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Greece Economic Outlook 2012: Risks, Challenges & Policy Suggestions

- The Greek economy has entered a critical phase; deterioration of euro area growth prospects enlarges risks for the domestic economic outlook
- Domestic economic policy should advance quickly on three fronts:
- First, for public debt dynamics to revert to a sustainable path, the ongoing PSI negotiations must lead to an agreement in the very short term, before business cycle conditions deteriorate significantly in the euro area
- Second, positively surprise markets through (a) improved tax collection and more concrete results in the fight against tax evasion and (b) containment of public expenditure and increased efficiency of public administration via the closure or merger of unproductive state entities
- Third, quick implementation of a critical mass of privatizations and structural reforms, that can assist to jumpstart economic growth

1. Overview

The Greek economy has entered a critical phase. The domestic recession has deepened in 2011, mainly as a result of fiscal austerity, tightened credit conditions, delays in the implementation of structural reforms and a worsening external environment. There is now a growing risk that the domestic economic downturn will persist in 2012 as euro area growth prospects continue to deteriorate, mostly due to the failure of euro area leaders so far to contain the sovereign debt crisis. We now expect the euro area economy to fall into recession in early 2012 as a result of tighter fiscal policy and higher borrowing costs for both sovereigns and the private sector. The effect of a euro area recession on the Greek economy would likely be significant, as exports remain the only source of growth, with a contribution of more than 3ppts both in 2010 and 2011.

At the current juncture, it is imperative that domestic economic policy advances quickly on three fronts.

First, for public debt dynamics to revert to a sustainable path, the ongoing PSI negotiations must lead to an agreement in the very short term, before business cycle conditions deteriorate significantly in the euro area.

Second, the immediate challenge is on the fiscal front to positively surprise markets through (a) improved tax collection and more concrete results in the fight against tax evasion and (b) containment of public expenditure and increased efficiency of public administration. The latter should be attained via, among other measures, the closure or merger of unproductive state entities rather than horizontal (and untargeted) wage cuts and tax increases.

Third, through the quick implementation of a critical mass of privatizations and structural reforms, that can assist to jumpstart economic growth.

If either one of these conditions is not met, the risk is high that the Greek economy will remain in a protracted recession, until wages and prices decline to such low levels

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that they generate enough external demand to counterbalance the negative effect of falling domestic demand, so as to stabilize the economy.

2. Growth Outlook

The Greek economy remains in deep recession for a fourth consecutive year. In accordance to data up to the third quarter of this year, we expect real GDP to contract by 6.0% in 2011, with the balance of risks remaining skewed to the downside.

Slippages have been observed in the execution of the 2011 budget in both expenditure and revenue sides. As a result, corrective measures had to be taken twice this year in order to facilitate achievement of the fiscal deficit target. Nonetheless, the initial deficit target of 7.6%-of-GDP was missed and the revised target of 9%-of-GDP will likely be missed as well. This failure can be partly attributed to the impact of the deeper-than-expected recession on automatic stabilizers. However, delays and inefficiencies in the implementation of structural and fiscal measures are also to blame. At the current juncture, it appears that any new round of additional austerity measures will magnify the fiscal drag on the economy by directly affecting domestic demand and further depressing consumer and business confidence. A deepening recession would increase scepticism over the sustainability of public finances, thus exacerbating the vicious circle.

It accrues that a rigorous and timely implementation of the agreed fiscal measures is of paramount importance for avoiding the need for extra measures and their ensuing impact on disposable income and the domestic economic climate. Achievement of fiscal targets is key for strengthening confidence towards the sustainability of public finances and for facilitating a gradual restoration of access to external financing.[1] The latter, in turn, is deemed to be an important prerequisite for a return to sustainable economic growth.

This year's sharp GDP contraction creates a positive base affect for 2012. However, next year's domestic economic outlook is further complicated by worsening conditions in main trade-partner economies. As we noted earlier, we expect the euro area economy to slip into recession in early 2012. Domestically, the evolution of gross domestic product depends, inter alia, on the nature of applied fiscal measures and their impact on domestic demand and, in particular, on private consumption.[2] A large fiscal drag would affect income- and consumption-related tax revenue as well as expenditure-side automatic stabilisers (subsidies, unemployment benefits etc), thus putting at risk the achievement of next year's fiscal targets. This would, in turn, necessitate extra corrective measures that would further exacerbate the fiscal drag on economic activity and so on. On the other hand, restraint of domestic demand may cause a more significant decline in imports[3] which, along with a better performance of exports, would counterbalance the contractionary effect of fiscal adjustment.

