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Second programme review
Important milestones & timeline of key dates and events

Introduction

This report presents the key themes of the current juncture in light of the 2nd programme review, which is well underway and its importance to the Greek economy's short and medium term prospects. Firstly, we present the key milestones ahead that will determine whether Greece will be able to attain the goal of short-term debt relief and inclusion to the ECB QE programme. Secondly, we examine the potential role of the IMF in the bailout programme, taking into consideration its divergent views on a number of issues. Thirdly, we go over the most critical prior actions by summarizing the positions of the Greek side and the official lenders on each one of them. Finally, we assess the performance of Greek sovereign bonds taking into account the impact of the latest domestic and international developments.

Key milestones

The 2nd review in the context of Greece's new bailout programme is underway and a number of programme related issues may be starting to clear out. The main target of Greece's strategic planning, which is the timely and successful completion of the review, appears within reach, opening the way for a series of positive developments to materialise in the coming months. According to numerous press reports and statements from domestic and EU officials, a political agreement in principle on the conclusion of the 2nd programme review at the December 5 Eurogroup (the last Eurogroup of the year) is likely, provided that a staff level agreement between the Greek side and official creditors on key prior actions will be reached in time for the November 28 Euroworking Group. This timetable will allow for the approval of the disbursement of the €6.1bn loan tranche that is attached to the 2nd review before year end. In case not all prior actions have closed by then, the tranche may be gradually disbursed in several sub-tranches linked to the fulfillment of pending actions by end-January 2017.

Meanwhile, at the December 5 Eurogroup the ESM is expected to present the short-term debt relief measures that could start being implemented immediately, as per the relevant decisions taken last May. As was analyzed in *"QE for Greece: a necessary precondition for stabilizing investor sentiment and preventing the need for further official sector financing post-2018"*,[1] the said package could include the following items: a) "smoothening" of the EFSF repayment profile i.e., potential extension of the weighted average maturity of the entire package of EFSF loans to Greece by up to 2 years; b) use of the ESM's diversified funding strategy to reduce interest rate risk - this could involve a swap of part of the EFSF/ESM facilities with new ESM loans of a longer maturity and lower interest cost. Indicatively, the swap of outstanding EFSF/ESM loans given to Greece for bank recapitalization purposes (up to €42.7bn = €37.3bn for the first bank recap + €5.4bn for the latest bank recap) with new ESM loans of longer maturity & lower interests could produce cumulative savings equivalent to 8-9ppts of GDP over the next three decades or so; and c) a waiver of the step-up interest rate margin related to the debt buy-back tranche (€11.3bn) that could reduce the 2017 debt service burden by c. €226mn. Some additional clarity on the medium-term debt relief measures could also be provided at the December 5 Eurogroup, sending a strong signal to financial

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[1] Eurobank Research, "QE for Greece: a necessary precondition for stabilizing investor sentiment and preventing the need for further official sector financing post 2018", Greece Macro Monitor, October 25, 2016, https://www.eurobank.gr/Uploads/Reports/GREECE_MACRO_Monitor_20161025.pdf

markets that EU partners remain committed to restore Greek debt sustainability in a gradual (and conditional) fashion.

The aforementioned actions would increase the chances of the IMF taking a decision to participate financially in the Greek programme, after publishing its updated sustainability analysis (DSA) on Greek public debt by the end of 2016. They would also open the way for the completion of the ECB's independent DSA for Greece, which could allow for the inclusion of Greek eligible securities into the ECB's quantitative easing programme (QE) sometime in early 2017. As we have extensively analysed in a number of recent reports, PSPP purchases of Greek debt following the successful completion of the 2nd programme review constitute a necessary precondition for stabilizing domestic sentiment, engineering a quick de-escalation of government bond spreads and potentially allowing for the Hellenic Republic to restore market access before the expiration of the present bailout programme (August 2018), thus averting the need for further official-sector financing.

