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Focus- Greece
Greek PM unveils 4-year plan to correct excessive deficit

In a closely-watched speech to domestic employer associations, labor unions and political party representatives on December 14, Prime Minister George Papandreou outlined his government´s plan to help correct Greece's excessive deficit by the end of 2013 and win back the trust of European Union partners.

As widely expected by markets, the announced fiscal consolidation plan contained little in the way of public-sector wage cuts and new tax hikes. Instead, it was based on a mixture of measures to rein in widespread tax evasion, fight corruption, strengthen transparency and accountability in the broader public sector and promote a ''greener'' development model for the Greek economy, which aims to strengthen productivity and competitiveness.

To a great extent, the government´s 4-year plan -- which will be presented in greater detail in the county's new stability and growth program to be submitted to EU authorities in late January -- contains measures that either have already been touted by the government in its draft 2010 budget (and ahead the October 4 parliamentary election) or leaked in the local press over the last couple of days.

Yet, the Greek PM presented some of these measures in greater detail and even announced some new initiative including, among others: the effective freeze in the salaries of public-sector employees earning more than 2,000 euros per month; a 10% cut in supplementary allowances, which often account for a significant portion of overall state worker salaries; the appointment of professional management to state pension funds; the scrapping of senior-management bonuses in state controlled banks and the imposition of a 90% tax on private bank bonuses.

From a fiscal consolidation stand point and in line with the targets specified in the draft 2010 budget (unveiled in November) , the new plan aims to reduce next year's general government deficit by around €8bn or ca 4ppts of GDP, with half of the adjustment expected to come from expenditure cuts and half of it from higher revenues. As such, the government sticks to its 2010 budget target of bringing the budget deficit down to 9.1%-of-GDP from 12.7%-of-GDP expected this year.

Looking further ahead, a fiscal adjustment of around 2ppts of GDP per annum is expected in the following 3-year period, with the overall deficit closing the year 2013 below 3.0%-of-GDP. In line with these projections, the government expects the public debt-to-GDP ratio to start reversing its upward trend from 2012 at the latest, though no official projection has been published thus far with respect the expected peak level of the ratio.

In terms of the market's reaction to the PM speech, the 10yr GGB/Bund yield spread widened to levels around 257bps in early trade on Tuesday, from late Monday´s levels of around 231bps, on the view that the measures announced may not prove sufficient enough to promote sustained fiscal consolidation. The general equity market index, ASE, retreated by around 2.1% yesterday, with financial stocks leading the losers´ pack.

Plan details and assessment

The government´s 4-year plan to address the effects of the global financial crisis and promote fiscal consolidation is structured along the following three major axes:

- Measures to help middle- and lower-income groups and support aggregate demand

- Measures aiming to fight corruption and reign in widespread tax evasion

- Fiscal measures to help correct the excessive deficit by 2013 and reverse the rising trend in the debt-to-GDP ratio by 1012 at the latest

The Greek Prime Minister stressed his government´s commitment to pass the majority of these measures by April 2010

Measures to help middle and lower income groups and support aggregate demand

In line with his pre-election promises, Mr. Papandreou re-iterated his commitment to:

- Raise public-sector wages and pensions slightly above the inflation rate next year. The wage rise will exclude public-sector employees with incomes exceeding 2,000 euros per month. (The latter group will see an effective freeze in their salaries). Furthermore a “solidarity” payment will be granted to the poor, while no new taxes will be implemented in 2010, besides the *already announced* hikes in the special consumption taxes on alcohol and tobacco products (see draft 2010 budget)

- Reintroduce a steeper, more progressive property tax, with a higher level of tax relief at the lower end. A new progressive inheritance tax will be also implemented, again with generous relief at the lower end

- Protect people who face difficulties paying back their bank loans by providing gradual dispensation to those in proven need. Also combat the high cost of living via, among other measures, a stronger competition agency to prevent cartel practices

- Increase liquidity in the market by providing loans on favourable terms to small- and medium-sized businesses (SMEs). Furthermore, provide guarantees (security) directly to firms based on objective criteria

- Boost entrepreneurship by simplifying the tax system as well as the bureaucracy faced by start-ups. Moreover, open up the scores of “closed-shop” professions, as demanded by the European Commission

- Tackle the effects of the economic crisis on the job market by strengthening labour inspectors, and raising unemployment benefits gradually to 70% of the basic wage, from 63% currently; Additionally, institute incentives for firms to hire the young via a generous programme of subsidizing social-security contributions for four years

- Increase public investment to 4% of GDP in 2010 and, more generally, rely on a new ‘’greener’’ model of economic development that aims to boost productivity and enhance competitiveness

Our assessment

Although financial markets would seemingly like to hear the Greek PM laying our an Irish-style fiscal consolidation plan that relays mainly on permanent spending cuts, we believe that the government is probably right to emphasize the importance of supporting aggregate demand. That is because, in contrast to Ireland, Greece is a relatively closed economy with private consumption accounting for slightly more than 70% of gross domestic product (2008 data). Needless to say, a sharp (and protracted) contraction in Greek domestic demand would weigh heavily on budget revenue and, in the absence of offsetting measures on the expenditure side, this would further increase the fiscal deficit. Of course, the counterarguments here are: **a)** a further rise in Greek sovereign spreads *e.g, as a result of financial markets interpreting the measures as being not aggressive enough,* would further raise the cost of new borrowing by the State and thus, exacerbate the crowing out effect on the domestic private-sector economy**. b)** The government has promised to pass the majority of the announced measures by April 2010. This appears to be an extremely challenging deadline, with Mr. Papandreou openly admitting yesterday that his government will need to implement in 3 months all things ''we did not do in the last decades".

