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GREECE MACRO MONITOR

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Focus notes: Greece

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Greek political leaders agree on main bulk of measures underlying new bailout package

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Greek Prime Minister Lukas Papademos and the leaders of the three political parties supporting his government reached in the early hours of Thursday an agreement over the main bulk of adjustment measures underlying the conditionality of the new bailout package that was hammered out at the October 26-27 EU Summit. A major stumbling block in the negotiations with official lenders - *reportedly relating to a troika demand for significant cuts in auxiliary pensions* - is confirmed to have been overcome following a new round of talks between the government and the troika delegation. A written statement issued by the Prime Minister's office in early afternoon on Thursday confirmed that the negotiations between the government and the troika on the issue which remained open for further discussion were "successfully completed", with the political leaders agreeing on the outcome of these talks. The agreement was based on a multi-page draft prepared by the troika delegation and the government earlier this week. The draft will be part of the new Memorandum of Understanding (MoU) underlying the new rescue programme. Its main targets and commitments will be included in an omnibus bill that will be submitted to the Greek Parliament tomorrow, with a vote expected to take place as early as Sunday, February 12, 2012. Reportedly, the bill will require a single ballot (i.e., it will not be voted on an item-by-item basis) so as to minimize the risk of dissenting votes, especially among coalition partner MPs

February 9 Euro group: ***What's on the agenda?***

Provided that the omnibus bill will pass in the upcoming parliamentary vote (our base line scenario), an official offer on the new PSI will reportedly take place early next week, with an intention to have the bond exchange completed by the first week of March. *Table A at the end of this document provides an updated timeline of the key dates and events to watch in the crucial period ahead.* At the time of writing this report (Thursday, February 9) Greek Finance Minister and Deputy Premier Evaggelos Venizelos was heading to Brussels to participate in an extraordinary Eurogroup meeting, scheduled to take place later today. According to reports, the new bailout programme, the general terms of the debt exchange deal (PSI) and the IMF's new debt sustainability analysis (DSA) for Greece will dominate the agenda of the Eurogroup meeting, which will also be attended by the Fund's Managing Director Christine Lagarde.

Greece – Memorandum of Economic and Financial Policies: *Key points*

In what follows we provide a list of the key adjustment measures that have reportedly been demanded by the troika. Our analysis draws on a number of sources and, in particular, an official report circulated in the local press earlier today. The report is titled *"Greece – Memorandum of Economic and Financial Policies"* and purportedly contains the general framework and conditionality of the new bailout program.

Key points

Domestic macroeconomic outlook and key challenges

— Greece faces three key challenges, including: **a)** a lingering lack of competitiveness, with the country's real exchange rate overvaluation being now estimated at 15-20 percent; **b)** an unsustainable fiscal position, with the government's primary balance remaining well below the corresponding *debt-stabilizing* level (the primary deficit is estimated to have reached around 2.5%-of-GDP in 2011); and **c)** liquidity and solvency problems in the domestic financial sector, stemming from its exposure to the sovereign, continuing deposit outflows and the deteriorating quality of domestic loan portfolios.

— To address these challenges the government is expected to build on the policies laid down in the previous program, but amend the mix of adjustment and financing so as to put additional emphasis on competitiveness and productivity-enhancing structural reforms as well as radical administrative improvements. However, the economy is expected to contract in the short term under the weight of fiscal austerity, upfront labor market reforms and the worsening external environment. Cumulative output losses are expected to amount to a further 4-5 percentage points this year and the next, with a return to positive quarter-on-quarter GDP readings now forecasted no earlier than in 2013.

Fiscal outlook and policies

— The successful implementation of the PSI operation, more attractive terms on official loans and a rigorous implementation of the fiscal consolidation program should facilitate a gradual de-escalation of the public debt-to-GDP ratio towards 120% by 2020, as envisioned in the October 26-27 EU Summit Statement.

— The underlying fiscal assumptions of the new programme are revised downwards to reflect a more realistic evolution of projected primary balances in the period 2012-2015. Specifically, the baseline forecast for the primary balance is revised to a deficit of 1.0%-of-GDP, from a small surplus expected earlier (*see 5th IMF Review of Greece's adjustment programme, Dec 2011*). The general government primary balance is expected to improve in the coming years, reaching a surplus of 4 ½ -of-GDP by 2015. Note that the latter target is higher than Greece's debt-stabilizing primary surplus (~ 1.7%-of-GDP as per the Dec. 2011 IMF baseline scenario).

— To facilitate attainability of the aforementioned fiscal targets, the government needs to apply additional austerity measures worth 1 ½-of-GDP in 2012 and a further 5%-of-GDP in the period 2013-2015. The bulk of new fiscal measures will be achieved through expenditure cuts that aim to permanently reduce the size of the state and improve government efficiency. Note that the main bulk of additional austerity measures to be applied in2012 (ca €3.3bn) have already been agreed with the troika and include, among others, reductions in defense costs and public health spending as well as further cut backs in the public investment program. Reportedly the new austerity measures for 2013-2015 will need to be specified by June 2012.

