last few years. Alongside the budget expansion, fiscal rules were relaxed, slowing the pace of fiscal consolidation and limiting progress towards stabilising the debt-to-GDP ratio.

Despite the uncertainty, the labour market should remain resilient throughout 2026. Though credit, income and economic activity will likely continue experiencing the cumulative effects of restrictive monetary policy, the outlook is for a soft landing of GDP.

From a monetary policy perspective, the Selic (official rate) rose from 9.25% (Dec 2021) to 13.75% (Aug 2022). It fell to 10.50% by mid-2023, before climbing again to its current 15%. This level of the Selic is expected to persist over the following months, still driven by unanchored inflation expectations and continued fiscal

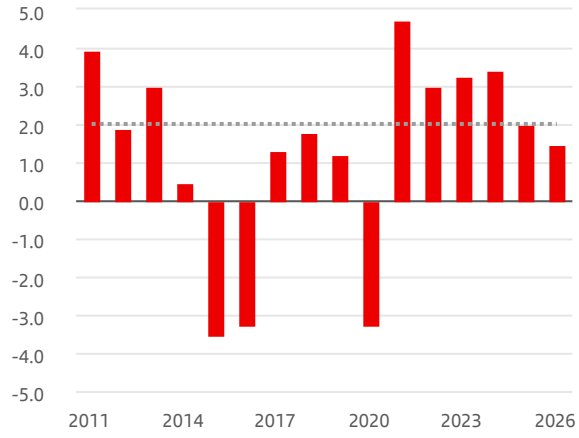
Brazil

challenges. For 2026, there is room for at least a 200-basis-point cut, with the Selic rate stabilising at 13% by December. Going forward, markets are expected to increasingly focus on the potential outcomes of the presidential election to be held in October 2026.

The agenda of financial market reforms and innovations, such as Brazil's instant payment system (PIX), Open Finance, improvements in collateral, fiduciary alienation, and mortgage rules, has increased sector efficiency and stimulated the credit impulse as a percentage of GDP. Though it has slowed since 2024, it is only slightly negative despite the long period of significant monetary policy tightening.

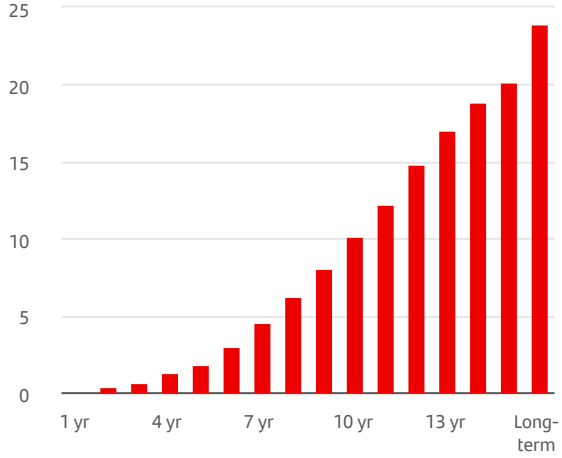
Despite the challenges faced, structural reforms implemented in recent years have strengthened resilience, including labour, pension and the newly approved consumption tax reform, creating the Brazilian Value Added Tax (VAT). If implemented effectively, the VAT reform could raise Brazil's potential growth significantly and support long-term stability.

Brazil: The challenge of increasing potential GDP growth
(% y/y)



Sources: Instituto Brasileiro de Geografia e Estatística (IBGE) and Santander Research.

Brazil: Increase in potential GDP associated with the direct impact of the VAT tax reform
(accumulated over the period, in %)



Sources: Center for Fiscal Citizenship (CCiF) and Santander Research.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	2.0	1.5	1.8
Unemployment rate	6.2	6.2	6.2
CPI inflation	5.4	4.4	3.9

Source: Santander Research.

Brazil: In focus

An upper bound for the official rate?

Brazil's monetary policy is undergoing a period of transition. The central bank is currently confronted with the challenge of maintaining a high official rate (Selic) over an extended period, a task made more arduous by the intensification of financial system changes and the ambiguity surrounding the fiscal stance. Inflation continues to exceed target levels, and the pace of convergence remains uncertain. Concurrently, the marginal effects of interest rates on economic activity appear more dispersed, giving rise to a key question: are we approaching an upper bound for the policy rate?

This theoretical 'upper bound', which is not widely formalised in the literature, refers to an interest rate threshold above which the costs — financial, systemic or fiscal (the latter being widely discussed, i.e. fiscal dominance risks) — begin to outweigh the benefits. Financial contagion models (Allen and Gale, 2000[1] ; Acemoglu et al., 2015[2]) show how local shocks can amplify in networks with limited liquidity or denser interconnections. Brunnermeier and Sannikov (2014)[3] demonstrate that monetary policy can generate non-linear effects, with a loss of stability beyond a certain point. Greenwood, Hanson, and Stein (2015)[4] summarise this logic with the concept of "interest rate fragility": beyond a certain level, raising interest rates can trigger more instability than discipline.

The changing anatomy of credit and financing channels

The anatomy of credit has shifted. The rise of instruments such as corporate bonds (known as *debêntures* in Brazil), CRIs (real estate receivables certificates), CRAs (agribusiness receivables certificates), and FIDCs (receivables/credit rights investment funds) has reduced the centrality of the traditional banking channel in funding companies. Large corporates have diversified their financing, and efforts are underway to expand this ecosystem to SMEs. This transformation represents a gain in allocative efficiency and contributes to the development of the financial system. However, it also poses significant challenges to the conduct of monetary policy.

Diminishing effectiveness of the official rate transmission channel

With reduced dependence on bank credit, the traditional Selic rate transmission channel loses traction. In response, monetary policy resorts to a more prolonged

[1] Allen, F., & Gale, D. (2000), 'Financial contagion', Journal of Political Economy, 108(1), 1–33.

[2] Acemoglu, D., Ozdaglar, A., & Tahbaz-Salehi, A. (2015), 'Systemic risk and stability in financial networks', American Economic Review, 105(2), 564–608.

[3] Brunnermeier, M. K., & Sannikov, Y. (2014), 'A macroeconomic model with a financial sector', American Economic Review, 104(2), 379–421.

[4] Greenwood, R., Hanson, S. G., & Stein, J. C. (2015), 'A comparative-advantage approach to government debt maturity', The Journal of Finance, 70(4), 1683–1722.

Brazil: In focus

rate hike — its nominal intensity increases, even though its marginal effectiveness declines. This combination can produce growing side effects. The action puts pressure on the cost of capital, reduces asset values, and makes debt servicing more expensive. The value of collateral is affected, increasing sensitivity to liquidity shocks and reducing appetite for duration.

There are still no clear signs of stress, nor are there clear indications that we have already reached this upper bound. But the hypothesis deserves attention, especially as latent risks begin to emerge. At the same time, there are signs that high interest rates are finally influencing bank credit and appetite for new issues in the capital market. This scenario reinforces the need for careful calibration, capable of avoiding both insufficient tightening and excessive persistence.

Balancing fiscal pressures and monetary effectiveness

The effects of monetary policy may be offset by fiscal policy. By sustaining demand and fuelling risk premiums, it could reduce the effectiveness of monetary policy actions. Against this backdrop, raising interest rates to compensate for the loss of monetary policy power can deepen side effects without guaranteeing the desired outcome. This underscores the importance of recognising the operational limits of the Selic rate. These limits should not be interpreted as indications of institutional weakness, but rather as a result of fiscal policy and financial transformations.

Maintaining macroeconomic stability should rely on a broad range of tools . A fiscal policy, well aligned with monetary policy, would enable monetary policy to operate at a lower cost. Policy coordination is becoming increasingly important on technical grounds.

Chile

Steady economic activity despite external headwinds

Chile is set for moderate growth due to external headwinds and a soft labour market. After expanding around 2.4% in 2025, GDP is expected to slow below 2.0% in 2026 before recovering in 2027. Inflation is on track to converge to the 3% target by 2026, enabling the central bank to bring the policy rate close to its neutral level. Fiscal consolidation will remain necessary to stabilise public debt.

Investment-led expansion. Chile's economy ended 2024 on a positive note, supported by transitory gains in export sectors, a trend that continued in early 2025. GDP is expected to expand by 2.4% in 2025, before moderating to 1.8% in 2026 and rebounding in 2027. Domestic demand, which had been lagging, began to strengthen in the second quarter of 2025, driven by a sharp increase in investment, reflecting progress on large-scale mining and energy projects. These sectors are expected to remain the main engines of growth, with total investment projections revised significantly upward. While mining and energy investment will lead the expansion, recovery across sectors has been uneven. Residential construction remains weak, though improvement is expected in the second half of 2026 as the stock of unsold newly built homes declines.

Gradual labour market improvement will support modest consumption growth. The labour market remains fragile, with unemployment high and employment growth stagnant over the past year. However, the share of formal employment has increased, and we expect a gradual recovery in labour demand towards 2026 as economic growth consolidates. Alongside lower household financial burdens and looser financial conditions, which ease access to credit, these trends should support private consumption growth of around 2% annually over the forecast horizon.

The external environment poses significant risks. A weaker global outlook, combined with rising trade tensions, threatens Chile's open economy. These headwinds are expected to slow growth in 2026 before conditions improve in 2027.

Inflation is converging to target, enabling the central bank to normalise the policy rate towards its neutral level. Inflation rose from 3.4% in December 2023 to 4.9% in early 2025, largely reflecting the adjustment of electricity tariffs after a multi-year freeze. This effect is temporary, and inflation has been gradually declining, with core inflation now below 4%. Limited second-round effects,

Chile

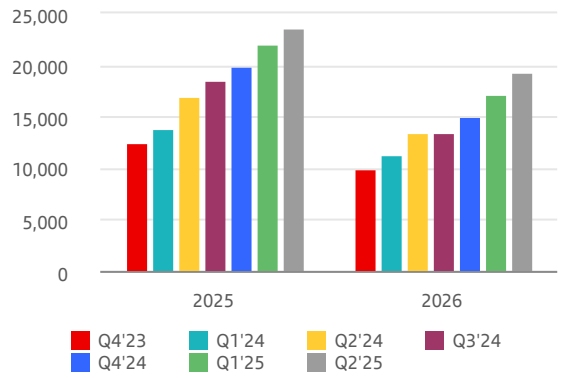
anchored expectations and a narrow output gap will allow inflation to converge to below 4% by the end of 2025 and reach the 3% target in 2026.

Monetary policy is expected to adjust in line with inflation convergence. The central bank is expected to lower the policy rate to 4.50% by 2025 year-end and to 4.25% in 2026. This gradual easing reflects contained inflation pressures, anchored expectations and increasing external risks.

Fiscal consolidation to preserve debt sustainability. Fiscal management remains challenging after a decade of persistent deficits. The deficit for 2025 is projected at 2.0% of GDP. Lower-than-expected revenues and tight fiscal space point to a need for consolidation in the following years.

Chile: Capex outlook strengthens on large-scale projects

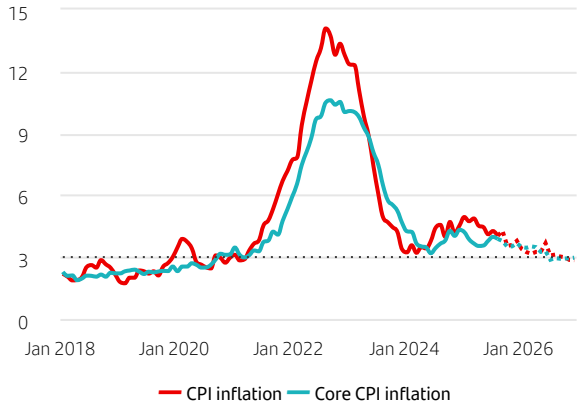
(USD mn)



Note: Each bar represents the quarter's investment projection for 2025 and 2026.
Sources: Chilean Corporation of Capital Goods and Santander Research.

Chile: Disinflation path through 2026

(%, y/y)



Sources: Chile's National Institute of Statistics and Santander Research.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	2.4	1.8	2.3
Unemployment rate	8.7	8.5	8.4
CPI inflation	4.3	3.2	3.0

Source: Santander Research.

Chile: In focus

Why has Chile's trend growth declined, and what can be done to reverse it?

During the 1990s, Chile's economy grew at an average annual rate of 6.3%, driven by a series of structural reforms that boosted efficiency and laid the foundations for sustained economic expansion. In the early 2000s, though growth moderated slightly, it remained strong — averaging 4.8% annually —, enabling Chile to rapidly narrow its income gap with advanced economies. Despite the headwinds, it has a valuable opportunity to reignite growth through productive transformation on the back of unique comparative advantages to lead in the industries of the future.

According to the World Bank, Chile transitioned from being a lower middle-income country in the late 1980s to achieving income levels comparable to OECD economies by the 2010s.

This robust performance was underpinned by several key factors:

- **Global integration,** through a network of 34 trade agreements covering nearly 90% of global GDP, which gave Chile preferential access to major markets and fostered competition and innovation.
- **Deep and sophisticated financial markets,** supported by a private pension system and a resilient banking sector, which facilitated the channelling of domestic savings into productive investment. Pension fund assets alone reached approximately 80% of GDP.
- **Strong institutions and macroeconomic stability**, including an independent central bank, prudent fiscal policy, technical regulators, low inflation, and a strong commitment to sound public finances.
- **Demographic dividend** from a growing working-age population that contributed positively to potential output.

However, the growth environment has shifted significantly in recent years. Between 2012 and 2024, average GDP growth fell to just 2% per year, reflecting a stagnation in Chile's convergence toward high-income status. According to internal estimates, the country's trend growth rate has declined to around 2.2%, which is not enough to close the income gap with advanced economies within a reasonable timeframe.

Chile: In focus

What's behind the slowdown?

Several structural factors help explain this slowdown:

- **Declining investment**: While investment expanded at over 9% annually between 1990 and 2008, it has averaged only 1% per year since 2014.
- **Stagnating total factor productivity (TFP)**, especially in non-mining sectors, which has remained flat since 2014 after growing at 2.7% annually in the 1990s.
- **Demographic headwinds**, including falling birth rates and an ageing population, which limit labour force growth and increase pressure on public finances.
- **Slowing globalisation**, with declining global trade and rising protectionist trends, which pose challenges for a small, open economy like Chile.

The path forward: From challenge to opportunity

Despite these headwinds, Chile has a valuable opportunity to reignite growth through productive transformation. A study by the International Monetary Fund (IMF)[1] found that among 28 countries that surpassed USD 26,000 in per capita income between 1950 and 2010, the median GDP growth rate in the subsequent decade was 2.9%.

Achieving growth of 3–3.5% is within reach if the necessary policy reforms are pursued with determination and consistency. In this regard, Chile possesses unique comparative advantages to lead in the industries of the future:

- **World-class renewable energy potential**, essential for the global energy transition.
- **Abundant strategic natural resources**, such as copper and lithium, which are critical to electrification and digitalisation.
- **Opportunities in sectors such as forestry, agribusiness, tourism, and digital services**, all of which can contribute to inclusive growth and job creation.

Reforms to unlock growth

Capitalising on these strengths will require bold and well-targeted reforms to improve productivity, stimulate investment, and foster innovation. Key policy priorities should consider:

1. **Modernising and streamlining the regulatory framework**. According to the National Evaluation and Productivity Commission (CNEP), it can currently take up to nine years to obtain permits for large-scale mining. Modernising and accelerating these processes is crucial to unlocking new investment, improving

[1] Guo and Schaechter (2025), 'Chile Can Grow Faster – But it Won't Be Like the 1990s Again', International Monetary Fund (IMF News).

Chile: In focus

resource allocation, adopting new technologies, and encouraging productive diversification.

2. **Boosting labour force participation**, particularly among women, by improving access to quality childcare and implementing policies that facilitate work-life balance.

3. **Improving education and workforce skills**, including the integration of digital skills and artificial intelligence to enhance productivity and adapt to future job market demands.

4. **Revising the tax system**, with a focus on reducing the effective tax burden on investment to stimulate capital accumulation and long-term economic growth.

