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Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

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Editor
Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Adjustment in twin deficits continues; signs of stabilization in domestic economic activity increase despite lingering risks

Summary of views

This report takes a close look at the evolution of Greece's twin deficits based on the most recent balance-of-payments statistics and the data for the State Budget execution. Moreover, it provides an assessment of recent developments in the real economy, taking into account the flash Q2 GDP release and a range of real activity and sentiment indicators signaling an ongoing stabilization of domestic economic conditions.

The main views expressed herein are as follows:

The government remains broadly on track to meet its 2013 fiscal targets. Furthermore, we now assign a high probability of a small general government primary surplus this year that would open the door for additional debt-relief measures from official lenders, in line with the explicit commitments provided at the 26/27 November 2012 Eurogroup.

The external imbalance continues to adjust rapidly, assisted by strong tourism revenue, the ongoing contraction of imports and the beneficial impact of earlier debt-relief measures on the income account. The current account deficit is now seen heading towards 1%-of-GDP or lower levels this year, from 2.9%-of-GDP in 2012.

Considerable risks continue to surround the near-term domestic economic outlook. Yet, the apparent stabilization of seasonally-adjusted output dynamics in Q2 2013 and the ongoing improvement in a range of real activity and sentiment indicators signal a more broad-based bottoming out of the domestic recession in the period ahead.

1. State Budget execution data for first 7 months of this year signal government on track to meet 2013 fiscal targets

1.1 7-month central government budget deficit sharply lower than expected, primary balance records 1.4%-of-GDP surplus

Preliminary data for the state budget execution in the first seven months of the year revealed a much better-than-expected headline outcome. The central government balance recorded a deficit of around €1.9bn (or ca 1%-of-GDP), which compares with a 7-month deficit target of €7.5bn envisaged in the revised medium-term fiscal plan (MTFS 2013-2016) and a shortfall of €13.2bn recorded in the same period a year earlier. As a result, the central government budget gap in January-July 2013 amounts to only 22.6% of the corresponding full-year deficit target, leaving a sizeable cushion to absorb any unforeseen slippages in the following months without necessarily threatening the ESA-95 programme targets for FY-2013.[1,2] In a similar vein, the state budget primary balance (that excludes interest payments) recorded a surplus of €2.57bn (ca 1.4% of GDP), compared to a corresponding 7-month deficit target of around €3.14bn (MTFS) and a shortfall of €3.08bn recorded in January-July 2012 (Table A1).

In More detail, the breakdown of the state budget execution data in January-July 2013 revealed the following trends:

- Ordinary budget gross revenue (i.e., before tax refunds) declined by 0.6% YoY, outperforming by ca €70mn the corresponding 7-month target set in the revised MTFS.

- Thanks to significantly lower tax rebates relative to the same period a year, net ordinary budget revenue (i.e., after tax refunds) grew by 4% YoY, resulting in a outperformance of the corresponding MFTS target by around €746mn.1 The main drivers of the aforementioned outperformance relates to an increase in net ordinary budget revenue in July 2013, as a result of:

  i. The transfer to Greece of future incomes accruing to the GGB holdings in the ECB's SMP portfolio (€1.5bn) and the Eurosystem NCB's ANFA portfolio (€29.5mn).[4,5,6]
  ii. Additional non-recurring revenue of €178mn, stemming from the off-budget accounts and the bank liquidity support plan.
  iii. The outperformance of corporate income tax (CIT) revenue by €82mn (or 48.3%) relative to the corresponding MTFS target, which helped to partly offset slippages incurred in the prior two months.

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[1] The latest revision of Greece's 2nd adjustment programme foresees a general government deficit of 4.1%-of-GDP along with a balanced primary position in FY-2013.
[2] As a comparison, the state budget shortfall in the first 7 months of last year covered around 84.3% of the 2012 deficit target.
[3] The sharp year-on-year decline of tax refunds in the first 7 months of 2013 can be attributed to, among others, administrative bottlenecks caused by a new risk-based system for VAT refund claims validation.
[4] The SMPs revenues had not been taken into account in the 2013 State Budget, because they are stemming from the European Council deficit of 26/27 November 2012, which came after the Budget was voted in Greek Parliament.
[5] Another source of financing to the Greek budget, albeit an indirect one, relates to the potential rollover of Greek government bonds (GGBs) held in the euro area NCBs investment (ANFA) portfolios. According to recent press reports, the potential rollover of ANFA holdings as a means of securing additional financing to Greece is currently under discussion with euro area authorities. As per the European Commission report on the first review of Greece's second adjustment programme (Dec 2012, page 54), the revised troika baseline scenario for the general government financing needs and sources of funding assumes a rollover of ANFAs holdings on equal terms, while acknowledging that this option would still need to be assessed and independently decided by NCBs. Such a rollover would reduce the financing need and smoothen the debt repayment profile over the programme period, without having a significant impact on the evolution of the debt-to-GDP ratio. As per the same source, the overall financing secured by the rollover of ANFAs holdings would amount to €3.7bn in 2012-2014 and €1.9bn in 2015-2016. Up to his point no decision has been reached on the potential rollover of GBBs held in the investment portfolios of euro area national central banks (NCBs) and, as a result, Greece has paid €1.8bn. In H1 2013 for the settlement of maturing ANFA GGBs.

iv. Higher indirect tax receipts (by €247mn or 11.1%) relative to the MTFS target for July 2013, thanks to substantial increases recorded in VAT and excise tax on tobacco.

v. Higher receipts in other non-tax revenue categories.

Table A1 – State Budget execution in January-July 2013 (modified cash basis in EURmn)

	Jan-Jul 2012	Jan-Jul 2013				FY-2012	FY-2013		
	Realization	Realization		Revised MTFS (2013-2016) target 1/	Deviation	Realization 2/	Revised MTFS (2013-2016) estimate	Budget 2013 target	
	€mn (1)	€mn (2)	YoY % (2)/(1)	€mn (3)	€mn (4) =(2)-(3)	€mn (5)	€mn (6)	(7)	YoY % (6)/(5)
I. Ordinary budget balance (A-B)	**-12,731**	**-3,734**	**-70.7%**	**-6,458**	**2,724**	**-13,174**	**-6,730**	**-9,480**	**-48.9%**
A. Ordinary budget net revenue *(a1+a2-a3)*	**25,839**	**26,862**	**4.0%**	**26,116**	**746**	**48,325**	**46,727**	**46,322**	-3.3%
a1. Ordinary budget gross revenue *(before tax returns) 3/*	27,874	27,702	-0.6%	27,632	70	51,482	49,542	49,137	-3.8%
a2. Special revenue from licencing and public rights	0	65		47	18	15	86	86	
a3. Tax refunds	2,035	905	-55.5%	1,563	-658	3,172	2,901	2,901	-8.5%
B. Ordinary budget expenditure *(b1+b2+b3+b4+b5)*	**38,570**	**30,596**	**-20.7%**	**32,574**	**-1,978**	**61,499**	**53,457**	**55,802**	**-13.1%**
b1. Primary expenditure	27,967	25,115	-10.2%	26,994	-1,879	47,529	45,150	45,050	-5.0%
b2. Loan disbursement fee to EFSF	0	124		113	11	541	130	75	-76.0%
b3. Military procurements (cash basis)	143	136	-4.9%	224	-88	410	750	750	82.9%
b4. Guatantees called	327	737	125.4%	857	-120	796	1,027	1,027	29.0%
b5. Net interest payments	10,133	4,484	-55.7%	4,387	97	12,224	6,400	8,900	-47.6%
II. Public investment budget (PIB) (C1-C2)	**-485**	**1,817**	**-474.6%**	**-1,070**	**2,887**	**-2,513**	**-1,714**	**-1,714**	**-31.8%**
C1. PIB net revenue	1,798	3,937	119.0%	2,380	1,557	3,601	5,136	5,136	42.6%
C2. PIB expenditure	2,283	2,120	-7.1%	3,450	-1,330	6,114	6,850	6,850	12.0%
III. Central government budget balance (I+II)	**-13,216**	**-1,917**	**-85.5%**	**-7,528**	**5,611**	**-15,687**	**-8,444**	**-11,194**	**-46.2%**
Central government primary balance (III+b5)	**-3,083**	**2,567**	**-183.3%**	**-3,141**	**5,708**	**-3,465**	**-2,044**	**-2,294**	**-41.0%**