The role of the IMF

An important related issue that has been at the centre of public debate in recent months and may now gain more clarity relates to the IMF's participation in the Greek programme. So far the IMF has refrained from financially participating in the Greek bailout programme, arguing that "the numbers need to add up". In its Staff Concluding Statement of the 2016 Article IV Mission published in September the Fund expresses its reservations on whether the changes undertaken so far in a number of areas are adequate to effectively address the issues of debt sustainability and long-term growth. In particular, the Fund claims that there should be a fiscally-neutral rebalancing of policies over the medium term toward lower pensions and a fairer distribution of the tax burden. In addition, action should be taken to curb the evasion of tax and social security contributions by avoiding further installment schemes. Instead, durable restructuring solutions for viable debtors should be put in place in line with their capacity to pay. Furthermore, audits should concentrate on large taxpayers and authorities should continue their efforts to strengthen the use of enforcement tools against those who can but do not pay. With regard to the banking system, the IMF stresses the importance of rapidly reducing NPLs and strengthening the governance of banks. On the structural reforms front, it is argued that earlier labour markets reform should not be reversed, but be rather complemented with ambitious efforts to fully open up remaining closed professions, foster competition, and facilitate investment licensing and privatisations, as well as bring Greece's collective-dismissals and industrial-action frameworks in line with international best practices. Finally, the IMF reiterates its position that even with full implementation of the policy agenda, debt relief will be required to restore sustainability and it should be calibrated on realistic assumptions about Greece's ability to generate sustained surpluses and long-term growth. (*A brief summary of the key findings of the latest IMF Staff latest Article IV Mission to Greece is provided in the Appendix at the end of this document)*.

Against this backdrop, German Minister of Finance Wolfgang Schaeuble reportedly held a meeting with IMF European Department Director Poul Thomsen on the sidelines of the November 7 Eurogroup to discuss a plan that would bring the Fund into the programme, without compromising Germany's firm positions on issues such as debt relief and primary surplus targets beyond 2018. The said plan reportedly entails the realization of the important milestones outlined in the previous section as regards the conclusion of the 2nd programme review and the inclusion of Greece into the ECB's QE programme so as for the Fund to contribute up to €6bn to Greece's bailout programme. It should, however, be noted that the IMF is understood to still be insisting on a number of issues that may well affect the outcome of the ongoing negotiations in the context of the second review. These include. inter alia: (i) the abolishment of the "personal difference" in existing pensions; (ii) a further decrease of the tax-free threshold; (iii) the abolishment of all tax exemptions; and (iv) the increase of the number of workers who may be collectively dismissed to 10% of total workers per month (from 5% currently) for companies with more than 150 employees.

Progress made so far in the negotiations on the 2nd programme review

The 2nd programme review commenced in October 21st and a second round of negotiations is currently under way with the ECB/IMF/EC/ESM mission heads having arrived in Athens on November 14th and being expected to depart on November 21st. The review comprises of more than 33 prior actions many of which are broken down into various steps and, therefore, intensive work is required for the set timetable to be met. According to a number of press reports and taking into consideration the workload at hand, another visit of the heads of the institutions to Greece sometime before or after the December 5 Eurogroup may not be excluded. In any case, as mentioned before, the Greek government aims for a political agreement on the conclusion of the review at the December 5 Eurogroup and to this end the Greek PM recently carried out a cabinet reshuffle assigning the leadership of key ministries to people that are expected to work more vigorously towards the completion of the prior actions that fall under their authority. Some of these actions, however, may prove more challenging than others either because of the diverse opinions between the Greek side and the institutions or because of inherent difficulties. These reportedly include, inter alia (i) labour market reform; (ii) projected fiscal gaps for 2017 & 2018 and sources of funding for their coverage, (iii) NPLs resolution, and (v) assessment of the privatisation programme. This section presents the main elements of each one of these issues.

I. Labour market reform

According to the Memorandum of Understanding (MoU, dated 19 August 2015) Greece has committed to undertake a wide range of labour market reforms to align its labour market institutions with best practices internationally and in Europe with a view to enhancing competitiveness and the growth potential of its economy. Since 2010, Greece has implemented a massive programme of reforms which placed a lot of emphasis on wage adjustment and in fact was successful in meeting the target of internal devaluation to boost wage competitiveness. Further reforms, however, should focus more on productivity enhancement. In this context, a consultation process was launched in July 2015 led by a group of eight independent experts with the mandate to put forward a number of recommendations which, albeit not binding, could be used as a basis in the current negotiations. The group of experts submitted its report at the end of September 2016 (an analysis thereof is presented in our note "Greek labour market reform and the agenda of the 2nd programme review"[2]) and it was considered a good starting point both by the then Greek Labour Minister George Katrougalos but also by the European Commissioner for Employment Marianne Thyssen. However, hitherto discussions with official lenders reveal considerable differences in the following areas:

(i) Collective bargaining

(ii) Minimum wage

(iii) Collective dismissals

(iv) Industrial action

Comments

- Prior to 2012 wages and other employment parameters were determined by the National General Collective Labour Agreement (EGSSE) which was signed between the social partners, namely employers' organisations and unions. In 2012 the EGSSE was abolished and firm level agreements obtained precedence over sectoral or occupational ones. This radical change resulted in a sharp decrease in the coverage by collective agreements from 83% in 2009 to 42% in 2013, while the number of sectoral agreements dropped from 163 in 2008 to 12 in 2015. The Greek government favours the reinstatement of the EGSSE arguing that it is a matter of fundamental employees' rights. According to press reports, however, official lenders oppose any reversal of already materialised reforms. The IMF in particular, in its Staff Concluding Statement of the 2016 Article IV Mission, states that the 2011 labour market reforms to collective bargaining were major steps forward and that a reversal thereof would risk the potential gains for investment and job creation.
- Prior to 2012 the minimum wage was set by the National General Collective Labour Agreement (EGSSE) at the national level covering all employees without the state intervening in the negotiations. The favourability principle determined the hierarchy of bargaining levels whereby lower levels of bargaining could only improve the standards of the higher level bargaining. In 2012 it was decided that the minimum wage would be set by the state and consequently it was cut by 22% and frozen at the 2012 minimum rate while automatic progression on grounds of seniority was suspended. The government is opting for a switch back to a national collective bargaining system for determining the minimum wage (with automatic erga omnes effect) and the experts' report is also supportive of this view. However, both employers' organisations and the institutions disagree. In fact, the IMF, in its Staff Concluding Statement of the 2016 Article IV Mission, argues that the current regime is beneficial as evidenced by the subsequent and notable improvement in labour costs.
- According to a number of press reports, the institutions request the increase of the maximum threshold for monthly collective dismissals to 10% of total employees – from 5% currently – and up to 30 employees per month for companies with more than 150 employees. Instead, the Greek government reportedly appears willing to accept a scheme of short-time work in times of economic hardships during which the employees will receive unemployment benefits as a compensation for the hours they could not work. Another issue concerns the role of the public administration in collective dismissals and whether an administrative authority should have the right – as is now the case – to approve or prohibit collective dismissals. The matter is currently being discussed at the European Court of Justice (ECJ) following a recourse by a Greek company and a decision is unlikely to be made prior to the ECJ's ruling.
- Lockouts are currently prohibited and the Greek government does not want this to change. The experts' report also does not see any reason to remove the prohibition on the grounds that, as things stand, there is a balance of power between employers and unions. On the other hand, the IMF suggests that more ambitious efforts should be made to bring Greece's industrial action framework in line with international best practices. According to press reports, the Greek side may be willing to accept certain amendments to the privileges that trade unionists enjoy.

[2] Eurobank Research, "Greek labour market reform and the agenda of the 2nd programme review", Greece Macro Monitor, October 18, 2016, https://www.eurobank.gr/Uploads/Reports/GREECE_MACRO_Monitor_20161019.pdf

