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FOCUS NOTES

Greece: Overview of latest domestic developments

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Part I- Eurogroup March 7th likely to set a date for the return of the mission heads to Athens to resume discussions with the Greek authorities over the 1st programme review

The February 29th EuroWorking Group failed to set a date on the return of the ECB/ESM/EC/IMF mission heads to Athens to resume discussions with Greek authorities in the context of the 1st programme review. Addressing a general news briefing earlier this week, IMF spokesman Gerry Rice acknowledged that "good progress" has been made among Greece's official creditors over the programme review. He pointed out that he expects an early return of the IMF mission to Athens clarifying that the exact timing will be officially announced after the upcoming Eurogroup scheduled for Monday, March 7th. According to local press reports, although there has been some convergence between the Greek side and European creditors on certain issues attached to the review, the IMF continues to have quite diverse views especially as regards the projected size of the fiscal gap for the period FY2016 - FY2018. Addressing the Hellenic Parliament, Greece's Minister of Finance Euclid Tsakalotos revealed that the positions of the government and European creditors "are very close… and existing differences existing are within the framework of negotiations". On the flipside, he strongly criticized the IMF for holding a hard stance asking for more fiscal measures that go beyond the conditionality attached to the bailout agreement signed in summer 2015. Against this background, some local press reports suggested that the likelihood of the review being split into sub-reviews, each one concentrating on certain deliverables, cannot be ruled out completely. Speaking to a local TV station earlier this week, Greece's Prime Minister Alexis Tsipras stressed that the government's intention is to have the legislation required for the implementation of the attached conditionality approved by the Hellenic Parliament by the end of March so as the review to be completed by (the Orthodox) Easter. Along these lines, European Commission Vice President Valdis Dombrovskis cautioned that the refugee crisis renders the swift finalization of the review ever more imperative while Greece's Minister of Finance Euclid Tsakalotos warned that, unless the review is completed soon, the success of Greece's economic adjustment programme will be in jeopardy.

Greece's 1st programme review- key deliverables

The section provides an updated analysis on the required prior actions for the successful completion of the 1st programme review.

Overhaul of the social security pension system

Addressing the European Parliament's Economic Affairs Committee, Eurogroup President Jeroen Dijsselblome pointed out that, while politically difficult, the Greek government needs to implement the vital reforms underlying the conditionality of the existing bailout programme, including the overhaul of the social security pension system. Echoing recent remarks by Deputy Director of the IMF's European Department Poul Thomsen, the Eurogroup President said explicitly that a cut in main pensions might be needed to safeguard the system's sustainability and lay the groundwork for an official agreement on the social security pension reform. On its side, the Greek government has set a red line on further cuts in existing pensions insisting that they have a broader social function as they often constitute the sole household income. In a recent interview to international newswires, Greece's Minister of Finance Euclid Tsakalotos warned that there is no room for further cuts in pensions arguing that such a request, especially by the IMF, goes beyond the MoU conditionality underlying the new bailout programme. As a compromise, the Greek side is reportedly mulling certain amendments to the social security pension plan earlier submitted to official creditors. According to the same sources, these include, inter alia, the following:

– *Establishment of a lower ceiling for main & multiple pensions.* Establishment of a ceiling no higher than €2,000 (net) for the main monthly pension compared to €2,773 currently and €2,304 initially proposed. With respect to multiple pensions the respective ceiling would be set at €2,400-2,500 (net) vs. €3,680 currently and €3,088 earlier suggested. According to the government's estimate, this measure would reportedly secure savings of c. 250mn/annum. During a recent TV interview, Greece's Prime Minister Alexis Tsipras said explicitly that his government's goal is to protect the vast majority of pensions ranging from €600-€1,200 and not cutting pensions of €1,4000 adding that "defending pensions of €3,000 is not included in the red lines list".

– *A cut in higher auxiliary pensions accompanied with an increase in social security contributions.* A reduction of 2%-20% in auxiliary pensions higher than €170/month. According to the government's estimate, this measure would reportedly secure savings of c. €300mn/annum. With c. €1.1bn has purportedly been covered already through relevant measures that have been penciled in the 2016 Budget, the remaining amount required for securing targeted savings of c. €1.8bn (or 1%-of-GDP) in 2016 through the overhaul of the social security pension system could reportedly be covered via a 0.5% increase in social security employee (estimated revenues of €170mn/annum). Though the IMF reportedly opposes an increase in social security contributions on the basis that it would harm business competitiveness, the European Commission seems willing to accept a 0.5% rise under the condition that it will be on a temporary basis.