Efforts to address this challenge are already underway. A recently approved law seeks to simplify sector-specific permitting processes, which is a step in the right direction. Furthermore, many of these issues have been explicitly included in the platforms of the leading presidential candidates. These developments support a scenario of cautious optimism: if Chile acts decisively, it can return to a more dynamic and sustainable growth trajectory.

Impact on long-term GDP growth from different policy measures

	Over 10 years	Annual	Equivalent One-Time Increase in GDP
Reduction of the corporate tax rate by two percentage points	1.2%	0.12%	
Reduction in permit processing times	2.4%	0.24%	
Clean energy, green hydrogen and its derivatives	1.1%	0.11%	
Further development of lithium	2.8%	0.28%	
Increased female labour force participation			1.8%

Source: Ministry of Finance (November, 2023), 'Report of the Expert Committee on Fiscal Space and Trend Growth'.

Mexico

Low growth but resilient

In 2025, Mexico's economy proved surprisingly resilient to uncertainty regarding US tariffs, owing in part to the front-loading of exports and extensive social transfers. Economic activity will likely accelerate slightly in 2026, from a low base, as greater clarity emerges on trade. A temporary boost will also come from the football World Cup. Nevertheless, we project that growth will remain below trend next year.

Average real GDP growth in 2025 is expected to be near 0.4%, the lowest since 2020, and considerably below that of its main trading partner, the US. Growth was surprisingly stronger than expected in the early months of the year thanks to robust exports, as external demand likely front-loaded their purchases from abroad, ahead of the US tariff hikes. By the second half of the year, however, GDP growth has moderated as trade flows normalised, while muted job creation and tighter bank lending standards weakened the domestic economy. In 2026, Mexico will likely benefit from somewhat stronger US growth (by far its main export market), lower domestic interest rates, and the one-off demand impulse from the football World Cup. We project real GDP growth of 1.0% in 2026 and 2.0% in 2027.

Annual headline inflation has benefited from relatively weak domestic demand. For most of the past year it fluctuated between 3.5% to 4.5%, driven by swings in agricultural prices. These levels are significantly below the near 9.0% peak recorded in late 2022. Meanwhile, annual core inflation has trended to levels that are slightly above the 4% upper band of the central bank's target range, as services disinflation has been rather limited. We anticipate that annual headline and core inflation will converge to a long-run rate of 4.0% over the coming quarters. From a monetary policy perspective, we believe that most of the easing cycle, which began in early 2024, is already behind us, and that the terminal overnight rate will settle at 7.0%.

On the fiscal front, the consolidation programme announced for 2025 has largely been executed as planned, with a further reduction in the fiscal deficit projected for 2026. In recent quarters, the government has cut spending to compensate for weak revenue growth. Against this backdrop, public investment in infrastructure has borne the brunt of the adjustment. Looking ahead, for 2026, the government has proposed several tax regime changes that target specific industries to strengthen the tax base and accomplish its fiscal targets. Overall, President Sheinbaum's administration remains committed to fiscal prudence, a stance that financial markets and ratings agencies appear to have largely discounted.

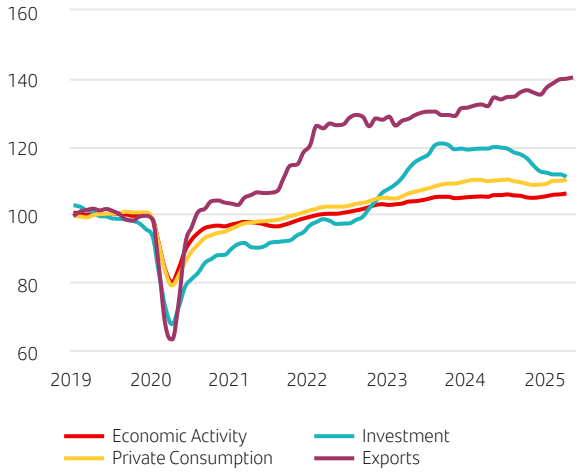
Mexico

Mexico's external accounts have continued to show limited imbalances. We project that the current account deficit will remain narrow in 2026, at less than 1.0% of GDP. In recent quarters, weaker remittance inflows from abroad were more than offset by a notable swing in the trade balance, which moved from a small deficit to a surplus, driven by the strength in manufacturing exports and the weakness in imports of capital goods. The projected size of the current account deficit is roughly one-third of the projected net foreign direct investment inflows, which leaves Mexico with a negligible vulnerability to volatile capital flows. These dynamics also help explain the relative strength of the Mexican peso.

Mexico's economy remains highly open and reliant on the US, its destination for over 80% of exports. Thus, global supply-chain reconfiguration brings risks but also opportunities: after US-China tensions intensified in 2017, Mexico's share of US imports rose. This year escalation could further strengthen North American integration. To capture these gains, Mexico must improve human capital, infrastructure and the legal framework.

Mexico: Exports have been the main driver of growth

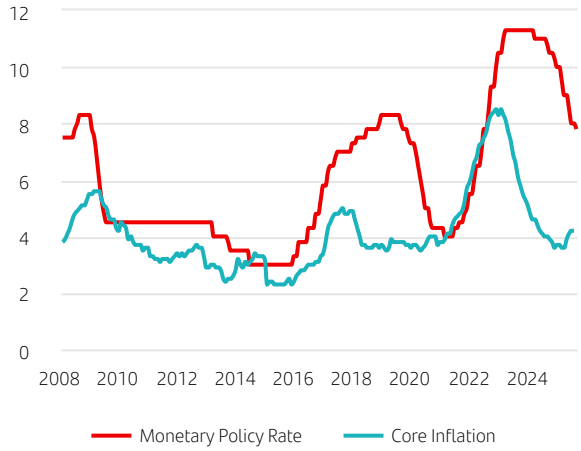
(Index 2019=100, SA)



Exports refer to the USD value of goods exported. Source: INEGI.

Mexico: Despite the easing cycle, the policy rate remains considerably above inflation

(%, % y/y)



Sources: INEGI and Bank of Mexico (Banxico)

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	0.4	1.0	2.0
Unemployment rate	2.8	3.5	3.8
CPI inflation	4.0	3.9	4.0

Source: Santander Research.

Mexico: In focus

Mexico's medium-term fiscal challenges

The current adjustment to public finances offsets the increase in the deficit that took place in 2024. It should be enough to fend off short-term concerns about fiscal policy. However, Mexico's public finances will continue to face challenges over the medium term.

Short-term fiscal adjustment underway

In 2024, Mexico's public deficit rose to 5.7% of GDP — the highest figure for at least three decades. This was a marked increase from the 3.7% average of the previous five years and represented a shift from the record of fiscal discipline maintained earlier. Mexico was one of the few countries that did not enact a fiscal response during the pandemic: though the ratio of public debt to GDP increased in 2020 due to a fall in GDP and tax revenues, it decreased steadily from 2021 until 2023. As a result, public debt at the end of 2024 stood at 51.3% of GDP, well below the Organisation for Economic Co-operation and Development (OECD) average of 110% of GDP.

For 2025, the incoming federal administration announced a fiscal adjustment plan, which included a reduction of the public deficit of 1.8% of GDP based on a sizable reduction of public expenditure. Though updated estimates show that the deficit will decrease by only 1.4% of GDP, falling short of the target due to lower oil revenues, there has been a significant effort to contain public expenditure. During the first half of the year, total expenditure dropped 3.8% in real annual terms, despite a 10.8% increase in interest payments. Excluding legally mandated items, public expenditure declined by 7.9% in the first part of 2025.

For 2026, the federal government proposed an additional reduction of the deficit to 4.1% of GDP. This will be attained through a series of measures to increase tax revenues. Under plausible assumptions about the evolution of the macro environment, public debt could continue to increase as a share of GDP in the coming years, albeit at a moderate pace. Against this backdrop, Mexico's debt is expected to preserve its investment-grade status in the foreseeable future despite the challenging global landscape, though we anticipate some additional fiscal slippage that would reduce the room to manoeuvre.

Medium-term challenges to public finances

Mexico's public finances face a series of medium-term challenges. The rigidity of public expenditure has increased significantly. While the legally mandated items of the budget — including interest payments, transfers to local governments and pension payments — which accounted for one-third of total expenditure 10 years ago, have risen to nearly half today. This trend is likely to persist due to the

Mexico: In focus

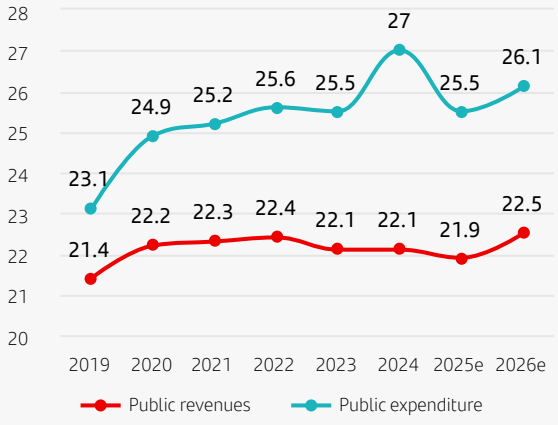
ongoing demographic transition. In addition, there are limits to the size of the cuts that discretionary budget items can withstand without having severe adverse effects on the economy: in the first half of 2025, public investment declined by 30.4% in real terms, and in 2025 its weight in total expenditure will decrease by a third compared to 2015.

Moreover, the contribution of oil revenues to public finances has decreased steadily due to the decline in oil production, and the fragile financial situation of *Petróleos Mexicanos* (Pemex), the state-owned oil company that is likely to continue requiring financial support from the government.

Mexico stands out for the narrowness of its tax base: despite recent enhancements to tax collection, tax revenues in 2025 are projected to reach 15% of GDP, well below the OECD average of 34% and the Latin American mean of 21%.

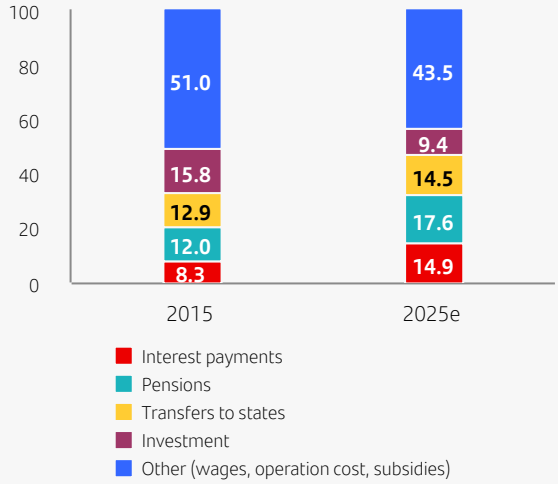
The debate on the need for a comprehensive tax reform that increases stable sources of public revenues will remain relevant in the years ahead.

Mexico: Public revenues and public expenditure
(% of GDP)
e/: estimates from the 2026 Budget Proposal.



Sources: Secretaría de Hacienda and Crédito Público.

Mexico: Public expenditure structure
(% of total expenditure)
e/: estimates from the 2026 Budget Proposal.



Sources: Secretaría de Hacienda and Crédito Público.

China

Convergence, challenges and the road ahead

China's outlook points to a gradual slowdown as domestic demand and infrastructure investment weaken. External demand offers only limited relief, leaving risks tilted to the downside. Policymakers are pacing fiscal measures and favouring incremental support to preserve flexibility ahead of the 15th Five-Year Plan in 2026.

China's medium-term prospects remain relatively resilient, underpinned by market size, growing technological strength — evident in rapid advances in AI, renewable energy and electric vehicles — and sustained strategic investment in infrastructure and digitalisation. The trajectory, however, will hinge on addressing structural vulnerabilities: demographic shifts (a declining birth rate, an ageing population, and a shrinking labour force), environmental sustainability, financial stability, and increasingly complex geopolitical dynamics.

Convergence dynamics are also key. Much of China's past growth has been driven by capital investment and catching up with the global technological frontier. As with any convergence process, sustaining rapid growth becomes harder as an economy nears that frontier. Combined with demographic decline, this points to a natural slow down, even if political and financial conditions remain stable.[1]

That said, technological innovation — particularly in AI — and structural reforms could positively influence the convergence path. Similarly, China's participation in regional and global economic partnerships could help sustain growth by boosting trade and investment flows.

Against this backdrop, we expect China's GDP to slow year on year to 4.6% in 2026 from 4.9% in 2025 (broadly in line with the 2025 government's 5% target). This assumes trade negotiations with the US will keep bilateral tariffs at current levels. The surge in US tariffs reduced shipments to the US, but the contraction was more than offset by robust external demand from non-US markets. The ongoing real estate adjustment is expected to persist through 2026.

All of the above is reflected in **soft domestic inflation over recent quarters**, amid sluggish demand and price-cutting by manufacturers in sectors with excess capacity. The government seeks to curb aggressive price competition with so-called 'anti-involution' supply-side measures. These will likely take several months to produce broader effects.

[1] Fernández-Villaverde, J., Ohanian, L., & Yao, W. (September, 2023), 'The neoclassical growth of China', VoxEU/CEPR.

China

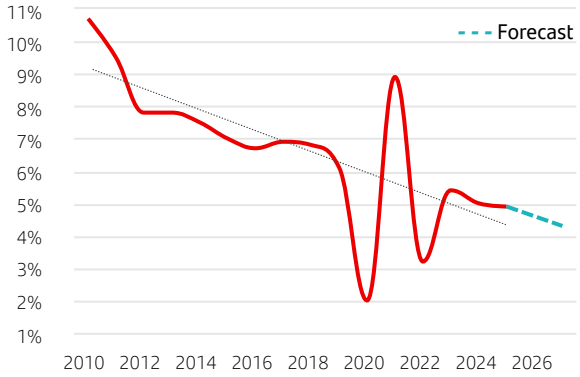
Fiscal capacity remains ample. Authorities have increased bond issuance in recent months but appear to be deliberately delaying the large-scale deployment of funds. This approach suggests a preference for strategic timing over immediate broad stimulus.

With downside risks to growth accumulating, policymakers could adopt incremental support measures, potentially including a modest rate cut in the fourth quarter of 2025. Importantly, authorities seem willing to tolerate moderate near-term growth to preserve policy space for more impactful interventions in 2026 — the first year of the 15th Five-Year Plan (2026–2030).

This upcoming 15th Five-Year Plan is expected to prioritise technological self-reliance (notably the scaling of AI across manufacturing to boost total factor productivity, in line with the "AI Plus" agenda), selective rebalancing towards domestic consumption, the green transition (after record installations of solar and wind power, the next bottleneck lies in system flexibility: markets, storage, demand response, and transmission), as well as supply chain and energy security. It will also emphasise external openness, even as geopolitical frictions persist.

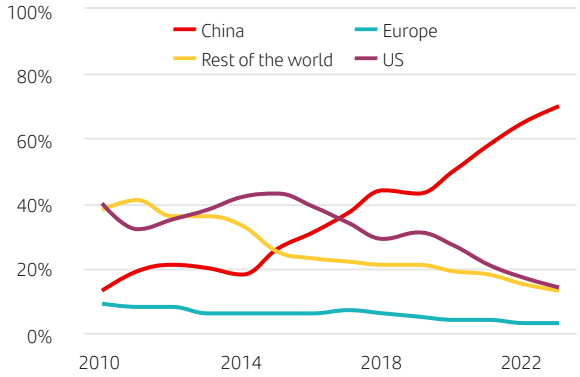
China stands at a pivotal moment. Its ability to effectively manage structural shifts, geopolitical uncertainty and the natural constraints of economic convergence will be crucial in shaping its future growth trajectory.

China: GDP annual growth



Sources: Refinitiv and Santander Research.

Granted AI patents



Sources: AI index Stanford University.

Macroeconomic forecasts

	2025	2026	2027
GDP growth (%)	4.9	4.6	4.3

Source: Santander Research.

Special topics

Santander

The equilibrium interest rate: A review of the main drivers

The equilibrium interest rate serves as the *north star* that guides central banks' monetary policy. The neutral (or natural) interest rate (R*) is the real rate that enables the economy to grow at full employment and at target inflation. In this article, we explore its key drivers - such as demographics, productivity, and even geopolitical trends - and, consequently, where it may be headed in the future.