Source: MoF, Eurobank EFG Research
1/ Target as included in the revised Medium Term Fiscal Strategy 203-2016).
2/ Data for FY-2012 are provisional and will be finalised following the Parliament ratification of the annual budget outcome review for 2012
3/ Includes an ammount of €1.5bn coresponding to the tranfer of future incomes stemming from Securities Market Program (SMP) that had not been taken into account in the 2012 State Budget

[6] Note that the €1.5bn transfer from the SMP portfolio constitutes part of the last EU loan installment (€4bn) released to Greece in July 2013. Upon fulfillment of a number of important prior actions and milestones to be reviewed in the context of the next troika review, Greece will be entitled to receive by end October 2013 another EU loan installment, consisting of €0.5bn equivalent to the income accrued to the SMP portfolio and €0.5bn from the EFSF.

- Higher recurring and non-recurring revenue in July 2013 (as detailed in items i to v above) more than offset slippages during that month in personal income tax revenue due to an extension given to the submission of income tax declarations as well as a further accumulation of direct tax arrears as a result of the delay in the collection of the main wealth tax on property (FAP 2011).

- On the expenditure side, ordinary budget primary outlays in January-July 2013 declined by 10.2% YoY, undershooting by around €1.88bn (or 1ppt of GDP) the corresponding MTFS target.[7] Furthermore, net interest payments declined by 55.7% YoY, thanks to the debt restructuring (PSI) and buyback operations conducted last year. As a result of the above developments, ordinary budget expenditure declined by 20.7% YoY, coming in significantly lower than the corresponding 7-month MTFS target.

- In the Program Investment Budget (PIB), higher net revenue (by €1.56bn) and lower expenditure (by €1,33bn) relative to the corresponding MTFS targets for January-July 2013 also facilitated the attainment of a better-than-expected central government deficit outcome over that period. We expect PIB spending to catch up with programme targets over the remainder of the year, a development that would provide some support to the domestic economic activity, especially given the high fiscal multipliers of public investment expenditure.[8]

1.2 Attainability of 2013 fiscal targets

In our July 18th Greece Macro Monitor we presented some basic arguments supporting the attainability of 2013 fiscal targets.[9] In what follows, we update these views taking into account the latest budget execution data and we also provide a more thorough analysis of the risks to the fiscal outlook lying ahead. More specifically,

i. As noted the previous section, the latest available cash-basis data on the state budget execution showed that the central government deficit in January-July 2013 undershot by €5.6bn (or around 3 ppts-of-projected GDP) the corresponding target envisaged in the revised medium-term fiscal plan. Furthermore, despite delays in the issuance of property tax bills and a decision to extend the deadline for the submission of income tax declarations, the realized central government shortfall in the first seven months of this year covered only 22.6% of the respective MTFS full-year deficit target. This constitutes a much lower coverage rate relative to that in the same period a year earlier, pointing to a considerable fiscal cushion created already to address any potential slippages incurred in the remainder of the FY-2013 accrual period.

ii. The last troika mission to Greece identified a number of shortfalls over the 2013-2014 period that could generate deviations from the agreed fiscal targets, equivalent to as much as 0.5ppts-of-GDP per annum this year and the next. Presumably, these shortfalls could be generated by, among others: a) delays in the issuance of a number of property tax bills; b) the government's decision not to implement a number of earlier-agreed measures for 2014, including the application of the new wage grid to armed forces and the implementation of a solidarity levy for the self-employed; and c) a reevaluation of the projected yield of certain revenue categories (e.g. social security contributions).

[7] A detailed breakdown of primary expenditure in the first 7 months of the current year has not yet been published, but available data for H1 2013 reveals that this has been mainly driven by lower salary and pension payments, which is by far the biggest component of state budget expenditure.
[8] See Monokroussos and Thomakos (2013), *"Greek fiscal multipliers revisited: Government spending cuts vs. tax hikes and the role of public investment expenditure"*, Eurobank Research, March 2013.
[9] See: a) Greece Macro Monitor, "Attainability of 2013 fiscal target, medium-term financing gaps and the case for new OSI", Eurobank Research, 18 July 2013 and b) IMF Country Report No 13/20, January 2013.

iii. According to troika staff calculations, item a) alone could result in a revenue slippage of around 0.3ppts-of-GDP this year, as considerable delays in the issuance of property tax bills (and the recent extension of deadlines for submitting tax declarations) may shift tax collections in part beyond the 2013 accrual period.[10] Such a backlog of tax payments due in a relatively short period of time could lead to tax collection delays and also depress disposable incomes, exacerbating the ability of taxpayers to service their tax obligations.[11] However, as we explained earlier, the government has already agreed with the troika (and adopted as a part of the prior actions to the latest EU loan disbursement) a number of measures, aiming to offset the aforementioned slippages. These include, among others, the frontloading of a luxury tax, the imposition of a special solidarity surcharge on income from interest and deposits, an increase in fees for lawsuits and a claw back mechanism in healthcare expenditure on diagnostics and private clinics so as to prevent expenditure deviations from fiscal targets.

iv. As noted in the last European Commission report for Greece[12], the budgeting and expenditure monitoring of the social budget still remains unsatisfactory, leading to significant uncertainty as regards revenue collections and spending overruns. Furthermore, the revenues from the newly introduced installment scheme for the collection of tax and social security contribution debt may deviate from the programmed targets, with the ensuing uncertainty expected to recede not earlier than the end of the current year, when the aforementioned schemes start to generate tangible results.

v. Another source of potential deviations from 2013 revenue targets relates to a recent government decision to reduce the VAT on restaurants and catering from 23% to 13%, with effect from 1st August until end-December 2013. According to troika staff calculations, the expected loss of revenue in 2013 from this temporary VAT reduction would amount to ca €130mn, with the ensuing shortfall to be mainly covered though cuts in the military procurement programme. According to local press, only a small fraction of restaurants and catering establishments have so far passed the VAT cut to the final consumer. In any case, the ensuing slippage in VAT revenue may prove lower than estimated presently, thanks to a record year for tourist inflows in Greece.[13]

vi. Notwithstanding the aforementioned problems, there is currently little uncertainty as regards the implementation of the fiscal package for 2013 & 2014, as most of it relies on (already-implemented) cuts in wages, pensions and operating expenditure (Table A2).

vii. Taking into account all aforementioned factors, we continue to expect fulfillment of the FY-2013 fiscal targets and we even see a good chance for the generation of a small general government primary surplus in ESA95 terms. Besides its signaling significance, such a development could open the door for a decision by official lenders to offer additional debt relief to Greece, as agreed in the 26/27 November 2012 Eurogroup.[14]

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[10] More specifically, between July 2013 and February 2014 Greek taxpayers will need to pay as many as nine different taxes, for a total notional amount, which, according to some reports, may well exceed €8bn (or 4.5% of GDP). These include: the personal income tax (PIT) for incomes earned in FY-2012 (issuance of PIT declarations began already); special levy on self-employed; special solidarity levy; wealth tax on property (FAP) for the fiscal years 2011, 2012 and 2013; PPC levy collected through electricity bills (5 installments); new luxury tax; and annual vehicle registration duty.

