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Focus notes: Greece

Latest macro & market developments

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Key points / contents

- Government submits medium-term fiscal austerity plan (MTFP) to parliament. Parliamentary approval of MTFP is key prerequisite for the release of the 5th tranche (€12bn) of official lending to Greece under the present EU/IMF €110bn bailout programme. It is also a precondition for the approval of additional financial assistance by official lenders.

- MTFP: Key components, projected fiscal impact and assessment

Government submits medium-term austerity plan to parliament; official lenders working on a new bailout plan, aiming to fully cover Greece's public borrowing needs for the period 2012-2014

The Greek government submitted to parliament yesterday its anxiously awaited medium-term fiscal plan (MTFP) for the period 2012-2015. The voting of the plan is considered to be a key prerequisite for the release of the 5th tranche (€12bn) of official lending to Greece under the present EU/IMF €110bn bailout programme. It is also a precondition for the approval of additional financial assistance by official lenders, aiming to bridge the projected gap in Greece's State borrowing needs for the current year and the next three *(i.e., until the end of 2014)*. Note that Greece has already received €53bn of funding under the existing programme.

The size and specific modalities of the new bailout package have not been announced yet, but according to a number of reports quoting *unnamed* EU sources, the new plan will provide additional financing well in excess of €100bn. According to the same sources, the amount of new financing provided by the euro zone *(i.e., in the form of EFSF loans)*, the IMF and the private sector could amount to as much as €90bn, with an additional €30bn being secured by state-asset sales. Note that the German parliament has already voted in favor of a resolution to back additional aid for Greece, while considerable uncertainty remains with respect to the form of private-sector involvement in the new bailout *(more analysis on the latter topic can be found in our June 4, Greece: Macro Monitor report)*.

Until recently, the prevailing view was that private-sector involvement would take the form of a Vienna-type agreement with private bondholders *voluntarily* replacing maturing Greek government securities (GGBs) in their portfolios with longer maturity paper *e.g. replace GGBs maturing in the period 2012-2014 with new 7-year paper inclusive of certain "sweeteners".* However, market uncertainty over the latter proposed scheme has increased considerably after Germany came up with the bolder idea of a Greek bond swap. The idea here would be to allow private investors to *voluntarily* exchange outstanding Greek bonds for ones with maturities extended by several years.

According to that idea, an incentive would be given to GGB holders to participate in the scheme by allowing the new securities to be accepted as eligible collateral in ECB liquidity-providing operations, while rejecting the old ones. Reportedly, the German government believes that any ensuing sovereign credit rating downgrades for Greek debt would stop short of triggering payouts of CDSs. Yet, it remains difficult to see how such an exchange (even if defined as "voluntary") could prevent downgrades of Greece's sovereign ratings to *e.g.* selective default category. It is not a surprise, therefore, that the ECB continues to oppose the notion of an exchange-based "reprofiling" of Greek debt.

Coming back to Greece's medium-term fiscal plan, it is important to note that according to a number of reforms the government's intention is to have the plan voted in parliament before the key Eurogroup and EU Council meetings on June 20 and June 23-24, respectively. This is important in our view as the government's prior suggestion that a parliamentary vote would probably take place no earlier than on June 28th raised questions about the willingness of official lenders to commit new financial assistance for Greece before the passing of the medium-term fiscal plan in parliament. As things stand at this point, and barring any unforeseen circumstances, the plan will likely get the necessary majority in parliament *(151 votes or more in favor are required, while the leading party currently controlling 156 seats in the 300-seat parliament)*.

The new measures envisioned in the medium-term fiscal plan amount to around €28bn for the period 2011-2015, with ca €6.4bn of that to be implemented this year in order to facilitate fulfillment of the 2011 general government deficit target of 7.4%-of-GDP. The rest of the measures are to be applied in the following four years. Table 1 on page 6 shows the main categories *(and projected impact in € millions and in ppt-of-GDP terms)* of the new fiscal measures included in the medium-term fiscal plan.