The concept of the neutral interest rate plays a central role in macroeconomic analysis. It serves as a key reference point for the calibration of monetary policy.

Unlike the nominal interest rates — observed daily in financial markets —, R* is unobservable and is instead shaped by long-term structural factors. Most central banks estimate it through models, given its role as a benchmark for monetary policy. When rates are set above R*, policy is contractionary; when below, it is expansionary.

The concept dates back to economist Knut Wicksell, who defined R* as the real (i.e. inflation adjusted) rate at which monetary policy exerts neither inflationary nor disinflationary pressure. As economist John H. Williams once described it:[1] "The natural rate is an abstraction; like faith, it is seen by its works. One can only say that if the bank policy succeeds in stabilising prices, the bank rate must have been brought in line with the natural rate; but if it does not, it must not have been."

Put simply, R* refers to the real interest rate that would prevail over the long term under conditions of general equilibrium. It can also be seen as the inverse of the price of risk-free assets — meaning that fluctuations in asset prices directly influence the level of R*.

The concept of the neutral interest rate plays a central role in macroeconomic analysis. It serves as a key reference point for the calibration of monetary policy, helping central banks assess whether policy is stimulative or restrictive. It also underpins asset valuation, as the long end of the real yield curve is influenced by both the expected path of the natural rate and the prevailing term premium.

Like any interest rate, R* is determined in credit markets by the balance between savings (the supply of credit) and investment (the demand for credit). For firms to undertake new investments, they need households and other savers to provide the capital to finance it. Thus, aggregate investment must match available savings. To achieve this, interest rates must be high enough to incentivise savings, while remaining low enough to encourage borrowing. The interest rate that achieves this balance in the long run is R*.

[1] John C. Williams (2023), 'Measuring the Natural Rate of Interest: Past, Present, and Future', Federal Reserve of New York.

In the US, the nominal equilibrium rate, according to the latest estimates, is around 3%.

Economic literature has long debated the factors that influence both the supply of savings and the demand for investment. Analysis focuses on the main structural drivers on each side, and how recent shifts may be reshaping the dynamics observed over the past two decades — particularly the period of persistently low interest rates following the 2008 global financial crisis. These dynamics now appear to be reversing.

This analysis does not aim to develop R* estimation models. The most widely used methods in academic literature include time-series approaches, semi-structural models, and dynamic stochastic general equilibrium (DSGE) models. Point estimate ranges from different R* models reveal considerable model uncertainty, reflecting the wide range of estimates produced by contrasting methodologies. Since R* is unobservable, economists must rely on a range of estimation techniques.

Between the early 2000s and 2022, interest rates reached historic lows across the global financial system. In the United States, the Fed Funds rate averaged 7.5% from 1980 to 2000, but only 1.7% from 2000 to 2022. In the euro area, the average benchmark rate fell from 4.8% to 1.5% over the same periods.

According to various studies, R* has declined sharply in advanced economies over the past three decades. For example, the Federal Reserve Bank of New York estimates that R* in the US dropped from 3.7% in 1990 to 0.4% in 2020, prior to the pandemic. In the euro area, R* fell from 2.65% in 1990 to 0.4% in 2020. Currently, the Fed estimates R* between 0.78% and 1.37% based on two different methodologies (from 2.78% to 3.37% in nominal terms). Recent publications from the ECB also suggest that R* estimates span a range of -0.5% to +0.5% through the end of 2024, implying a nominal rate between 1.75% and 2.25%.

The nominal equilibrium rate in the euro area seems to be between 1.75% and 2.25%

What have been the main drivers of this historically low R*? And more importantly, are these drivers still in place? As previously mentioned, several forces that impact on savings and investment patterns help explain fluctuations in R*. This analysis focuses on five key structural drivers: demographics, fiscal deficits, productivity, geopolitics, and energy transition.

Demographics

Demographics appear to play a major role in shaping R*. According to the United Nations, by the mid-2030s there will be 265 million individuals aged 80 and older — outnumbering infants — and by the late 2070s, the global population aged 65 and over is projected to reach 2.2 billion, exceeding the number of people under 18.

The overall impact of population ageing on R* remains subject to debate.

Higher life expectancy tends to increase precautionary savings, placing downward pressure on R*. The so-called 'Japanese effect' describes how ageing populations and higher capital per worker reduce the marginal productivity of capital, which weakens investment incentives and lowers rates.

However, the overall impact of population ageing on R* remains subject to debate, as various forces act in different directions. The sustainability of pension systems will come under growing pressure as the dependency ratio rises. This could raise

government deficits, putting upward pressure on interest rates. Similarly, age-related reductions in labour supply could elevate wages and inflationary pressures, driving nominal interest rates higher.

Some of these ideas are encapsulated in what's known as the "Goodhart and Pradhan effect", described in their book 'The Great Demographic Reversal'.[2] They argue that an ageing global population, coupled with deglobalisation, will trigger a long-term reversal in previous disinflationary trends, leading to structurally higher inflation and interest rates.

Fiscal deficits

Fiscal deficits — and public debt-to-GDP ratios — have risen sharply in major economies over recent decades. Growing concerns have emerged regarding the sustainability of these deficits, especially in countries like the United States and several European nations. According to the Institute of International Finance (IIF), over $21 trillion was added to global (public and private) debt in the first half of 2025, marking a new record high of $338 trillion.

Beyond demographic pressure on pension systems, the current geopolitical climate is prompting increased defence and infrastructure spending, often financed through larger deficits. According to the Stockholm International Peace Research Institute (SIPRI), global military expenditure reached USD 2.7 trillion in 2024, marking ten consecutive years of growth and a 37% increase between 2015 and 2024. The 9.4% rise in 2024 was the steepest annual increase since at least 1988. Financing such spending will require higher debt issuance, which will likely exert upward pressure on interest rates.

Higher productivity growth typically boosts R* as it raises expected returns on capital and stimulates investments.

Productivity

Productivity is frequently cited as a key determinant of R*. Higher productivity growth typically boosts R* as it raises expected returns on capital and stimulates investment demand. Conversely, slower productivity growth may contribute to a lower natural rate.

The persistent slowdown in productivity in advanced economies likely contributed to the low R* observed in recent decades.[3] Laubach and Williams (Federal Reserve, 2016) estimated that a one percentage point decline in trend GDP growth (primarily driven by lower productivity) linked to a 0.9–1.0 percentage point drop in R*. Similarly, the OECD (2021) found that declining productivity across advanced economies has been a primary driver of falling R*. In the euro area, average productivity growth fell from ~1.6% (1995–2005) to ~0.6% (2010–2020), which is consistent with near-zero R* levels.

However, transformative technologies — especially AI — could reverse this trend. McKinsey (2023)[4] estimates that generative AI could raise global labour productivity by 0.1 to 0.6 percentage points annually through 2040, depending on the pace of

[2] Charles Goodhart and Manoj Pradhan (2020), 'The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival'.

[3] Kathryn Holston, Thomas Laubach, John C. Williams (2016), 'Measuring the Natural Rate of Interest: International Trends and Determinants'

[4] McKinsey Global Institute (June, 2023), 'The economic potential of generative AI: The next productivity frontier'. McKinsey & Company.

adoption. When combined with complementary technologies, the uplift could reach 0.2 to 3.3 percentage points per year, adding USD 2.6–4.4 trillion in annual economic value. The IMF (2025) projects that AI adoption could cumulatively boost total factor productivity (TFP) in Europe by 1% over five years, or 0.2 percentage points annually, though stricter regulation could reduce this by a third.

Geopolitics

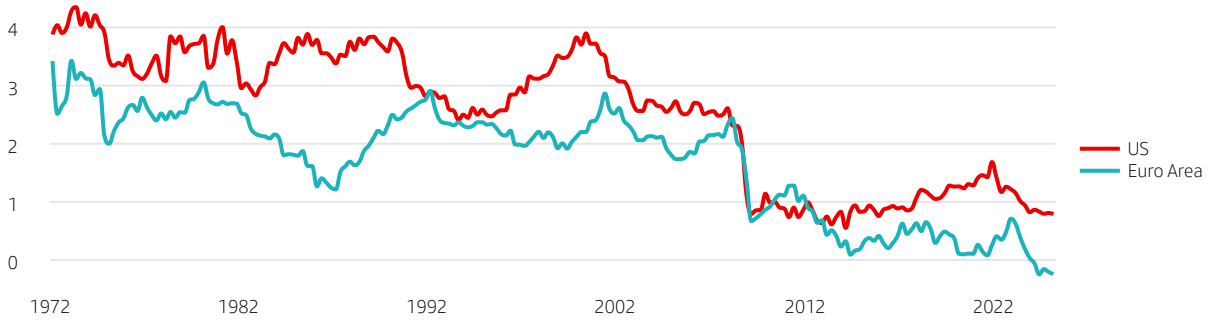
Geopolitical fragmentation may push the world toward a less efficient equilibrium with higher costs, inflation and interest rates.

Globalisation has been a powerful deflationary force over the past decades, enabling efficiency gains that lowered costs, restrained inflation, and compressed interest rates. But shifting geopolitics could significantly alter global supply chains, with security concerns becoming paramount.

The rise of nearshoring and friendshoring could undermine supply chain efficiency, raising production costs and inflationary pressures and, therefore, interest rates. Likewise, escalating tariff tensions may further fragment global trade. China's integration into the global economy was instrumental to the early 21st century's 'low inflation, high growth' dynamic. However, China now appears to be transitioning toward a slower-growth equilibrium.

In sum, geopolitical fragmentation may push the world economy toward a less efficient equilibrium with higher costs, inflation and interest rates. The IMF estimates that severe fragmentation could reduce global GDP by up to 7% in the long term — about USD 7.4 trillion in lost output. The World Economic Forum and Oliver Wyman (2025)[5] estimate potential losses of up to USD 5.7 trillion (5% of global GDP), while McKinsey (2025[6]) projects that fragmentation could reduce global trade growth by up to USD 3 trillion by 2035 — roughly 25% of projected trade gains. Recently, the IMF concluded that following US tariff increases early in 2025, global trade has slowed, supply chains have shifted, and uncertainty has risen. The Fund estimates a cumulative global output loss of 0.2% by 2026 relative to pre-tariff forecasts.

Natural rate (r*)
(%)



Source: Kathryn Holston, Thomas Laubach, and John C. Williams (June, 2023), *'Measuring the Natural Rate of Interest after COVID-19'*, Federal Reserve Bank of New York Staff Reports, no. 1063, EUMFTA by the European Commission.

[5] World Economic Forum & Oliver Wyman (2025), 'Navigating global financial system fragmentation'.

[6] McKinsey Global Institute (January, 2025), 'A new trade paradigm: How shifts in trade corridors could affect business'. McKinsey & Company.

Energy transition

Reaching net-zero emissions will require massive investment. Some estimates suggest that achieving the Paris Agreement's targets would necessitate roughly USD 9.2 trillion in annual investment by 2050 — USD 3.5 trillion more than today's annual investment of USD 5.7 trillion.

All things being equal, increased investment raises the equilibrium interest rate. More broadly, UNCTAD[7] estimates the global Sustainable Development Goals financing gap -which includes climate transitions and others areas- at around USD 4 trillion per year. Meeting climate targets will likely push R* higher, given the sheer scale of required capital deployment.

Today, structurally higher interest rates coexist with low unemployment, reflecting an environment that will require unprecedented levels of investments.

What will the new equilibrium rate be?

While uncertainty remains, the equilibrium rate in the 'new normal' will differ from that of the hyper-globalised, ultra-liquid world that followed the 2008 financial crisis. Today, we observe the coexistence of structurally higher interest rates with low unemployment, reflecting an environment in which mounting demands — for pension systems, public finances, ageing populations, and the green transition — will require unprecedented levels of investment.

At the same time, the rise of AI could spur productivity gains, lift average returns and, therefore, push rates higher. Ultimately, all these challenges share a common feature: they will demand significant financing for investment in the coming decades.

This underscores the need for regulatory frameworks that actively promote financing, supported by consistent and stable policy regimes. Only then will we be able to fund the triple transition — energy, technology, and demographics. Close coordination among governments, regulators, the private sector and broader society will be essential.

Drivers of neutral interest rate (The direction of arrows indicates the effect on the interest rate)

	Between 2007-2022	Since 2022 and beyond
Savings		
Demographics		
Pension systems	↑	↑ ↑
Life expectancy	↓	↓ ↓
Labour markets	↓	↑
Fiscal deficits	↑	↑ ↑
Investments		
Productivity	↓	↑
Geopolitics	↓	↑
Climate transition	↑	↑ ↑

Source: Santander Research.

[7] United Nations Conference on Trade and Development (March, 2024), 'Trillion-dollar shift urgently needed to align global finance with climate and development goals'.

Regulation and productivity: In search of the optimal balance

Understanding the link between regulation and productivity is increasingly key against a backdrop of weak growth and competitiveness. While regulatory frameworks are essential for economic functioning, their design and complexity can either support or hinder productivity gains. This article explores the empirical challenges of measuring regulatory impact and the emerging consensus on the existence of an optimal regulatory threshold.

Defining this link between regulation and productivity is challenging: while there is abundant data on countries' economic performance, robust and reliable indices that faithfully capture the features of a regulatory framework remain scarce. Ultimately, regulation and its economic impact are unobservable variables that must be estimated indirectly.

While regulation is essential for economic functioning, overregulation can generate negative effects on economic development.

Recent studies have nonetheless advanced the understanding of this relationship. Preliminary steps in this effort involve correctly defining what is meant by regulation or regulatory complexity, as well as establishing robust empirical methods for its measurement. For instance, De Lucio and Mora-Sanguinetti (2021)[1] propose three dimensions to define the concept of regulatory complexity: (1) the quantitative dimension (volume of norms), (2) the qualitative dimension (complex or ambiguous drafting), and (3) the relational dimension (interconnectedness between rules).

Regulation and normative frameworks are necessary to establish standards, agree rules, properly align incentives, and ensure appropriate conditions for activities to be carried out. When used without following these criteria or efficiency principles, regulation results in excessive bureaucracy that hampers competitiveness, the business climate and, ultimately, private initiative and productivity. A useful analogy is the Laffer Curve in tax theory,[2] which posits that beyond a certain threshold, further increases in tax rates reduce revenue due to disincentives to work and invest. The so-called *overregulation* generates negative effects on innovation, entrepreneurship, productivity and, therefore, economic development.

[1] Juan de Lucio and Juan S. Mora-Sanguinetti (2021), 'Drafting 'better regulation': The economic cost of regulatory complexity', Journal of Policy Modeling, volume 44, issue 1.

[2] The Laffer curve illustrates a theoretical relationship between tax rates and government's tax revenue. It assumes that no tax revenue is raised at the extreme tax rates of 0% and 100%, meaning that there is a tax rate between 0% and 100% that maximises government tax revenue. The shape of the curve is a function of taxable income elasticity — i.e. taxable income changes in response to changes in the rate of taxation. The idea was made popular by supply-side economist Arthur Laffer.

The regulatory 'Laffer Curve'

This *regulatory Laffer Curve* suggests that there is an *optimal* level of regulation that maximises its positive impact on economic activity. Before and after this point, there are two *non-optimal* or suboptimal zones: the first zone of *insufficient* regulation in which market failures prevail, generating negative externalities, systemic risk, information asymmetries, etc. In such cases, introducing regulation improves legal certainty, business confidence and performance.

Once the theoretical zone of *optimal regulation* is surpassed, there arises a zone of *overregulation* characterised by high compliance costs, barriers to entry and resource allocation inefficiencies.

But once the theoretical zone of *optimal regulation* is surpassed, there arises a zone of *excessive regulation* or *overregulation* that is characterised by high compliance costs, barriers to entry regarding competition, excessive bureaucracy, resource allocation inefficiencies, and disincentives to investment and private initiative, thereby reducing aggregate welfare. Between these extremes lies the efficient zone — one that balances protection with dynamism and fosters long-term growth.