II. Projected fiscal gaps for 2017 & 2018 and sources of funding for their coverage

Official creditors reportedly project that the 2016 fiscal target for a surplus of 0.50%-of-GDP will be probably outperformed and the general government primary account will record a surplus of 0.8%-of-GDP, above the 0.63%-of-GDP 2016 Budget target, purportedly thanks to the strengthened efficiency of the tax collection mechanism and the modestly better than initially projected GDP growth dynamics in 2016. However, they seem to question the attainability of the fiscal target for a primary surplus of 1.75%-of-GDP and 3.50%-of-GDP for FY-2017 and FY-2018 respectively and request the adoption of additional measures (i.e., besides those already agreed under the existing MoU). In more detail, the institutions reportedly project a budgetary shortfall of around €910mn cumulatively for the next two fiscal years (€360mn and €550mn in 2017 and 2018, respectively) mainly due to the lack of adequate funding for the implementation of the Social Solidarity Income scheme, scheduled to be launched nationwide in January 2017. According to the existing MoU, the cost of the aforementioned scheme is estimated at 0.5%-of-GDP annually and has to be covered through permanent savings in areas of non-discretionary spending identified either by the World Bank (*i.e.*, elimination or/and reduction of certain welfare benefits & tax deductions) or by spending reviews. Reportedly, official creditors oppose the Greek side's argument that any fiscal shortfall materializing next year could be fully covered through the current outperformance of budgetary revenue, amid concerns as to the sustainability of such outperformance.[3] In an attempt to reach a compromise, the Greek government has reportedly committed to reassess the criteria for the provision of certain welfare benefits, aiming to secure budgetary savings of c. €250mn/annum. As per the same sources, the Greek government vehemently refutes the creditors' proposal for the decrease of the tax-free threshold to €5,000 — in line with the World Bank's proposal — from €8,600 currently (for individuals with no children) insisting that any remaining budgetary shortfall could be covered through revenue outperformance and, if needed, reduced operation costs of the Ministry of National Defense. With respect to the fiscal target for 2018, the Greek government reportedly adopts a relatively more optimistic stance, arguing that any fiscal shortfall is not likely to exceed €400mn and could be covered through permanent savings identified by the spending review [4] as well as elimination/reduction of certain welfare benefits and tax deductions. Besides the finalization of the 2017 Budget that has to be tabled to Parliament by November 21st, legislation of the 2017-2020 Medium-Term Fiscal Strategy (MTFS) constitutes a prior action for the completion of the 2nd review. The Greek side reportedly aims to pursue a primary surplus target no higher than 2.5%-of-GDP for 2019 and beyond, an issue that is expected to be included in the agenda of the December 5th Eurogroup.

III. NPLs resolution

Non-performing loans (NPLs) is one of the most serious problems of the Greek economy as they constitute a threat to financial stability and deprive the economy of indispensable liquidity, hampering investment and growth. According to the most recent BoG data, the level of non-performing exposures (NPEs) in Greece is the second highest in Europe, standing at 45.1% of total exposures or €108bn. A number of initiatives have been undertaken in the past few months to address the problem including the legal framework for a secondary market for both non-performing and performing loans, the revision of the banks' Code of Conduct and the adoption of certain objectives and key performance indicators to reduce NPEs by 40% by the end of 2019. Another means to tackle NPLs is the out-of-court workout for companies with debts to the public (e.g. tax authorities and social security funds) and/or the private sector (e.g. banks and suppliers). The construction of the legal framework for out-of-court settlements is included in the prior actions for the 2nd programme review and based on the latest press reports the Greek government submitted its proposal to the institutions. The proposal reportedly foresees that a company may be liable to a debt haircut only if it is deemed viable based on its operating results and the haircut may reach at most 50% of the company's total debts. In addition, all types of arrears will potentially be subject to a haircut including those to the tax authorities, a provision that is understood to have been initially opposed by the General Secretariat for Public Revenues (GSPR). It nevertheless remains to the discretion of the GSPR to decide which types of arrears will be cut first (e.g. basic debt, fines, surcharges, etc.) depending on their fiscal impact. The same discretion will be granted to other debt holders as well. The relevant bill is expected to be tabled to Parliament in the coming days.

IV. Assessment of the privatisation programme

(i) Finalisation of internal regulation for starting up the new Privatisation and Investment Fund
(ii) Timely implementation of the agreed privatisations

[3] According to the preliminary State Budget Execution data for January-October 2016 the fiscal surplus was at €1.306mn, against a targeted deficit of €3.499mn in the 2016 Budget and a deficit of €793mn in the respective period of 2015. The State Budget Primary Balance recorded a surplus of €6.497mn, against a targeted primary surplus of €1.791 in the 2016 Budget. Ordinary Budget net revenues over-performed the corresponding target by €2.398mn while ordinary budget expenditures were lower by €2.373mn compared to their 2016 Budget target.

[4] The spending review is reportedly scheduled to be completed by June 2017 so as the relevant findings to be incorporated in the Budget 2018.