[11] At the end of 2012, unpaid obligations reached €56bn for taxes and more than €12bn for social security contributions. To deal with this problem, the Greek government introduced recently a couple of installment schemes (a basic one and one-off "Fresh Start' installment scheme) that will replace a multitude of earlier schemes, carrying amnesty-like features.

[12] European Commission Occasional Papers 159/July 2013, "The Second Economic Adjustment Programme for Greece Third Review – July 2013".

[13] According to the Association of Greek Tourist Enterprises (SETE), tourist arrivals this year are expected to 17 million, with direct tourism revenues amounting to €11bn (up by more than 10% relative to the prior year).

[14] For a more thorough analysis on this issue see Greece Macro Monitor, "Attainability of 2013 fiscal target, medium-term financing gaps and the case for new OSI", Eurobank Research, 18 July 2013.

Table A2 – Package of new austerity measures 2013-2016

(Percent of GDP)

New Fiscal Measures	2013-14	2015-16
Expenditure Measures	5.10	0.04
Compensation of employees	0.79	0.01
Social Security transfers	3.23	0.04
Subsidies	0.09	0.01
Intermediate consumption	0.75	-0.01
Gross fixed capital formation	0.24	0.00
Revenue Measures	2.06	0.02
Direct taxes	0.90	0.01
Indirect taxes and sales	0.61	0.00
Social security contributions	0.38	0.00
Total	7.15	0.06
Memorandum item:		
Tax administration gains	0.34	1.30

Source: IMF staff estimates
1/ Fiscal measures introduced at the first review

1.3 Longer term fiscal outlook

From a longer term perspective, Greece's medium-term fiscal outlook continues to be surrounded by considerable risks, not least because of the severe domestic economic situation and uncertainty regarding the longer-term impact of current efforts to downsize the public sector and repair the tax collection mechanism.

Nonetheless, in the absence of substantial implementation slippages in the applied adjustment programme (and/or sizeable deviations from the envisaged baseline macro scenario), the key medium-term term target of reaching a 4.5ppts-of-GDP primary surplus by 2016 does not seem to be out of reach, especially if one interpolates from past experience with major fiscal adjustment efforts in Greece.

For instance, a major fiscal effort over the 7-year period preceding euro area entry resulted in considerable primary surpluses, to the tune of 3.6%-of-GDP/annum on average in 1994-2000. Given then the significant fiscal effort currently underway (Greece's cyclically-adjusted primary balance by far the highest in EU-17, currently), we don't see why Greece could not generate primary surpluses of the targeted size over the coming years.

More imminently, the ongoing implementation of fiscal structural reforms and the planned introduction of a new property tax to replace both the existing real estate tax collected by the electricity company (PPC levy) and the wealth tax on property (FAP) create uncertainty as regards the fulfillment of the FY-2014 fiscal targets.[15] The issue is expected to be more thoroughly examined in the context of the next troika review (September 2013).

[15] The new property tax is expected to be revenue-neutral, raising some €2.7-2.9bn/annum from 2014 onwards.

2. Greece's external sector adjustment picks up momentum; current account deficit heading to 1%-of-GDP or lower in 2013

2.1 Current account developments in H1 2013

In an empirical study on the determinants of Greece's current account (CA) we published in April 2012, we projected a much faster adjustment in the external position relative to that foreseen in the troika's earlier baseline scenario, forecasting back then a switch into a positive current account balance as early as in 2016.[16,17] That is, assuming a rigorous implementation of the labor market reform and the fiscal measures agreed as part of the conditionality underlying the present bailout programme.

Bank of Greece's balance of payments statistics over the last 18 months or so reveal that the adjustment in the country's external deficit is actually occurring at much faster pace than implied by even our earlier (relatively upbeat) forecasts. In H1 2013, the account deficit underwent a further significant adjustment, contracting by €4bn relative to the same period a year and reaching €2.9bn or around 1.6% of projected full-year GDP. This positive development was mainly the result of a further sizeable decline in the trade deficit and, to a lesser extent, a narrowing of the income account deficit as well as respective increases in the current transfers and services surpluses (Table B1).

In more detail, the trade deficit shrank by €2.8bn in January-June 1013, primary driven by a decline in the net oil import bill by €2.0bn (or 36.1% YoY). Separately, Receipts from exports of goods excluding oil and ships rose by 2.9%, while the corresponding import bill fell by 4.1% (Graph 1.1 depicts the evolution of year-on-year growth of merchandise exports excluding oil & ships).

Apparently the ongoing decline in imports is primary the result of weak domestic demand due to the domestic recession and the fiscal austerity programme. On the other hand, the positive growth of merchandise imports reflects improved competiveness, not only from a relative *labor-cost* perspective, but also because of recent improvements in a range of institutional factors determining competitiveness (see analysis below). These trends are also manifested in the most recent *customs-based* statistics, which are believed to provide a more accurate picture of merchandise trade flows (Graph 1.2).

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[16] See Monokroussos and Thomakos, Eurobank Research *"A technical study on the determinants of Greece's current account position"*, April 2012. (http://www.eurobank.gr/Uploads/Reports/Economy%20%20Markets%20Apr2012.pdf)

[17] See e.g. IMF Country Report No. 12/57 (http://www.imf.org/external/pubs/ft/scr/2012/cr1257.pdf)

Table B1 – Greece: Balance of payments components (EURmn – provisional)

		January-June 2011	January-June 2012	January-June 2013
I	**Current account (I.A + I.B + I.C + I.D)**	**-12,726.0**	**-6,910.5**	**-2,882.7**
I.A	Goods	-14,209.0	-11,076.3	-8,266.9
	Oil balance	*-5,591.0*	*-5,661.7*	*-3,620.3*
	Ships' Balance	*-1,679.5*	*-657.7*	*-550.5*
	Trade balance excluding oil and ships	*-6,938.5*	*-4,756.9*	*-4,096.2*
I.B	Sevices	4,538.3	4,983.2	5,499.6
	Travel (net)	*2,023.9*	*1,903.8*	*2,483.0*
	Transportation (net)	*3,113.9*	*3,571.9*	*3,089.8*
	Other services (net)	*-599.4*	*-492.5*	*-73.1*
I.C	Income	-4,049.8	-2,356.0	-2,041.5
I.D	Current transfers	994.5	1,538.5	1,926.0
II	**Capital tranfers**	**310.2**	**1,067.6**	**1,108.2**
III	**Current account & Capital transfers (I + II)**	**-12,415.8**	**-5,842.9**	**-1,774.4**
IV	**Financial account * (IV.A + IV.B + IV.C + IV.D)**	**12,313.6**	**6,812.7**	**677.4**
IV.A	Direct investment*	-1,490.3	82.4	1,050.8
IV.B	Portfolio investment *	-9,708.0	-71,578.0	-9,841.0
IV.C	Other investment*	23,515.9	78,308.3	9,537.6
	(of which, loans of General Goverment)	*20,304.3*	*75,295.5*	*27,002.0*
IV.D	Change in reserve assets **	-4.0	0.0	-70.0
V	***Balancing item (I + II + IV + V = 0)***	***102.1***	***-969.8***	***1,097.0***

Source: BoG, Eurobank Research
* (+) net inflow (-) net outflow
** (+) decrease (-) increase

Regarding the adjustment in the incomes balance, it is important to emphasize that the ongoing improvement recorded in the first six months of 2013 is primarily the result of sharply lower interest payments on foreign-held Greek government bonds, following the March 2012 debt restructuring (PSI), the debt buyback operation conducted last December and the rest of relief measures announced at the 26/27 November 2012 Eurogroup. This improvement is expected to continue in the period ahead, as the PSI operation will result in a significant *multi-year* compression of debt servicing costs.[18]