Recent research supports this view. Using a database of over 200,000 Spanish norms, Mora-Sanguinetti et al. (2023)[3] found that greater regulatory complexity reduces employment and value added. These findings are consistent with US-based research by Bailey and Thomas (2017),[4] which showed that highly regulated industries experience slower employment growth.

The impact of regulation on economic activity has been widely debated in the European Union of late, particularly in light of the proliferation of regulations and standards while the region also faces weak productivity and competitiveness. According to *The Future of European Competitiveness*, a report by Mario Draghi commissioned by the European Commission,[5] the US enacted approximately 5,500 regulations between 2009 and 2024, while the EU implemented around 13,000 over the same period.

Between 2009 and 2024, the EU rolled out about 13,000 rules, more than double the US's 5,500, according to Draghi's report.

In response, the so-called *Competitiveness Compass*, presented by the European Commission in early 2025, aims to restore Europe's dynamism and boost its competitiveness and economic growth. Another important step taken by the European Commission is the *Omnibus Simplification* plan, whose goal is to reduce sustainability reporting requirements by at least 25% for all companies and up to 35% for SMEs to strengthen their competitiveness against the US and China. According to Commission estimates, this would save around EUR 6 billion annually in administrative costs. It is encouraging to see that this omnibus approach to simplifying existing regulations has extended beyond the original scope of sustainability to other areas and sectors (e.g. defence) and has become a shared concept for numerous European authorities and institutions that have understood that regulatory simplification and efficiency are essential to compete in today's world.

[3] Juan S. Mora-Sanguinetti, Javier Quintana, Isabel Soler and Rok Spruk (2023), 'Sector-level economic effects of regulatory complexity: evidence from Spain', Bank of Spain, Working Papers, Number 2312.

[4] James B. Bailey and Diana Weinert Thomas (2017), 'Regulating Away Competition: The Effect of Regulation on Entrepreneurship and Employment', Mercatus Center, George Mason University.

[5] Mario Draghi (2024), 'The future of European competitiveness', European Commission.

This focus on reducing bureaucratic burden is warranted. According to Business Europe, over 60% of EU firms view regulation as a barrier to investment, and 55% of SMEs cite regulatory and administrative hurdles as their primary challenge.

Over 60% of European´s Union firms view regulation as a barrier to investment.

Historical evidence supports this concern. In 2017, the US Council of Economic Advisers estimated that excessive regulation cost the US an average of 0.8% of GDP growth per year since 1980.[6] Di Vita (2018)[7] shows that regulatory complexity hinders regional growth in the case of Italy, and Kirchner (2012)[8] demonstrates that at a national level (Australia), growth in legislation, as measured by the number of pages, is negatively related to growth in real income per capita.

Sometimes, the issue is not only overregulation but also a lack of harmonisation or administrative complexity. An IMF study[9] estimates that intra-EU trade barriers remain significant. These barriers might be as high as a tariff equivalent of about 44% on average for goods trade — three times higher than trade barriers between US states. For services, these estimated barriers are even steeper, equivalent to a 110% tariff, and among financial services are estimated to be close to 100%. As economic activity increasingly shifts toward services, their overall drag on growth becomes greater.

Lowering intra-EU trade barriers to US internal levels could raise productivity by 7 percentage points in the long term.

The IMF noted that this illustrates how much more progress is needed on the internal front, where the largest share of EU countries' trade takes place. Reducing these barriers would deliver significant benefits: lowering intra-EU trade barriers to US internal levels could raise productivity by nearly 7 percentage points in the long term, according to the Fund. This would halve the current productivity gap between advanced EU economies and the US.

As a result of legal and regulatory fragmentation, the European Single Market remains far from its full potential. The share of SMEs selling across borders has stagnated at 8% since 2019, and intra-community trade has remained close to 20% of GDP, compared to over 70% in the US.

Productivity, the *holy grail* of economic development

Traditional economic growth theory holds that increases in output can stem from the accumulation of labour, capital goods (machinery, etc.), or from the efficiency with which both production factors are combined — commonly referred to as productivity. In traditional growth models (like Solow's), this is estimated through the residual (what cannot be explained by increases in labour or capital goods). Assuming that growth via labour or capital accumulation has limits in the medium and long term (due to diminishing marginal returns), or could be similar to that of other countries,

[6] The Council of Economic Advisers to the US president (2017), ''The Growth Potential of Deregulation'.

[7] Di Vita, G. (2018), 'Institutional quality and the growth rates of the Italian regions: The costs of regulatory complexity', Papers in Regional Science 97(4), pp.1057-1082.

[8] Stephen Kirchner (December, 2012), 'Federal legislative activism in Australia: A new approach to testing Wagner's law', Public Choice Vol.153, No. 3/4.

[9] Alfred Kammer (2024), 'Europe's Choice: Policies for Growth and Resilience', International Monetary Fund European Department.

growth through productivity becomes the *holy grail* of economic development — the most sustainable and highest *quality* path to increase output and long-term growth.

What drives productivity improvements — commonly measured as total factor productivity (TFP) — are elements such as technology, labour force training, innovation, the development of an ecosystem that fosters entrepreneurship, and even institutional quality, among others. As such, it is important to understand the relationship between regulation and other variables such as growth or employment, it is particularly crucial to explore the relationship between regulation and productivity.

The relationship between economic regulation and productivity is critical, as productivity is the key driver of long-term growth and development. In essence, the focus is on how regulation influences a country's long-term economic prosperity, driven by productivity.

The relationship between economic regulation and productivity is critical, as productivity is the key driver of long-term growth and development.

Nicoletti and Scarpetta (2003)[10] found that entry liberalisation aimed at moving the level of barriers to entry in some European countries towards the OECD average over a 10-year time horizon might have a two-fold effect. First, entry liberalisation (lower regulatory barriers) in service industries is estimated to boost annual TFP growth in the overall business sector by approximately 0.1 to 0.2 percentage points in countries like Portugal, Greece and Italy. Second, there is also an indirect effect of the removal of trade and administrative barriers to entry in excess of those existing in the average OECD country. This effect depends on the technology gap that countries have accumulated in some heavily regulated manufacturing industries: such reforms are estimated to boost manufacturing-wide annual productivity growth by 0.1-0.2 percentage points in some European countries (most notably Germany, France, Italy and Greece). Along the same lines, Crafts (2006)[11] demonstrated strong evidence that regulations that inhibit entry into product markets have an adverse effect on total factor productivity growth in OECD countries, consistent with endogenous growth models.

Productivity and regulation

Taking data from various sources, we developed two regressions to examine the relationship between regulation on one hand, and productivity and GDP per capita on the other. In the first case, we used data from The Conference Board on TFP growth for a group of 24 countries over the past 10 years. We then combined it with an index that represents the quality of regulation. For this purpose, we used the *Burden of Government Regulation* index compiled by the World Economic Forum (WEF).

The Burden of Government Regulation index measures how burdensome it is for companies to comply with public administration requirements. It evaluates: 1) Compliance costs: the index assesses the effort and resources companies must expend to meet government regulations, permits, reporting requirements, etc.; 2) The ease of doing business: it reflects how easily businesses can start, operate, and close

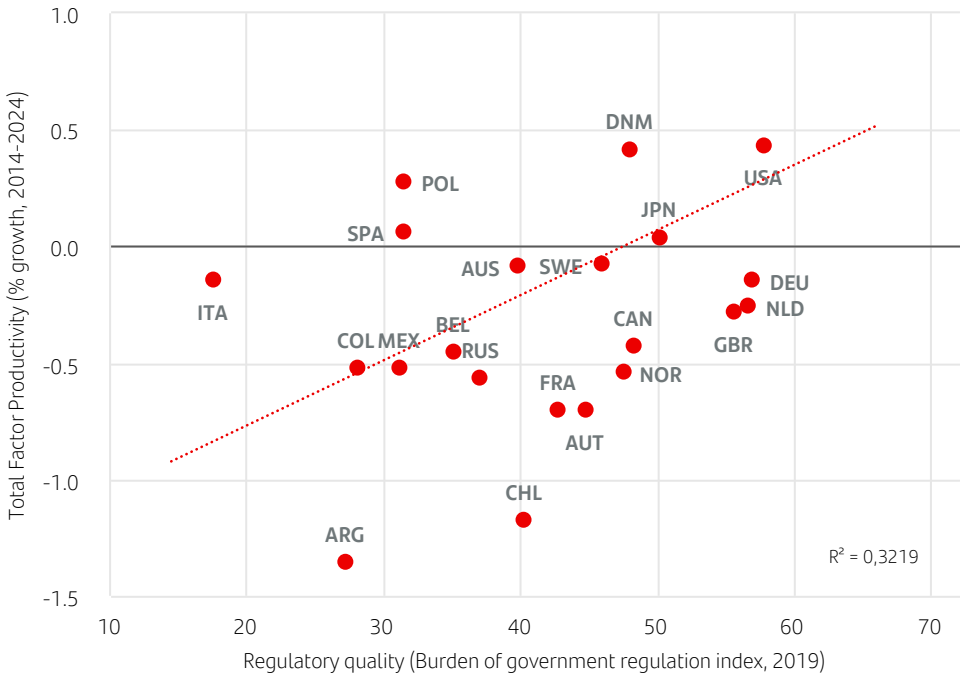
[10] Giuseppe Nicoletti and Stefano Scarpetta (2003), 'Regulation, Productivity and Growth: OECD Evidence', OECD working papers.

[11] Crafts, Nicholas (2006), 'Regulation and Productivity Performance', Oxford Review of Economic Policy.

down, considering factors like licensing, property registration, and bureaucratic procedures; and 3) Regulatory quality: it assesses the government's ability to create and implement sound policies and regulations that promote private sector growth and efficiency. The results indicate a close relationship between productivity growth performance and regulatory quality.

The results indicate a close relationship between productivity growth performance and regulatory quality.

Relationship between regulation and productivity

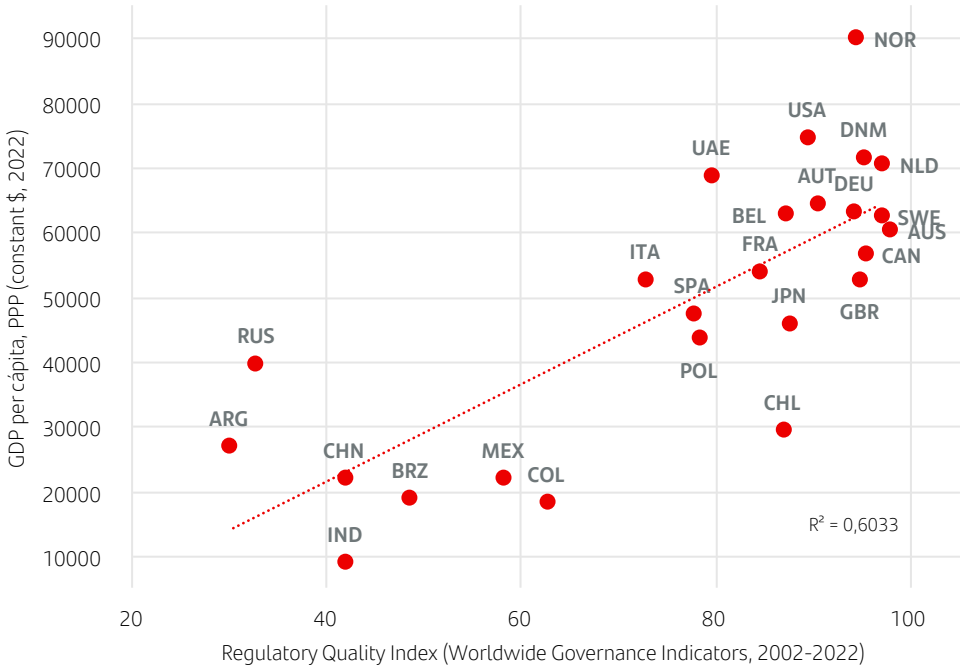


Source: Santander Research based on The Conference Board and WEF data.

We also explored the relationship between GDP per capita and regulatory quality. If we consider that a high level of GDP per capita is the natural consequence of accumulated years of high productivity, this graph would be expected to display a pattern similar to the previous one. In this case, to measure regulatory quality we used the 'Regulatory Quality Index' compiled by the World Bank (Worldwide Governance Indicators). It captures perceptions (through surveys, specialists' opinions, institutional data, etc.) of the government's ability to formulate and implement sound policies and regulations that permit and promote private sector development. Once again, the results show a correlation between GDP per capita and regulatory quality for the group of countries analysed.

Simplifying frameworks and enhancing regulatory quality could unlock productivity gains.

Relationship between regulation and GDP per capita



Source: Santander Research based on World Bank.

It is broadly established that regulation plays a foundational role in economic development, but its effectiveness depends on clarity, proportionality, and coordination. Evidence suggests that, in many countries and regions, simplifying frameworks and enhancing regulatory quality could unlock productivity gains that are crucial for long-term growth.

The macroeconomic effects of artificial intelligence

As a potential general-purpose technology, AI widespread adoption could transform economies, increasing efficiency and innovation. Despite early productivity lags, investment and integration are speeding up. The extent and speed of AI's macroeconomic impact will depend on adoption rates, complementary infrastructure and policy choices.

AI, the next GPT and the potential for transformation

AI is becoming a transformative technology with profound impact, comparable to electricity or the Internet.

"Artificial Intelligence (AI) is the ability of a machine to display human-like capabilities such as reasoning, learning, planning and creativity" (European Commission, 2023).[1] Developments in recent years have brought us closer to a world in which we live alongside these 'machines', undoubtedly bringing vast changes and improvements.

Since its birth in the 1950s, AI has evolved through advances in machine learning during the 1990s, the development of deep learning in the 2010s, and the invention of large language models (LLMs) that enable neural networks to understand the context of words. LLMs have become the leading light in generative AI, whose main feature is the ability to create texts, images, music and other content based on natural language prompts.

Research shows generative AI increases employees' productivity in tasks that require cognitive abilities.

Traditional machine-learning models are also effective and will continue to find new uses. They help companies by performing numerical, optimisation and predictive model-related tasks that reduce errors and increase speed and quality. The novelty of generative AI is that it enables to move away from systems that perform certain tasks through code and extensive and painstaking data collection to train neural networks, to systems that can perform a wide range of tasks more easily and at a lower cost.

Companies are already reporting a positive impact on productivity and on the anatomy of work. Corporate research shows that generative AI increases employees' productivity in tasks that require cognitive abilities (i.e. the brain's capacity to receive, process and produce information), particularly in areas such as customer support, drafting, and programming. Some studies even point to a positive impact on the bottom line and productivity in companies that invest in and use AI.

How far can it go?

Despite the signs, people are divided on how far it can go. But it is broadly accepted that AI can become a transformative technology of profound impact if it becomes the

[1] European Commission (2023), 'Facing the future: AI-driven research projects overcoming real-life challenges'.

next general-purpose technology (GPT). GPTs such as engines, electricity, computers and the Internet eventually reach widespread and versatile use, with ripple effects that enhance other technologies, affect sectors and, ultimately, bolster productivity.

GPTs usually impact on economies in three stages. First, for a recent innovation that is yet to be widely used, the overall productivity benefits are not so obvious. Second, as the technology evolves and gets better, its costs fall and its wider roll-out starts to nudge productivity upwards (transforming tasks, organisation, business models, strategies, efficiency, the basis of competition in several sectors and, over time, accelerating productivity at macroeconomic level, which will impact on economic growth and living standards). And third, amid widespread use of the technology and a slowdown in enhancements, the law of diminishing returns starts to kick in and productivity gains begin to tail off.

Productivity is the key component in terms of AI's potential impact on GDP per capita.

How and why AI impacts on economies

If we analyse the economy from the supply side — or production —, we can break down GDP growth into GDP per capita (living standards) growth plus population growth. GDP per capita depends on the number of people in work, the number of hours worked, and each employee's hourly productivity.

Productivity is the key component in terms of AI's potential impact on GDP per capita. For example, in the 1990s, living standards in the US improved significantly on the back of higher productivity and the widespread use of the Internet and computers.

AI impacts on productivity through two main channels:

A way of boosting productivity is the potential effect on advances in technology and innovation.