New austerity measures and projected fiscal impact

The specifics of the new fiscal measures included in the medium-term fiscal plan can be found in a full document submitted to parliament yesterday. Below we elaborate further on some of these measures:

The intended streamlining of the public wage bill is expected to be achieves vis-à-vis:

a) A reduction in the overall number of public-sector workers by 150k employees *(or by 230k employees if 2009 is used as the base year for comparison)*. Among other measures, this is expected to be attained by a further drastic reduction in the number of workers currently employed in the public sector under special contracts. Furthermore new hires will be reduced significantly by applying the so-called 1:10 rule in 2011 *(i.e., only one new hire for every 10 civil servants retiring or unilaterally deciding to leave the state)* and a 1:5 rule thereafter.

b) Further rationalization of wage-related costs *vis* additional wage restraint, reductions in civil servant special benefits and the cost of overtime pay *(rise in work-week hours from 37.5 to 40)*. More importantly, the new single payment authority will become operational from July 2011, reducing significantly existing disparities in basic wages and special benefits among different worker groups in the broader public sector.

Operational costs at the general government level amounted to ca 7.3%-of-GDP in 2009, before being cut by 1.5ppts-of-GDP last year. The medium-term plan envisions a further cumulative reduction of 0.5ppts-of-GDP by 2015 so as to bring this important spending category towards the 5%-of-GDP level currently prevailing in a number of euro zone economies.

Additional cost savings (of ca 0.6ppts-of-GDP cumulatively until 2015) are expected to come from the closure/merger of a wide range of entities within *(or outside)* the broader public sector, currently receiving various State budget transfers. These would include, among others, consulates, military camps, museums, schools and police stations.

As to the cost structure of public enterprises, the medium-term plan (MTFP) notes that their overall cost to the general government budget exceeded €2.5bn (> 1ppt-of-GDP) in 2009. These costs were in the form of direct net budget transfers and the assumption, by the State, of their outstanding liabilities to third parties. The MTFP now aims to restructure a number of loss-making public enterprises (in the public transportation and other sectors) so as to improve their net annual results by €1.5bn by 2015.

The MTFP also aims to reduce defense-related expenditure by ca €1.1bn (or by 20%) in the period 2010-2015. Additional savings of ca €2bn will also be generated by streamlining further health- and pharmaceutical-related expenditure. These will be attained via the establishment of a central procurement system for state hospital supplies, a better rationalization of drug lists, the electronic checking of prescriptions, extensive use of generics and other measures. According to the MTFP, the cost savings from health-related expenditure amounted to ca €2bn in 2010.

Additional savings (in excess of €4bn) are also targeted in the period 2011-2015 via the rationalization of wide range of social transfers *e.g.* special pensions for those working in arduous professions, special benefits etc. This is a very important spending category for the State budget, considering that social transfers currently amount to ca €45bn/annum or around 20% of GDP.

According to the MTFP, tax revenues in Greece are currently around 5ppts-of-GDP lower than the EU average. This is due to widespread tax evasion and a relatively narrow tax base *e.g.* as a result of a multitude of tax exemptions and discounts. On the latter, the plan notes that, currently, out of ca €100bn of personal incomes declared only an amount of €30bn is taxed. To deal with these problems, the medium-term fiscal plan provides for a number of initiatives and actions -- already laid out in a special bill voted in parliament last April -- to rein in tax avoidance *(extra revenues from increased tax compliance are projected at €3.bn in 2011-2015)*. In addition, the government estimates that a number of measures aiming to broaden the tax base -- with respect to both direct and indirect taxes –will bring an additional €6bn to state coffers over the corresponding period. Finally, the MTFP notes that the government intends to review anew the entire tax system in September 2011, with a view to selectively reduce certain tax rates, provided that this will relive the poor, assist economic growth and have a broadly neutral budgetary effect.

At the local government level, the MTFP targets a net benefit for the general government budget of ca €1.3bn via the implementation of the so-called “Kaliktates” reform (voted in parliament in 2010). The reform aim to reduce/consolidate a vast number of local government entities, rationalize expenditure and boost revenues.