In any case, more important for growth prospects, and thus for debt dynamics, is that economic policy manages in 2012 to lay the foundations for a swift rebalancing of the Greek economy towards an exports-led growth paradigm. In our view, this is key for a return to high and sustainable growth rates in the medium to long run. We believe the return to a potential growth rate of ca 3% is feasible in the medium-term. Sustaining such rates of growth is sufficient for bringing about real convergence and improving debt dynamics. Reasons supporting a more dynamic trend growth path in the years ahead include:

- Accumulated excess demand of the pre-crisis period has been removed as a result of the multi-year recession, with the output gap being now strongly negative

[1] In theory, the PSI scheme for Greece announced at the October 26-27 EU Summit should not directly affect the agreed primary fiscal deficit targets, since the deeper haircut would only reduce expenses on interest. Yet, achievement of primary surpluses as early as in 2012 is a key precondition for the continuation of official lending.

[2] Private consumption remains the largest component of gross domestic product, currently accounting for more than 70% of GDP. Since the subordination of Greece in the EU-IMF support mechanism, the decline of private consumption has not been equiproportionate to the reduction of disposable income. This is counter to the initial MoU's objective for a reduction in the propensity to consume. It can partly be explained by the fact that households were running down on their savings in order to finance personal consumption. This behavior is consistent with a more general intertemporal smoothing of consumption on behalf of the consumer. However, households now start to realize that the disposable income reduction is of permanent nature. Hence, we can expect consumption to begin aligning with developments in real incomes. This will be mediated by the empirically documented fact that, for lower incomes, some parts of consumption are income-inelastic. Of course, private consumption will also be affected by developments in wages and unemployment.

[3] Imports can fall more aggressively than general domestic demand since, to a large extent, they constitute goods of high income elasticity. However, a limit to this is imposed by the fact that exports have a large import content.

- ULCs have declined, thereby removing a considerable portion of accumulated real appreciation

- South-Eastern Europe, an area of strategic importance to Greece and a main destination for its exports, has embarked on a dynamic growth path, despite short-term difficulties

- Capital intensity in Greece is lower than the EA average and returns on capital have been historically growing quicker. This, combined with low capacity utilisation as a result of the crisis and higher labour market flexibility due to structural reforms, should create new investment opportunities once the investment environment and funding opportunities improve

- Institution building (e.g. rationalisation of public administration, speeding up of court procedures and introduction of more competition in product & services markets) is empirically proven to yield sizable growth returns

- Reduction in the size of the public sector produces crowding-in of investment and exports

- Ca €20bn of EU Structural and Cohesion Funds are still unutilized, while the requirement of co-financing by national sources has been eased. The latter is now allowed to be moved in the future with funds being also available by the EIB. The so called "European Marshall Plan" can help ease the resource scarcity in the Public Investment Budget.

However, we do recognise that, post-2020 effects of ageing on growth will kick in, though the IMF's respective projections may prove too pessimistic. A recalibration of the social security system and productivity-enhancing structural reforms are necessary to counter these developments.

3. Assessment of recent fiscal developments and outlook

The latest available data on the *State* budget execution and the *General Government* accounts signal significant overshooting risks to the 9.0%-of-GDP *revised* fiscal target for 2011. A strong indication supporting the latter view is provided by a reported rise in the general government deficit to 10.6%-of-*projected* GDP over the first 10 months of this year[4]. Furthermore, accumulated arrears already reached ca €6.7bn in October 2011.

In our view, a full-year reading for the general government deficit (ESA-95) of 10%-of-GDP or more should not be ruled out. If so, the *efficiency coefficient* of the fiscal adjustment program would fall to 10% or lower, from ca 51.5% in 2010[5]. The dramatic fiscal slippage that is evident so far this year appears to be beyond any standard estimates of the potential impact of the economic recession on government finances. Apparently, these developments have a number of policy implications. As per the 5th IMF program Review, domestic authorities need to further advance various *agreed* structural reforms, so as to underpin the adjustment effort. On the fiscal institutional front, the 5th Review calls for increased emphasis on cracking down on tax evasion, a second installment of measures to overhaul the social security system as well as a fully-fledged tax reform (to be introduced by March 2012).