Finally, the increase in the services surplus in the first half of 2013 is due to higher net travel receipts (mainly from tourism) and lower net payments for "other" services, which offset the drop in net transport receipts. In more detail, travel spending in Greece by non-residents increased by 17.8% YoY (also reflecting a rise in non-residents' arrivals by 12.3% over the same period, according to the Bank of Greece's border survey), while, at the same time, travel spending by residents abroad declined by 8.3% YoY. In line with the aforementioned developments, we forecast the external shortfall for the present year as a whole to decline much more significantly than expected earlier, reaching 1.0%-of-GDP or even lower levels, from 2.9%-of-GDP in 2012 and 9.9%-of-GDP in 2011.[19]

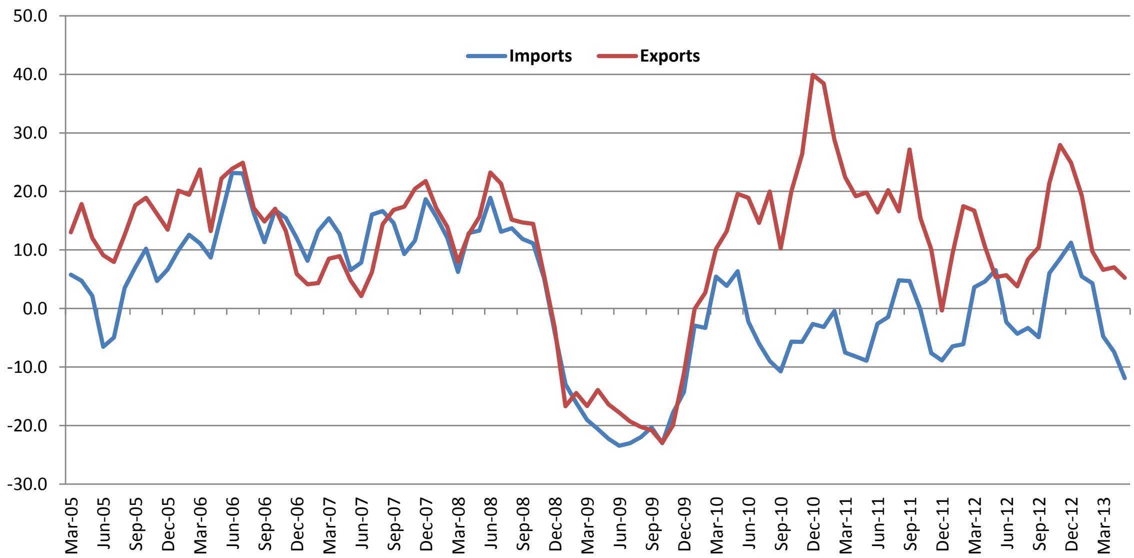
[18] A thorough analysis on the implication of the recent debt restructuring for Greece's liquidity and sovereign solvency position can be found in Eurobank *Research "Conditionality, implications for sovereign solvency and valuation of the Greek PSI deal"* March 2012. http://www.eurobank.gr/Uploads/Reports/6312GREECE%20MACRO%20FOCUS%20March%202%202012.pdf

[19] On a national account basis, the troika baseline scenario now forecasts Greece's current account deficit to contract to 2.8%-of-GDP this year, from 5.3%-of-GDP in 2012, reaching 0.8%-of-GDP by 2016.

Graph 1.1 – Greece: Merchandise exports & imports excl. oil and ships (%, YoY - annual data)

Source: BoP, Eurobank Research

Graph 1.2 – Greece: Customs-based merchandise exports & imports (%, YoY, 3mma – monthly data)



Source: ELSTAT, Eurobank Research

2.2 Current account developments in Greece viewed from a more intertemporal perspective

Greece's current account position underwent a sizeable deterioration in the initial years following the country's euro area entry in 2001. According to Bank of Greece's balance of payments statistics, the current account gap widened from levels around €10.6bn (7.8%-of-GDP) in 2000 to a record €34.8bn (15.6%-of-GDP) in 2008, before embarking on a declining path, reaching €5.6bn or 2.9%-of- GDP at the end of 2012. In a recent empirical study, we traced the post-EMU entry deterioration in Greece's external position back to a number of underlying factors, including, among others[20]:

— accumulated loss of economic competitiveness against main trade-partner economies;
— pronounced fiscal policy relaxation following the euro adoption; and
— domestic financial deepening post the euro adoption.

The recent significant adjustment in Greece's current account balance is already reflected in a broad range of balance-of-payments components as shown in Table B2 and Graphs 1.3 below.

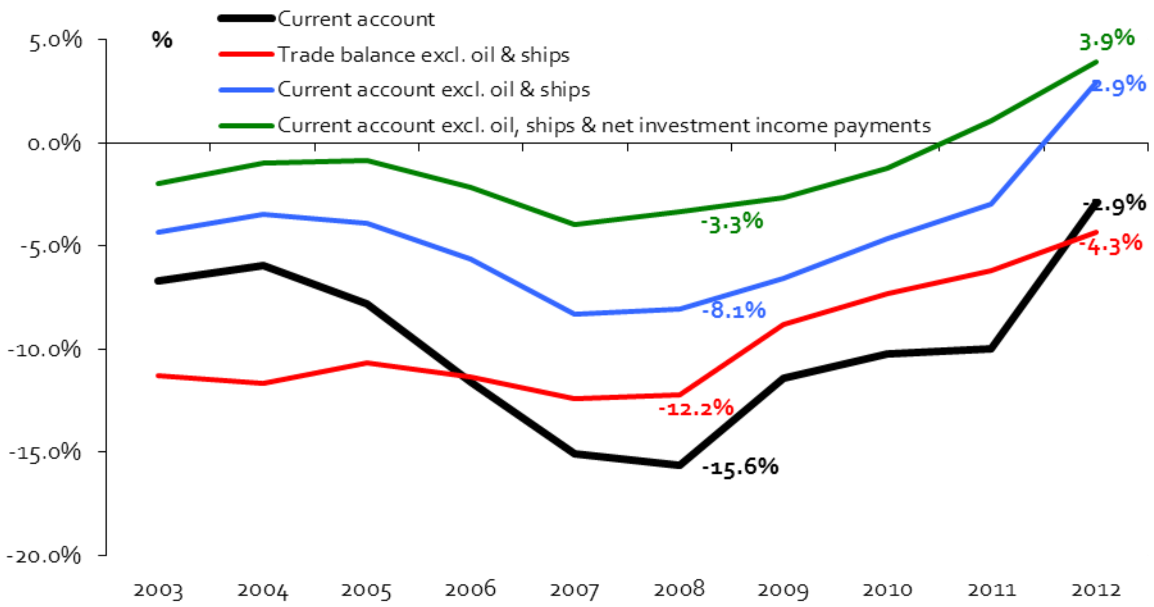
Table B2 – Greece: Balance of Payments indicators (%-of-GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	H1 2013
Current account	-6.7%	-6.0%	-7.8%	-11.6%	-15.1%	-15.6%	-11.4%	-10.2%	-10.0%	-2.9%	-1.6%
Current account excl. oil & ships	-4.3%	-3.5%	-3.9%	-5.7%	-8.3%	-8.1%	-6.6%	-4.6%	-3.0%	2.9%	0.7%
Current account excl. oil, ships & net investment income	-1.9%	-1.0%	-0.9%	-2.1%	-4.0%	-3.3%	-2.7%	-1.2%	1.1%	3.9%	1.7%
Trade balance	-13.6%	-14.1%	-14.5%	-17.3%	-19.2%	-19.8%	-13.6%	-12.9%	-13.2%	-10.1%	-4.5%
Trade balance excl. oil & ships	-11.3%	-11.6%	-10.7%	-11.4%	-12.4%	-12.2%	-8.8%	-7.3%	-6.2%	-4.3%	-2.2%
Exports of goods	6.7%	7.0%	7.5%	7.9%	8.1%	8.9%	6.8%	7.8%	9.8%	11.4%	6.0%
Imports of goods	20.3%	21.2%	22.0%	25.3%	27.3%	28.7%	20.4%	20.7%	23.0%	21.5%	10.5%
Services balance	6.9%	8.6%	8.1%	7.5%	7.7%	7.7%	5.6%	6.0%	7.1%	7.6%	3.0%
Gross travel receipts	5.7%	5.7%	5.7%	5.6%	5.2%	5.2%	4.6%	4.4%	5.1%	5.2%	1.8%
Gross transportation revenue	5.8%	7.4%	7.3%	7.0%	7.8%	8.6%	6.0%	7.0%	6.8%	6.9%	3.2%
Incomes balance	-2.3%	-2.4%	-3.0%	-3.5%	-4.3%	-4.8%	-4.0%	-3.5%	-4.2%	-1.1%	-1.1%
Current transfers	0.7%	1.3%	1.1%	1.5%	2.0%	1.8%	0.9%	0.9%	1.3%	1.2%	0.6%
Capital transfers	0.7%	1.3%	1.1%	1.5%	2.0%	1.8%	0.9%	0.9%	1.3%	1.2%	0.6%
Current account & capital	-5.9%	-4.6%	-6.7%	-10.1%	-13.1%	-13.8%	-10.5%	-9.3%	-8.7%	-1.7%	-1.0%
Financial account (net)	5.8%	4.5%	6.7%	10.0%	12.8%	13.4%	10.8%	9.5%	8.6%	1.8%	0.4%
Direct investment	0.3%	0.5%	-0.4%	0.5%	-1.1%	0.6%	0.1%	-0.4%	-0.2%	1.2%	0.6%
Portfolio investment (net)	7.4%	7.6%	3.9%	4.0%	8.1%	7.4%	10.0%	-9.5%	-9.6%	-51.9%	-5.4%
Other investment (net)	-4.6%	-5.1%	3.1%	5.7%	5.9%	5.4%	0.7%	19.4%	18.4%	52.5%	5.2%
Government	*-1.6%*	*-0.6%*	*-0.2%*	*-0.2%*	*-1.1%*	*-0.3%*	*1.3%*	*13.6%*	*19.3%*	*56.3%*	*14.7%*
Source BoG, Eurobank Research											

