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Focus notes: Greece

Progress made in the latest round of negotiations with the troika and challenges the Greek government is likely to face in the period ahead

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This report takes a close look at the most recent macroeconomic and political developments in Greece, with an emphasis on the progress made in the latest round of negotiations between the Greek government and the troika on the fiscal and structural measures that need to be implemented as part of the conditionality underlying the present bailout programme. With an agreement having already been reached between the two sides on the bulk of new fiscal measures and prior actions to the disbursement of the next EU-IMF loan tranche, we present a detailed overview of what has already been agreed and the pending issues still lying ahead. Finally, based on the most recent information we managed to collect from a number of sources we believe to be reliable, we provide a timeline of the key dates and events that deserve close monitoring in the period ahead.

Troika staff teams conclude visit to Greece; agreement reached with domestic authorities on most of the required measures for the completion of 1st program review

According to a statement issued by the EC/ECB/IMF troika on October 17th, an agreement has been reached with the Greek government on the bulk of core measures required for the completion of the 1st programme review. As per the same statement, discussions on remaining issues will continue from respective headquarters and through technical staff in the field, with an intention to reach full agreement "over the coming few days". Financing issues will also be discussed in due course between the official lenders and the domestic authorities. In a similar note, Greek Finance Minister Yiannis Stournas expressed his optimism that a final agreement is likely to be sealed soon, paving the way for the release of the next EU-IMF loan tranche (€31.3bn) by mid-November. Troika inspectors left Athens late last week so as to brief European leaders about the progress of negotiations at the Oct. 18/19 EU Summit. In an official statement released upon completion of the last EU Summit, EU-17 leaders welcomed the progress made so far by the Greek government and the troika towards reaching an agreement on the policies underpinning the present adjustment programme, adding that they are looking forward to the conclusion of the 1st programme review. As per the same statement, the Eurogroup will examine the outcome of the 1st review in light of the troika's report and "will take the necessary decisions". Eurozone leaders also hailed the Greek government's determination to deliver on its commitments and acknowledged that "good progress" has been made to bring the adjustment programme back on track.

Issues on which agreement has reportedly been reached between domestic authorities and the troika

I. New fiscal austerity package for 2013-2014. This was a key programme benchmark for Q2 2012 that was actually missed due to the prolonged pre-election period.

Comments

— The new package is estimated to be worth ca €13.5bn in terms of net projected fiscal impact and to consist of ca €11bn in expenditure measures and €2.5bn in revenue-side measures.

— On the expenditure side, the main bulk of new measures (i.e., up to €7.8bn) will reportedly be generated from horizontal cuts in **(i)** pensions (estimated savings of €4.9bn, including €1bn from a 2-year increase in the retirement age to 67); **(ii)** public-sector wages (estimated savings of €1.7bn); and **(iii)** welfare benefits (estimated savings of €1.2bn). The remaining part of the expenditures package will reportedly come from structural measures i.e., savings from national defense, health care, education, local government, overhaul of the public administration, municipalities.

— On the revenue side, ca €1.5bn is expected to be generated by the abolishment of the tax-free threshold and a change in the scale of effective income tax rates for freelancers and self-employed. The remaining part of revenue-side measures will reportedly involve, among others, improved collections of taxes and social security system contributions to be generated from an upcoming overhaul of the national tax system.

II. Distribution of new fiscal measures over the coming two years. The two sides reportedly agreed on a front-loaded implementation profile for the new austerity package. Specifically, measures worth €9.2bn will be implemented in 2013 and the remaining €4.3bn in 2014. Note that the FY-2013 draft budget that was submitted to Parliament in early October envisaged implementation of new fiscal measures worth €7.8bn next year, with the remaining ca €5.8bn to be applied in 2014.

Comments

— As per a number of local press reports, the troika's demand for a more front-loaded implementation of new measures was based on more downbeat projections about the evolution of the general government primary balance relative to their earlier forecasts (March 2012) as well as the Greek draft budget assumptions. According to the updated IMF *Fiscal Monitor* released last week, Greece is projected to generate a broadly balanced general government primary position in 2013 and a primary surplus of 1.5%-of-GDP in 2014. On the other hand, Greece's FY-2013 draft budget targeted a 1.1%-of-GDP primary surplus next year, based on the assumption that new austerity measures worth €7.8bn would be implemented and real GDP would contract by a further 3.8% next year.