On that basis, we broadly concur with the view that a further realignment may be needed in the government's medium-term fiscal plan (MTFS) towards expenditure-side measures. This should be an important area of discussions in future negotiations with the Troika on (i) the corrective actions than need to be taken to offset slippages in the execution of the 2011 budget and (ii) the identification of additional measures for the period 2013-2014. As per the 5th Review, these are estimated at 3ppts-of-GDP, consisting of 2ppt-of-GDP in adjustment measures and 1ppt-of-GDP in contingency measures.

4. Policy Suggestions

A recalibration of the present adjustment programme is necessary, both with respect to fiscal administration and the necessary growth-enhancing structural reforms. As a general rule, changes should not solely focus on the introduction of new measures but also on the reorientation of the Programme through a prioritisation of already-agreed policies according to their maximum contribution to growth and fiscal efficiency. As far as fiscal adjustment is concerned, a change in the mix of economic measures is needed to prevent the economy from slipping into a spiral of mutually-reinforcing fiscal slippages and recession. Tax burden on entrepreneurial activity and on labour should be reduced and substituted by larger (and of permanent nature) expenditure-side measures. These should not constitute horizontal wage cuts, which undermine motivation and productivity; they should rather target

[4] The monthly general government accounts are provided on a cash basis and they may not be directly comparable to ESA-95 accrual-basis statistics. Yet, they still appear to provide a strong indication of the magnitude of overshooting risks surrounding the attainability of the 2011 fiscal target.

[5] OECD (2011), Economic Surveys, Greece; Bank of Greece Interim Policy Report (Nov. 2011). The efficiency coefficient is measured as the ratio of the nominal reduction in the fiscal deficit to the total worth of measures applied over a certain year (~ €19.4bn in 2011).

reduction of redundancies via the closure of unnecessary public entities and a radical reorganisation of public administration to reduce bureaucratic procedures, overlappings and veto points (which also work as strongholds of corruption). Social benefits should also be radically redesigned to include only those in real need.

It is of paramount importance to reverse cuts in public investment, which has so far been the easy way to counterbalance slippages in public consumption. Given the high multiplicatory effect of public investment, this practice has taken a heavy toll on growth. From the revenue side, restructuring of tax rates in a way that favours productive activities could help in reinvigorating economic activity. However, this should be accompanied by measures able to incur measurable broadening of the tax base (subjective taxation, reform of tax legislation to increase the cost of no compliance, accelerated prosecution of tax offenders and introduction of simplicity and transparency in the legal framework). This is important, not only for ensuring budget neutrality of the final policy mix, but also for consolidating a sense of justice in burden sharing. The latter is, in turn, critical for containing social turmoil and for inducing a sense of ownership of the Programme by the general public.

So far, economic policy has attempted to simultaneously meet two *potentially-conflicting* objectives; namely, reduce the fiscal deficit and public debt on the one hand and revive economic growth on the other. In our view, the completion of the PSI will provide valuable space to the government to focus on growth-enhancing policy measures, so as to put an end to the vicious cycle of fiscal austerity and deepening recession.

The ultimate aim of the reforms program should be to increase the competitiveness of the Greek economy and redirect capital and employment from the non-tradable to the tradable sector. Given that the fiscal adjustment process will restrain public and private consumption in the years to come, dynamic rates of growth in exports and investment are required in order to ensure that real convergence will be achieved in a sustainable way, without instigating phenomena of overheating observed in the past.

In the short term, the recovery of the Greek economy crucially relies on safeguarding capital adequacy and liquidity of Greek banks in order to ensure adequate funding of the real economy. To support reform of the growth paradigm, bank financing should not focus on consumer credit but on avoiding the collapse of solvent and productive corporations or postponement of investment projects with good prospects. Banks continue to support domestic corporations despite a significant drawdown of deposits and in contrast to what happened in other countries facing debt crises, where credit expansion became acutely negative. However, given lack of access to international capital markets, banks' ability to continue funding the economy depends on liquidity support from the ECB and access to Emergency Liquidity Assistance (ELA) provided by the Bank of Greece. This is even more important following the October 26-27 EU Summit agreement for a more aggressive PSI, which may further undermine banks' ability to extend credit. Possible pressure for an abrupt reduction in liquidity support would lead banks to rapid deleveraging and the real economy to a much deeper recession.