In what follows, we take a closer look at some recent developments in a number of factors affecting economic competitiveness. Graph 2 below show the evolution of Greece's (unit labor costs-based) real effective exchange rate (REER) relative to major trade partner economies. The source of the data is *AMECO* and as depicted in the graph below, the REER is declining rapidly and is expected to return to pre-EMU entry levels by the end of 2013/2014.

[20] A thorough analysis on the way these and other factors affected the evolution of the country's external imbalance can be found in *P. Monokroussos and D. Thomakos, Eurobank Research "A technical study on the determinants of Greece's current account position", April 2012.*
http://www.eurobank.gr/Uploads/Reports/Economy%20%20Markets%20Apr2012.pdf

Graph 1.3 – Greece: Current account and main components (%-of-GDP)



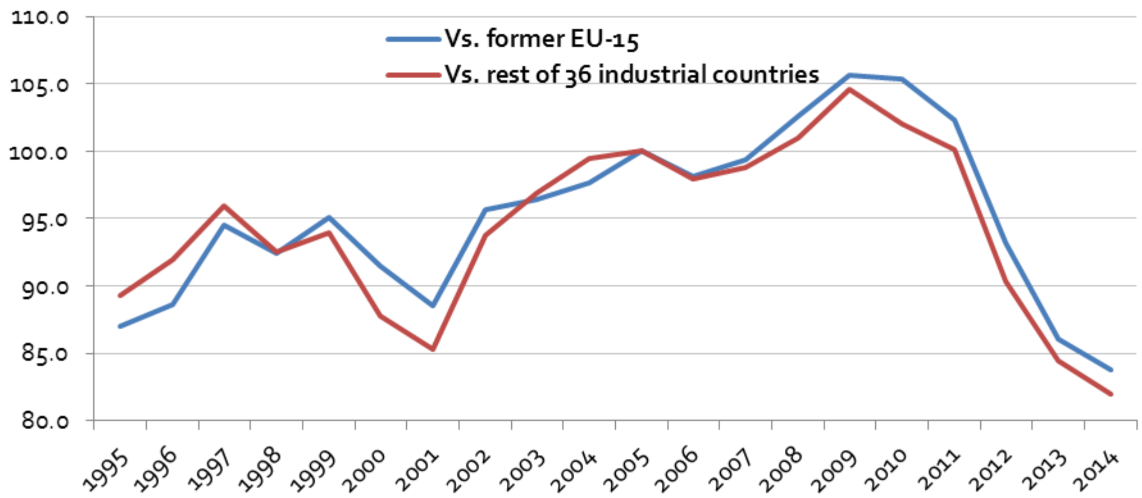
Source: BoG, Eurobank Research

The bottom line of all these is that the adjustment in domestic wages in Greece is proceeding rapidly and, arguably, faster that envisaged in the troika's earlier macro baseline. This is apparently the result of pronounced domestic recession and the ensuing rise in the unemployment rate (>27% currently) as well as the labor market reform introduced in February 2012 as a prior action to the 2nd bailout agreement with the euro area partners and the IMF.

Of course, wage cost is only one of the factors affecting competitiveness. Luckily, it appears that significant improvements have been made in Greece lately, as regards a range of *institutional* factors affecting competitiveness. That is attested in *e.g.* the annual *World Bank Doing Business 2013* report released some time ago. The report showed that Greece rose 11 places in a ranking of 185 countries globally, with respect to improvements made in the domestic regulatory environment aiming to facilitate entrepreneurship.

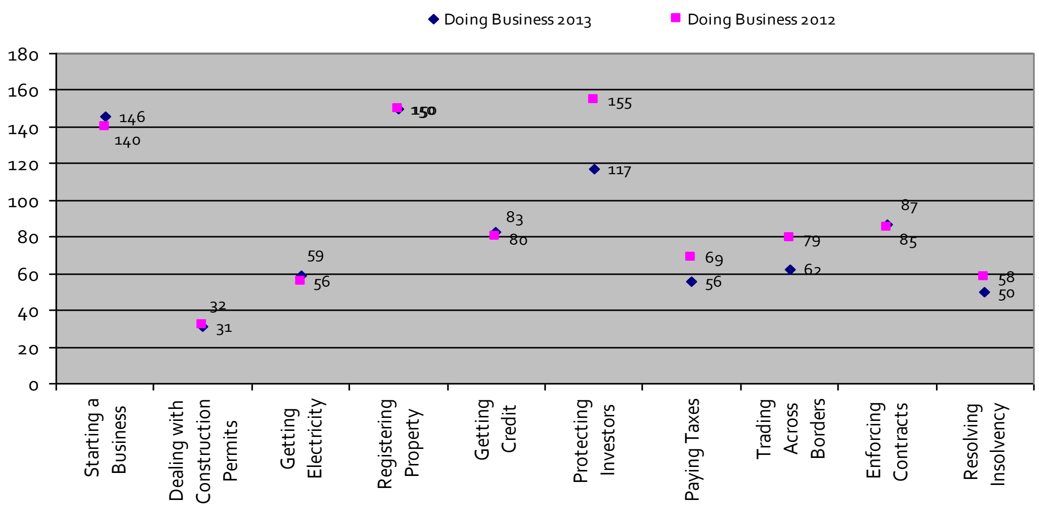
Specifically, Greece was placed 78th compared to 89th last year. The World Bank report cited that Greek authorities implemented a range of broad reforms, including business regulation reforms, in an effort to help the economy resume growth and return to a sustainable fiscal position. The report also said that the adopted reforms resulted to an improvement in Greece's regulatory environment at a greater pace in the past year than in any of the previous six years. In more detail, Greece showed progress in the following 5 key areas: (i) dealing with construction permits; (ii) protecting investors; (iii) paying taxes; (iv) trading across borders; and (v) resolving insolvency. On the other hand, Greece deteriorated its position on 4 fields: (i) starting a business; (ii) getting electricity; (iii) getting credit and (iv) enforcing contracts. With regards to the registering property measure, Greece was placed 150th, unchanged compared to last year (Graph 3).