Comments

- As part of the conditionality attached to the 1st programme, the two sides reached common ground earlier this year in appointing the new privatization Fund's 5-member Supervisory Board. Official creditors accepted the Greek government's proposal for three Board members, while, the Greek side accepted the institutions' proposal for the two members, including the President of the Board, Jacques le Pape, former right-hand of IMF General Director Christine Lagarde during her stint at the French Finance Ministry.[5] The Supervisory Board's main task will be to oversee the proper functioning of the Fund based on its founding law and other key internal documents. Yet, before the Privatisation and Investment Fund becomes fully operational, the two sides have to reach an agreement on the appointment of the members of the Board of Directors who will be assigned with executive tasks, including the management of the Fund's subsidies. Decisions on the appointment of the Board of Directors members will be reached by a qualified majority and both sides will have veto rights.
- The Greek government and the Hellenic Republic Asset Development Fund (HRADF) have taken important steps over the last few months in advancing the privatisation programme. These include: (i) the 40-year Concession Agreement with Fraport AG-Slenter Ltd Consortium for the development and operation of the 14 Regional Airports against payment of €1.23bn; (ii) the Share Purchase Agreement with Cosco Group Limited for the transfer of the 67% stake of Piraeus Port Authority for €280.5mn (an additional 16% of shares will be transferred five years later for €88n following completion of a mandatory €300mn capital expenditure programme); (iii) acquisition of the 90% share capital of Astir Palace Vouliagmenis SA, generating €95mn for the Greek state; and (iv) approval of a €45mn binding offer by Ferrovie dello Stato Italiane S.p.A for the 100% stake in state-run rail operator Trainose. Assuming that all these privatisations evolve as planned, recent local press reports suggest that the 2016 proceeds target will likely be met, assuming that the planned sale of certain real estate assets and a likely 20-yr extension of the Athens International Airport concession generate an additional c. €1bn within the next couple of months. Under the existing MoU conditionality, on top of €0.4bn collected in 2015, the privatisation revenue target (excluding bank shares) stands at €2.5bn for 2016, €2.2bn for 2017 and €1.1bn for 2018.[6]
- Despite the aforementioned progress, deviations from the agreed timeline for certain privatisations remain. Under the existing MoU, these include, inter alia, the engagement of advisors, initially planned for Q3 2016, for the evaluation and recommendation of alternative strategic options for the following privatisations: (i) the 35% stake of Hellenic Petroleum (HELPE); (ii) the 65% stake of Public Gas Corporation (DEPA);(iii) the 23% stake of Thessaloniki Water Supply & Sewerage (EYATH), (iii) the 35% stake of Hellenic Petroleum (HELPE); (iii) a minority stake of Athens Water Supply & Sewerage (EYDAP); and (ii) the 17% stake of Public Power Corporation (PPC). For the privatisation programme to gain further momentum, an imminent hurdle that has to be addressed is the appointment of a new HRADF Chairman after Stergios Pitsiorlas quit this post to be appointed Deputy Minister of Economy and Development in the recent cabinet reshuffle.

Greek government bonds outperform, bucking the negative trend in EMU periphery markets

Reversing fully their earlier gains, the majority of EMU sovereign bond markets came under pressure and peripheral spreads widened markedly over the last few sessions, as the unexpected US presidential outcome shifted market focus on populism risk in Europe ahead of a string of looming ballots in the region, *i.e.*, the Italian referendum and repeated presidential election in Austria both on December 4, general elections in the Netherlands on March 15 2017, French presidential election in April & May 2017 and German presidential election in autumn 2017. Admittedly, market reaction reflects a higher risk premium to political risks, as investors are currently assigning a higher probability to nationalistic outcomes after the US Republican party secured a sweeping victory defying the majority of opinion polls.

Bucking the negative trend in the EMU periphery, Greek sovereign bonds firmed amid increased market optimism over a timely conclusion of the 2nd programme review and subsequently, Greece's inclusion in the ECB's quantitative easing (QE) programme. A better than expected Q3 GDP flash estimate, also had some impact supporting our view that the Greek economy has probably bottomed out in H1 2016.[7] The 10-yr GGB yield was hovering around 7.35% at the time of writing (Thursday, Nov. 17, 16:00 CET) within distance from the 5 1/2 month low of 7.25% marked a week earlier and close to 7.13% year-to-date low recorded in late May after hitting a year-to-date peak of 11.8% in mid-February. Notably, the Greek bond market has been the star performer in the EMU

[5] The new Privatization and Investment Fund will in effect consist of a holding company with four subsidiaries under its management, namely (i) the Hellenic Republic Asset Development Fund (HRADF); (ii) the Hellenic Financial Stability Fund (HTSF) which holds capital instruments in the four systemic banks; (iii) a sub-entity that will monetize certain real estate assets of the Greek State (State Owned Real Estate Corporation S.A, ETAD) and (iv) a sub-entity to manage/monetize State Owned Enterprises (SOEs) and other shareholdings of the Greek State (State Owned Participations S.A., EDHS).

