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Focus notes: Greece

Greece's external sector adjustment gains momentum; full-year current account deficit seen at 4.5%-of-GDP or lower

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In an empirical study on the determinants of Greece's current account (CA) we published last April, we projected a much faster adjustment in the external imbalance relative to that foreseen in the troika's earlier baseline projections[1,2]. Assuming a rigorous implementation of the labor market reform and the fiscal measures agreed earlier this year as part of conditionality underlying the present bailout programme, we forecasted back then a switch into positive current account balances as early as in 2016 *i.e.,* three years earlier than envisaged in the IMF March 2012 report.

Bank of Greece's balance of payments data for the January-August 2012 period revealed that the adjustment in the country's external deficit is actually occurring at a much faster pace than implied by even our (more optimistic) forecasts. Specifically, the cumulative current account deficit in the first eight months of 2012 decreased by 66.5% YoY, which compares with annual rates of decline of ca 8% recorded in each of the respective 8-month periods of 2011 and 2010.

In line with the aforementioned developments, the external shortfall for the present year as a whole is now expected to decline much more significantly than expected earlier, reaching 4.5%-of-GDP or even lower levels. This compares with an earlier (March 2012) IMF forecast for a 7.5%-of-GDP deficit in 2012 and a 9.8%-of-GDP realization in the previous year. The significant adjustment in Greece's current account balance is already reflected in a broad range of balance-of-payments sub-components as depicted in ***Table 1***.

Graph 1 below also depicts the main drivers of the current account improvement in the first eight months of 2012. Specifically, the improvement primarily reflects sizeable declines in the trade and income account deficits (by ca €4.6bn and €3.3bn, respectively) and, to a lesser extent, increases in the surpluses of the services balance and the current transfers balance (by ca €0.67bn and €0.45bn, respectively). On a year-on-year basis, the trade shortfall in the first eight months of 2012 declined by 24.5% YoY, reflecting a 42.5% YoY drop in the trade deficit excluding oil and ships as well as respective falls of 2.5% YoY and 71.5% in the bills of net oil and ships purchases. Receipts from exports of goods excluding oil and ships rose by 4.6%, while the corresponding import bill decreased at a much faster rate (by 12.8%).

[1] P. Monokroussos, 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)

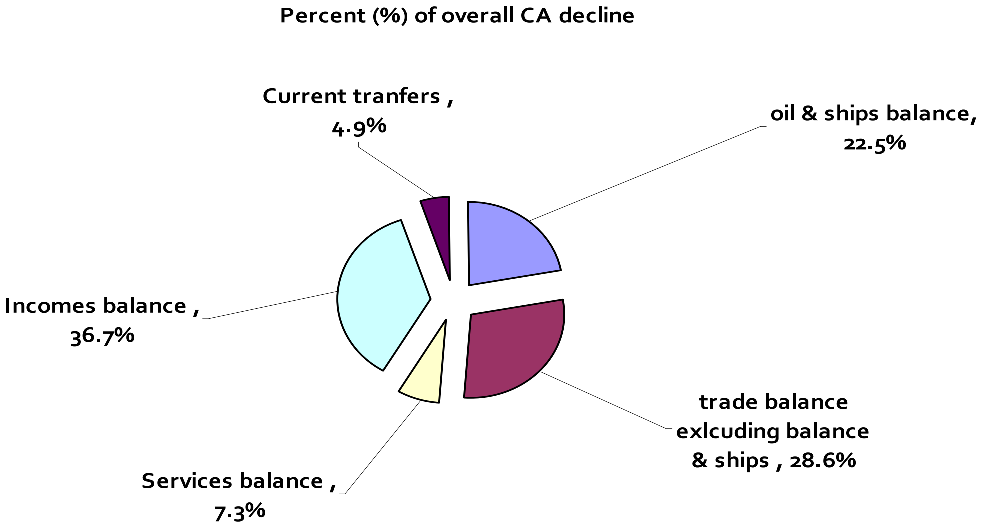
[2] IMF Country Report No. 12/57 (http://www.imf.org/external/pubs/ft/scr/2012/cr1257.pdf)

Table 1 - Greece: balance of payments indicators (January-August period; in ppts-of-GDP)