– *Provision of a lower national state guaranteed pension.*[1] Provision of a national state guaranteed pension of €360/month to pensioners with 67 years of age or above, provided that they have covered at least 20 years of insurance. As a reminder, the government's initial plan reportedly envisioned the provision of a €384/month pension to pensioners with a minimum of 15 years of insurance. On their side, official creditors argue that, given the Greek economy's dire financial condition, the said pension should not exceed €320/month for pensioners with 20 years of insurance while for those with a minimum 15 years of national insurance contributions it should be further reduced to €300/month.

– *Downward revision in replacement rates*. Downward revision in initially proposed pension replacement rates so as to ensure a closer link between contributions and benefits, in line with official creditors' proposal.

– *Reduction in pension lump sum payments*. Opposing official creditors' proposal for an annulment of pension lump sum payments, the Greek government has counter posed a reduction of up to 25%.

– Weighted average reduction up to 35% in dividends provided by the so-called Civil Servants Share Fund to retired civil servants.

– *Alternative sources of revenues.* As a counter proposal to official creditors' suggestion for the implementation of the zero deficit clause on supplementary funds (projected revenue of c. €300/annum), the Greek government is said to consider alternative sources of revenue, including, inter alia, the imposition of a tax on stock transactions, 10% of privatization proceeds and the fight against tax evasion.

On their side, official creditors appear to reject certain compromises the Greek government vowed to offer to protesting farmers against the proposed social security pension reform. These reportedly incorporate, among others: (i) establishment of a tax-free threshold for low-income farmers; and (ii) maintenance of the autonomy of OGA (Agricultural Insurance Organization) until 2021 (i.e., OGA to be exempted from the planned integration of all social security funds under a single entity). According to Minister of Labour and Social Insurance Giorgos Katrougalos, the government intends to submit to Parliament the draft bill related to the social security pension reform by the end of this month (March 2016).

[1] According to the Greek government's proposed scheme the calculation of new pensions would be determined as the sum of two components: (a) the basic pension that will depend on total working years and; (b) revised replacement rates + a national state guaranteed pension.

Fulfilment of agreed fiscal targets for years 2016, 2017 and 2018

Official creditors are said to be concerned that some of the measures already approved by Parliament have either not been properly implemented or their projected fiscal impact has been overestimated. Against this background, they reportedly project that the Greek government has to adopt additional measures – beyond those already agreed under the existing MoU conditionality- so as to secure fulfillment of the agreed fiscal target for a primary surplus of 0.5%-of-GDP in FY-2016, 1.75%-of-GDP in FY-2017 and 3.5%-of-GDP in FY-2018. On its side, as was reiterated by IMF spokesperson Gerry Rice earlier this week, the Fund anticipates a fiscal gap of up to 4%-5%-of-GDP (or €7.5-€9bn) to arise cumulatively by FY-2018. Specifically for FY-2016, the Fund reportedly foresees a fiscal shortfall of c.0.5%-of-GDP (or c. €1bn) based on certain assumptions including GDP contraction of 2.0% in FY-2015 -compared to official data suggesting full-year real GDP contraction of 0.2%- and a FY-2015 general government primary shortfall of 0.6%-of-GDP. On their side, European creditors reportedly adopt a relatively more optimistic stance arguing that the Greek economy recorded a mild recession in FY-2015 and the 2015 fiscal target was outperformed with the general government primary account recording a meagre surplus of 0.2%-of-GDP. Based on the above, they reportedly foresee a fiscal gap of 0.2%-of-GDP in FY-2016 (or c. €300mn) and 3.0%-of-GDP (or c. €5.5bn) cumulatively up to FY-2018. The Greek government reportedly concurs with that projection arguing however that the anticipated fiscal shortfall for the period FY-2016-FY-2018 could be eventually contained to around €1.5bn (or 0.8%-of-GDP) assuming full implementation of all measures penciled in the 2016 Budget. Under the MoU conditionality, the Greek government has committed to implement additional fiscal measures for 2017 and 2018, projected to yield at least 0.75%-of-GDP and 0.25%-of-GDP respectively, so as to attain the medium term primary balance target of 3.5%-of-GDP.[2]

Income tax code reform

The Greek government's draft of the planned income tax code reform essentially maintains different tax scales depending on the origin of income, reportedly projecting to increase budgetary revenue by at least c. €350mn/annum. Specifically, the proposed plan envisions, inter alia:

(i) _Adoption of three tax scales for rental income._ With respect to rental income, three tax scales will be implemented, compared to two currently; 15% (from 11% currently) for annual rental income up to €12,000, 35% (from 33% currently) for income up to €40,000 and 40%-45% for income above €40,000. Based on three tax scales, the government reportedly estimates that annual revenue would be increased to €250mn compared to c. €140mn under the existing tax system.