Graph 2 - Greece's real effective exchange rates, based on total economy ULCs
(Double exports weights, year 2005 = 100)



<u>Note to Graph 3</u>
The real effective exchange rate (REER) is a typical competitiveness indicator utilized in empirical studies of the current account. The expected sign in the corresponding relationship is negative. That is because, on a ceteris paribus basis, an appreciation of the real exchange rate increases the purchasing power of domestic incomes in terms of imported goods. It also increases the relative value of financial, real estate and other assets held by domestic residents. These effects tend to reduce domestic saving and increase the propensity to consume. A REER appreciation of the domestic currency also tends to reduce the price competitiveness of a country's exports in international markets. The aforementioned factors have probably even been amplified in the euro area following the introduction of the single currency as a result of strengthened competition.

Graph 3- Greece's rankings in the World Bank's *Doing Business* indicator



3. Increasing signs of stabilization in domestic economic activity point to improving GDP dynamics in the period ahead

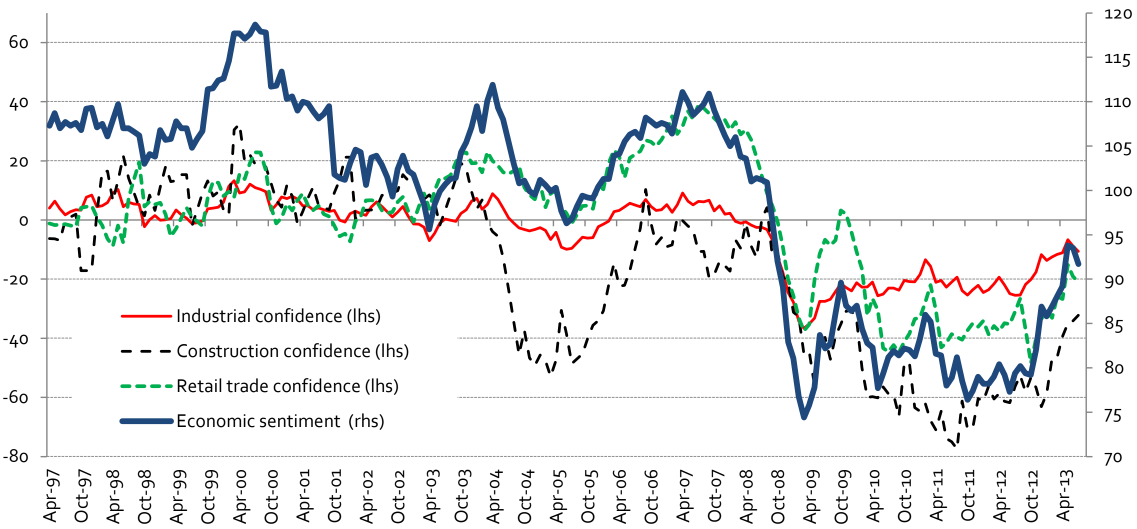
3.1 Considerable uncertainty continue to surround the domestic economic outlook, but Increasing signs of stabilization signal improving growth dynamics in the quarters ahead

Forward looking indicators and survey data for the first six months of 2013 signal a gradual stabilization in domestic economic activity, with improving sentiment beginning to reflect in hard economic data. Among others:

- The **Economic Sentiment Indicator** for Greece stood in July 2013 near a 5-year high, signaling improving economic conditions going forward. In a similar vain, the **Construction, Retail Trade and Industrial Confidence Indicators** for Greece all stood in July near their highest levels in over three years, remaining though at fairly weak levels (Graph 4.1).

- Greece's **Purchasing Managers Index (PMI)** remained in July 2013 below the boost-or-bust level of 50 for the 47th consecutive month. Yet, the pace of contraction continued to ease for the fourth month in a row, with the headline manufacturing index coming in at a 43-month high of 47.0 from 45.4 in June and well above an all-time low of 37.7 recorded in February 2012. The breakdown of the July PMI data showed that the improvement was mainly due to the new orders component, which declined by the lowest rate since January 2010 as well as the output sub-index which fell at the slowest pace in the last 28 months.

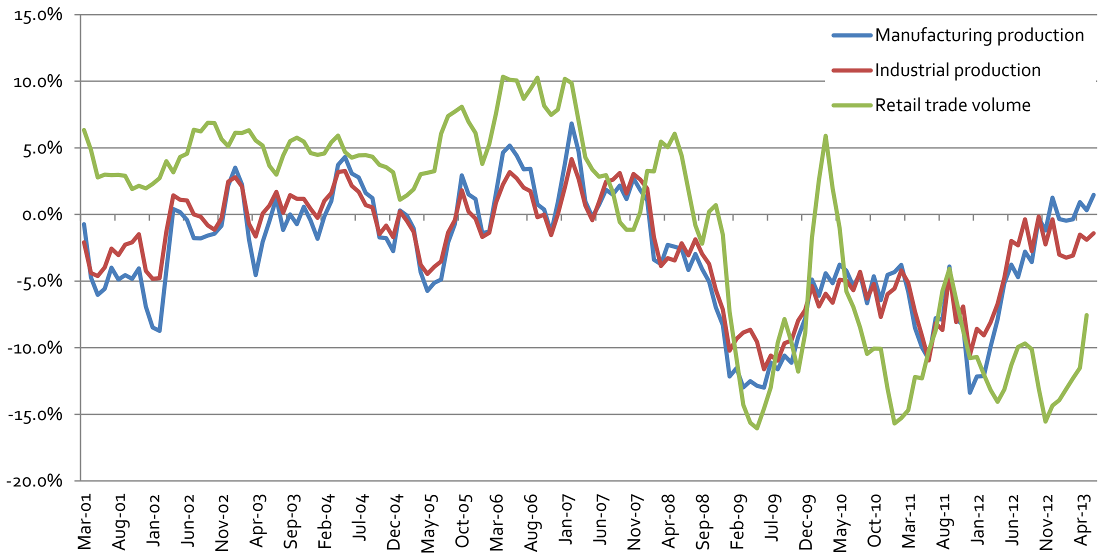
Graph 4.1 – Greece: Economic sentiment and confidence indicators



Source: European Commission, Eurobank Research

As regards hard economic data, Greece's **industrial output** and **manufacturing production** grew by 0.4% YoY and 4.2% YoY, respectively in June 2013 signaling a continuing stabilization in domestic industrial activity following rapid declines over the previous 5 years. Yet, spare capacity in industry remains a pretty depressed levels, with the respective **capacity utilization** rate standing at 64.5% in May 2013 compared to levels of 70% or higher in the years preceding the global financial crisis. In a broadly similar vain, the year-on-year growth of the **volume retail sales** remained in a negative territory in the first 5 months of the year, thought the respective pace of contraction appears to have stabilized lately (Graph 4.2).