	2009	2010	2011	2012
Current account	**-7.0%**	**-6.5%**	**-6.6%**	**-2.3%**
Trade balance	-8.9%	-8.8%	-9.1%	-7.1%
Trade balance excl. oil & ships	-5.6%	-5.0%	-4.2%	-3.0%
Exports of goods	4.3%	4.7%	6.3%	7.1%
Imports of goods	13.2%	13.5%	15.4%	14.2%
Exports of goods (excl. oil & ships)	3.2%	3.1%	4.1%	4.4%
Imports of goods (excl. oil & ships)	8.9%	8.1%	8.3%	7.5%
Services balance	4.0%	4.1%	4.8%	5.3%
Gross travel receipts (mainly from tourism)	3.3%	3.1%	3.7%	3.7%
Gross transport revenue (mainly from shipping)	3.9%	4.6%	4.5%	4.6%
Income balance	-2.7%	-2.3%	-2.6%	-1.1%
Current tranfers	0.6%	0.4%	0.4%	0.6%
Capital tranfers	0.7%	0.3%	0.5%	0.8%
Current account & capital transfers	-6.3%	-6.2%	-6.0%	-1.5%
Current account net of net investment income	-4.31%	-4.32%	-4.00%	-1.30%
Current account net of investment income payments to non residents	-3.1%	-3.2%	-3.0%	-0.3%
Financial account	**6.7%**	**6.8%**	**6.4%**	**2.2%**
Direct investment (net)	0.5%	-0.3%	-0.8%	1.0%
Porfolio investment (net)	9.1%	-8.0%	-6.4%	-37.8%
Other investment (net)	-2.9%	15.0%	13.6%	39.0%
Of which loans to General Government	*-0.8%*	*8.1%*	*15.4%*	*37.4%*

Source: BoG, Eurobank Research

Graph 1 – Contributors to the improvement (decline) in the CA balance in Jan-Aug 2012



Source: BoG, Eurobank Research

Apparently the ongoing decline in imports has primarily been the result of collapsing domestic demand due to the lingering sovereign debt crisis 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 (***Table 2*** & ***Graph 2***).

Regarding the adjustment in the incomes balance, it is important to emphasize that the sizeable improvement recorded in the eight months of 2012 is primarily the result of sharply lower interest payments on foreign-held Greek government bonds, following the March 2012 debt restructuring. This improvement is expected to continue in the period ahead, as the successful PSI operation will result in a significant *multi-year* compression of debt servicing costs. [3]

Table 2 – Merchandise imports & exports excluding oil products (August 2011 - August 2012)

(Provisional data)

	Imports - Arrivals (in million €) August			Exports - Dispatches (in million €) August		
	2011	2012	Changes % 2012/2011	2011	2012	Changes % 2012/2011
I. European Union	1644.9	1515.5	**-7.9**	723.4	787.4	**8.8**
II. Third Countries	765.5	720.6	**-5.9**	402.5	449.4	**11.7**
Total	**2410.4**	**2236.1**	**-7.2**	**1125.9**	**1236.8**	**9.8**

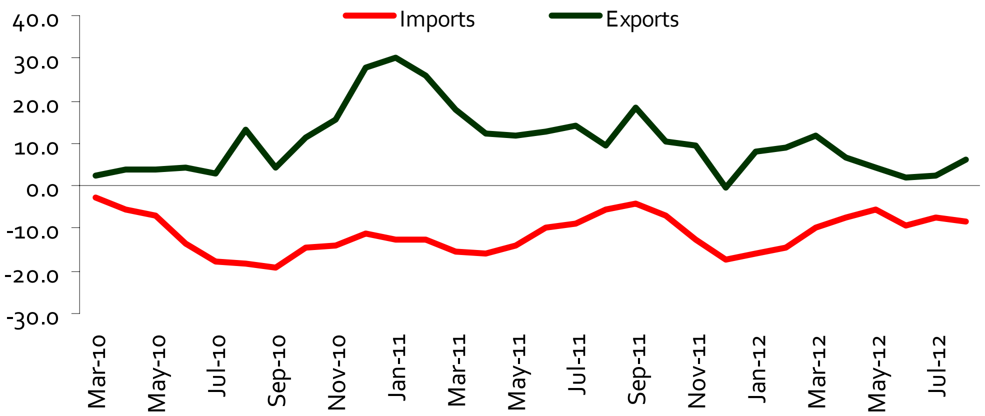
Source: EL.STAT

Turning next to the services balance, the apparent resilience of travel receipts despite earlier concerns about a sharp decline in tourism arrivals - *among other reasons, because of heightened domestic political and economic instability in the period leading to the June 17 national election* - comes as a positive surprise, revealing not only an increasing diversification of the Greek tourism product to new markets, but also significant cost competitiveness gains. Specifically, gross travel receipts in the first eight months of this year declined by 3.4% YoY, but net travel receipts actually grew by 10.3% YoY (after dropping by 7.3% YoY in January-August 2011) as Greek travelers abroad spend ca 20% less than in the same period of last year. In a similar vein, net transport receipts rose by 11.7% YoY in the eight months to August 2012, after registering a 12.3% YoY drop in the same period a year earlier.

From the financing side, the most striking development is the sharp increase in net portfolio outflows in the period January-August 2012, which has been more than offset by the concurrent rise in surplus of "other investment", mainly as a result of higher official sector loans to the general government. Elsewhere, the net balance of direct investments recorded a surplus of €2.06bn compared to a deficit of €1.7bn in the same period a year earlier.

[3] 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

Graph 2 – Greece's merchandise imports & exports (3-mma, YoY %)



Source: EL.STAT; Eurobank Research

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 (14.9%-of-GDP) in 2008, before embarking on a declining path, reaching ca 21.1bn or 9.8%-of- GDP at the end of 2011. In an empirical study we published earlier this year we traced the post-EMU entry deterioration in Greece's external position back to a number of underlying factors, including, among others:

— 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.