(ii) _Unified taxation system for wage earners, pensioners, self-employed, freelancers and farmers_. Four income tax scales will be applied for wage earners, pensioners, self-employed, freelancers compared to three currently; 22% for annual income between 0-€25,000, 32% for €25,001-€40,000, 42% for €30,001-60,000 and a top tax rate of 50% (vs. 42% currently) for declared annual income above €60,000. This taxation system will also be applied on farmers with the government purportedly abandoning initial plans for an increase in their income tax rate from 13% currently to 20% in 2016 and 26% in 2017. A tax-free threshold of €9,500 will be applied solely for wage earners, pensioners and farmers.[3] Reportedly, official creditors argue for a relatively lower threshold. It is worth mentioning that, according to official figures published by the General Secretariat of Public Revenue, out of the country's 8,517k taxpayers in FY-2015, about 3% declared annual income above €30,000, paying 42% of the €73.93bn total income tax revenue that was flown into the State coffers.[4] Reportedly, the government does not intend to implement the MoU conditionality envisioning the integration as of 2016 of the solidarity surcharge into the income tax aiming to achieve more progressivity into the income tax system. Instead, it is considering to continue the implementation of the solidary surcharge as a separate tax. The said plan, reportedly projected to generate a budgetary shortfall of €50/annum, has been already submitted to official creditors but no response has been received so far. As per the same sources, the solidarity tax will be applied, not on the entire annual income as is currently the case, but on a specific segment of it. The top rate is reportedly expected at 10% for annual income above €500,001.

In a recent interview to a local TV station, Greece's Prime Minister Alexis Tsipras revealed that a bill incorporating the legislation related to the income tax reform will be submitted to Parliament within this month (March 2016), along with another one envisioning the provision of certain incentives for the voluntary declaration of hitherto undeclared income.

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[2] Measures that have already approved by the Hellenic Parliament but are not yet properly implemented include, inter alia: (i) the overhaul of the pension system; (ii) the income tax reform; (iii) increase in tax rates for rental income; (iv) the imposition of a special levy on each column of the gambling games of OPAP; (iv) participation of the Greek State on revenues from gambling VLTs; and (v) reduction in defense spending.

[3] According to the General Secretariat of Public Revenue,1,176k taxpayers paid no income tax in FY-2015, 1,305k declared annual income up to €1,000 while almost 50% of all taxpayers (or 3,98k) declared annual income below €5,000.

[4] The tax free threshold for farmers rises to12,000/annum in case of agricultural subsidies. It is worth noting that, according to the General Secretariat of Public Revenue, 93% of farmers declared in FY-2015 annual income up to 5,000.

Finalization of outstanding issues related to the NPL resolution framework

The non-performing loans (NPLs) regulatory framework agreed between the Greek government and official creditors late last year introduced a framework for the management by non-banking institutions of all categories of NPLs originated by Greek banks. Yet, potential repurchases were permitted solely with respect to NPLs of large corporations (with a turnover in excess of €50mn/annum and more than 250 employees). Certain NPL categories were excluded from the scope of permitted sales including consumer loan up to €20k, loans granted to SMEs up to €500k, loans granted to freelancers up to €250k and loans collateralized with Greek State guarantees or the debtor's primary residence. With regard to the purportedly sale of those NPLs to non-banking institutions, the Greek government reportedly insists on the adoption of certain terms and conditions including, among others, the outstanding loan amount, the period during which the debtor has stopped servicing his/her loan and the prospect of the company's viability. On their side, official creditors have reportedly adopted a more liberalized stance insisting on the repurchase of all NPL portfolios arguing that any protection should apply only to the socially and financially vulnerable groups. Under an agreement reached between the two sides during the first phase of discussions in the context of the 1st programme review that took place in early February, the relevant regulatory framework has to be approved by the Hellenic Parliament by March 15th. In a meeting held a couple of weeks earlier, Bank of Greece Yannis Stournaras asked the Hellenic Bank Association to intensify its efforts for the efficient management of NPLs. In cooperation with the Single Supervisory Mechanism (SSM), the Bank of Greece reportedly targets a reduction in NPLs from 35.5% of total loans in December 2015 to 25% by 2018, subject to the evolution of domestic economic conditions.