[6] Privatization proceeds from non-bank assets are expected to lower State financing needs by €6.2bn over the programme period

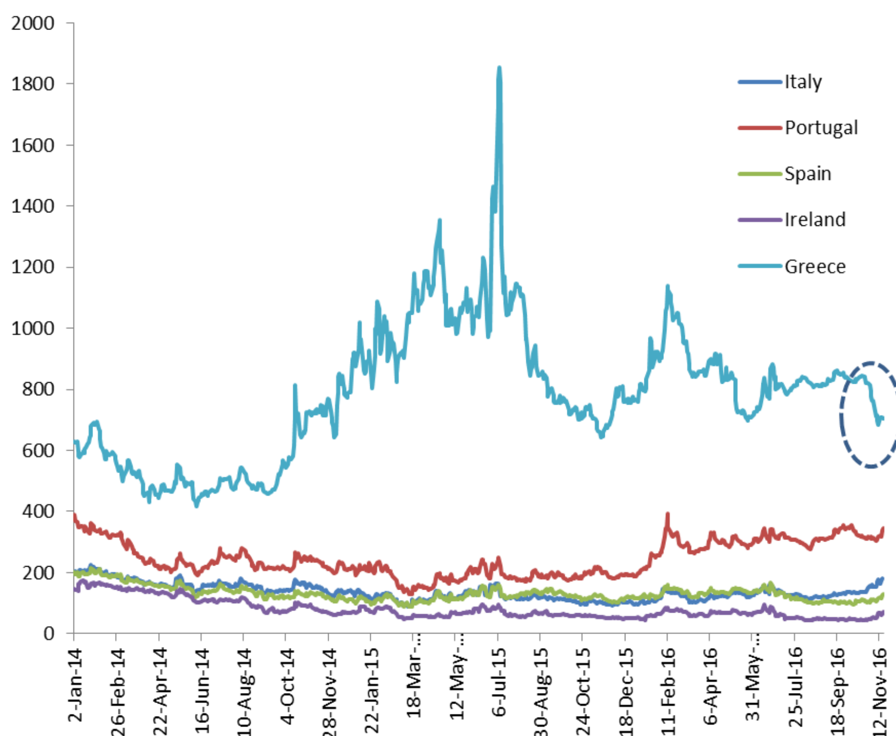
[7] Eurobank Research, Global Economic & Market Outlook, "*The Greek economy performs above market expectations in Q3 2016*", November 16, 2016, https://www.eurobank.gr/Uploads/Reports/Global_Economic_Market_Outlook_20161114.pdf

sovereign space so far this year. Partially assisted by an increase of the 10-yr Bund yield to multi-month highs in an environment of increased bond aversion due to expectations of higher US inflation pressures and wider budget deficits — should the US President-elect's proposals over an expansionary fiscal policy and trade protectionism be implemented — the 10-yr GGB/Bund yield spread was trading close to 700bps after hitting multi-week highs around 845bps a month earlier having narrowed by some 60bps cumulatively so far this year.

On the flip side, yield premiums of the majority of EMU peripheral sovereign bonds vs. their German peers remained in a widening trend with Portugal being one of the main underperformers amid mounting worries over the health of its banking sector. Reflecting increasing signs of stabilization in investor sentiment towards Greece, the cost of insuring Greek government bonds against default has fallen sharply over the last few months with the 5yr CDS trading close to 958bps at the time of writing, not too far from a four-month low of 917bps recorded a couple of weeks earlier and some 648bps lower from year-to-day highs in mid-February. Secondary market volume rose over the last couple of weeks with trading volume reaching some €500mn over the last 2-3 weeks, a fivefold increase compared to the average monthly volume recorded over the last few months.