- **Capital**. AI is a form of capital and people are more productive when they have more capital to carry out their tasks. Thus, adopting AI can boost productivity if it increases capital per employee, e.g. through new software. Another channel is if AI reduces depreciation rates by improving maintenance.
- **Total factor productivity**. For AI, the most direct line of action is efficiency gains. In other words, this is when AI helps make or perform tasks more efficiently and enables people to be more productive in their jobs and frees up time. It also paves the way for better work practices (e.g. when the invention of the steam engine and the need to manage railway timetables led to the adoption of the standard timetable, which made for a more efficient use of time).

  Another way of boosting productivity — perhaps larger but more uncertain — is the potential effect on advances in technology and innovation. If AI could push innovation, it could go beyond a one-off productivity boost and support a more durable rise in productivity.

The extent to which improvements in productivity have a notable macroeconomic impact primarily depends on the degree of technology adoption (if there is a large enough share of companies and sectors to be reflected in macro-level data).

Evidence from past general-purpose technologies indicates that new occupations can emerge and offset losses over time; for instance, research using data from the US Census[2] links most long-term employment growth to new roles. Yet, outcomes vary across sectors and regions, and transition costs may arise and should be monitored. For AI, complementary investment, skills and re-skilling, and responsible deployment will be critical to ensure broad-based, inclusive gains.

GPTs usually impact on economies in stages. To check which stage we are in now, it is useful to examine data on AI adoption.

AI in today's economy

GPTs usually impact on economies in stages. To check which stage we are in now, it is useful to examine data on AI adoption (how widespread it is), corporate investment, labour market and productivity to gauge its presence and impact. The US is our primary focus as the leader in AI development and adoption and the country with the most available data.

- **Adoption**, especially of generative AI, has ramped up rapidly, with widespread household use and a rapid increase among companies. However, it is still in its infancy. A fast roll-out does not necessarily imply broad penetration. According to the US Census Bureau, 9.9% of companies were using AI to produce goods and services in September 2025, though that figure varies significantly depending on company size and sector.

Almost 10% of companies in US were using AI to produce goods and services in September 2025.

- **Investment** is growing strongly, which macroeconomic data is starting to reflect. It is reasonable to assume that the cycle of corporate investment in AI will follow this path: first, soaring investment in model development; second, as processing costs fall, an increase in user (especially software companies) investment in AI adoption.

  Reports and surveys on companies point to a significant ramp-up in AI investment in recent years (see *The 2025 AI Index Report*[3]). In the past two years, investment in software, communications equipment and hardware has grown at a slightly lower rate than in previous years, and well below what we witnessed in the second half of the 1990s during the information and communications technology (ICT) boom. But during the first half of 2025, tech-related investment explained almost all the investment in this period. In particular, investment in computers and peripheral equipment grew at 42% year on year in the second quarter of 2025, which is consistent with the first phase of the expected AI investment cycle.

- **Productivity**. In line with this, aggregate productivity has not yet shown broad-based acceleration, though some sectors are moving faster than others.

Momentum has moderated in some firms. According to S&P Global's AI and Society survey,[4] the share of companies that abandoned generative-AI projects rose to 42% in 2024, from 17% a year earlier. This pattern is not unprecedented: in the 1980s, the

[2] David Autor (July, 2022), 'The Labor Market Impacts of Technological Change: From Unbridled Enthusiasm to Qualified Optimism to Vast Uncertainty'. NBER working paper series, 30074.

[3] Stanford University (2025), 'The 2025 AI Index Report'.

[4] S&P Global (2024), 'AI and society: Implications for global equality and quality of life'.

'productivity paradox' described the lag between ICT investment and measurable gains in macroeconomic data.

We must overcome adoption barriers for technology to generate the productivity gains it promises (first in companies and then at aggregate level):

- External barriers such as cost and regulatory uncertainty are the most salient.
- Internal barriers are more difficult to spot. The existence of a technology does not mean firms are harnessing its full potential. The impact of GPTs will not be reflected at scale until several conditions are met: the implementation of complementary infrastructure (effective databases and data management, encryption, access and risk control systems, some of which will come to the fore in future innovations), employees learning new skills, and organisations undergoing profound change.

Companies are beginning to create new structures and processes. 78% of respondents say their organisations use AI in at least one business function.

McKinsey's *The State of AI survey*[5] provides some clues as to where companies are at:

- Companies are beginning to create new structures and processes. They are reshaping workflows, enhancing governance, and working to mitigate a growing set of risks. However, these tend to be in the early stages and in large enterprises.
- 78% of respondents say their organisations use AI in at least one business function. Only 16% say their company uses it in five or more functions. Most respondents have yet to see a positive impact on organisation-wide results, and only 1% of company executives describe their gen AI roll-outs as 'mature'.

AI future economic impact scenarios

Uncertainty about the future of AI and the size and speed of its impact is substantial.

Uncertainty about the future of AI and the size and speed of its transformative power is substantial.Experiences with other GPTs are a useful starting point and guide for thinking about the future:

- The *First Industrial Revolution* (steam power): Innovations transformed Great Britain from an agricultural economy into the wealthiest nation of the 19th century. However, average living standards rose slowly, about 0.4% per year over 70 years.
- The *Second Industrial Revolution* (United States): From roughly 1860 to the turn of the 20th century, the US overtook Great Britain as the world's largest economy. It took years before productivity data reflected the change. US labour productivity grew by 2.0% per year between 1899 and 1929. However, TFP growth was actually stronger between 1929 and 1941 (1.9% per year) than it was during the first three decades of the 20th century (1.1% per annum).
- In the *ICT revolution*, memory chip and silicon microprocessors that power personal computers were introduced around 1970. Two decades later, fewer than 10% of the world's businesses were using computers. As the world moved into the information age with the arrival of email, mobile phones and the Internet, productivity growth

[5] McKinsey (2025), 'The state of AI: How organizations are rewiring to capture value'.

remained stubbornly low. It was not until the widespread adoption of these technologies in the 1990s that TFP accelerated anew.

It is impossible to predict what AI will do in 20 or 30 years. Most of the near-term effects must involve existing technologies and improvements in them.

Historically, productivity gains from GPTs have often taken decades to materialise, though delays appear to have shortened over time — a pattern consistent with declining 'adoption lags'.

Given its nature, AI is more comparable to the ICT revolution. Compared to IT, however, AI is considerably easier to use and implement in processes — frequently without new hardware, deep end-user know-how, or major reconfiguration of business practices. Consequently, the impact of AI on productivity could be felt sooner. But can we really know how much sooner?

Before attempting numbers or timelines, it is worth clarifying a key issue that is often under-explained in predictions about AI's impact. As Nobel laureate Daron Acemoglu notes, "*it is impossible to predict with any confidence what AI will do in 20 or 30 years. One can say something about the next decade, because most of the near-term effects must involve existing technologies and improvements in them*".

The main known unknown is that current model breakthroughs eventually lead to artificial general intelligence (AGI). If this were to occur, innovation effects could shift from a substantial, one-off productivity increase to a more pronounced acceleration in productivity growth.

The largest impact is expected from automating some tasks and making some workers in different occupations more productive.

Accordingly, estimates that follow focus on the potential short- to medium-term effects of existing technologies and their improvements, rather than the longer-term and potentially much more transformational effects of AI (as in the case of AGI).

Impact scenarios: An analysis framework

Microeconomic studies document productivity gains from AI for specific occupations. The largest impact is expected from automating some tasks and making some workers in some occupations more productive. The extent to which such micro-level gains — and any employment effects — translate into aggregate productivity and growth remains uncertain.

Many studies that simulate AI's effects on aggregate productivity and economic growth are based on the framework from Acemoglu (2024),[6] which examines the medium-term effects arising from small changes in productivity and in the mix of labour and capital inputs in a single country framework that:

- includes two channels for AI-based productivity gains: automation and task complementarity; and

[6] Acemoglu (2024), 'The Simple Macroeconomics of AI', NBER working paper series, 32487.

- applies Hulten's theorem (Hulten, 1978),[7] which shows how micro-level productivity improvements translate into macro changes and aggregated productivity growth by calibrating three key parameters: exposure to AI; the AI adoption rate; and savings.

o Exposure to AI across occupations reflects assumptions about AI capabilities and the potential scope of applications.

o The AI adoption rate is the share of AI-exposed tasks where benefits exceed costs, making AI adoption profitable.

o Labour cost savings capture the unit-cost reduction enabled by AI.

Estimating productivity gains from AI adoption requires making additional assumptions and new-task creation.

Because Acemoglu's framework focuses on small technological changes, it is not designed to analyse fundamental long-run shifts in economic structure, sectoral compositions or the impact of factor reallocation across tasks. It is, therefore, unsuitable for estimating potentially large transformational effects such as the creation of new industries or a step-up in the pace of scientific discovery. In practice, estimating productivity gains from AI adoption requires calibrating Hulten's three parameters and making additional assumptions about factor reallocations and new-task creation — a key source of dispersion across published estimates.

Impact scenarios

Studies of AI's medium-term macro effects report a wide range of estimates.[8] Using more conservative assumption tends to mute productivity gains and cross-country dispersion; more optimistic assumptions point to larger upside risks.

Studies of AI's medium-term macro effects report a wide range of estimates.

Acemoglu's (2024) estimates provide a baseline. For the US, he considers a cumulative TFP increase of just a 0.7% over 10 years (0.06% annually), assuming a share of tasks exposed to AI of 19.9%; the share of tasks that will be cost-effective at 23%; and labour saving costs of 27%. Nevertheless, the study does not include factor reallocations across tasks. Finally, assuming capital grows in line with TFP, GDP would rise 1.0%–1.15% (this capital-growth assumption is common across studies).

Other studies offer more optimistic estimates based on more positive assumptions on the three key parameters and incorporating reallocations of factors across tasks and new-task creation. Aghion and Bruel (2024)[9] estimate and impact in TFP of 6.8% in 10 years (0.68% annually) assuming a share of tasks exposed to AI of 60%; the share of tasks that will be profitable at 50%; and labour saving costs of 40%. Work by some private institutions places the medium-term (10-15 years) productivity increase at up to 10-15%, under even more optimistic — albeit plausible, given the available research — assumptions.

[7] Hulten (October, 1978), 'Growth Accounting with Intermediate Inputs', The Review of Economic Studies, Vol. 45, No. 3, pp. 511-518.

[8] These IMF Working Papers include a revision of contributions to the literature of the impact of AI in the macro: Misch, F., Park, B., Pizzinelli, C., & Sher, G. (2025), 'AI and productivity in Europe', IMF working paper No. 2025/067 and Cerutti, E., Garcia Pascual, A., Kido, Y., Li, L., Melina, G., Tavares, M. M., & Wingender, P. (2025), 'The global impact of AI: Mind the gap', IMF working paper No. 25/76.

[9] Aghion, P., & Bunel, S. (June, 2024), 'AI and growth: Where do we stand?', Federal Reserve Bank of San Francisco.

An uncertain future

Views on AI's future range widely — from those who think that we may soon reach Artificial General Intelligence (AGI)[10] (AI matching human performance across cognitive tasks), to those who view AI as a normal technology, with similar potential to previous GPTs[11] (or even those who argue[12] that the impact of recent technological advances may be smaller than past technological revolutions).

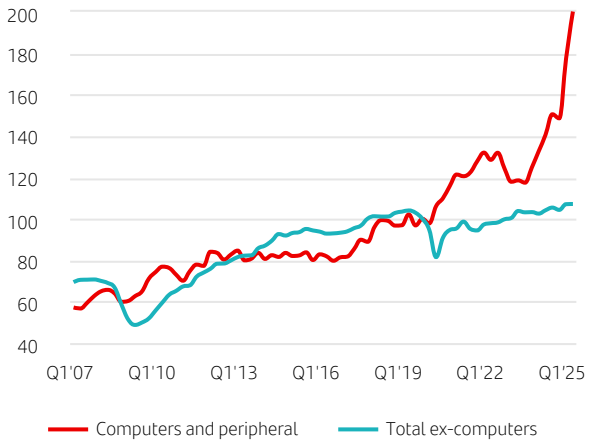
Amara's Law states that we tend to overestimate the short-term impacts of new technologies and underestimate their long-term effects.

We do not claim to have the answer. But we tend to think that Amara's law[13] which states that we tend to overestimate the short-run impacts and underestimate the longer-term ones.— could likely apply as in previous episodes of technological transformation.

AI adoption is proceeding quickly, but there are many adoption barriers to overcome before the technology as we know could unleash its potential. This process can be slow and costly. Even so, a gradual diffusion of AI would change the nature of work and could have significant macroeconomic effects that will vary across countries.

As with prior technological revolutions, AI brings uncertainty and new questions. Outcomes will depend on the policies adopted — and how they align with demographic shifts, climate change, the transformation of globalisation, geopolitics and other secular trends that are shaping the world.

US: Real equipment investment, computers vs other products
(Q4'19=100)



Source: U.S. Bureau of Economic Analysis (BEA).

US: AI business adoption
(% business using AI in producing goods or services)

ISO week year from first day in collection period & Collection Period Fortnight [01-26]. (Years with 53 weeks will result in fortnight 26 being 21 days long).
Note: Source: US Census, Business Trends and Outlook Survey.

[10] Korinek & Suh (2023), 'Scenarios for the transition to AGI', NBER working paper series, 32255.

[11] Narayanan, A., & Kapoor, S. (April, 2025), 'AI as Normal Technology', Knight First Amendment Institute.

[12] Gordon (2016), 'The Rise and Fall of American Growth', Princeton University Press.

[13] Roy Amara was a prominent futurist, president of the Institute for the Future. His law was never formally published, but it is cited in several books on futurology.

Housing markets: Trends, challenges and policy responses

Housing markets worldwide have been facing significant pressure in recent years. After years of rising prices and shrinking supply, the recent modest price corrections mask persistent affordability tensions, especially in advanced economies. Supply constraints and uneven demand fuel deep social and economic challenges.

Housing prices: Recent shifts

Prices remain 20% above post global financial crisis levels.

In 2024, the global residential property market saw a 1.6%[1] decline in real house prices, continuing a gradual correction that began in mid-2022. Advanced economies registered a modest 1% increase, led by the euro area at 1.9%, while emerging market economies experienced a 3.5% fall, with Asia dropping sharply by 5.7%. Despite significant regional differences, real house prices remain roughly 20% above post-Global Financial Crisis (GFC) levels worldwide, which reflects persistent long-term upward pressure.

Though monetary policies have tightened following the post-pandemic inflation surge, price adjustments have been relatively modest. In fact, prices are generally rebounding even as interest rates remain high compared to pre-pandemic levels, signalling a return to the long-term trend of rising housing prices, particularly in developed countries.

By 2030, around 40% of the global population will need access to adequate housing.

Research from the Bank for International Settlements (BIS)[2] highlights the decline in housing supply elasticity — from about 6% to 4% over the past 50 years — as a central factor driving price increases. This reduced responsiveness of supply amplifies price volatility and magnifies the effects of demand shocks and monetary policy on prices, especially in markets constrained by regulatory and geographic factors.

Looking ahead, the United Nations[3] estimates that by 2030, approximately 3 billion people — around 40% of the global population — will need access to adequate housing, which translates into a demand for roughly 96,000 new, affordable and accessible units every day. However, the World Economic Forum[4] (WEF) points out that the challenge is not a global housing shortage but rather a mismatch between

[1] Bank for International Settlements (May, 2025), 'Statistical release: BIS residential property price statistics in Q4 2024'.

[2] Bank for International Settlements (December, 2024), 'Monetary policy and housing markets: insights using a novel measure of housing supply elasticity', BIS Quarterly Review.

[3] United Nations Economic Commission for Europe (2025), 'Challenges and priorities for improving housing affordability in the UNECE region', UNECE Real Estate Management Advisory Group.

[4] World Economic Forum (July, 2025), 'We don't have a global housing shortage – we have a global housing mismatch'.