2011-2015 plan for privatizations and management of state assets

Additional to the measures highlighted above, the MTFP also provides full details about the program of privatizations and management of state assets. Overall €50bn is expected to be generated until 2015 from the sale and better utilization of state assets. Up to €15bn of that is sought to come from state companies (listed and non-listed) and infrastructure. Another €35bn will be generated from the sale of rights and developments of real estate assets. The government has already selected advisers for a significant number of projects, with procedures initiated for others. Furthermore, a special “Sovereign Wealth Fund” is being established to include all individual portfolios of State assets. If successful, the asset sales plan is expected to help reduce the country’s public debt-to-GDP ratio by some 20ppts cumulatively till 2015.

Among other assets, 2011 privatization targets include:

- Hellenic Telecommunications Organization
- Hellenic Postbank
- Piraeus Port
- Thessaloniki Port
- Thessaloniki Water & Sewage Company

Projected evolution of main fiscal variables under the medium-term plan

The medium-term fiscal plan provided detailed annual breakdowns of the projected evolution of key fiscal variables and budgetary components in the period 2011-2015. Some of there are highlighted below:

Under a <u>no-policy-change</u> scenario:

- General government budget deficit rises from 10.4%-of-GDP projected in 2011 to 14.4%-of-GDP in 2015
- Gross public debt ratio follows an explosive path, reaching 198.9%-of-GDP in 2015, from 142.8%-of-GDP estimated in 2010 and 160.6%-of-GDP projected in 2011.

Scenario envisioning implementation of medium-term fiscal plan

- General government budget deficit declines to 1.1%-of-GDP by 2015, from 7.4%-of-GDP projected in 2011
- Gross public debt rises to 159.3%-of-GDP (falls to 139.5%-of-GDP if €50bn plan of state asset sales is fully implemented) by 2015, from 157.7%-of-GDP (155.5%-of-GDP) projected in 2011.

MTFP: Brief assessment

We are planning to come up with a more thorough assessment of the MTFP in the coming days, but we provide below a brief assessment and number of points we deem worth mentioning:

- Passing of the medium-term fiscal plan appears in parliament appears to be a key prerequisite for a) the released of the 5th tranche of official lending to Greece under the existing EU/IMF bailout programme and b) agreement over a new financial package to Greece to cover State borrowing needs in 2012-2014.
- Provided that the MTFP will finally be voted in the Greek parliament, its rigorous implementation will be key for its success. This is particularly important as:
  - **a)** last year’s fiscal adjustment was primarily driven by horizontal cuts in wages and pensions as well as sharp hikes in a range of VAT and other indirect tax rates
  - **b)** With a vast volume of important EU/IMF-agreed legislation having already been passed in parliament, the government will now need

to tackle the "hard core" of its reforms agenda for significantly downsizing the public sector, reigning in tax evasion and promoting a more productive and competitive domestic macro environment

Lingering uncertainty over the domestic growth environment, signs of reforms fatigue within the government, rising social dissent about the (near-term) recessionary implications of the austerity measures and resistance from powerful trade unions and vested interests represent some of the main risks to MTFP implementation.

Table 1 - Greece: Medium-Term fiscal plan

Measures to address identified cummulative fiscal gap of €28bn in 2011-2015

Type of adjustment	€ mn	% of GDP
Streamlining of the public wage bill	2.2	0.9ppt
Reduction in operational expenses	1.2	0.5ppt
Closure/merger of pulbic entities	1.5	0.6ppt
Restructuring of state-owned enterprises	1.5	0.6ppt
Reduction in defence spending	1.2	0.5ppt
Streamlining of health expenditure	0.8	0.3ppt
Streamlining of pharmaceutical expenditure	1.1	0.4ppt
Reduction in social security funds expenditure & streamlining of other social spending	4.2	1.7ppt
Increase in social security funds revenue & tackling social security contribution evasion	3.1	1.2ppt
Increased tax compliance	3.5	1.4ppt
Reduction in tax exemptions & other tax revenue	6.0	2.4ppt
Increase in local government revenue	1.4	0.5ppt
Reduction of public investment expenditure	0.5	0.2ppt
Total	**28.2**	**11%**

Source: FinMin, Eurobank EFG Research

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