Startup of the new Privatization Fund

The MoU conditionality envisages the establishment of an independent Privatization Fund, managed by domestic authorities under the supervision of the relevant European institutions. The Fund's mandate should be to manage valuable Greek assets –including the shares of the Greek recapitalized banks- through privatization and other means with a view to eventually monetize assets worth up to €50bn during the programme period. As part of the conditionality attached to the release of the last ESM loan installment (amounting to €1bn) in late December, an independent Task Force, appointed by the Greek side, identified options and prepared recommendations of the operation goals, structure and government of the Fund. Yet, certain actions required for the startup of the new Privatization Fund are still pending. These reportedly include, inter alia; (i) the selection of the assets that will be transferred; and (ii) the finalization of the bill incorporating the relevant legislation dictating the operation framework of the new Fund. The government's proposal that 10% of the privatization proceeds to be reportedly channeled to the financing of social security funds, is currently among the open issues in discussions with official creditors in the context of the review.

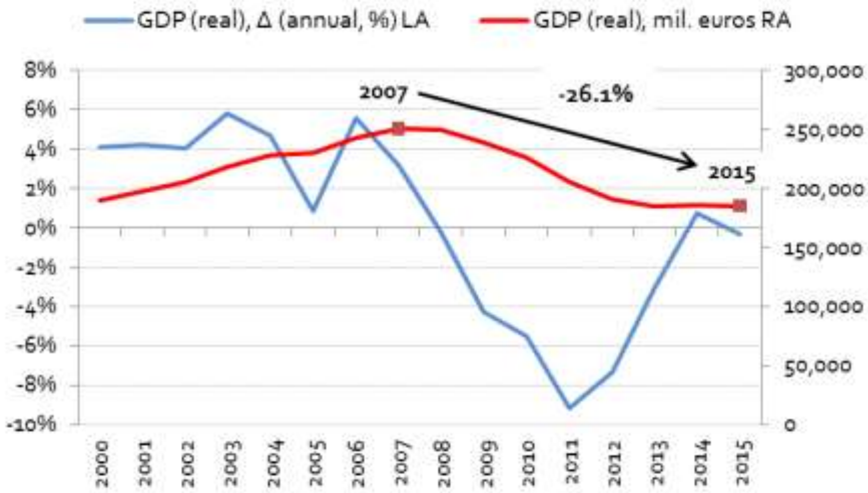
Part II- Overview of recent macroeconomic developments

FY2015 GDP contraction milder than expected

Real GDP for 2015 fared better than previously estimated based on the provisional seasonally adjusted data released by the Hellenic Statistical Authority earlier this week. The Q4 2015 data show an increase of GDP in volume terms by 0.1% qoq against a decrease of 0.6% calculated for the flash estimate released on February 12, 2016. On an annual basis, the contraction was also milder than expected, namely -0.8% against -1.9% of the flash estimate.

This favourable development led to a full-year 2015 real GDP contraction of 0.2% against -0.7% previously estimated, which translates into a carry-over of -0.4% into 2016.

Figure 1: Real Gross Domestic Product



Source: (a) Hellenic Statistical Authority (EL.STAT.), (b) Eurobank Research.