Graph 4.2 – Greece: Manufacturing production and retail trade volume (YoY, %, 3mma)



Source: EL.STAT, Eurobank Research

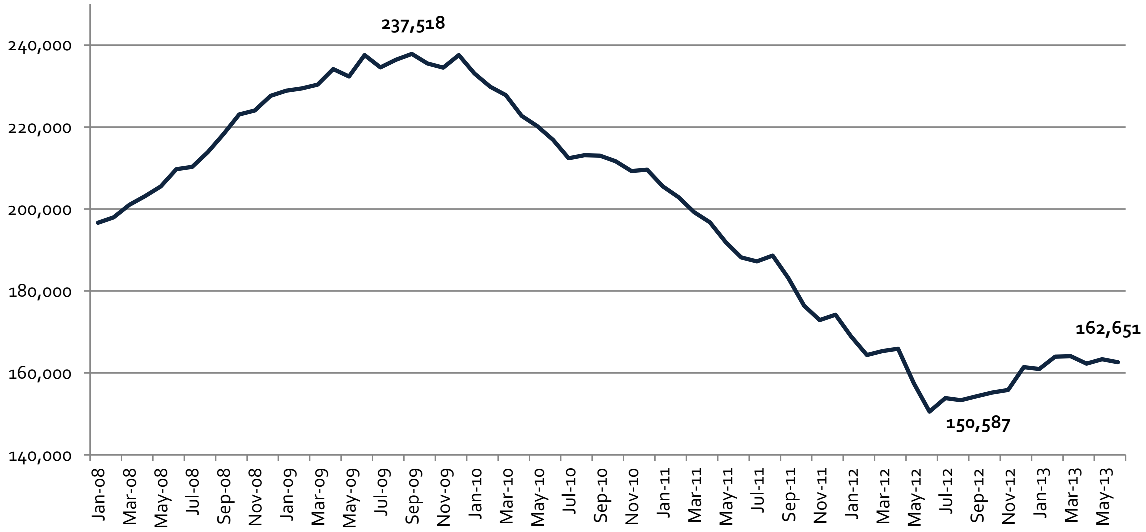
- Domestic liquidity conditions have also improved in recent months, (Graph 4.3), thanks to the ongoing return of deposits to the domestic banking system, accelerating clearance of government arrears and a number of initiatives taken recently to ease severe constraints still hindering the financing of the domestic economy. In more detail:

- The gradually recovery in **domestic bank deposits** that was set in motion after the June 2012 national election broadly continued in recent months, albeit with some brief interruptions instigated by the turmoil in Cyprus and pockets of domestic political uncertainty preceding the recent government reshuffle. Elsewhere, the process of **arrears clearance** accelerated in recent months following a slow start, reaching a pace of disbursements of around €700mn/month since April 2013. Yet, cumulative payments since December 2012 reached around €2.6bn in May 2013, rendering the €6bn programme target for July 2013 a rather difficult proposition.

- As we noted in Section 2.1 of this document, 2013 is expected to be a record year for the Greek tourism industry, with **tourist arrivals** expected to exceed 17 million. According to the latest balance-of-payment statistics released by the Bank of Greece, gross travel receipts grew by 17.8% YoY in H1 2013, reaching €3.3bn. Direct travel receipts for the full year are expected to amount or even exceed €11bn (or 6pprs-of-GDP), raising hopes for a more positive influence on domestic growth dynamics in the second half of the this year. Tourism is by far the most important industry of the Greek economy, accounting to more that 15 percent of domestic GDP, according to some estimates.

- In these lines, a further significant contraction in the external deficit this year raises the scope for a positive contribution to Greek GDP growth this year from net trade, after a broadly neutral contribution in 2012.

Graph 4.3 – Greece: Domestic private-sector deposits to domestic MFIs (EUR mn)



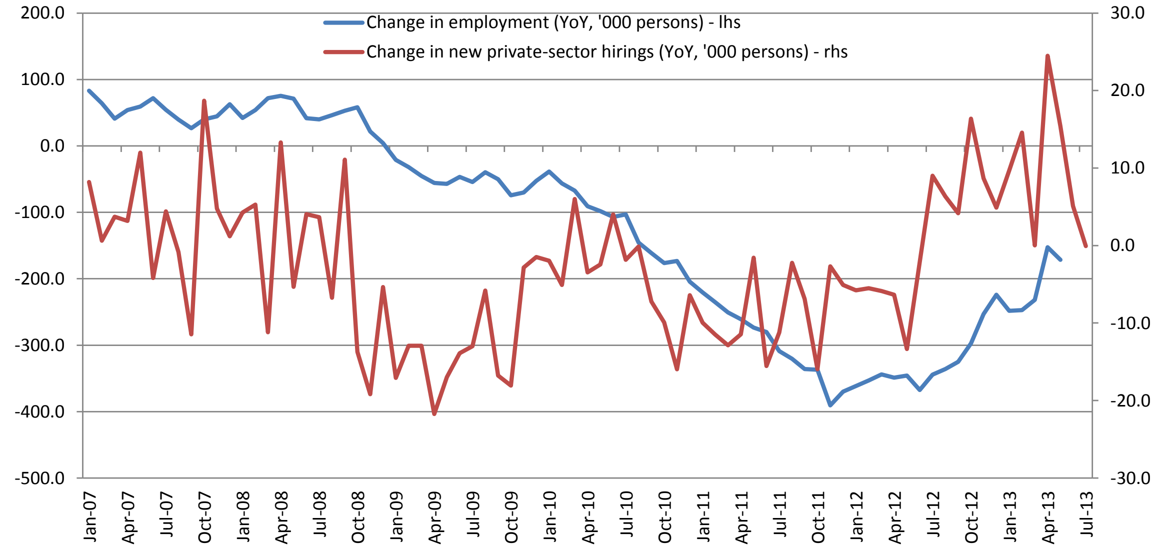
Source: BoG, Eurobank Research

Notwithstanding the signs of economic stabilization highlighted above, considerably risks continue to surround social cohesion and the outlook of domestic economic activity. Among others:

- The **jobless rate** hit a new historic high in May 2013, coming in at 27.6%, with unemployment being particularly pronounced among youth (64.9%). The unemployment rate is usually a lagging indicator of domestic economic activity and some further rise should not be excluded towards the end of the current year, following the beneficial impact on temporary employment to be exerted by the strong tourism season during the summer months. Having said that, recent positive net firing figures on the labor market provide some hope that the jobless rate may be nearing a cyclical peak (Graph 4.4).

- Despite the recent signs of improvement in domestic liquidity conditions and the completion of the domestic bank recapitalization programme, **new loan issuance** remains weak, weighing on private investment activity. This is mainly the result of weak domestic demand and the high-rate of non-performing loans (NPLs), which hinders the ability and willingness of domestic banks to provide credit to the private economy (Graph 4.5). Notwithstanding some moderation in the rate of new delinquencies, **NPLs** continue to increase in Q1 2013, reaching 29% of total loans, compared to 24.2% at the end of 2012. In March 2013, restructured loans amounted of 5.6% of total loans. A more resolute way in dealing with non-performing loans is necessary for the faster restoration of bank financing to the real economy. This is going to be one of the main focuses of the present adjustment programme in the period ahead.

Graph 4.4 – Greece: Change in employment and new hirings



Source: ELSTAT, Labour Ministry, OAED

Graph 4.5 – Greece: Bank credit to the domestic private sector (outstanding balances, YoY, %)

Source: BoG, Eurobank Research

- The new and heavily front-loaded fiscal consolidation programme (austerity measures worth 6.5ppts-of-GDP being applied in 2013-2014) continues to unleash deflationary pressures in the domestic economy (see Table A2). While the mail bulk of expenditure-side measures in the aforementioned package has already been implemented (i.e., steep cuts in wages and pensions instrumented in early 2013), significant headwinds for the domestic private economy remain in the form of an exceptionally heavy tax burned in the second half of the year. As we noted already, between July 2013 and February 2014 Greek taxpayers will need to pay as many as nine different taxes, for a total notional amount, which, according to some reports, may well exceed €8bn (or 4.5% of GDP). These include: the personal income tax (PIT) for incomes earned in FY-2012 (issuance of PIT declarations began already); special levy on self-employed; special solidarity levy; wealth tax on property (FAP) for the fiscal years 2011, 2012 and 2013; PPC levy collected through electricity bills (5 installments); new luxury tax; and annual vehicle registration duty.