Key labor market and fiscal institutional reform s

In this subsection we provide a brief summary of the key labor market and fiscal institutional reforms that will be incorporated in the new bailout programme. Note that some of these measures had earlier been agreed with the troika as part of the government's medium-term fiscal plan (MTFS) and the 2012 budget.

— ***Actions to improve the functioning of the labor market.*** A range of measures aiming to enhance wage flexibility with a view to further reduce labour costs and boost competitiveness. The main target is a 15% reduction in unit labor costs until 2015. If by the end of February an agreement with social partners has not been reached, then the government will need to take legislative action to allow wage and non-wage costs to adjust as needed. The aforementioned target is expected to be reached via the following measures:

- collective sectoral agreements will have a limited duration of three years;
- the grace period after a sectoral labour contract is expired (i.e. "continuance") will be reduced from six to three months;
- permanent tenure in all existing legacy contracts in all companies will be eliminated;
- wage maturities will be frozen until unemployment falls below 10%;
- elimination of unilateral resource to arbitration (i.e. to the Organisation for Mediation & Arbitration OMED);
- a 22% weighed average reduction in the minimum gross wage at all levels based on seniority, marital status and daily/monthly wages;
- an additional 10% cut for young people under 25 years of age in an effort to tackle high youth unemployment;
- minimum wages will be frozen until the termination of the adjustment programme (end of 2015);
- social security contributions to be reduced by 2% for Social Security Foundation (IKA). Offsetting measures will be taken to ensure that the aforementioned measure will not yield an additional burden to the budget. A further 3% cut in social security contributions to IKA will be applied as of 01.01.2013, in a manner that is neutral for the budget;
- Should the aforementioned measures fail to yield the expected effects on the labour market and until labor costs, additional steps will be taken to strengthen wage flexibility and boost employment.

— ***Key reforms in the public sector***

- The special wage status for judicial employees, state doctors, diplomats, political appointees, professors, policy and armed forces will be reformed by the end of June. Special wage regimes account for about one-third of the public sector wage bill
- General government employment to be reduced by at least 150k in the period 2011-2015, including 15k by the end of 2012. To achieve this, the existing 1:5 hiring to attrition ratio will continue to be strictly applied while contractual employment should be reduced.
- Merger/shrinking of general government entities will help identify redundant public employees
- Controls of hiring. Reduction in the annual intake into military, police schools and public academies to a level consistent with hiring plans
- Reduction in outpatient pharmaceuticals from 1.9% to 1½% -of-GDP in 2012.
- A thorough review of social spending programs will be undertaken with the aim to identify additional measures worth ½%-of-GDP to be taken over 2013-2015. The review will be completed by end-June 2012. Allowances will be provided under income criteria.
- Reduction in supplementary pensions. The objective is the generation of €600mn in savings in 2012, via i) a framework law that would reform supplementary pension funds, estimated to yield annual savings 0.4%-of-GDP per year by 2014, ii) a 15% reduction in the pensions of employees of state companies Public Power Corporation, Telecommunications Organization, a 7% reduction of Nautical Insurance Fund (NAT),iii) introduction of reforms to eliminate arrears and deficits in lump sum pension funds

— ***Tax reform.*** The programme envisions the introduction of a tax reform that will aim to simplify the tax system, broaden the tax base and rebalance the burden-sharing across taxpayers to boost growth and competitiveness. The new taxation system will be concluded and parliamentary approved by June 2012.

— ***Bank recapitalisation framework.*** The Hellenic Financial Stability Fund (HFSF) law will be amended to allow the use of contingent convertible bonds and to provide for restrictions on HSFH voting rights for a 5 year period. The voting rights of the HFSH for the common shares it holds will depend on the size of the capital injection by private investors via common shares.

Note:

An assessment of the likely impact of the aforementioned measures on fiscal solvency and the domestic macroeconomic outlook will be provided in our next *Greece Macro Monitor* report.

Table A – Updated event risk timeline

February 2012	9	ECB Governing Council meeting
		Emergency Eurogroup meeting on Greece
	10-14	Government submits to Parliament "prior actions" legislation
		Governments and euro area national parliaments approve €30bn loan for running the PSI
		Eurogroup approves provision of temporary EFSF credit enhancement (up to €35bn)
	15-16	Official public offer for the Greek debt swap (PSI)
	16-27	EFSF provides credit enhancement
	25-26	G-20 Finance Ministers and Central Bankers meet
	27	Deadline for private bondholders to affirm participation in PSI
March 2012	1-2	EU Summit
	5	Upon agreement with official lenders, Greece decides on voluntary debt exchange offer
		Eurogroup approves terms of the new loan agreement
		Eurogroup approves disbursement of €30bn for running PSI, first loan installment for bank recapitalisation of €10bn, €5.5bn for debt servicing
	6	PSI implementation concludes
	8	ECB Governing Council meeting
	19-30	Greek parliament endorses new rescue package & corresponding implementation measures
	20	Greece redeems €14.435bn of 3-year sovereign paper

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