— €1.4bn in additional fiscal measures for 2013 (*i.e.,* over and above these assumed in the FY-2013 draft budget) would reportedly be generated from**: (i)** the annulment of the 13th & 14th installment in Agricultural Insurance Organization pensions (expected to yield €0.6bn in additional saving); **(ii)** deeper than initially expected cuts in main and supplementary pensions for state and private sector employees exceeding cumulatively €1,000 gross per month (expected to yield €0.2bn in additional saving). Specifically, a 3% cut (vs. 2% planned initially) will be applied for pensions amounting cumulatively €1,000-€1,500, a 6% cut (vs. 5% planned initially) for pensions amounting €1,501-€2,000 and a 12% cut (vs. 10% planned initially) for pensions exceeding €2,001; **(iii)** elimination of special tax exemptions (estimated to yield €0.45bn in saving); and **(iv)** abolition of special bonuses for pubic employees *i.e.,* special allowances for meeting agreed performance targets (estimated to yield €0.15bn in savings).

III. Adjustment clauses. *Comment:* Troika officials reportedly demanded the new package of austerity measures to incorporate an *adjustment clause*. Under that scheme, the fiscal package should indicate explicitly additional expenditure measures in the form of new cuts in wages, salaries and benefits that would need to be automatically implemented in FY-2014 should Greece's general government primary deficit exceed 0.5%-of-GDP in FY-2013. On its part, the Greek government has reportedly requested the inclusion of a clause of equivalent measures so as to potentially allow for a relaxation of the fiscal effort in FY-2014 should a primary surplus is generated in FY-2013. Reportedly, the two sides agreed that both clauses will be incorporated in the new fiscal package.

IV. **Fulfillment of as many as 89 "prior actions**". These prior actions that need to be complemented before the release of the second EU-IMF loan tranche were explicitly spelled out in the new Memorandum of Understanding (MoU) that was endorsed by the Greek Parliament in February, 2012. They apparently fell behind schedule due to the protracted pre-election period. ***Comment***: As a prerequisite for the release of the next EU-IMF loan tranche, the troika has reportedly requested the issuance of the related ministerial decrees as well as the promotion of respective legislation in Parliament. Reportedly, the Greek government intends to fulfill ca 80% of the 89 "prior actions" by late October and the remaining by the time EU officials give the green light for the disbursement of the next EU-IMF loan tranche. *(*For a brief overview of some important prior actions for the release of the next EU-IMF loan installment see ***Table 1*** in the *Annex* section of this report).

V. **Additional cuts in the operating costs of the health system.** This has reportedly been requested by the troika as a precondition for the release of the next EU-IMF loan tranche. ***Comment***: According to the local press, the Ministry of Health and Social Solidarity agreed to implement a number of saving measures to cover an estimated shortfall of ca €1bn in this year's budget of the National Healthcare Organization EOPPPY (see ***Table 2***).

Table 2: Cuts in the operating costs of the health system the two sides reportedly agreed

(i) 200mn cuts in compensations of those insured in EOPPY.
(ii) New list of prescribed drugs in order to save ca €300mn.
(iii) Prescriptions to be based on the active substance of a drug so to save ca €150mn. (Pending disagreements exist between the troika and the Greek side over the use of brand name or generic drugs).
(iv) Those insured in social security funds and chose private hospitals for their hospitalization will pay 30% of their expenses, from 15% currently.

VI. **Overhaul of the national taxation system.** According to the local press, a thorough overhaul of the national taxation system will need to be voted by Parliament as one of the key preconditions for the release of the next EU-IMF loan installment (see ***Table 3*** in the Annex section of the report).

