

Executive summary

Spain is immersed in a prolonged recession. The depressing impact on activity of private sector deleveraging and the need for sizeable fiscal consolidation following the bust of the domestic credit boom has been compounded by the euro area debt crisis and structural rigidities in the labour market, resulting in a steep increase in unemployment and a banking crisis. The prospect of an immediate recovery remains remote as deleveraging of the private sector still has a long way to go while the feedback loop between government finances and the banking sector remains strong, notwithstanding the loan of up to 100 billion euros from the euro area governments to recapitalise the banks. This feedback loop must be broken. Further structural reforms are needed to boost employment, notably among youth, and improve competitiveness, helping to reduce the current account deficit further. Given the major risks that have built up, decisive policy action on all these fronts is urgent if the situation is to be turned around.

The financial crisis needs to be addressed quickly. Progress has been made in the comprehensive recognition of losses, which is key for restoring confidence in the banking sector. The government has taken an important step by tightening the provisioning rules on the banks' real estate-related exposures. Rapid orderly resolution of non-viable banks and recapitalisation of viable banks with capital needs will be key, as planned in the Memorandum of Understanding with the European Union on a financial sector reform programme, which is a welcome framework. The impaired housing-related assets need to be transferred to the planned asset management company at prices which are sufficiently low to limit risks for public finances. Action needs to be taken to ensure that the substantial amounts of hybrid capital and debt buffers will share the burden of losses, especially when the holders of these instruments are institutional investors. Reform of bankruptcy procedures would help to shift resources from insolvent companies to productive use.

Confidence in public finances needs to be restored. To restore credibility, the government should aim at meeting its new headline deficit targets adopted in July 2012, unless GDP growth is far lower than expected, in which case the automatic stabilisers should be allowed to operate, at least partially. Reform of budgetary rules across all levels of government and recent consolidation measures mark substantial progress. The rules need to be strictly implemented, notably to improve regional government finances. They should be backed up with an independent fiscal council, as planned by the government, to assess budgetary policies at all levels of government. The consolidation measures needed to reach the deficit target in 2014 and the permanent budgetary measures needed to stabilise government debt should be spelled out. There is further scope for tax reform to contribute to budgetary consolidation and make the tax system more green-growth friendly. Further pension reform would improve long-term sustainability and improve incentives to move activity from the black to the formal economy.

Addressing very high unemployment requires a broad range of reforms. *The unemployment rate in Spain has reached painfully high levels, in particular among young people with low levels of education. The 2012 labour market reform makes significant progress in addressing some key structural weaknesses of the labour market, notably as concerns employment protection and collective bargaining. If the reform does not prove effective, more steps could be taken to reduce labour market duality by moving towards a single contract. An option to improve the flexibility to adapt to economic conditions would be to abolish the legal extension of collective bargaining outcomes, or to replace it by an opt-in system. Quick action is also needed to improve the effectiveness of placement services. More job-search assistance and training must be provided, especially for the young unemployed, and active labour market programmes need to be targeted to the most vulnerable groups. Job-search requirements for receiving unemployment benefits need to be tightened. Action should also be taken to prevent youth from dropping out of education at a very early stage. Steps to better match skills with firms' demands can improve the school-to-work transition: the government is taking steps to reform vocational education, which is welcome.*



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