

## Letter from the Editors

Since its drastic restructuring and reorganization in the 1960s, the Spanish public pension system has undergone a series of reforms to address structural problems, as well as economic and demographic challenges, with a goal to improve long-term sustainability. The most ambitious of these reforms was in 2011, implemented in January 2013. This reform introduced measures to increase the retirement age from 65 to 67 and to extend the benefits calculation period from 15 to 25 years. Most importantly, it alluded to the gradual introduction of a sustainability factor to take into account life expectancy trends and the system's financial indicators, laying the groundwork for improved health of the pension system in the long term.

While the 2011 reform represents significant progress, it falls short of reducing the burden of pension system debt and deficit on public accounts. In response, the Spanish government plans to accelerate the introduction of the sustainability factor in line with recommendations received from the EU and other international organizations.

In this July issue of the SEFO, we examine the current pension system outlook and the possible implications of a new sustainability factor. Given the high degree of sensitivity surrounding this debate, the implementation of this reform is not expected to be a simple process, yet a critical one for the survival of the pension system. Moreover, alongside this reform, pre-existing pensions schemes will also need to be reevaluated to ensure compatibility.

We also take another look at the EU banking union project, where we note some progress, particularly in the area of bail-ins; however, overall advancement has been limited largely due to the lack of political consensus. Certain elements of the proposed union are already falling short of expectations; for example, the envisioned Single Resolution Mechanism (SRM) currently lacks scope and financial firepower. All of this is taking place in the context of persistent EU financial market fragmentation, in part exacerbated by government policies of providing guarantees to the banking sector. Surprisingly, the banks that enjoy larger support are not those from peripheral countries. Public support in the form of implicit guarantees ranges from 0.7% in Portugal to 4.0% in Austria. These differences have a significant impact on credit. Empirical evidence shows that a 1% increase in an implicit guarantee, resulting in lower funding costs to banks, is passed on in the form of a 0.52% lower interest rate for firms on bank loans.

As long as fragmentation exists, it remains a credible threat for the Euro, emphasizing the need to move forward rapidly on the EU banking union project, not just for the benefit of peripheral countries, but for the Eurozone as a whole.

On a related note, we examine the need for prudential regulation in the area of competition policy, where findings show that an increase in competition tends to lead to an increase in risk taking behavior within the financial sector. Thus, regulators must strive to strike a balance between competition and proper incentives when designing financial sector policies.

Moving on to the fiscal front, we take a look at the impact of changes to Spain's VAT rates since the onset of the crisis and analyze the potential for additional increases.

Finally, despite a worsening international context, the end of the recession in Spain seems to be in sight, but the recovery is expected to be a slow one. We include a Special Feature on the medium term outlook for Spain. In this article, the author presents us with 12 key factors for consideration as regards the medium term outlook for the Spanish economy, supported by the latest forecasts published by the International Monetary Fund (IMF) and the European Commission (EC). The article concludes that in the context of slow, but steady progress towards EU integration and in the absence of domestic or external shocks, the Spanish economy should continue on a path towards economic recovery and fiscal consolidation over the medium term.