Looking ahead, Greece is expected to continue outperforming other periphery markets as the government remains strongly committed to the fulfilment of the conditionality attached to the new bailout programme and upcoming data will likely boost optimism over an improved outlook for the Greek economy. Most importantly, inclusion of Greek marketable debt in the ECB's quantitative easing programme is expected to exert a profound impact on risk premia, contributing to a further significant GGB yield spread compression in our view.[8] The technical picture for the 10-yr GGB/German Bund yield spread suggests that a clear move below the 683bps recent low (Nov. 11) has the potential to open the way for further narrowing towards 632bps (Nov. 19, 2015 low) ahead of 560bps (May 15, 2014 peak).

Table 1: EMU 10-yr yield spreads vs. their German counterpart



Source: Bloomberg

[8] Eurobank Research, Greece Macro Monitor, "*Greece's prospective inclusion in ECB's QE programme, potential timing, purchasing volumes & market impact*", June 30, 2016, https://www.eurobank.gr/Uploads/Reports/GREECE_MACRO_Monitor_201606.pdf

Appendix - IMF Staff latest Article IV Mission to Greece: Key findings

In order to gain a better understanding on the IMF Staff's position and views on Greece's current stabilization programme, this section presents a brief summary of the Concluding Statement issued following their latest Article IV Mission to Greece (Sept 2016).

Summary of key findings

Greece needs to significantly deepen and accelerate the pace of implementing reforms in order to address pervasive structural problems that continue to hinder its recovery and pose considerable risk to long-term growth. These include: (i) a vulnerable structure of public finances due to unfavorable pension spending financed by high tax rates on narrow bases and a deteriorated payment culture; (ii) impaired bank and private sector balance sheets; (iii) lingering structural obstacles to investment and growth; and (iv) an unsustainable public debt burden, despite the large-scale debt relief received already. On fiscal policy in particular, the IMF staff does not necessarily see the need for further adjustment, especially taking into consideration the unprecedented fiscal consolidation attained thus far. This view stems from the Fund's well-publicized belief that the maintenance of high primary surpluses similar to those assumed in Greece's bailout programme (3.5% of GDP from 2018 onwards) would be quite difficult to sustain by an economy with adverse demographic trends and persistently high unemployment. Yet, the current composition of fiscal adjustment is deemed to add significant risks to the budget and to deter investment and employment, as it mainly relies on overtaxing narrow tax bases. In more detail, the IMF staff estimates that budgetary spending remains exceedingly focused on unaffordable pensions provided to current retirees, which crowds out much needed social spending to protect vulnerable groups, including the unemployed. Thus, a fiscally-neutral rebalancing of policies over the medium term toward lower pensions and a fairer distribution of the tax burden are deemed essential for the public sector to be able to provide adequate services and social assistance to vulnerable groups, while creating the conditions for investment and growth. Looking forward, such efforts should focus on the key areas of social spending and tax policies. On the former item, the IMF notes that despite the recent pension reform, which aims to lower spending by about 1 percent of GDP in the medium-run, the pension system's deficit remains highly unsustainable, at 11 percent of GDP (compared to an average of 2½ percent in the euro-area). Furthermore, the current policy of largely sheltering current pensioners while relying on much higher tax rates and lower expected pensions for current wage-earners is neither consistent with sustainable growth nor socially fair on grounds of inter-generational equity. As a result, a further reduction in current pensions is important (by e.g. unfreezing current pensions and applying the new benefit formula) in order to create the necessary space for social spending to protect vulnerable groups and provide essential public services. On the latter issue, the IMF staff notes that despite recent reforms in the income tax system and VAT, these reforms continue to rely on increasing tax rates, creating disincentives to work in the formal economy. Moreover, the income tax reform has not tackled Greece's very generous tax credit, which allows for more than half of wage earners to be exempt from income taxes (compared to 8 percent in the euro-zone). Such exceptionally generous exemptions for the middle-class are difficult to justify on social-fairness grounds, as they forego the revenues needed to protect the most vulnerable groups through welfare and unemployment benefits that are common elsewhere in Europe. In this context, the authorities should reduce tax (and social security contribution) rates, while lowering the generous income tax credit and eliminating remaining exemptions that benefit the rich.

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