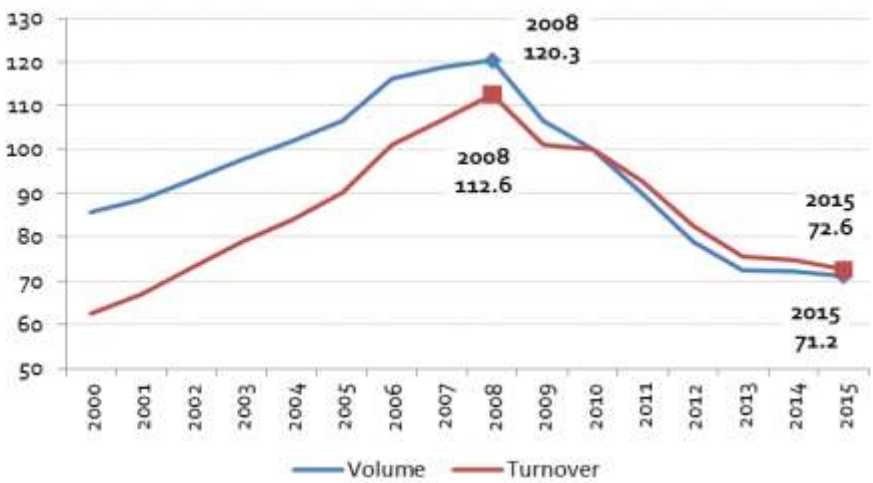
With regard to the individual components of GDP from the demand side for the FY2015, public consumption increased 0,27%, government consumption decreased 0.11%, gross fixed capital decreased 13.25%, exports decreased 3.75% and imports decreased 6.88%.

Retail trade in 2015 contracts for the 7th consecutive year

According to data published by the Hellenic Statistical Authority on the 29th of February 2016, the turnover index in retail trade for FY 2015 recorded a drop of 2.8% compared to FY 2014, the 7th annual consecutive decline. The store categories where decreases were recorded were automotive fuel (-11.7%), furniture, electrical equipment and household equipment (-6.6%), department stores (-5.4%), food, beverages and tobacco (-2.1%), pharmaceutical products and cosmetics (-2.0%) and super markets (-1.4%).

The volume index in retail trade fell by 1.4% in 2015, which marks the 7th annual decrease in a row. With regard to the individual store categories, declines were recorded in furniture, electrical equipment and household equipment (-3.8%), food, beverages and tobacco (-3.3%), department stores (-3.3%), super markets (-1.7%), automotive fuel (-1.6%) and pharmaceutical products and cosmetics (-0.4%). On the other hand, clothing and footwear (8.0%) and books, stationery and other goods (7.1%) have recorded a rise on an annual basis.

Figure 2: Turnover and Volume Indices in Retail Trade



Source: (a) Hellenic Statistical Authority (EL.STAT.), (b) Eurobank Research.

February 2016 PMI Manufacturing indicates a slowdown of production

The Markit PMI Manufacturing for Greece came in at 48.4 in February 2016, down from 50.0 in January 2016. This reading marks the second deterioration in a row indicating a slowdown in manufacturing activity in Greece. According to the Markit report, the survey revealed a drop in incoming new business and a contraction in new export orders, which may be partly attributed to the farmers' multi-day strike in the form of blockages of national highways. Furthermore, the survey suggested the shedding of employees though at a slow pace. With regard to performance, average lead times have increased for the 15th consecutive month, whereas vendor performance has deteriorated.

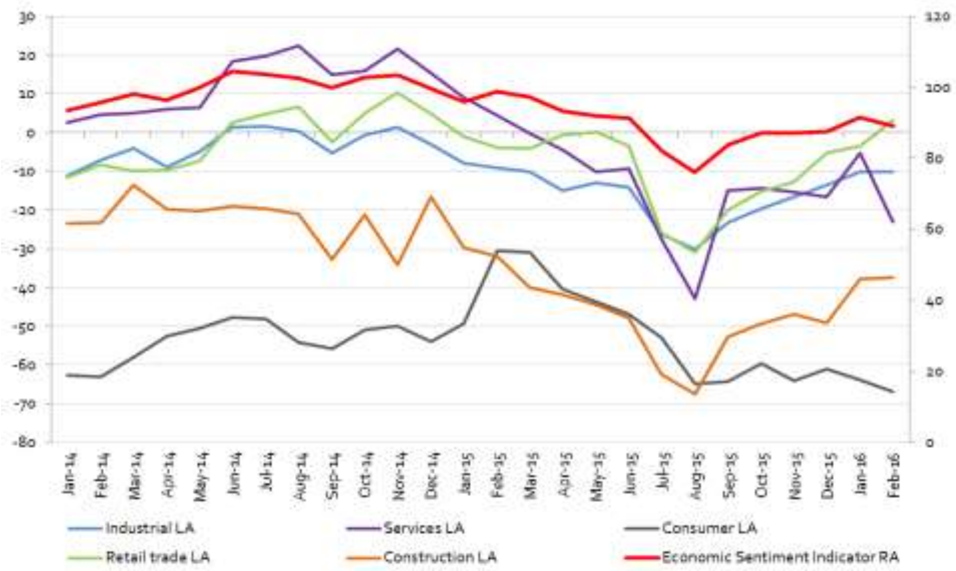
Figure 3: Markit Manufacturing PMI

Source: (a) Markit PMI (b) Eurobank Research.