From a medium-term perspective, a sustained improvement in the total productivity of the Greek economy requires institutional changes, aiming to create an attractive business environment, improve public administration and reduce bureaucracy and corruption. It is crucial that structural reforms are implemented simultaneously, so as to produce a critical mass of synergies and thus, maximise their growth impact. Very important among structural reforms are the ones pertaining to the reduction of oligopolistic conditions in goods & services markets (e.g. state monopolies in strategic sectors, oligopolistic structures in state procurements, closed professions, cartels), as well as the reduction of labor market rigidities, so as to reduce unemployment and contain inflationary pressures which harm competitiveness. In this respect, it is important to note that it is the non-wage cost of production that harms price competitiveness the most and needs to be addressed. Wage costs have improved considerably during the past two years due to the sharp decline in wages, both in the public and the private sectors, and are expected to continue to do so in the year ahead.

Longer term, it is absolutely necessary to redirect factors of production such as capital, labor and technology from the non-tradable to the tradable sector of the economy. Given the speed of private sector adjustment, we expect wage competitiveness of the Greek export sector to improve further in the next two years and to return to levels prevailing before EMU entry. However, the decline in relative unit labor costs is not enough to make the Greek economy competitive again. The largest part of the competitiveness gap of the Greek economy is due to the increase in the prices of non-tradables relative to the prices of tradables. In our view, addressing this is even more important than reducing the wage cost of the export sector. This increase in relative prices of non-tradables has led during the past decade to a re-direction of economic resources to the sector of non-tradables. This, in turn, contributed to the worsening of the trade deficit and the productivity of the economy as a whole, given the lower technological intensity on non-tradeables sectors.

Economic policy must facilitate this re-channeling of resources from the non-tradables to the tradables sector. In addition, the economy should pursue specializations in goods & services of higher quality and technological intensity, both in new sectors, as well as in new segments of sectors in which Greece has traditionally had a comparative advantage. These areas could

include, among others, tourism, shipping, renewable energy sources, organic and protected origin agricultural products, financial services, medical services, classical studies, metals, chemicals and pharmaceuticals. The more efficiently this is done, the less burden of adjustment will fall on wages. Insisting in low value added activities will result in further loss of market shares due to increased competition from low labor cost economies. One way to promote a re-channeling of processes is to reassess the use of ESPA funds.

Public ESPA funds should be targeted to support investment in the tradable sector. This could be accomplished by measures which ensure that firms which apply for such funds are required to provide an export business plan (and possibly evaluation of the investment project's contribution in creating productive capacity and upgrading of economic infrastructure). The logic of subsidies should be abandoned. The technical assistance of the Task Force should be more actively utilized to this end.

Furthermore, economic policy should focus on removing barriers to exports by (a) simplifying legal requirements for export-related activities and (b) introducing an e-customs system. Finally, motives should be introduced for attracting FDI in sectors of technological intensity and export orientation, instead of sectors serving the domestic market, as was the case in previous years. The privatization program should be effectively utilized to this end, rather than being seen as a cash cow.

5. Full implementation of new rescue package key for improving debt sustainability

This section attempts a brief assessment of the new bailout plan for Greece agreed at the October 26th EU Summit. To begin with, we provide below some important highlights of the new debt sustainability analysis (DSA) included the 5th IMF Review of the country's adjustment program.

IMF 5th Review - Revised debt sustainability analysis (DSA)

Projected debt dynamics under the new IMF baseline scenario have worsened against both the 4th program review (July 2011) and the Troika's most recent DSA (October, 2011); this mainly reflects the following factors:

— lower real GDP growth in 2011-2020 (on average, by 1.1ppt/annum vs. the July DSA and by 0.3/annum vs. the October DSA);

— lower inflation (GDP deflator) in 2011-2020 (on average, by 0.2ppt/annum vs. the July DSA); and

— lower primary surpluses (on average, by 1.9ppt-of-GDP/annum vs. the July DSA and by 0.1ppt-of-GDP/annum vs. the October DSA in 2011-2020).