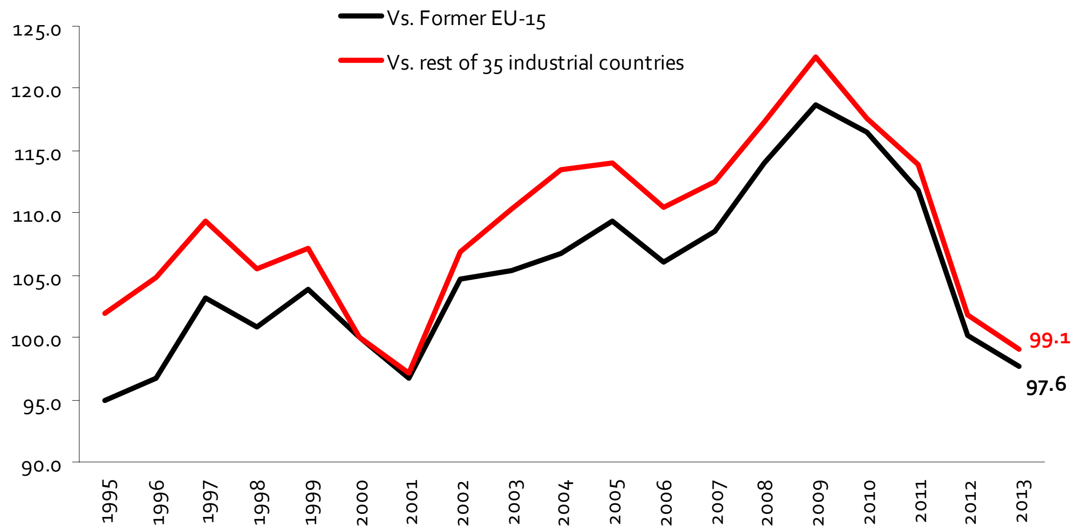
A through analysis on the way these and other factors affected the evolution of the country's external imbalance can be found in *P. Monokroussos and D. Thomakos, Eurobank Research "A technical study on the determinants of Greece's current account position", April 2012.*

http://www.eurobank.gr/Uploads/Reports/Economy%20%20Markets%20Apr2012.pdf

In what follows, we take a closer look at some recent developments in a number of factors affecting economic competitiveness. ***Graph 3*** below shows 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.

Graph 3 - Greece's real effective exchange rates, based on total economy ULCs

(Double exports weights, year 2000 = 100)



Source: AMECO

Note to Graph 3

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.

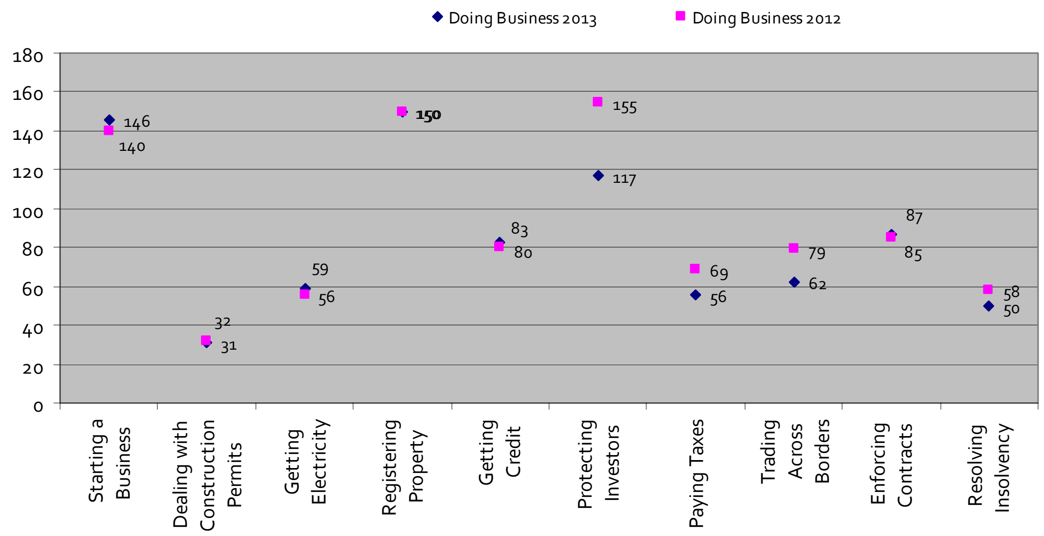
The baseline of all these is that the adjustment in domestic wages in Greece is proceeding rapidly and, arguably, faster that envisaged in the troika's March 2012 baseline projections.[4] This is apparently the result of pronounced domestic recession and the ensuing rise in the unemployment rate (>25% currently) as well as the labor market reform introduced in February 2012 as a prior action to the 2nd bailout agreement with 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 earlier this week. 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.

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

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 4***).

Graph 4 - Greece's rankings in the World Bank's *Doing Business* indicator



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