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FOCUS NOTES

3rd Economic Adjustment Programme

Progress and short-term outlook

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The present report summarises the latest developments in the implementation of the 3rd Economic Adjustment Programme for Greece and provides an overview of the central issues of the upcoming 3rd review, such as key prior actions, privatisations and the position of the IMF as well as a broad timeline for the period ahead.

Overview of 3rd Economic Adjustment Programme

The 3rd Economic Adjustment Programme programme for Greece that commenced in August 2015 is now in its 3rd year and scheduled to be completed in August 2018. The total amount of funds committed to Greece under the ESM programme are EUR86 billion out of which EUR39.4 billion[1] has been disbursed so far. From that amount, EUR5.4 billion was used for the recapitalisation of Greek banks that took place in December 2015 and EUR34 billion for debt servicing and arrears clearance. It is assumed that the total programme disbursement will reach EUR58.6 billion, lower by EUR27.4 billion earmarked in the original envelope. This reduction is attributed to lower bank recapitalisation needs, a higher primary surplus and higher usage of subsectors' financial resources. The average interest rate on ESM loans to Greece (as of 28 April 2017) stands at 1% while the average weighted maturity of ESM loans to Greece is 32 years.

2nd programme review: significant achievements and positive developments

So far two reviews have been successfully completed, albeit with significant delays, while the Greek authorities and the institutions' (EC/ECB/ESM/IMF) technical teams are currently doing preparatory work for the 3rd programme review, which is expected to commence by end-October with the arrival of the institutions' heads to Greece. During the 2nd review, which was completed in June 2017, a large bulk of legislation was passed through the Hellenic Parliament addressing a number of politically sensitive but also vitally important prior actions in the areas of fiscal policy during and after the programme period, NPLs resolution, product, labour and energy markets and public administration. The most important such measures are:

- A EUR535 million (0.3% of GDP) package of measures (primarily savings from tax expenditures and social benefits) to reach the 2018 ESM fiscal target.
- A fiscal package to enter in force as of 2019 envisaging a pension reform and a reduction of the personal income tax credit, each delivering net savings of 1% of GDP. The fiscal package also foresees a growth-enhancing tax package and a targeted spending package, both contingent upon the attainment of a primary surplus of 3.5% of GDP in a sustainable manner.
- A major reform of the welfare system to constrain expenditure and better address the needs of the most vulnerable.
- The Medium Term Fiscal Strategy for 2018 – 2021 based on the agreed primary surplus target of 3.5% of GDP over the medium term.
- An out-of-court framework was legislated to support the NPL resolution strategy. The electronic platform for the out-of-court workout has been operating since the beginning of August and as of 3 October, 137 applications have met the criteria and are moving to the mediation phase. As regards electronic auctions, the legislative framework has been enacted while the technical infrastructure has been put in place.
- The partial deregulation of Sunday trade.

[1] An additional EUR0.8billion have been earmarked for arrears clearance and will be disbursed conditional on Greece having reduced the stock of arrears by EUR1.2 billion until 31 October 2017. Beyond this deadline, the amount will be returned to the general programme budget and its disbursement will require fresh approval by the ESM Board.

- The framework regarding collective dismissals and industrial action was further reformed to achieve more flexibility and fairness in the labour market and safeguard the progress already made in this area. In addition, it was agreed that the current framework concerning collective bargaining would be maintained until the end of the programme (August 2018).
- A process was launched under EU competition rules to bring around 40% of the Public Power Corporation (PPC) lignite-fired generation capacity under the control of other market participants. Additionally, the auctioning of electricity by PPC is being implemented, and, coupled with the divestment of lignite plants, is expected to bring the market share of PPC below 50% by 2020 as scheduled.
- The reform of the specialised wage grids for public administration employees and the creation of a modern mobility scheme.