As a result of the aforementioned revisions, the gross public debt to GDP ratio (excluding the impact of the PSI) is now projected at 157% in 2020, *compared to* 152% in the October DSA and 130% in the July DSA. On the other hand, assuming near-universal participation in the new PSI, the debt ratio (net of debt for collateral requirements) is now seen falling to 120%-of-GDP in 2020 (i.e., same as in the October DSA).

All in, the new debt sustainability analysis is much more demanding relative to both that of the 4th IMF Review and the Troika's October 2011 DSA. On the flip side, the silver lining of the new DSA is that its underlying assumptions are *way more realistic* than in the prior reviews and thus, easier to accept as a plausible scenario going forward. More specifically,

— forecasted medium-term potential growth in the new IMF baseline has been revised to 2.5%/annum, from 3.0%/annum in the original program, whereas long-term potential growth (period 2020-30) is now seen converging gradually towards 1.50%-1.75%. Modest growth projections in the medium term serve the dual purpose of both underlining the necessity of the PSI as well as eliminating the regularity of negative surprises which was undermining support for the Programme so far. Yet, one could argue that potential growth could turn out to be higher than assumed in the IMF's new DSA, as a result of institutions building, the impact of structural reforms and the crowding in of the private sector. That is especially so if perceptions over fiscal sustainability improve eventually.

— the new IMF baseline scenario projects a shift into a positive primary fiscal position from next year, with the primary surplus seen ranging between 4.3ppt-of-GDP and 4.5ppt-of-GDP per annum in the period 2014-2020. Clearly, this is more realistic than the kind of surpluses projected in the July 2011 baseline and more in line with past country experience. In the second half of the 90s, Greece managed to accumulate annual primary surpluses in excess of 4ppt-of-GDP without undertaking nearly as an aggressive fiscal consolidation effort as the present one;

— another interesting aspect of the IMF's new debt sustainability analysis (DSA) is its relatively conservative assumptions with respect to projected privatization revenues. Inclusive of State receipts from the divesture of assets linked to domestic bank recapitalizations, these are now expected to amount to €46bn in 2011-2020 vs. €66bn in the 4th Review.

Second rescue program for Greece – Implications for sovereign liquidity and solvency

The second bailout package for Greece agreed at the October 26th EU Sumit is expected to have a significant beneficial impact on the country's sovereign liquidity and solvency outlook. From a liquidity standpoint, the new package is expected to cover fully the government's borrowing requirements until 2014. Specifically, the 5th IMF program review provides the following estimates:

- Total government borrowing needs through end-2014 are estimated at €222bn.
- This total borrowing need stands against:

— €34bn of still undisbursed commitments under the *existing* EU-IMF program;

— €100bn in new official financing (as per the Oct 26-27 Summit Statement);

— €30bn for PSI inducements; and

— €61bn financing from the PSI operation (assuming nearly-universal participation);

As a result of the aforementioned, no market access via (medium- & longer-term) bond issuance is expected through end-2014. In addition, it is estimated that the full implementation of the 2nd bailout package will also reduce dramatically Greece's borrowing requirements in the initial years following the expiration of the new official lending program. This would be the result of deferred bond amortizations due to the PSI operation, a 10-year grace period on new EFSF loans and lower interest rate expenditure. These features help to avoid the negative impact that a unilateral restructuring of debt would have on the terms of the economy's financing and thus on growth prospects.

In line with the analysis provided in the previous section, the new bailout package will also improve considerably Greece's sovereign solvency outlook. Among other factors, this will be the result of a significant reduction in interest rate expenditure (by more than 2ppt-of-GDP per annum in the period 2012-2020). Additional benefits for the country's fiscal position could also stem from an alignment of the terms and conditions of the existing (i.e., already disbursed) EU bilateral loans with those of the new EFSF loans under the new lending program.

The implication of the above is that perceptions over public debt sustainability may indeed improve significantly, provided that Greece manages to fulfill all requirements leading to the timely implementation of the new support package, with the more imminent challenge being the release of the next loan tranche by March 2012. In turn, improved perceptions over debt sustainability can decisively contribute to an improvement of the investment climate and consumer confidence. It is of outmost importance to emphasize that a swift return to positive GDP growth and strong privatization revenue would be instrumental in stabilizing debt dynamics in the years to come. On the latter point, a quick start to the privatization program with the sale of one or more *flagship* items could improve investor perceptions over the government's ability to implement the agreed program.

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