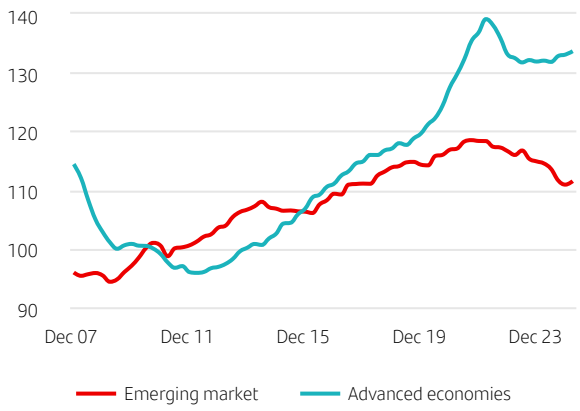
supply, demand, affordability and access. Rural-to-urban migration and economic migration have resulted in surplus properties in depopulated areas alongside overcrowded cities.

The main cause of stress in housing markets is not the lack of credit, but supply restrictions and structural rigidities.

The McKinsey Global Institute[5] estimated that about 440 million urban households worldwide may be living in substandard housing or face housing costs that exceed 30% of their income by 2025. Access to land is typically the biggest constraint for housing development and one of the major drivers of cost, representing in extreme cases as much as 80% of a home's price. Globally, McKinsey estimated that unlocking land to the fullest extent could reduce the cost of owning a standard housing unit by up to 20%.

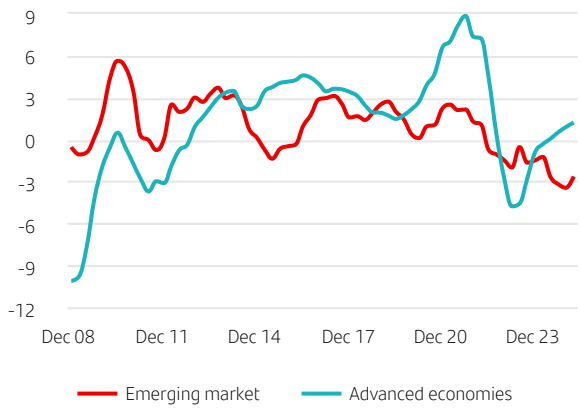
Housing affordability has worsened significantly since the pandemic, driven by soaring prices, vastly higher mortgage rates, and ongoing supply shortages. Analysis of 32 European countries confirms that affordability issues are concentrated among low-income households and tenants paying market rent. Poorer households typically spend over 40% of their income on housing costs, exceeding widely accepted affordability thresholds and experiencing significant 'housing stress', which limits their spending on other essentials and increases the risk of poverty.

Evolution of residential property prices
(2010=100, real terms)



Source: Bank of International Settlement.

Evolution of residential property prices
(% y/y, real terms)



Source: Bank of International Settlement.

[5] McKinsey Global Institute (2017), 'Housing affordability: A supply-side tool kit for cities'. McKinsey & Company.

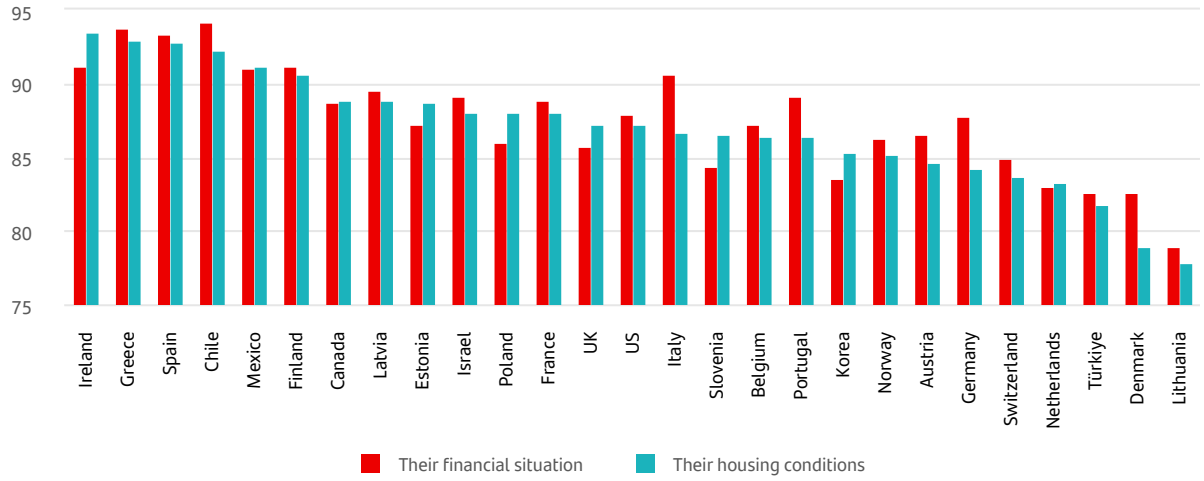
Vulnerable households, (low-income and young people) are the most affected.

The worldwide housing affordability stress and economic externalities

The worldwide affordability stress is a key social issue with negative economic externalities. Some of them include labour market distortions as high costs push low-wage workers away from cities, exacerbating urban productivity losses and social inequality. Poor-quality rental housing and short-term rentals further reduce housing availability and quality for vulnerable groups.

Young people are disproportionately affected, with 60% of adults aged 18–29 reporting housing affordability concerns, heightening intergenerational equity issues. This leads to an increase in the age of emancipation and lower fertility rates. Indeed, housing is the second most cited barrier to childbearing in most OECD countries.

Selected social and economic reasons contribute to lower fertility, by country
(% of respondents, 2024)



Source: OECD.

The worldwide affordability tensions should be tackled urgently, as it has negative short and long-term consequences on social cohesion and economic growth.

The current house price boom is due to supply constraints and is not associated with credit.

Not a financial stability issue this time

Housing expansions differ fundamentally between non-boom expansions with moderate price growth and housing booms marked by rapid, sustained house price increases. According to IMF research[6] covering 68 countries, booms lead to stronger short-term GDP and consumption growth — driven by wealth effects — but are followed by deeper, longer contractions with sharper declines in GDP, investment and housing supply compared to non-boom expansions.

[6] B. Albuquerque, E. Cerutti, Y. Kido and R. Varghese (2025), 'Not all housing cycles are created equal: Macroeconomic consequences of housing booms', IMF working paper No. WP/25/50, Washington, DC.

Boom-related contractions are more severe when accompanied by credit booms, reflecting capital misallocation towards real estate at the expense of productivity in other sectors.

The current house price boom is generally due to supply constraints and is not associated with credit. In fact, there has been a step deleveraging process. In advanced economies, household indebtedness reached 85% of GDP in 2009 (with several countries around 100%), while in 2024 this figure dropped to 67%. Financial systems and regulators have learnt from the GFC experience. Moreover, most countries have developed macroprudential tools and monitor mortgage conditions more closely.

Household debt in advanced economies has fallen from 85% to 67% of GDP since 2009.

As several stress tests show, the banking sector is solid and has the appetite and the capacity to finance both the supply and the demand side of the market.

Common solutions for local problems

Though residential markets are closely related to idiosyncratic issues there is no 'magical recipe' to solve the issues, however there are some guidelines that seem to be followed to address current problems in housing affordability.

Supply-side reforms are critical:

- Removing or loosening restrictive land-use regulations.
- Accelerating permitting processes.
- Ensuring a stable framework of legal certainty.
- Fostering investment through public-private partnership programmes, especially for the development of social or affordable rental homes.
- Promoting construction productivity to foster industrial construction.
- Incentivising urban regeneration, accommodating the housing stock to varying demand needs (smaller house for smaller households), and facilitating downsizing can be effective tools to increase supply.
- Implementing energy-efficient building programmes to align affordability with sustainability goals.

No 'magical recipe', but supply-side reforms and leveraging technology are critical.

On the demand side, when market pressures come mainly from supply constraints, setting measures to target social problems (e.g. enabling vulnerable and young people to access the market) is crucial.

Finally, leveraging technology helps enhance market data. This is especially vital in emerging markets, particularly for informal housing sectors, helping improve tenure security and access to finance. Blockchain land registries, digital platforms and GIS mapping help reduce transaction costs and broaden affordability.

Multifaceted approach: accessibility, sustainability, and financial resilience.

Conclusion

Global housing markets remain at a crossroads due to generalised affordability difficulties, which is one of today's main social challenges and could have a widespread impact on the economy in the short and long term.

Integrated and holistic policy responses that focus on supply-side expansion measures in the most stressed regions are urgent and should be accompanied by targeted demand support and improved transparency. Enhanced data monitoring and innovative technologies further strengthen the policy toolkit.

Only through multifaceted and coordinated strategies can policymakers build resilient and inclusive housing systems that will sustain economic growth, social equity and financial stability for decades to come.

Europe's automotive industry: Between transformation and competitive pressure

The automotive sector — one of Europe's strategic pillars — is undergoing rapid transformation, driven by decarbonisation goals, technological disruption, and rising global competition. To support the transition and safeguard competitiveness, the European Commission has launched an industrial action plan that could prove a turning point in EU economic policy.

Strategic relevance of the sector

Europe's automotive industry accounts for 13 million jobs and 7% of the EU GDP.

The automotive industry is a major contributor to Europe's gross value added (GVA). It employs approximately 13 million people — directly and indirectly — and accounts for 7% of the EU's GDP. By nature, the sector is also heavily engaged in research and innovation (R&D), which enhances competitiveness and generates positive spillover effects in related sectors such as components, distribution, financial and insurance services, and transport.

According to the European Automobile Manufacturers' Association (ACEA), in 2024 Europe produced around 16% of the world's cars and acted as a key exporter, generating a trade surplus equivalent to nearly 1% of the EU's GDP.

Market situation and trends

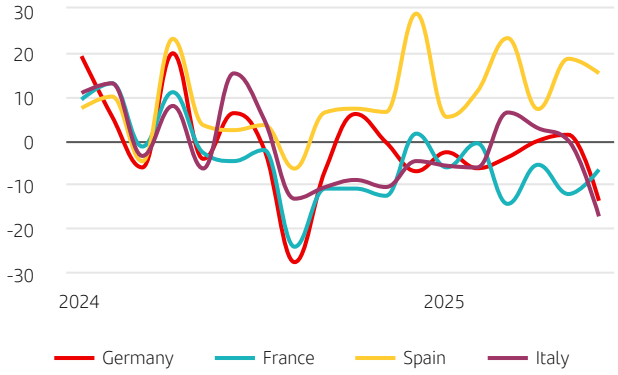
The ongoing decline in vehicle demand since 2019 underscores the fragility of Europe's automotive sector. In the first half of 2025, sales remained about 20% below the levels recorded in 2019.

Electric vehicles have reached a 15.6% market share — still far from the 2030 EU target.

From January to June 2025, vehicle sales in the EU reached 5.6 million units, a 1.9% year-on-year decline, particularly in the largest markets that together account for over 66% of total EU sales. France registered the steepest decline (-7.9% year on year), followed by Germany (-4.7%) and Italy (-3.6%). Spain was the exception, with a nearly 14% increase. Outside the European Union, the UK grew by 3.5%.

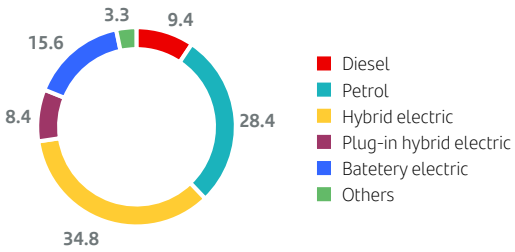
In terms of powertrains, battery electric vehicles (EVs) increased their market share to 15.6%, up from 12.5% a year earlier. However, this falls short of the pace required to meet the EU target of 30 million electric vehicles by 2030. Hybrid and plug-in hybrid vehicles remain the most popular, accounting for 43% of total sales.

EU: New car registrations
(%, y/y)



Source: European Automobile Manufacturers' Association.

EU: Weight on total vehicle sales by energy source Jan-Jun
(%)



Source: European Automobile Manufacturers' Association.

Sales of petrol and diesel vehicles fell 23% compared to a year earlier, reducing their share of total sales to 37.8%, down from 48.2%. Nonetheless, internal combustion vehicles still make up a substantial share of the European market.

Factors behind the industry's slowdown

The drop in production, exports and vehicle registrations across the EU since 2019 is driven by a combination of supply- and demand-side factors:

- **Weak economic growth**: Sluggish GDP performance and low consumption, particularly in Germany and France.
- **High vehicle prices**: Post-pandemic inflation, supply chain bottlenecks, rising costs of materials, energy, wages and R&D costs for technological adaptation have driven prices up.
- **Shifting consumer preferences**: Electric vehicle (EV) demand has not fully offset the declining appeal of the internal combustion engine (ICE) vehicles. Uncertainty around environmental regulations and urban restrictions discourages ICE purchases, while EVs remain unaffordable for many socio-economic groups.
- **End of EV purchase incentives**: The removal of subsidies in Germany and France has reduced demand. Spain stands out, supported by programmes such as MOVES III.
- **Energy transition challenges**: The shift to EVs requires major investment from manufacturers to adapt to new technologies. The EU's increasingly strict emissions standards and the 2035 ban on new combustion vehicle sales have also contributed to declining production and sales.
- **Rising foreign competition:** Chinese EVs are more affordable and technologically advanced, thanks to lower labour costs and state support.
- **Global supply chain disruptions:** Persistent shortages of key components.

The EU is committed to achieving climate neutrality — net-zero greenhouse gas emissions — by 2050.

- **US trade policy**: Tariffs on automobile imports from the European Union increase uncertainty in the European automotive industry, as the United States remains one of the EU's key export markets.

Electric vehicles: The cornerstone of the green transition

Electric vehicles cost 22–30% more than combustion-engine vehicles in the euro area (2024–2025).

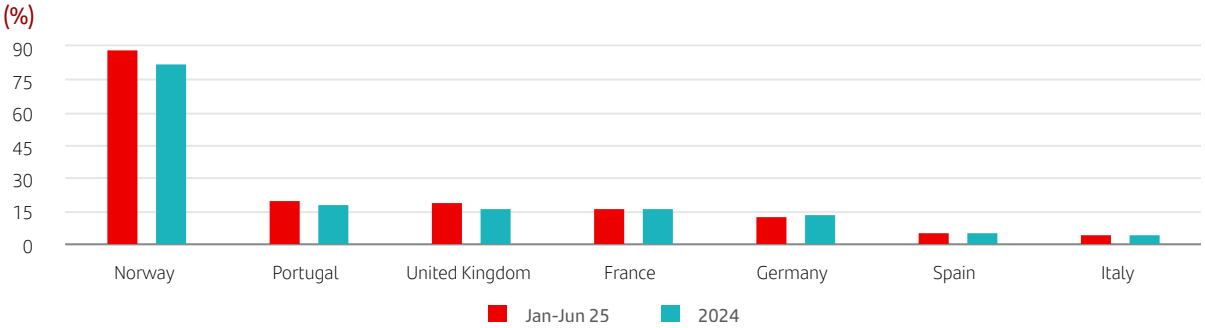
The EU is committed to achieving climate neutrality — net-zero greenhouse gas emissions — by 2050. This deadline marks the end of combustion and hybrid vehicles. EVs play a central role in reducing the transport sector's emissions, one of Europe's highest-emitting sectors. The shift towards electric mobility is being propelled more by regulation than by market forces.

However, the EV rollout is slower than anticipated. In the first half of 2025, EV registrations grew 22% year on year in the EU, raising their market share to 15.6% (from 12.5% a year earlier). Germany saw a rise of over 5 percentage points to 17.7%; Italy increased by 1.3 percentage points to 5.2%; France remained flat at 17.6%; and Spain grew by nearly 3 percentage points to 7.6%. But to meet targets, EV sales must accelerate significantly.

One major barrier remains their price. Though the price gap with ICE vehicles is narrowing, it is still considerable. As of 2024, EVs cost on average 22% more than ICE vehicles in the euro area.[1] A Shell survey[2] showed EVs were up to 30% more expensive than comparable ICE models. Another factor holding back the growth of EVs is the limited size of the second-hand market due to consumer concerns, partly about uncertainty over used EV prices and the lack of public incentives for their purchase. This uncertainty, together with price volatility compared with internal combustion and hybrid vehicles, makes EVs a less attractive option.