The successful completion of the 2nd programme review in conjunction with an overall ameliorating outlook of the Greek economy brought about a series of positive developments:

- Moody's upgraded Greece's long-term issuer rating as well as all senior unsecured bond and programme ratings to Caa2 and Caa2 from Caa3 and Caa3, respectively. The outlook has been changed to positive from stable.
- Moody's upgraded the ratings of all Greek mortgage covered bonds to B3 from Caa2.
- The ESM Board of Directors approved the third tranche of €8.5 billion of financial assistance to Greece:
  - ✓ The first disbursement under this tranche amounts to €7.7 billion out of which, €6.9 billion are to be used for debt servicing and €0.8 billion for arrears clearance.
  - ✓ The second disbursement of €0.8 billion is intended for arrears clearance and should be released before 31 October 2017, subject to Greece making progress on arrears clearance using to this end its own resources along with ESM funds.
- The European Council decided to close the excessive deficit procedure for Greece through the abrogation of Decision 2009/415/EC[2].
- The IMF Executive Board approved in principle a €1.6 billion Stand-By Arrangement for Greece.
- S&P revised its outlook on Greece to positive from stable while affirming its 'B-' long-term foreign and local currency sovereign credit ratings.
- The Hellenic Republic issued a new syndicated €3bn 5YR government bond for the first time since 2014, at a yield of 4.625%.
- Fitch upgraded Greece's long-term issuer rating to 'B-' from 'CCC'

3rd programme review: main items and medium-term timeline

The 3rd programme review is scheduled to commence by end-October and for this purpose preparatory work is already underway between the Greek authorities and the technical teams of the institutions (EC/ECB/ESM/IMF). The swift completion of this review – by early 2018 – is acknowledged by all sides as a pre-requisite for the smooth conclusion of the whole ESM programme, the restoration of financial markets' confidence and the return to a sustainable growth path. In an interview in July, the Greek Finance Minister Euclid Tsakalotos had stated that the timely completion of the 3rd programme review would allow Greece to proceed with further bond issuances in the first months of 2018 and that delaying the implementation of the programme does nothing but maintain uncertainty. On the same wavelength, during his speech at the 12th Annual Greek Roadshow in London in September, Alternate Minister of Finance George Chouliarakis stressed the importance of the swift completion of the 3rd programme review as it will allow Greece to recover, gain momentum and retrieve full and sustainable access to the financial markets. European officials' latest statements are on the same lines. Indicatively, during an interview in Athens on 25 September, Eurogroup President Jeroen Dijsselbloem pointed out that at this point the interests of the Greek side are perfectly aligned with those of the institutions so emphasis must be placed in finishing the 3rd programme review by the end of the year and added that the Greek PM is committed to making sure that everyone delivers.

As regards the 3rd review conditionality, during a meeting in early September between the Greek FinMin Euclid Tsakalotos and the European Commissioner Pierre Moscovici it was agreed that the 3rd programme review will comprise 95 prior actions (out of the remaining 113 prior actions in total). According to EC Vice President Valdis Dombrovskis a large part of these prior actions has already been legislated and must now be implemented. Nevertheless, the preparatory work of the institutions' technical staff has reportedly revealed that so far only 20 prior actions have been completed; therefore, an intensive effort is required to meet timetables.

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[2] http://data.consilium.europa.eu/doc/document/ST-11240-2017-INIT/en/pdf

The key prior actions of the 3rd review are the following:

- Operation of electronic auctions platform. NPLs remain at significant levels. According to the "Report on Operational Targets for Non-Performing Exposures" released by the Bank of Greece (6 September 2017), at end-June 2017, the stock of Non-Performing Exposures (NPEs) had decreased by 2.0% and 3.2% compared to end-March 2017 and end-December 2017 respectively, reaching €102.9 billion or 44.9%[3] of total exposures. The quarterly default rate remained above 2% still exceeding the cure rate, constituting write-offs the main tool for NPE reduction. Quarterly write-offs amounted to €1.9 billion reaching €3.3 billion for the first semester of 2017. In this context, banks are pressured to utilise more also the other available tools for NPLs reduction, namely the electronic auctions platform, the out-of-court workout and the sale of loan portfolios. With regard to the electronic auctions platform in particular, according to press reports, the institutions are pushing for its launch as a pre-condition for the start of the 3rd review while the Greek government reportedly intends to set it in motion in November.
- Labour market and industrial action. Continuing the reform of the legislation regulating trade union activity, which was undertaken during the 2nd programme review, as a key deliverable for the 3rd review, the authorities must analyse and adopt legislation to increase the quorum for first-degree unions to vote on a strike to 50 percent.
- Pensions: Pension applications according to the new benefit rules (Law 4387/2016) are to be recalculated and processed. Delays in this area during the previous review were attributed to technical problems, but authorities appear reassuring that these have now been overcome.
- Privatisations: A number of items pertaining to the privatisations programme are still open with the most critical ones being the appointment of the BoD members of the subsidiaries of the Hellenic Corporation of Assets and Participations (HCAP), the approval of the HCAP Strategic Plan by the General Assembly, the resolution of any archaeological or other issues delaying the Hellinikon project and the submission of the new policy for toll pricing to be implemented on Egnatia motorway and its vertical axes.
- Public administration: During the previous review modern mobility and assessment schemes were created. Based on those, the first assessment exercise and the new mobility scheme were to be implemented in September but have been delayed especially due to strong resistance by public sector employees as regards the assessment scheme in particular. To overcome this problem, on September 19, the Greek Parliament passed a bill amendment that foresees that "the evaluators must have fulfilled their assessment obligations for their subordinates in order to be able to participate in the proceedings for the selection and appointment of heads in accordance with law 3528/2007 (A' 26) and law 3584/2007 (A' 143) or in accordance with other general or specific provisions".
- Energy: finalisation of the structural measures to divest PPC's lignite-fired generation capacity. Currently the Ministry of Energy and the Pubic Power Corporation (PPC) are working with the EC Competition and Energy Directorates-General in order to finalise the PPC's proposal for the sale of 40% of its lignite-fired production units. The market test for the said proposal is scheduled to take place by end-October.
- Property taxes: The authorities with the aid of technical assistance will legislate to ensure the alignment of property tax assessment zonal values with market prices. The first draft model for the calculation of the updated tax assessment zonal values has reportedly been prepared and it comprises data from the Bank of Greece, the Association of Notaries and the Independent Authority of Public Revenue. Nevertheless the completion of this project stumbles over the fact that in a large part of the country, transactions are so few that the available data is insufficient.
- Regulated professions: Any unjustified and disproportionate restrictions must be alleviated, while a Presidential Decree must be issued for the liberalisation of the reserved activities for engineers and on public works' engineers' registries.
- Land use: The authorities are to submit to the Council of State a Presidential Decree to harmonise older legislation with Law 4269/2014.

[3] Including off-balance sheet items.

- Social safety nets: New legislation must be adopted to specify the design of a means-tested housing benefit. Amended, rationalized educational benefits must be implemented. A major reform of the family benefit system must be legislated. New legislation for a pilot scheme must be adopted to move from the current impairment assessment to a functional assessment to determine eligibility for disability benefits. The transport benefits system must be reformed.
- Investment licensing: Primary and secondary legislation are to be adopted in the remaining mining sectors.

Privatisations: State of play in major projects

In our "Greece: 2017 Economic Outlook" (March 1, 2017) report we presented the most prominent privatisation projects that are currently underway and constitute pre-requisites in the context of the 3rd Economic Adjustment Programme for Greece. Since then, significant progress has been made in a number of these projects although a lot still remains to be done. In spite of delays, based on recent statements by the Greek PM Alexis Tsipras, it is our understanding that the government is determined to stick to its commitments as regards privatisations, not just in order to secure the relevant expected revenue but also in the context of a broader strategy to increase business confidence towards Greece and attract much-needed investment.

It is noted that the recently submitted draft 2018 State Budget foresees privatisation revenues in the area of EUR1.6billion in 2017 and EUR1.2billion in 2018 while the HCAP CEO Rania Ekaterinari recently stated that the expected revenue from privatisations will be in the area of EUR1.9billion in 2017 and EUR2.5billion in 2018.