Measures aiming to fight corruption and reign in widespread tax evasion

Mr. Papandreou emphasized yesterday his government´s strong commitment to fight corruption and clamp down on widespread tax evasion. (According to some estimates, the size of the grey economy in Greece may be higher than 30%-of-GDP, with the PM admitting yesterday that illegal fuel trade alone probably exceeds €10bn per year). To that end, the government plans to utilize a host of measures, ranging from a specialized tax squad and the electronic cross checking of retail trade receipts to the electronic connection of local tax and urban planning agencies with the state's general accounting office. In an effort to make the fight against corruption and tax avoidance a national priority, Mr. Papanderou met yesterday with other political leaders to reach a minimum consensus on the proposed reforms. (President Carolos Papoulias himself chaired the meeting).

<u>Our assessment</u>

We have no reason to doubt the government´s strong commitment to crack down on corruption and widespread tax evasion, though, we believe, this will be a very challenging pursue given the extent and endemic nature of these problems. On a rather reassuring note, the government has already shown some tangible (and highly symbolic) results in that direction by recently uncovering some high-profile cases of tax avoidance by a number of doctors and other professionals located in one of Athens' most prestigious downtown areas. Having said that, other Greek governments in the past have committed to fight corruption and reduce tax avoidance, albeit with limited success. In any case, the measures announced so far appear to be in the right direction and the government´s pledge to reduce discretion among public sector employees in tax authorities and urban planning agencies may eventually help to attain the desired results.

Fiscal measures to help correct the excessive deficit by 2013

Mr. Papandreou presented yesterday a multitude of fiscal measures aiming to eliminate the excessive deficit by the end of 2013 and attain the necessary primary surpluses so as to reverse the rising trend in the public debt ratio by the year 2012 at the latest. Note that the majority of these measures were already known either because they were included in the government´s pre-election programme or because they were detailed in draft 2010 budget that was unveiled in early November. Among other items these included,

Expenditure containing measures

- The pubic sector incomes-policy measures for 2010 we have already detailed (pleased see first bullet of *Measures to help middle and lower income groups and support aggregate demand*)
- A hiring freeze for permanent public sector jobs in 2010, excluding the ''sensitive sectors'' of health, education and security. Starting in 2011, one new civil servant will be hired for every five retiring
- One-third reduction of all short-term employment contracts in the public sector will be implemented in 2010

- Board member pay at public enterprises will be cut by 50%, while managers´ compensation in state-run companies will be capped and reduced by at least 10% next year

- No bonus will be paid to the managers of state-controlled banks

- A 10% reduction is new social security expenditure will be implemented in 2010 (no details have been given on this measures)

- Central government operational expenditure will be cut by 10% next year (as it was specified in the draft 2010 budget), with public consumption expenditures expected to be cut by 25%

- One third of offices of Hellenic Tourist Organization's offices abroad will be closed and state press offices will be relocated to Greek consulates abroad

- Starting in 2010, ministries, public corporations and other entities in the broader public sector will be submitting 3-year budget plans, which will be subject to tight expenditure controls and close monitoring

- Defense expenditure will be reduced (by a yet unspecified amount) in the years 2011 and 2012

- The government will soon initiate a public discussion with social partners to construct a new reform in the social security system

Revenue enhancing measures

- A new tax law to be introduced early next year will help broaden the tax base and support the government´s revenue generating effort. The new law will introduce a progressive taxation scheme for all income earners where income from all sources will be treated uniformly (after the appropriate adjustments to avoid double taxation). Distributed corporate earnings in the form of dividends to individuals will be included in this system, after deducting (the lower) tax on retained earnings. The latter will remain at its current lower level, but certain tax breaks deemed unnecessary will be abolished.

- The government is also planning to abolish ETAK (the Uniform Property Tax) and reintroduce a steeper, more progressive property tax, with a higher level of tax relief at the lower end.

- Finally, it will reintroduce a progressive inheritance tax, again with generous relief at the lower end. The government will also tax the net profits generating from short-term transactions in the Greek stock market.

Our assessment

Again, the measures specified above appear to be in the right direction though rigorous implementation will be key to attain the desired results. A brief look at the main targets of the draft 2010 budget helps to clarify the extent and magnitude of the challenges ahead. Specifically, the new budget forecasts 9.0%YoY growth in net ordinary revenue next year, a target implying an elasticity with respect to nominal GDP growth of around +9.0, whereas the corresponding annual average in the past 8-10 years was not much higher than +1.0. *(Ordinary budget revenues are officially expected to decline by -4.7% in 2009).* On the expenditure side, the new budget targets a 3.8% YoY decline in primary expenditure next year, whereas this same– *mostly non discretionary* – category of public spending has a long history of significant undershooting budgetary targets (+17.2% in 2009 according to the most recent official estimates).

<u>Bottom line:</u> Yesterday's speech contained little surprises relative to what have been announced in the government´s pre-election program and the draft 2010 budget. Yet, the Greek PM presented some of these measures in greater detail and even announced some new initiative to help correct the excessive deficit. There is little doubt that the new government has so far shown a strong resolve to implement its fiscal consolidation plan, but, again, rigorous implementation of the announced measures is key for addressing long-standing structural problems in the economy and win back the trust of European Union partners and financial markets.

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