Letter from the Editors

In February 2012, the Spanish government approved one of the country´s most exhaustive and comprehensive labour reforms. Three years after the reform´s implementation, the May issue of *Spanish Economic and Financial Outlook* (SEFO) takes an in-depth look at its impact primarily on two of the main shortcomings of the Spanish labour market – high labour costs and lack of flexibility.

The principal aspects of the reform essentially target five key areas: (i) internal flexibility, (ii) collective bargaining, (iii) employment protection, (iv) contract type; and, (v) in-company training and active labour market policies. Provisional data suggest that the reform has had a positive impact on accelerating wage adjustment, internal flexibility and collective bargaining, while further measures will be needed to address duality and improve active labour market policies.

As regards the reduction of labour costs, the latest trends all point to an increase in the degree of real wage flexibility in recent years. According to the OECD, together with the January 2012 wage restraint agreement with social partners, the labour-market reform induced a drop in unit labour costs of between 1.2% and 1.9%, *i.e.* around 50% of the drop observed in the months following its adoption. In this context, the May SEFO explores the extent to which the decline in wages has been a result of the reform´s impact on collective bargaining and internal flexibility.

Initial evidence demonstrates the 2012 reform is, in fact, driving the emergence of a new collective bargaining model in Spain. The structural changes, however, coexist with a reduction in coverage, weakening the role of collective bargaining in the wage setting process. This new collective bargaining model is characterized mainly by: (i) more decision-making power for employers; and, (ii) increased coverage of non-provincial sectoral agreements. The latter change is in the right direction, as this could help avoid fragmentation and past inefficiencies mostly linked to the provincial level. The former, however, will require additional efforts to limit excess monopsony power, given that collective bargaining coverage of workers is on the decline.

Furthermore, we present evidence of the 2012 reform´s success in increasing reliance on internal flexibility as a wage adjustment mechanism. While preliminary data reveal that the bulk of Spain´s wage adjustment is still taking place through reliance on external flexibility (*i.e.* dismissals), the acceleration of wage declines post reform for *stayers* (those sticking to the same employer and the same job throughout the entire period of analysis) can be interpreted as an increase in internal flexibility for firms. In short, roughly two-thirds of the change in wages between 2008 and 2013 was due to external flexibility factors and one-third due to internal flexibility. By contrast, during the last two years, 70% of the total wage adjustment was due to internal flexibility.

Finally, although there has been some progress in introducing a higher degree of flexibility in labour relations, looking at the reform from a legal perspective, in this issue of SEFO we show that new legal guidelines governing modifications of working conditions, redundancies on economic grounds and collective bargaining, have greatly curtailed, if not overruled, the most important changes brought about by the 2012 reform. The resulting legal uncertainty is preventing firms from being able to fully take advantage of the measures to increase flexibility, and thus, benefit from the reform´s intended effects.

The May issue of SEFO also explores relevant issues affecting the Spanish financial sector and financial markets, such as: (i) the competitiveness of Spanish banks measured against leading European banking systems, (ii) trends in Spanish banks´ dividend policies; and, (iii) the comparative evolution of Spanish mortgage rates.

First, we compare the Spanish banking model to its European peers in terms of liquidity, income generation and operating efficiency, risk profile, and solvency. We find that, on the whole, Spanish banks are outperforming their peers in terms of income generation, but low interest rates, the absence of credit growth, the end of the sovereign carry trade, and finally, the higher cost of risk of the Spanish traditional banking model should all put downward pressure on profit margins going forward. On a positive note, potential changes to measurement of solvency indicators could improve the comparative financial strength of Spanish credit institutions.

Second, we examine the impact of the crisis on Spanish corporate dividends, revealing the strong effort made by the IBEX-35 and, in particular Spanish banks, to maintain stable dividends in the face of earnings contraction brought about by the crisis. Banks´ reliance on innovative dividend policies, such as the scrip dividend, allowed them to increase capital, while keeping dividends stable. In the post crisis environment, however, we anticipate a return to traditional cash dividend payments.

Third, we provide a snapshot of the comparative evolution of Spanish mortgage interest rates. Despite the lag in the correction of Spain´s mortgage market, recent evidence points to a rapid decline of mortgage interest rates in Spain relative to its euro area peers. Recent factors, such as the progressive removal of interest rate floors and historically low market rates are resulting in more favorable terms for mortgage borrowers.

Finally, we conclude with an overview of the latest fiscal performance at the regional level and the outlook for 2015. The regions have made significant progress on fiscal consolidation from 2010-2014, largely on the basis of spending cuts. That said, the adjustment process appears now to have stabilized, with the effect of recent measures having run its course. Reaching the budgetary stability and debt targets in 2015 does not look possible, although a slight improvement over the 2014 deficit could be achieved. Over the medium-term, correcting outstanding imbalances will require additional measures on the income side, coupled with the implementation of more adequate control mechanisms to ensure regional commitment to fiscal targets.