Issues on which a compromise has not yet been reached between the Greek government and the troika

I. **New structural measures aiming to induce more flexibility in the domestic labor market and further compress wage costs**. The adoption of a number of new reforms in the domestic labor market has reportedly been requested by the troika as another important precondition for the resumption of official financing to Greece under the existing bailout programme. ***Comment***: It is important to note that according to the more recent Eurostat data, Greece is steadily closing its *wage-cost* competitiveness gap relative to EU peers and other main trade partner economies. Specifically, total nominal hourly labor costs in Greece fell by 11.5% YoY in Q1 2012, while the respective euro area and EU average measures increased by 1.5% YoY and by 1.4% YoY. As per the same data, Greece was the only EU country to record a double-digit decrease in the nominal hourly labor costs in Q1 2012, while only two other member states Slovenia and Portugal registered a fall of 1.2% and 1.3% respectively (for a brief overview on the new labor market reforms proposed by the troika see ***Table 4*** in the Annex section of this report).

II. **Immediate layoffs in the public sector,** so as to help attain an agreed target of reducing the total public sector employment by 150k over the period 2011-2015. Minister of Administrative Reform Antonis Manitakis, who has been openly opposing the troika's request for outright layoffs in the public sector, presented an alternative plan for a reduction in the number of civil servants. Under the plan, up to 11,000 public employees who (i) have been found guilty of serious discipline offenses or have an administrative inquiry ordered against them (estimated at around 8,500); or (ii) are unjustifiably absent from their work for a long period (estimated at around 2,500) would be removed from the public sector in due course. In parallel, the government intends to place in redundancy status some of the

20,000 employees of closed or merged state entities who will score poorly in regular evaluation tests (note that the first test will not be completed before early 2013), or/and have limited qualifications. Under the latter scheme, employees would be transferred to a special labour reserve and would be receiving 75% of their basic monthly salary for a year before being subject to permanent separation. ***Comment:*** The troika technocrats expressed reservations over the enforceability of Mr. Manitakis' proposal and requested the provision of relevant data (e.g. number of employees to be made redundant, identification of the public entity they are employed, detailed timeline and estimated savings from redundancies, timeline of evaluation tests or administrative inquiry orders against perjury employees). The troika technocrats reportedly demand some 3k-4k public-sector employees to be dismissed by the end of 2012, as a sign of the government's determination to implement public administration reform.

Other important issues that deserve close monitoring in the period ahead

I. Sources of funding to cover the financing gap ensuing from a 2-year extension in the country's fiscal adjustment pogramme. According to reports, a 2-year extension in Greece's fiscal programme was discussed at the October 8 Eurogroup.

Comments

— IMF Managing Director Christine Lagarde was one of first senior officials to back openly such a proposal. Speaking at a news conference during the annual meeting of the IMF and the World Bank earlier this month, the IMF head argued that, given the deeper-than-expected recession and lingering market pressure, Greece should be granted an additional 2-year period to meet its fiscal targets. Ms. Lagarde's comments came in the wake of the IMF updated *World Economic Outlook*, which acknowledged that multipliers used in generating growth forecasts "have been systemically too low since the start of the Great Recession". Along similar lines, European Commissioner for Economic and Monetary Affairs Olli Rehn was quoted as saying on the sidelines of the same event that Greece's official lenders are considering giving the country more time to implement its fiscal adjustment programme.

— A number of press reports suggested recently that, according to some estimates, the ensuing financing gap from a 2-year time extension in Greece's adjustment programme could reach between €15bn and €40bn. On its part, the Greek finance ministry estimates that a 2-year extension would necessitate some €12bn in additional funding and that "technical solutions" could be found to cover the ensuing borrowing gap without having to commit new funds from the official sector. The ministry reportedly estimates that the ensuing financing gap could rise to €25bn under an adverse scenario envisaging significant privatization revenue shortfalls, higher bank recapitalization needs than currently estimated, a deeper-than-expected recession and slippages in the fiscal consolidation program.