Economic Sentiment reflects deterioration of expectations

The Economic Sentiment Indicator (ESI) in February 2016 decreased to 89 from 91.6 in January 2016. Most sectoral indicators (i.e. industrial, consumer, and services) registered lower than in the previous month reflecting a cautious stance on behalf of market players amid insecurity with regard to the completion of the 1st programme review and strong protests by a number of social groups against the proposed reforms in social security, taxation and pensions. On the other hand, the retail trade and construction confidence indicators increased compared to the previous month.

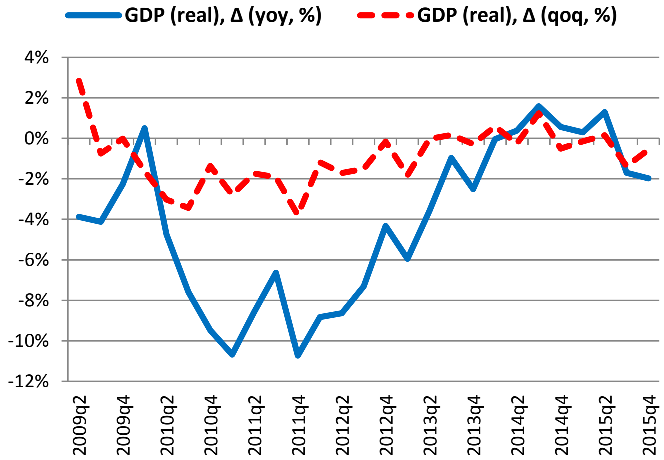
Figure 4: Economic Sentiment Indicator and Sectoral Indicators



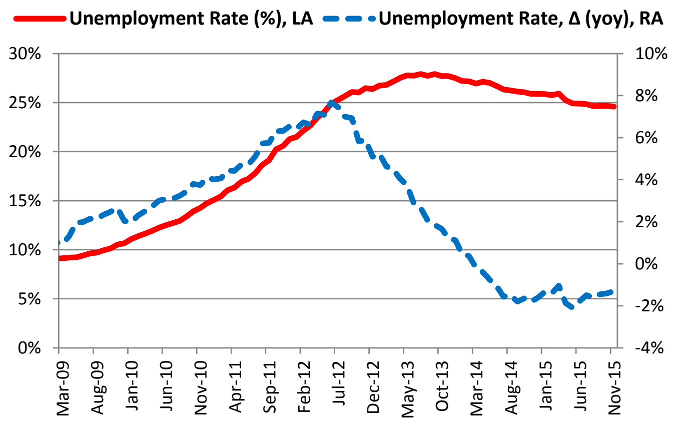
Source: (a) European Commission, Business and Consumer Surveys (b) Eurobank Research.

Table A1: Fundamental Macroeconomic Data of the Greek Economy

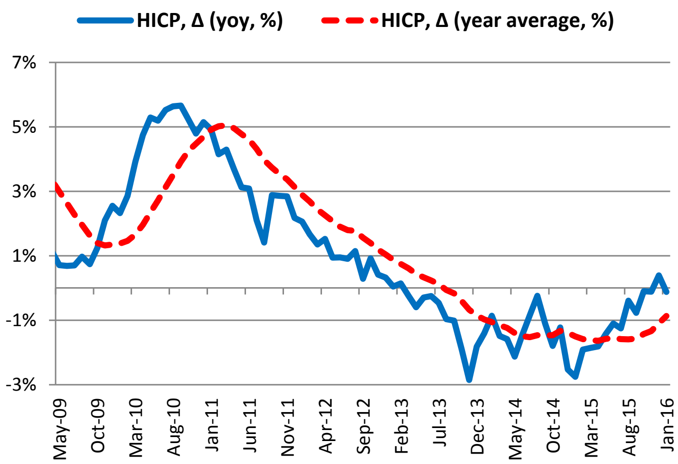
Real GDP, changes (%) non-seasonally adjusted yoy%, seasonally adjusted qoq%



Unemployment rate (seasonally adjusted data)



HICP and CIP (%)



Source: Hellenic Statistical Authority (EL.STAT.)

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