Thus, Europe's automotive industry must produce electric vehicles that are both compliant and competitive. The new CAFE (Corporate Average Fuel Economy) regulation, in force since 2025, imposes strict CO_2 emissions limits. Compliance falls on manufacturers, with penalties for violations. Meanwhile, Chinese EVs are affordable, high-quality and well-designed — factors that helped China surpass Japan in 2023 as the world's top vehicle exporter.

Weight of electric vehicles in total vehicle sales



Source: ACEA.

[1] Jato Dynamics. Muñoz, F. (January, 2025), 'Battery electric vehicles: Global trends, Chinese OEMs, and price challenges'.

[2] Shell PLC (June 2025), 'Shell Recharge Driver Survey 2025'.

China's competitive pressure

China's automotive capacity surged after 2020. While domestic subsidies helped establish China's EV industry, its future growth relies heavily on exports. This puts pressure on Europe's industrial base.

China controls roughly 70% of the global supply of battery-critical raw materials.

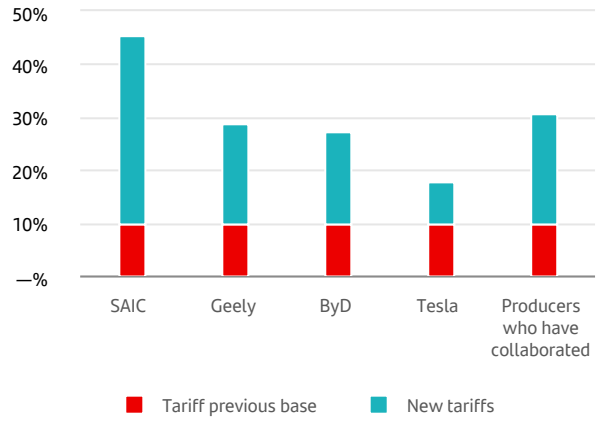
In response, the European Commission launched an investigation in 2024, concluding that China's entire EV value chain — including R&D — is supported by state subsidies, a practice that is largely restricted in Europe.

This led to provisional tariffs of up to 37.6% on Chinese EV imports, in addition to the existing 10% duty. The main targets are three Chinese producers, and they affect Western brands manufacturing in China.

These tariffs will remain in effect for five years. According to the China Association of Automobile Manufacturers (CAAM), Chinese EV sales in Europe dropped 10.4% in 2024, contrasting with 81% growth in 2023. In the first half of 2025, Chinese EV imports to the EU fell nearly 16%.

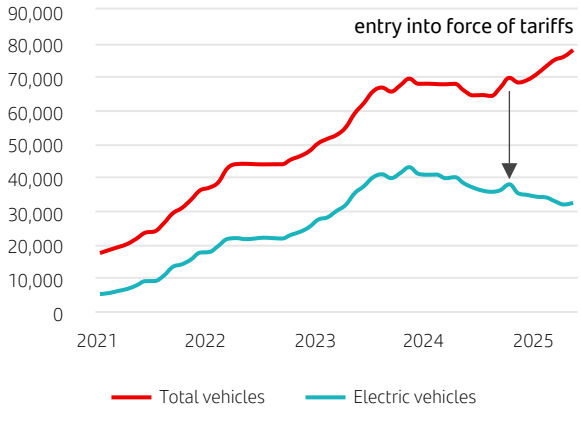
China's response was swift. Its Ministry of Commerce urged companies to suspend major investments in Europe. More significantly, it restricted exports of raw materials needed for battery production — causing supply chain disruptions in Europe. China controls roughly 70% of the global supply of battery-critical raw materials.

EU: Tariffs on EVs produced in China
(%)



Source: European Commission.

EU tariffs on Chinese EVs have reduced imports
(12m moving average)



Source: DataConnex.

EU industrial strategy for the automotive sector: Industrial policy and strategic autonomy

Tariffs may provide temporary relief for EV-related investment in Europe to take effect, but competing with China in both technology and cost remains a challenge. The EU is implementing several strategies and an industrial action plan to keep its automotive sector competitive.

Automotive Industrial Action Plan with five pillars: clean mobility, innovation, training, supply chain resilience and level playing field.

The plan

The Industrial Action Plan for the automotive sector was presented on 5 March 2025. It is built around five strategic pillars: clean mobility, innovation and digitalisation, workforce training, supply chain resilience, and a level playing field/business environment.

Though the plan does not assign a fixed budget, it mobilises billions of euros through existing programmes. Over EUR 3.5 billion has been explicitly identified, with further funding available from structural, cohesion and national funds.

The plan addresses pressing constraints, such as the challenge of complying with the original Clean Air for Europe (CAFE) directive. CO_2 targets for passenger cars and vans have been made more flexible by allowing averaging over 2025–2027, protecting investment. This change was formalised in a regulatory amendment adopted in May 2025. The Critical Raw Materials Act also highlights Europe's dependency on rare earths (90% controlled by China). In April, China's tighter export controls on magnets and rare earths, in response to US tariffs, further disrupted supply chains and prompted EU efforts to reduce external dependencies.

Strategic approaches

- **Cross-sector cooperation**: Inspired by the Airbus model, public-private partnerships are being promoted to strengthen the regional automotive ecosystem.
- **Infrastructure development**: Accelerated deployment of EV charging infrastructure and V2G (Vehicle-to-Grid) systems.
- **Semiconductor competitiveness**: Supporting Europe's capacity in semiconductor manufacturing, which is critical for advanced vehicles.
- **Raw material sovereignty**: Securing strategic battery materials and reducing dependency on third countries.
- **Small car promotion**: Encouraging the development of compact, efficient vehicles adapted to urban European mobility.
- **Common industrial policy**: Promoting a unified and decarbonised EU-wide industrial framework through green economic zones and partnerships with major cities.

The European Commission has taken action to support the sector with a plan that deploys key instruments.

Conclusion

The sustained decline in vehicle demand since 2019 reveals a structural change in the automotive industry. The European Commission has taken action to support the sector with a plan that deploys key instruments in the areas of battery financing, flexibility in CAFE regulation, and the promotion of coordinated and collaborative innovation in connected and autonomous vehicles. The plan is yet to produce substantial results in terms of production or in regaining global market share, likely because its implementation is in its early stages. Time will provide more evidence of its effectiveness.

The EU–Mercosur agreement: A strategic alliance for the 21st century

Latin America's renewed engagement with the European Union is gaining momentum, with the EU–Mercosur agreement nearing conclusion after more than two decades of negotiations. This landmark deal stands out not only for its scale, but also for its potential to reshape Latin America's trade and investment landscape. Alongside the modernised agreements the EU has with Mexico and Chile, it reflects a broader shift towards regulatory convergence, sustainability and global value chain integration. Beyond their economic impact, these agreements signal Latin America's intent to strengthen strategic ties in an increasingly fragmented global order.

The trade agreement between the European Union and Mercosur marks a historic milestone in relations between the two regions.

The trade agreement between the European Union and Mercosur — reached in preliminary form in 2019 and legally finalised in December 2024 — marks a historic milestone in relations between the two regions, at least for a couple of reasons. First, it successfully concludes lengthy negotiations that began in 1999 and had been repeatedly stalled due to divergent interests and shifting geopolitical dynamics. Second, it is one of the most ambitious trade deals globally, covering a market of 780 million people and nearly 25% of global GDP — the largest ever concluded by either bloc.

The agreement enhances both parties' global standing. For the EU, it cements its position as Latin America's leading trade partner, with deals covering 97% of the region's GDP. For Mercosur (Argentina, Brazil, Paraguay and Uruguay), it is the first agreement with another bloc and a step forward in both extra- and intra-regional integration, leveraging the EU's wider trade network in Latin America.

UE agreements	Joint Population (mn)	Trade in goods (USD mn)	Trade in services (USD mn)	Tariff savings for EU companies (USD mn)	Aggregate GDP (USD tn)
Canada	550	72,000	35,000	600	18.0
Japan	640	135,000	53,000	1,000	21.0
Mercosur	775	88,000	34,000	4,000	19.0

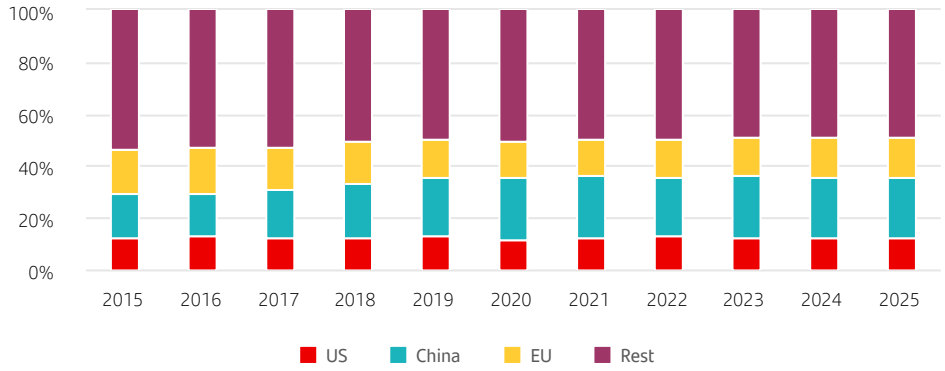
Source: European Commission.

Initial figures and key advantages

Bilateral trade, (USD 135 billion annually in goods and services) holds significant potential for further growth due to tariff elimination.

Bilateral trade, exceeding USD 135 billion annually in goods and services, has strong growth potential from tariff elimination. The EU is Mercosur's second-largest trading partner (after China and ahead of the US), while Mercosur ranks 11th for the EU — though this agreement will generate its highest tariff savings to date, surpassing those of the Japan and Canada deals. On investment, ties are even deeper. With nearly USD 400 billion in foreign direct investment (FDI) stock, the EU is Mercosur's largest foreign investor. The agreement will also streamline operations for European firms that are already active in the region.

Mercosur - Imports + Exports by partner
(% of total)



Note: 2025 data: 12-month cumulative as of March 2025.
Sources: International Monetary Fund and Refinitiv.

Agreement architecture: Market access and regulatory framework

For both blocs, gradual tariff removal and openness in services and procurement deepen value chains, boost competitiveness and foster growth.

The agreement consists of two pillars: market access and regulatory cooperation.

On market access, it covers trade in goods and services and public procurement, which is crucial for infrastructure development. In goods, phased liberalisation combines tariff elimination and quotas to accommodate sensitive sectors on both sides.

For Mercosur, the main benefits are in agriculture: the EU will eliminate 99% of tariffs — 82% fully and 18% through quotas — on products such as meat, sugar and ethanol. Industrial exports like footwear and textiles, notably from Brazil, will also benefit. The agreement is expected to foster industrial integration into EU value chains, promote economic diversification and reduce dependency on raw materials.

For the EU, key gains include the removal of tariffs on strategic industrial sectors: automobiles (35%), auto parts (14–18%), machinery (14–20%), chemicals, pharmaceuticals, clothing and footwear (up to 35%). These will be eliminated gradually over 5–10 years, allowing for adjustment. The deal also has geostrategic value, supporting food, energy and mineral security — especially key to the green transition — against a backdrop of global tensions.

In services — an area with high growth potential and linguistic affinities between Mercosur and countries like Spain and Portugal —, the agreement removes many restrictions on sectors such as tourism, business services, finance, telecoms and maritime transport, while allowing both sides to regulate non-discriminatorily.

In procurement, it guarantees a level playing field for companies from the other bloc, allowing European firms to participate in major infrastructure projects in Mercosur and vice versa. While large companies will be directly benefit, there will also be a spillover effect for SMEs through increased participation in cross-border value chains. Subnational procurement remains protected.

The trade pillar requires approval by the European Parliament and a qualified majority in the Council (not unanimity).

On the regulatory side, the agreement does not impose new rules but encourages regulatory harmonisation. Mercosur exports will have to comply with existing EU standards, which will help raise their levels of quality, safety and sustainability.

Notably, it includes binding clauses on sustainable development — environmental, labour and social commitments aligned with the Paris Agreement, including, for the first time, specific targets on deforestation to 2030. This dimension strengthens the position of companies in both regions that uphold ESG principles.

Ratification: Challenges and prospects

The final step for the agreement to enter into force is ratification — an area that presents certain challenges. The structure divides the process into three components: the political and international cooperation chapters require ratification by each of the 27 EU Member States, while the trade pillar falls under the exclusive remit of the EU. As such, the trade component needs only a qualified majority vote in the EU Council and approval by the European Parliament (without requiring unanimity).

It is estimated that EU-Latin American trade could grow by up to 70% and intra-Latin American trade by up to 40%.

Though some Member States have expressed reservations — related mainly to agricultural and environmental matters —, these appear to be in the minority. Current expectations point to ratification of the trade pillar in the second half of 2025.

On the Mercosur side, each country must ratify both the trade and cooperation components individually. However, the agreement allows each Mercosur country to provisionally apply its own commitments with the EU, even if other members have not yet completed domestic ratification.

An opportunity to strengthen regional integration

Once ratified, the EU–Mercosur agreement will expand the European Union's trade network in Latin America to cover 97% of the region's economy — leaving only Bolivia and Venezuela outside the framework. This far exceeds the coverage achieved by the United States (44%) and China (14%). As such, this strategic alliance could serve as a powerful instrument to elevate the global role of both regions.

For Mercosur, embracing the pact would go beyond external liberalisation — it could also act as a driver for deeper regional integration. By leveraging the EU's bilateral agreements across Latin America — through harmonised rules of origin, simplified

procedures, and common standards —, a broader, integrated economic space could emerge, connecting over 1.1 billion people and a combined GDP comparable to that of the United States. Against this backdrop, the agreement's economic impact would be significantly amplified. According to estimates by the Real Instituto Elcano and the Bank of Spain, EU–Latin America trade could grow by up to 70%, while intraregional trade within Latin America could increase by as much as 40%[1].

Latin America and the Caribbean trade agreements with the EU, the US, and China

	Partner country	% of LAT GDP		Partner country	% of LAT GDP		Partner country	% of LAT GDP
EU	Mexico Chile Peru Central America Colombia Ecuador CARIFORUM MERCOSUR	**97%**	**US**	Mexico (UMSCA) Chile Peru FT CAFTA - DR Colombia Panama	**44%**	**China**	Chile Peru Costa Rica Nicaragua Ecuador	**14%**

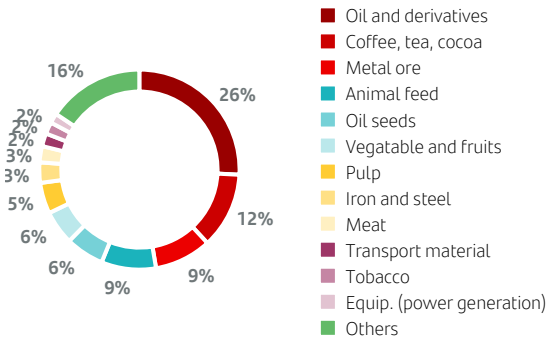
CARIFORUM: Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago. **Central America**: Panama, Guatemala, Costa Rica, El Salvador, Honduras, and Nicaragua. **UMSCA**: US, Mexico and Canada Free trade agreement. **MERCOSUR**: Argentina, Brazil, Paraguay and Uruguay. **FTA AFTA-DR**: Dominican Republic-Central America-United States Free Trade Agreement

Source: RIElCano.

The importance of the EU-Mercosur agreement for Brazil

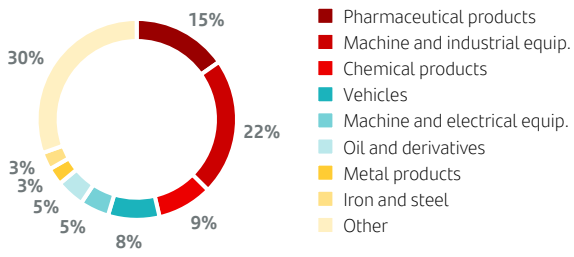
The EU is Brazil's second-largest trading partner, though its share has declined relative to other regions. Figures reveal a growing share of commodity-based exports and imports, alongside a decline in manufactured goods. In 2024, Brazil's key exports to the EU were oil and derivatives (25.8%), coffee, tea and cocoa (12.3%), metal ores (9.2%), animal feed (8.8%), and oilseeds (6.2%). Brazilian imports to the EU were mainly pharmaceutical products (15.3%), machinery and industrial equipment (22.1%), chemicals (8.9%), vehicles (8.3%), and electrical machinery (4.7%).