— While the prospect of committing fresh official funds to finance a 2-year extension in Greece's fiscal program has been ruled out by a number of high-level EU officials, the Greek government reportedly considers a number of alternative financing sources, including: **(i)** increased T-bill issuance vs. what is projected in the March 2012 EC/ECB/IMF baseline scenario***;*** **(ii)** an extension of the repayment profile of old GGBs held in ECB portfolios and maturing between 2013 and 2016***;*** **(iii)** a reduction in the interest rate (3m Euribor+ 150bps) on the EU bilateral loans Greece received under the 1st bailout programme (€52.9bn); (**iv)** higher-than-projected privatization revenue/ renting out of public property; and (**v)** the ECB and central banks of the Euro system to pass on to Greece coupon income and implicit capital gains from their GGB portfolios. The ECB and Eurosystem national central banks are estimated to hold ca €46bn of old GGBs (in notional terms). Regarding option (ii), note that ECB President Mario Draghi said recently that the prospect of the central bank rolling over or rescheduling its SMP portfolio of GGBs would constitute monetary financing which is against the central bank's policy rules.

II. Updated DSA scenarios. The IMF seems to be of the view that more austerity will not be enough to bring Greece's public debt-to-GDP ratio towards a sustainable m-t path and that a comprehensive solution to lighten the debt burden (including *e.g.* some form of Official Sector Involvement) is urgently needed to put the country's adjustment programme back on track. ***Comment***: IMF Managing Director Christine Lagarde indirectly broached that issue in a speech late last month. Ms. Lagarde stressed that the worsened economic conditions and programme implementation slippages have created a financing gap in Greece that can not be solved by budgetary measures alone and that the overall debt burden should be addressed as part of the equation. On the other hand, a group of eurozone member-states, including Germany, reportedly consider an OSI for Greece as a politically unpalatable idea. Speaking during the annual meeting of the IMF and World Bank earlier this month, German Finance Minister Wolfgang Schaeuble insisted that any restructuring of Greek debt including official sector involvement (OSI) is not an option as it would legally prevent numerous euro area member states from offering any fresh aid or guarantees to countries in need in the future. The IMF is a preferred creditor, leaving the ECB and eurozone governments bearing the main cost of any new restructuring of Greek public debt involving the official sector. As per the IMF's updated *Fiscal Monitor* (Oct. 2012), Greece's debt-to-GDP ratio is now seen peaking at 181.8% in 2013 (upwardly revised from 167.3%-of-GDP projected in the troika's March 2012 baseline) before falling to 152.8%-of-GDP in 2017 (vs. 137.5%-of-GDP in March 2012). Reportedly, the IMF now forecasts Greece's debt-to-GDP ratio falling to 120% or lower not earlier than 2023.

Events timeline and challenges to be faced by the Greek government in the way to the release of the next EU-IMF loan tranche

As things stand at this point, the Greek government hopes that a final agreement with ruling coalition leaders and the troika on a number of pending issues will be sealed before the *Euro Working Group* meetings of October 26 and October 29. The agenda of the said meetings will reportedly include: (**i)** the 1st review of the present adjustment programme for Greece; and **(ii)** the progress made so far by the Greek government in fulfilling the requirements for the next EU-IMF loan tranche release. According to the local press, one can not rule out completely the possibility of an extraordinary Eurogroup taking place in late October/early November - *i.e.,* ahead of the scheduled November 12 Eurogroup - , with the sole purpose of addressing the Greek case.

But, before the troika gives the green light for the release of next loan tranche, the Greek government needs to clear a number of important hurdles. Specifically, the Greek Parliament has to approve: **(i)** the FY-2013 budget; **(ii)** the new package of austerity measures (€13.5bn) for the period 2013-2014 and the updated MTFS; and **(iii)** a multibill incorporating the required legislation for the 89 prior-actions along with additional cuts in the operating expenses of the health system, new labor market reforms and an overhaul of the national tax system. According to the local press, the Greek government intends to have all these measures voted in Parliament before the November 12 Eurogroup.

As things stand at this point, parliamentary approval of the new measures may not prove an easy task. In a meeting of Greek coalition party leaders early last week, the heads of the two junior political parties raised red lines against the troika's demand for new labor market-related structural measures. Specifically, PASOK head Evaggelos Venizelos blamed the troika for deliberate delays in negotiations with the Greek government, stressing that no further labor market reforms will be accepted beyond the package of relevant measures approved by Parliament in February 2012 (i.e., as a key prior action to the signing of the present bailout programme). Separately, press reports quoted last week an unnamed PASOK official as saying that Democratic Left's support was a precondition for PASOK to back new labor reforms.