3.2 Q2 flash GDP report signals some stabilization in quarter-on-quarter dynamics, auguring well for the full-year growth outcome

According to Greece's latest national accounts data, real GDP declined by 4.6% YoY in Q2 2013, bringing the average rate of output contraction in the first half of the year to 5.1% YoY. This follows cumulative real output losses of 21.8ppts over the period 2008-2012 in what turned out to be the deepest and most drawn out recession in recent economic history. Note that the troika baseline macro scenario forecasts a 4.2% real GDP contraction this year following a 6.4% decline in 2012, before a shift to positive output dynamics from 2014 onwards (Table 3.1). This trajectory is broadly in line with our latest forecasts update (April 2013), which includes a downward revision to 2013 real GDP growth to -4.2% from -3.8% expected previously, along a switch to slightly positive output dynamics next year (+0.4%).[21]

Table 3.1 – Troika baseline GDP forecasts

	2011	2012	2013	2014	2015	2016
Real GDP	-7.1	-6.4	-4.2	0.6	2.9	3.7
Final domestic demand contribution	*-10.1*	*-10.4*	*-6.1*	*-1.1*	*1.7*	*3.1*
Net trade contribution	*-0.4*	*0.0*	*0.4*	*0.0*	*0.0*	*0.0*

Source: EC (July 2013)

The flash Q2 GDP report did not contained data for the evolution of main GDP components (these will be provided with the revised Q2 2013 national accounts series) and reported the respective figures in non-seasonally adjusted terms. Note that due to a structural break in the quarterly General Government data (and the resulting availability of data for only a very short period *i.e.,* 2009Q1-2013Q2 on which to apply the seasonal adjustment calculation) as well as major changes reflected in the economic indicators used in the estimation of quarterly GDP, the implementation of seasonal adjustment does not provide satisfactory results and thus, Greece's stats agency (EL.STAT) reports quarterly national accounts only in non-seasonally adjusted basis.

We perfectly understand the technical complications involved in deriving seasonally adjusted quarterly GDP series for Greece at this stage, but we nonetheless we attempt such an exercise below for demonstrative purposes. Table 3.2 below shows the results of two seasonal-adjustment models applied to quarterly real GDP figures over: i) the period 2009 Q1 – 2013 Q2 (18 observations) and ii) the full sample period Q1 2000- Q2 2013 (58 observations). Although the picture portrayed as regards seasonally-adjusted GDP dynamics is by no means conclusive at this stage, one should not ignore what appears to be a kind of stabilization in quarter-on-quarter growth in the first half of the year. As Table 3.2 demonstrates, Q2 seasonally-adjusted GDP recorded only a tiny decline compared to the previous quarter and a continuation of this trend in H2 2013 (e.g. on the back of strong tourism revenue) would imply upside risks to the troika's -4.2% baseline forecast for full-year GDP.

For the time being, we stand clear of updating our Greek GDP growth forecasts form this year and the next (-4.2% and + 0.4%, respectively), awaiting for a more complete set of economic data releases in the following months. We will revisit this issue in the following weeks once we have the first results of our **Nowcasting GDP Model** for the Greek economy (Eurobank Research upcoming)..

[21] See Greece Macro Monitor, "Greece: An updated simulation for GDP and its components in 2013 and 2014", Eurobank Research April 25, 2013.
http://www.eurobank.gr/Uploads/Reports/FOCUS%20GREECE%20APRIL25_2013.pdf

Table 3.2 – Greece: Real GDP non-seasonal adjusted and seasonally-adjusted data

In EUR millions	Real GDP *non* seasonally-adjusted	Seasonal adjustment **Model 1** (sample period Q1 2009 - Q2 2013)	Seasonal adjustment **Model 2** (sample period Q1 2009 - Q2 2013)	Seasonal adjustment **Model 1** (sample period Q1 2000- Q2 2013)	Seasonal adjustment **Model 2** (sample period Q1 2000 - Q2 2013)
2009Q1	47,439	50,868	50,841	50,920	50,895
2009Q2	51,254	50,774	50,789	50,850	50,880
2009Q3	53,607	50,788	50,849	50,979	50,920
2009Q4	51,543	51,422	51,368	51,101	51,158
2010Q1	46,972	50,452	50,435	50,503	50,475
2010Q2	49,816	49,261	49,284	49,334	49,367
2010Q3	50,064	47,329	47,339	47,507	47,461
2010Q4	46,916	46,935	46,922	46,642	46,676
2011Q1	42,840	46,068	46,056	46,115	46,085
2011Q2	45,889	45,333	45,350	45,400	45,419
2011Q3	48,072	45,312	45,318	45,482	45,497
2011Q4	43,201	43,353	43,338	43,082	43,067
2012Q1	39,954	42,990	42,990	43,033	43,001
2012Q2	42,951	42,406	42,424	42,469	42,478
2012Q3	44,873	42,208	42,179	42,366	42,437
2012Q4	40,737	40,960	40,977	40,704	40,656
2013Q1	37,704	40,584	40,583	40,625	40,572
2013Q2	40,994	40,446	40,463	40,506	40,534
% QoQ change	Real GDP *non* seasonally-adjusted	Seasonal adjustment **Model 1** (sample period Q1 2009 - Q2 2013)	Seasonal adjustment **Model 2** (sample period Q1 2009 - Q2 2013)	Seasonal adjustment **Model 1** (sample period Q1 2000- Q2 2013)	Seasonal adjustment **Model 2** (sample period Q1 2000 - Q2 2013)
2009Q1	-9.7%			-2.0%	-2.1%
2009Q2	8.0%	-0.2%	-0.1%	-0.1%	0.0%
2009Q3	4.6%	0.0%	0.1%	0.3%	0.1%
2009Q4	-3.9%	1.2%	1.0%	0.2%	0.5%
2010Q1	-8.9%	-1.9%	-1.8%	-1.2%	-1.3%
2010Q2	6.1%	-2.4%	-2.3%	-2.3%	-2.2%
2010Q3	0.5%	-3.9%	-3.9%	-3.7%	-3.9%
2010Q4	-6.3%	-0.8%	-0.9%	-1.8%	-1.7%
2011Q1	-8.7%	-1.8%	-1.8%	-1.1%	-1.3%
2011Q2	7.1%	-1.6%	-1.5%	-1.6%	-1.4%
2011Q3	4.8%	0.0%	-0.1%	0.2%	0.2%
2011Q4	-10.1%	-4.3%	-4.4%	-5.3%	-5.3%
2012Q1	-7.5%	-0.8%	-0.8%	-0.1%	-0.2%
2012Q2	7.5%	-1.4%	-1.3%	-1.3%	-1.2%
2012Q3	4.5%	-0.5%	-0.6%	-0.2%	-0.1%
2012Q4	-9.2%	-3.0%	-2.9%	-3.9%	-4.2%
2013Q1	-7.4%	-0.9%	-1.0%	-0.2%	-0.2%
2013Q2	8.7%	-0.3%	-0.3%	-0.3%	-0.1%

Source: EL.STAT, Eurobank Research

Note to Table 3.2

Model 1 results in line with X-12 quarterly seasonally adjustment method, Release version 0.2.9 (Source: U.S. Census Bureau)
Model 2 results in line with X-11 quarterly seasonally adjustment Model (Source: U.S. Census Bureau)

Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank

Financial Markets Research Division
Platon Monokroussos: *Head of Financial Markets Research Division*
Paraskevi Petropoulou: *G10 Markets Analyst*
Galatia Phoka: *Emerging Markets Analyst*

Economic Research & Forecasting Division
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Ioannis Gkionis: *Research Economist*
Vasilis Zarkos: *Economic Analyst*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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