The following section examines the progress made and pending actions in the main privatisation projects in the 3rd Economic Adjustment Programme.

Hellenic Corporation of Assets and Participations S.A. (HCAP). The HCAP was established by Law 4389/2016 and holds a central role in the privatisations programme as it is the "umbrella" organisation in charge of the management and exploitation of Greek state assets through its subsidiaries. The HCAP is operating as of February 2017. Nevertheless, there are still some outstanding issues pertaining in particular to its internal regulations as well as to the staffing and operation of its subsidiaries. As a result, besides these projects that are already underway (e.g. DESFA, Hellinikon), other major projects such as the exploitation of EYDAP, EYATH and ELTA are not expected to commence before 2018.

14 Regional Airports. The 40-year concession for the development and operation of 14 regional airports to the consortium Fraport AD – Slentel, was completed with the payment of EUR1,234million.

Trainose S.A. The sale of Trainose to Ferrovie dello Stato Italiane SpA was completed with the payment of EUR45million.

Piraeus Port Authority S.A. (OLP). A 67% share of HRADF in OLP was sold in August 2016 to the Chinese Cosco Group Limited. The sale of the 67% share in OLP which will materialise in two phases (51% + 16%) was concluded in 2016 and a tranche of €280.5 million corresponding to 51% was received. The remaining 16% for an additional €88 million will be transferred once the investor has completed investments in the area of €300 million at the port.

Hellenic Gas Transmission System Operator S.A. (DESFA). On September 22 the BoD of DESFA announced that in agreement with Hellenic Petroleum SA (HELPE) two investment schemes are qualified to proceed to the next phase of the tender process for the acquisition of 66% (31% stake owned by HRADF and 35% stake owned by HELPE) of DESFA share capital. These are: a consortium composed of Snam S.p.A./ Enagás Internacional S.L.U./ Fluxys S.A./ N.V. Nederlandse Gasunie and Regasificadora del Noroeste S.A.

Athens International Airport (AIA). The signing of the extension of the 31.07.1995 Airport Development Agreement for 20 additional years (i.e. until 11.06.2046) took place on September 30th, 2017 between the Greek State, the HRADF and the "Athens International Airport SA" (AIA). The AIA's offer provides a total cost of €600 million, including the corresponding VAT. The net proceeds from the privatization program amount to €483.87 million. The completion of the transaction is subject to approvals by the competent European authorities and the Greek Parliament.

Hellinikon. The Central Archaeological Council (CAC) recently declared 0.3 million sqm of land (out of 6.2 million sqm in total) as a "site of archaeological interest". The decision was met with discontent on behalf of the concessionaire who, nevertheless, refrained from making a statement before the extent to which this decision affects its masterplan has been assessed. According to press reports, the government appears reassuring that the project will proceed as planned. The European Commission took notice of the CAC decision and pointed out that the Greek authorities are committed under the terms of the Memorandum of Understanding to take necessary measures to promote the specific privatisation project. On another topic, the Forestry Dispute Resolution Committee decided in early October that the declaration of part of the Hellinikon site as woodland should be annulled.

Post-programme regime

The ESM programme for Greece is scheduled to expire in August 2018 and the post-programme period is already being discussed. According to the Memorandum of Understanding (Compliance Report, The Third Economic Adjustment Programme for Greece Second Review, June 2017) a cash buffer of around EUR 9 billion must have been built by August 2018 and this amount is expected to cover financing needs of around 10 months following the end of the programme while for the coming two years, amortisation payments on public debt (as of end-December 2016) amount to EUR 4.6 billion in 2018, EUR 13.6 billion in 2019[4]. It should be noted that during a speech in September, ESM Managing Director Klaus Regling argued that Greece will most likely not need the whole remaining amount (c. €46 billion) that has been earmarked in the context of the 3rd Economic Adjustment Programme.