On his part, Democratic Left leader Fotis Kouvelis stated clearly that his party would refuse to cast a positive vote on the new austerity measures should they incorporate the troika's proposed labor market reforms. The head of the junior partner described the latter as "utterly destructive", arguing that they exceed the endurance of the Greek society. Separately, Greek Premier Antonis Samaras announced on Sunday his decision to expel Mr. Nikos Stavrogiannis from his party's parliamentary group after the latter was quoted as saying in a newspaper interview that he intends to vote against the new austerity measures.

We remain on the view that new austerity package will be finally ratified by the Greek Parliament, but, in view of the aforementioned, we would not out rightly exclude dissenting votes from some coalition MPs *(up to 3 from democratic Left and 3-6 from Pasok, according to some media reports).* As a reminder, the tripartite ruling coalition controls 179 seats in the 300-seat Parliament; *New Democracy* controls 129, socialist *PASOK* 33 seats and *Democratic Left* 17.

Provided that the Greek Parliament has endorsed all prerequisites for the unlocking of the next aid installment (and the troika has issued a broadly constructive 1st review on the present adjustment programme), the November 12 Eurogroup is expected to give the green light for the disbursement of the next EU-IMF loan tranche. Once the green light is given, official lenders will reportedly consider ways to finance a 2-year extension in the country's adjustment programme and possible ways to make Greece's debt sustainable long term.

Next EU-IMF loan installment to be reportedly paid into an escrow account

Press reports published last week suggested that, the next EU-IMF loan tranche will be put into an escrow account in the Bank of Greece instead of being paid directly to the Greek government. This segregated account was established earlier this year, upon official lenders' demand, to ensure that priority is granted to debt servicing payments. As per the same reports, the Greek government will be allowed to withdraw funding gradually, dependant on its progress to the implementation of the adjustment programme. Under the present programme, the next EU-IMF loan tranche will amount to €31.3bn and will consist of: **(i)** €29.6bn in EFSF financing; and **(ii)** €1.65bn in IMF funding under the new 4-year Extended Arrangement for Greece. In a recent newspaper interview, Greek Prime Minister Antonis Samaras said explicitly that in the absence of timely release of the next EU-IMF loan installment, the country will face bankruptcy by late November. Separately, some local press reports suggested that the troika will seek Greece's new *Letter of Intent* to be signed not only by Prime Minister Antonis Samaras, Minister of Finance Yiannis Stournaras and Governor of the Bank of Greece, Giorgos Provopoulos but also by the two coalition party leaders, PASOK head Evaggelos Venizelos and Democratic Left head Fotis Kouvelis so as to ensure the maximum possible political commitment.

Annex

Table 1– Important "prior actions" to the release of the next EU-IMF loan tranche

Health care system

- Newly established National Organization for Healthcare Provision (EOPPY) to rationalize the number of contracts with private doctors so as to bring the *doctor-to-patients* ratio down towards the (much lower) EU average.
- The Ministry of Health and EOPPY (and the other social security funds when they merge) to establish an effective monitoring system for drug prescriptions.

Fiscal Consolidation

- Legislation to be enacted for an average reduction of 12% in the so-called "special wages".

Tax policy

- Government to prepare a tax reform aiming to simplify the tax system, broaden the tax base, eliminate a multitude of tax exemptions and preferential regimes.
- Web publication of the key performance indicators for the tax authority.
- Effective tax administration; the government to complete a formal performance review and replace managers who do not meet performance targets.
- The government to start publishing on the web monthly data on the defined "tax refunds in arrears" with a lag of 20 days after the end of each month.
- The Code of Books and Records to be repealed and be replaced by simpler legislation.

Asset management and privatization

- Government to submit to the EU Commission information on the financial situation of each state asset that is expected to be privatized in the course of 2012.

Bank recapitalization

- Legislation to be enacted to support the strategy for bank recapitalization and resolution (i.e., capital adequacy requirements, technical aspects of bank resolution, recapitalization framework, resolution framework).

Adjustment of labour market and strengthening of labor market institutions.