Brazil's exports to the EU by product in 2024



Sources: MDIC and Santander Research.

Brazil's imports to the EU by product in 2024



Sources: MDIC and Santander Research.

[1] Talvi, E., Berganza, J. C., Campos, R. G., Timini, J., & Estevadeordal, A. (2025), 'EU–Mercosur: Platform towards a new era of transatlantic and intraregional Latin American integration?', Real Instituto Elcano.

The agreement holds strategic value for Brazil's long-term growth and global integration. According to the Brazilian Institute for Applied Economic Research (IPEA),[2] the agreement could lift Brazil's GDP by 0.46 percentage points and increase investment by 1.49 percentage points annually, while the trade balance could improve by over USD 300 million accumulated between 2024 and 2040. While the macro impact may be modest in the short term, the broader gains are more significant: greater integration into global supply chains, improved competitiveness via access to capital goods, and a more diversified export base beyond traditional partners.

The agreement is expected to raise Brazil's medium and long-term growth, stimulate investment and improve the trade balance.

Agribusiness will benefit the most. Brazil gains preferential EU access for poultry, beef, pork, sugar and ethanol under quotas. IPEA estimates agricultural exports to the EU will grow by 5%, with pork and poultry up nearly 20%, both cumulative over the period. Domestic output is set to expand by 2%, led by proteins and vegetable oils. Manufacturing will see selective gains. Lower tariffs on capital goods and inputs will reduce costs for apparel, footwear, pulp and paper, and aerospace. However, sectors like chemicals, pharmaceuticals and machinery may face increased competition.

The agreement also modernises Brazil's industrial base and enhances its appeal to European investors, who already account for nearly half of Brazil's FDI stock. With better regulatory alignment, Brazil could attract more capital, especially in green and tech sectors.

Environmental provisions were key to concluding the deal. Updates to the 2019 draft — including sustainability rules and a chapter on critical minerals — align with the EU's green agenda. Brazil, with its renewable-heavy energy matrix and mineral reserves, is well placed to support Europe's energy transition and expand in biofuels, sustainable aviation fuel and green hydrogen.

The case of the EU-Mexico free trade agreement

In 2024, bilateral trade between Mexico and the EU reached USD 91 billion.

The EU and Mexico signed their first free trade agreement (EUMFTA) in 2000, following negotiations held in 1998–99. It was the EU's first FTA with a Latin American country and Mexico's first with a partner outside the Americas. For Mexico, it was part of a broader strategy of trade liberalisation launched in the 1990s. By 2024, Mexico had signed FTAs with 50 countries, covering over 1.3 billion consumers and 55% of global GDP.

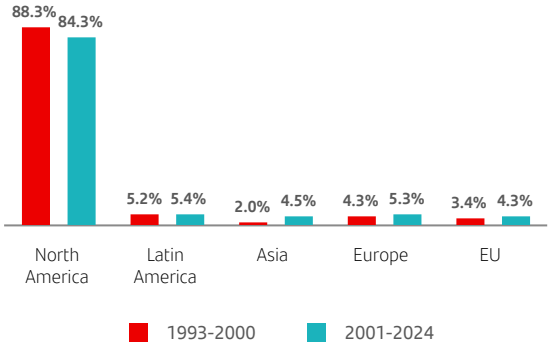
While the EUMFTA significantly lowered trade barriers, it did not eliminate them entirely. Many industrial goods became tariff-free immediately, while others — such as vehicles, electrical components, and agricultural products — were subject to gradual phase-outs. Sensitive goods, including animal products and processed foods, remained protected.

In 2024, bilateral trade between Mexico and the EU reached USD 91 billion. However, this represents a moderate share of their total external trade. For Mexico, the US

[2] Ribeiro, F. J. da S. P., Betarelli Junior, A. A., & Faria, W. R. (December, 2023), 'Evaluation of the impacts of the Mercosur-European Union Free Trade Agreement', Brasília: Instituto de Pesquisa Econômica Aplicada (Ipea), Technical Note No. 68.

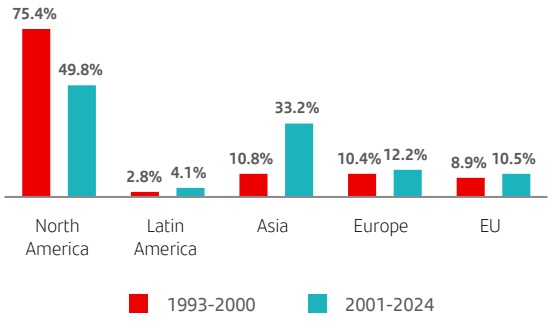
continues to dominate as an export destination (over 80%), though exports to Asia have doubled — comparable in size to those to the EU. Mexican exports to EU are mainly concentrated in automotive products, machinery and electrical components. The EU is Mexico's third-largest import partner, after the US (40.1%) and China (20.8%). Imports from the EU also centre on the automotive sector, machinery and electronics, mirroring export trends.

Mexican exports by destination
(% of total)



Source: Banco de México.

Mexican imports by country of origin
(% of total)



Source: Banco de México.

Mexico's trade with the rest of Latin America has grown in absolute terms but remains modest — only 5.4% of its exports and 4.1% of imports. These figures are well below the level of intraregional trade seen in other parts of Latin America, largely due to Mexico's deep integration with North America. The EU–Mercosur agreement and the modernised EU–Mexico deal could provide a framework to strengthen ties between Mexico and other Latin American economies.

The EU has accounted for 27% of total FDI inflows to Mexico, the second-largest investor after the US (42%).

Foreign direct investment ties with the EU are significantly stronger than trade volumes suggest. Over the past two decades, the EU has accounted for 27% of total FDI inflows to Mexico — an average of USD 6.4 billion per year —, making it Mexico's second-largest investor after the US (42%). Conversely, the EU is also the second-largest destination for Mexico's outward investment, receiving 22% of total flows.

Following a 2015 European Commission assessment of the EUMFTA,[3] the EU and Mexico launched negotiations to modernise the agreement. The new agreement aims to lower remaining trade barriers, promote investment and support the Paris Agreement goals through the enforcement of environmental standards. The agreement covers such areas as digital trade and public contracts, and would remove barriers for access to finance, telecommunications, energy, and other sectors.

Since the agreement includes provisions on investment a full ratification is required with approval by all 27 EU Member States. However, the trade section can be

[3] European Commission (2015), 'Assessment of the implementation of the EU–Mexico Free Trade Agreement', Directorate-General for Trade.

implemented following approval by the European Council and the European Parliament, pending full ratification.

While Mexico has long pursued a trade-led growth strategy that is anchored to a competitive, export-oriented manufacturing base, its exports remain heavily concentrated in the US market. Amid uncertainty over North America's trade future, diversifying export destinations has become increasingly important. With a market of 450 million people and 17% of global GDP, the EU is well positioned to support Mexico's diversification strategy and reinforce a rules-based global trade system.

The case of the EU-Chile free trade agreement

The association agreement between Chile and the European Union, signed in 2002 and in force since 2003, institutionalised political dialogue, cooperation and trade, enabling liberalisation, reducing tariff barriers, and encouraging foreign direct investment. Over two decades, it more than double bilateral trade and consolidated the EU as Chile's third-largest trading partner and its principal foreign investor.

New UE-Chile agreement: tariff-reduction coverage rises to 99.6% of tariff lines, and around 96.5% of Chile's products will be duty-free.

However, given shifts in the global economy — including the rise of the digital economy, sustainability imperatives, and the growing weight of services —, Chile and the EU agreed to modernise the framework.

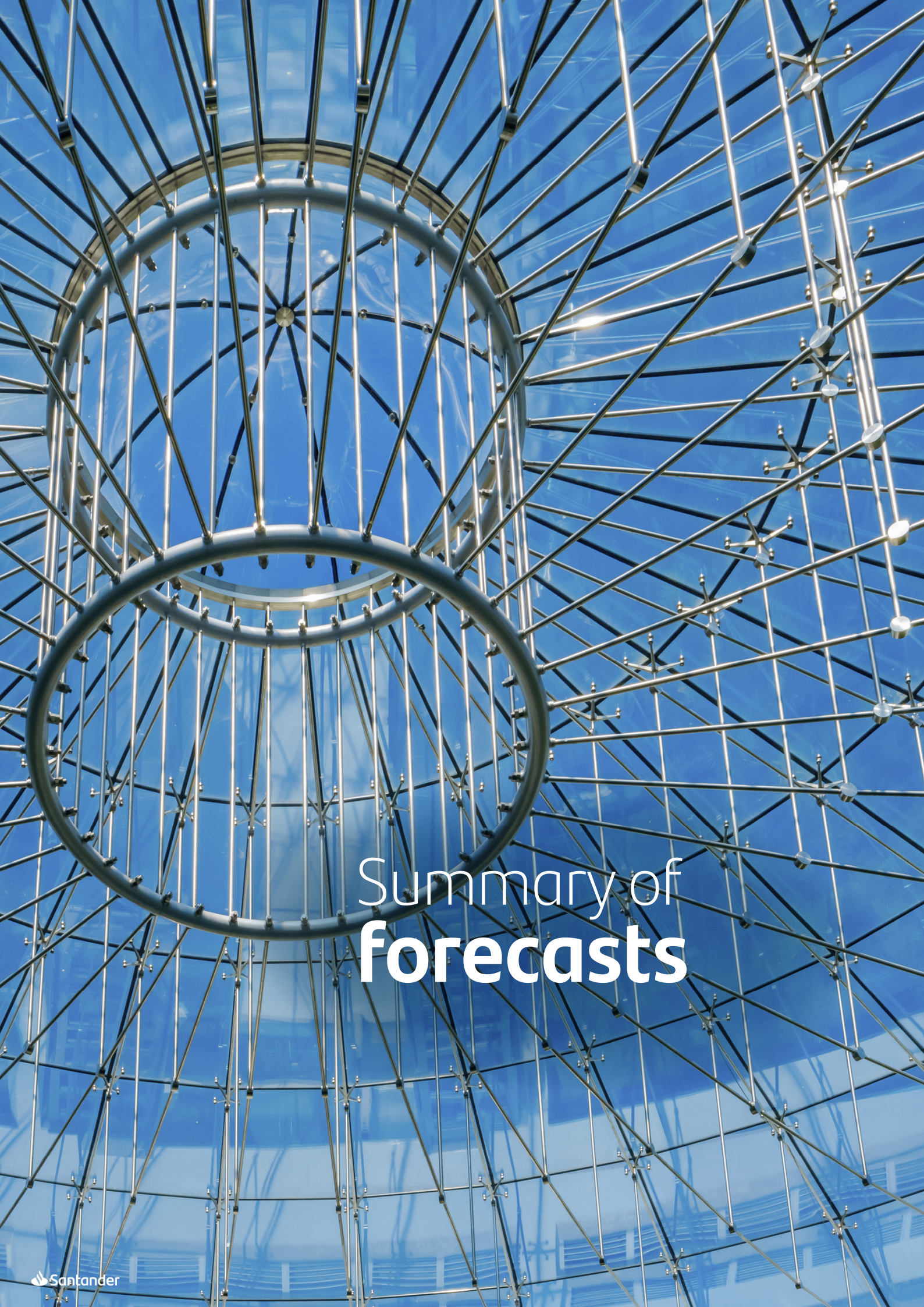
In December 2023, the parties signed a modernised deal architecture composed of the Advanced Framework Agreement (AFA) and an Interim Trade Agreement (ITA), with the latter covering the EU-exclusive parts of the trade and investment pillar while the AFA undergoes broader ratification. The ITA entered into force on 1 February 2025; the AFA will take effect once ratified by the EU's 27 Member States and Chile, at which point the ITA will be repealed and replaced by the comprehensive agreement.

The new framework expands market access beyond the 2002 agreement. The EU's tariff-reduction coverage rises from 94.7% to 99.6% of tariff lines, and around 96.5% of Chile's products will be duty-free once staging is complete. On the EU side, 99.9% of EU exports to Chile become duty-free (all products except sugar).

For Chile, the modernised framework reinforces its long-standing, rules-based approach to global integration.

Beyond tariffs, the AFA/ITA updates rules from customs and origin (including origin self-certification), sanitary and phytosanitary measures, and technical barriers to trade, and adds new chapters on gender, SMEs, digital trade, energy, strategic raw materials, and sustainability. It also enhances cooperation on regulatory issues, anti-dumping measures, cybersecurity, and environmental protection. Investment protection (via an investment court system) will apply once the AFA enters into force.

For Chile, the modernised framework reinforces its long-standing, rules-based approach to global integration. It deepens access to the EU market — facilitating trade in goods and services — and strengthens cooperation in areas where Chile has strategic advantages (lithium, copper, green hydrogen and clean energy). Beyond Chile, the agreement also reinforces Latin America's broader role as a reliable partner for Europe at a time of shifting global value chains.



Summary of **forecasts**

Santander

	2025	2026	2027
World			
GDP growth (%)	3.1	3.1	3.2
United States			
GDP growth (%)	1.8	1.8	1.9
Unemployment rate	4.3	4.4	4.2
CPI inflation	2.8	2.8	2.3
Official rate*	4.00	3.25	3.25
USD/EUR*	1.18	1.21	1.23
Euro area			
GDP growth (%)	1.2	1.3	1.7
Unemployment rate	6.3	6.2	6.0
CPI inflation	2.1	1.9	2.0
Official rate*	2.00	2.00	2.25
USD/EUR*	1.18	1.21	1.23
Portugal			
GDP growth (%)	1.6	1.9	1.6
Unemployment rate	6.4	6.4	6.5
CPI inflation	2.2	2.1	2.1
Spain			
GDP growth (%)	2.8	2.0	1.7
Unemployment rate	10.3	9.8	9.6
CPI inflation	2.5	2.0	2.1
Poland			
GDP growth (%)	3.5	3.7	3.4
Unemployment rate	3.2	3.2	3.2
CPI inflation	3.9	3.0	2.6
Official rate*	4.50	4.00	4.00
PLN/EUR*	4.30	4.30	4.30
UK			
GDP growth (%)	1.3	1.0	1.4
Unemployment rate	4.6	4.8	4.8
CPI inflation	3.3	2.4	2.3
Official rate*	3.75	3.50	3.25
GBP/EUR*	0.90	0.90	0.90

	2025	2026	2027
Latin America - 7			
GDP growth (%)	1.8	1.8	2.2
Unemployment rate	5.7	5.9	5.9
CPI inflation	7.5	5.4	4.4
Latin America - 7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay.			
Argentina			
GDP growth (%)	3.5	3.7	3.7
Unemployment rate	6.3	6.0	5.6
CPI inflation	30.0	16.0	8.7
Brazil			
GDP growth (%)	2.0	1.5	1.8
Unemployment rate	6.2	6.2	6.2
CPI inflation	5.4	4.4	3.9
Official rate*	15.00	13.00	10.25
BRL/USD*	5.80	6.00	5.90
Chile			
GDP growth (%)	2.4	1.8	2.3
Unemployment rate	8.7	8.5	8.4
CPI inflation	4.3	3.2	3.0
Official rate*	4.50	4.25	4.25
CLP/USD*	950	930	940
Mexico			
GDP growth (%)	0.4	1.0	2.0
Unemployment rate	2.8	3.5	3.8
CPI inflation	4.0	3.9	4.0
Official rate*	7.00	7.00	7.00
MXN/USD*	18.7	19.4	20.2
China			
GDP growth (%)	4.9	4.6	4.3

(*) End of period
Source: Santander Research

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The Year Ahead

Resetting growth in a new geoeconomic era

Santander