In Spain, before the economic crisis broke, a large number of multi-year contractual agreements, in the public and private spheres alike, would generally be revised on the basis of the past performance of the overall consumer price index. Significant examples of this practice were the wage increases set under collective bargaining agreements. This procedure, also known as indexation, means increases in the overall price index prompted by temporary shocks, e.g. that caused by a temporary rise in fuel prices, ultimately raise the price of all indexed goods, irrespective of the demand for them or of the costs associated with their production.

As a consequence, prices lose effectiveness in signalling changes in relative demand or changes in the cost of different products and, therefore, in helping reallocate productive resources in accordance with efficiency criteria. In addition, this leads the behaviour of inflation to become strongly inertial, since the presence of indexation clauses in the prices of certain factors of production determines, in the face of shocks emerging, direct increases in production costs, indirect effects (those prompted by price rises in the goods and services used by some of the inputs that have become dearer) and second-round effects (those occurring when the initial rise in prices induces an across-the-board revision of inflation expectations that feeds through durably to final prices). In an increasingly globalised world, the presence of indexation clauses prompts a loss of competitiveness that has an adverse bearing on activity and employment. This problem is compounded in a single monetary area, where it is not possible to use the exchange rate as a unilateral means to restore competitiveness.

The intensity of the economic crisis in Spain and its high cost in terms of unemployment dramatically highlight the problems that can be generated by insufficient flexibility in cost- and price-setting, limiting their adaptation to changing cyclical conditions.[1]

1 See the articles "Una aproximación al impacto del precio de petróleo sobre la economía española y la de la zona del euro" in the March 2009 Boletín Económico, and "The functioning of the labour market and unemployment growth in Spain" in the July 2009 Economic Bulletin.

In response to this, various mechanisms have been considered in recent years to reduce the Spanish economy's high degree of indexation. Specifically, there have been three significant developments since 2012:

— The "II Agreement for Employment and Collective Bargaining: 2012-2014", signed by the social agents, recommended a new framework for defining multi-year wage indexation clauses. The agreement suggested activating these clauses only if inflation exceeded 2% at the end of the year. It further recommended that the payment resulting from this clause should not be built into wage levels, which would considerably reduce the nominal inertia of wages. It was likewise suggested that if inflation in Spain were higher than that of the euro area, the latter should be the indicator used as a benchmark to calculate the impact of the clauses and that significant international oil price rises should be stripped out from price indices. The data available infer these recommendations were widely followed. Of all the newly signed agreements in 2012 incorporating an indexation clause, 70% adhered to the parameters of the Agreement. That has made for a significant reduction in the impact of indexation on compensation per employee. Specifically, the impact of the estimated clause for 2013 would be 0.2 pp, compared with the increase of around 1 pp which, in the absence of the agreement, would have resulted from considering the difference between the December 2012 CPI and the wage settlements agreed for that year (a difference of close to 2 pp).

— Further, on 20 December 2013, the Council of Ministers approved the draft law on dis-indexation in respect of the CPI. This legislation will be applicable for all public-sector agreements, while in the private sector it will only be so in the absence of an agreement stating otherwise. The general rule for the public sector will be that there can be no form of indexation, meaning that price increases may be justified solely by changes in determinants directly related to the cost of the service. This will be applicable not only to certain general government expenditure

COMPETITIVENESS GUARANTEE (IGC) AND CONSUMER PRICE (CPI) INDICES
Year-on-year rates of change

SOURCES: INE and Banco de España.

items, but also to revenue items, such as the re-setting of specific electricity-system costs, urban transport charges, excise duties and fixed charges. In the private sector, such revaluation will be subject to the free will of the parties and, if there is no explicit agreement, a new index will be used, namely the "Competitiveness Guarantee Index" (IGC by its Spanish abbreviation), to be published monthly by INE. The change in the IGC will be equal to inflation in the euro area minus a correction factor that will reflect the loss of competitiveness that has occurred since 1999, when EMU was launched. This index will have a ceiling of 2% and a floor of 0%. As the accompanying chart shows, the use of this indicator would have entailed significantly lower price revaluations than those actually implemented in agreements in recent years. Likewise, its use will foreseeably restrict the number of revaluations in the near future.

— Finally, the pensions reform approved late last year replaced the automatic revaluation based on the year-on-year rate of the CPI in November with the "annual revaluation factor". With this factor, the annual revaluation of pensions depends on the growth of several variables: the system's revenues, the number of pensions, the difference between the average pension of incoming and outgoing pensioners (substitution effect) and the system's current shortfall. Also, floor and ceiling clauses are established, standing at 0.25% and at CPI growth plus 0.5%, respectively. Following the entry into force of this measure, the budgeted increase in pensions for 2014 is at 0.25%. It should in any event be stressed that the main aim of this reform is to ensure the sustainability of the pensions system, linking pension revaluation to potential expenditure/revenue shortfalls in the system. The reform is particularly important in light of foreseeable population ageing in Spain, which will exert growing pressure on pension spending, among other items.

In sum, these significant changes provide for progress in overcoming one of the biggest handicaps to the Spanish economy's ability to adapt to the requirements arising from membership of an area of monetary integration and price stability. They will foreseeably give rise to a widespread change in behaviour that will substantially reduce the Spanish economy's degree of indexation, so that price-setting is in step with the associated supply- and demand-side fundamentals. The upshot should be a substantial improvement in the determinants of competitiveness and of job creation, which would prevent some of the imbalances that have compounded the current crisis in Spain from re-emerging.