- Adoption of new legislation aiming to determine by law the wage floors set by the National General Collective Agreement (NGCA). *Comment*: The Ministry of Employment, Social Security & Welfare made known last week the timeline for the final adoption of this specific scheme. Note that discussions between the Greek government and social partners over the determination of the minimum wage began in July 2012 and they are expected to conclude by the end of this month. Taking into consideration the social partners' proposals, the government will proceed by the end of this year with the required legislation of the new scheme. The respective legislation will be voted in Parliament by the end of January 2013 and will enter into force in April 1st, 2013.
- Government to enact legislation aiming to reduce social contributions to IKA (the largest Social Insurance Institute) by 5 percent and implement measures to ensure that this is budget neutral.

Business environment and enhanced competition in open markets.

- Full liberalization of remaining closed professions (*e.g.* lawyers, taxi drives, pharmacists).
- Effective implementation of EU rules (e.g. recognition of professional qualifications, franchised diplomas) in key services sectors such as retail (e.g., open air markets), agriculture (e.g., slaughter houses), employment (employment agencies) real estate and technical services.
- Adoption of legislation enforcing each professional association to publish on the webpage information related to the amounts of the applicable fees broken down by type and nature of service.

Table 3 – Key components of the new tax reform

(i) Retrospective elimination as of this year, of all tax exemptions (e.g. medical expenses, the interest on mortgage loans for the purchase of first home) except disability benefits. Special tax discounts and other favorable tax measures for habitants in border areas and in Aegean islands (i.e., for whom the tax-free threshold stands 1/3 higher at €7,500 annually) will also be abolished.

(ii) Retrospective elimination as of this year of all family allowances and tax exemptions related to the number of dependant children (currently €2,000 for one child, €4,000 for two children, €7,000 for three children and €10,000 for more than three children). Instead, families will receive a special allowance, that will be provided based on income criteria and directly from the tax authorities and not by Agricultural Insurance Organization (OGA), prefectures etc. as is currently the case.

(iii) Introduction of a comprehensive property tax for all real estate assets, including farmland, which will replace all other taxes imposed currently on property. The new tax will be scaled; the Ministry of Finance is reportedly considering rates starting from 0.1% and reaching up to 3% or 4%. There will be a tax free threshold of €100k.

(iv) The appointment of a specially-assigned general secretary from the Ministry of Finance to oversee the collection of taxes. The official who will fill the newly established post will be responsible for overseeing the crimes squad, tax offices and other tax-related bodies and to assist the government in its attempt to clamp down on evasion and increase revenue collection.

(v) The Code of Books and Records to be repealed and be replaced by simpler legislation.

(vi) Introduction of new penalties for tax offenses and tax evaders; measures to improve protection of those denounce corruption in the tax mechanism.

(vii) Closing of cashiers in all tax offices and introduction of mandatory payment of all taxes through the banking system.

Table 4: New labor market reforms the troika reportedly required

(i) 50% reduction in lay-off compensation. _Comment_: For dismissed employees who have worked with the same employer for *more than* 16 consecutive years, the troika reportedly proposed a ceiling of 12-month salaries (vs. 24 currently) along with a special bonus of 6 minimum wages (6*€586/month= €3,516). Instead, the government reportedly proposed the level of the severance pay to be proportional to the number of working years. Local press reports suggested over the weekend that the two sides agreed that dismissed employees who have worked with the same employer for *up* to 16 consecutive years will maintain their right for compensation equal to 12-month salaries.

(ii) Increase in the number of maximum workdays from 5 currently to 6 per week, in both public and private sector. The government reportedly argues that the number of working hours per week should not exceed 40 and employees should have the choice to approve or reject this scheme in the context of collateral contracts.

(iii) Abolishment of: (a) a 9% automatic increase in the minimum wage set by the National General Collective Agreement (NGCA) after every three years of continuous employment; and (b) special benefits attached to the minimum wage, including the marriage allowance as of April 1st, 2015. _Comment_: The two sides reportedly agreed automatic three-year pay rises to employees earning the minimum wage to be *frozen* rather than abolished (as the troika had reportedly initially proposed).

(iv) Minimum daily rest time to 11 consecutive hours between shifts from 12 currently.

(v) Delinking of working hours of employees from the opening hours of establishments.

(vi) The two-week consecutive leave to be taken any time during the year in seasonal sectors.

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