Meanwhile, as regards the post-programme regime it is expected that Greece will continue to be under some form of surveillance although the discussion of this issue is considered pre-mature. On this wavelength EC Vice President Valdis Dombrovskis argued (September 2017) that the details of the post-programme period are to be determined at a later stage and the focus should now be on the swift conclusion of the 3rd review. In a similar vein, Eurogroup President Jeroen Dijsselbloem argued in an interview (25 September) that it is a joint ambition of both the Greek government and the European Commission to have a "clean exit". This scenario is possible but requires that until August 2018 "everything falls in place", namely that the review is completed, all elements of the programme are fulfilled so that the programme itself is successfully completed and that access to the financial markets is restored. But even then, there will be some kind of post-programme surveillance as in all countries that carried out economic adjustment programmes.

The stance of the IMF. Following the successful completion of the 2nd programme review, in July 2017 the Executive Board of the IMF approved in principle a €1.6 billion Stand-By Arrangement for Greece, which will become effective once there have been specific and credible assurances from Greece's European partners to ensure debt sustainability and provided that Greece's economic programme remains on track. The new financial arrangement will be activated upon another decision of the IMF Executive Board once the necessary requirements are in place and its duration will be until 31 August 2018, a few weeks after the expiration of the ESM programme. Recently, the IMF has been reported to request stress tests and Asset Quality Review (AQR) for Greek banks, on the grounds that Greek banks may require further recapitalisation and this should be determined well before the expiration of the ESM programme. Both Greek and European authorities reacted to this request with the Greek Financial Minister arguing that Greek banks are being adequately supervised under the existing SSM programme and that an Asset Quality Review at this point would constitute an unjustified distraction from their core activities. Common ground was apparently found with the ECB reportedly intending to conduct the stress tests for Greek banks in February 2018 – several weeks before originally scheduled – in order to have them completed by May 2018 so that any decisions regarding the potential recapitalisation of Greek banks can be made before the programme expires, in August 2018.

As regards the participation of the IMF in the programme, its spokesperson and Director of Communications Gerry Rice, reiterated in September that in order for the precautionary standby arrangement for Greece to move forward, more clarity is needed around debt relief as well as commitment by Greece to see the agreed reforms through within the set timetable. On the subject, the Greek FinMin Euclid Tsakalotos had repeatedly argued that the Greek government can work either with or without the IMF but in any case the Fund needs to make a decision about its participation by the end of 2017.

It should be noted that, in its World Economic Outlook (WEO) report, October 2017, the IMF revised downwards its projections for Greece's GDP annual growth to 1.8% for 2017 and 2.6% for 2018 (from 2.2% in 2017 and 2.7% in 2018 in its WEO, April 2017 report). The unemployment rate has been revised upwards to 22.3% in 2017 (from 22% in April) and to 20.7% in 2018 (from 20.2% in April). As regards the primary surplus, the IMF foresees it at 1.7% of GDP for 2017 and 2.2% of GDP for 2018, below the ESM programme targets of 1.75% and 3.5% of GDP respectively.

[4] Platon Monokroussos, "How far apart are the official creditors in their positions towards Greek public debt?", May 2017

Timeline.

- Mid-October 2017: Commencement of 3rd programme review
- Early 2018: Completion of 3rd programme review
- February 2018: Initiation of stress tests for Greek banks
- May 2018: Release of stress tests' results
- August 2018: Completion of 3rd Economic Adjustment Programme

Note: It is estimated that a 4th review will be carried out sometime in spring 2018 and a final review in summer 2018 before the completion of the programme.

Conclusion. It is our view that in spite of the complexity and large number of pending reforms, there is strong commitment on behalf of the Greek authorities to carry out the ESM programme in a smooth and timely manner so as to restore financial markets' confidence towards Greece and to support the country's apparent return to economic growth. Conditions are ripe, both in the Greek society and the political establishment for a more vigorous implementation of reforms as it is growingly evident that these reforms constitute the foundation for the return to a sustainable growth path.

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