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New austerity measures boost hopes for a successful completion of 5th EU/IMF programme review

- Government announces new austerity measures in an effort to bring adjustment programme back on track, secure continuous access to official funding
- The measures aim to bridge identified budget gaps in 2011-2012 and rebalance the overall thrust of the medium-term fiscal plan towards expenditure-side adjustment
- The latter is likely to improve budget execution as revenue performance is presently constrained by a deeper than expected recession and lingering dis-functionalities in the tax collection mechanism
- In our view, the new austerity package significantly increases the chances for a successful completion of the 5th EC/IMF/ECB programme review (our baseline scenario)
- Looking further ahead, a rigorous implementation of the adjustment programme will be critical for securing the uninterrupted flow of official funding and, more imminently, the ratification of the July 21 EU Council announcements by national EU parliaments

Following a second conference call with troika inspectors in as many days on Tuesday, deputy premier and finance minister Evaggelos Venizelos said in a statement that "satisfactory progress" was made during his talks with international lenders. A team of senior EU/IMF/ECB technocrats is now expected to return to Athens early next week, in an effort to complete the 5th review of the country's stabilization programme. Mr. Venizelos presented to the Greek cabinet yesterday a number of new proposals discussed earlier with troika officials. The proposals aim to: **a)** speed up implementation of a number of key structural reforms envisioned in the government's medium-term fiscal plan (MTFS) for the period 2011-2015 and **b)** introduce new austerity measures to ensure fulfillment of the *previously-agreed* fiscal deficit targets for this year and the next (€17.1bn and €14.9bn, respectively).

Notably, the new austerity package aims, primarily, to reduce costs in the broader public sector and engineer a rebalancing of the overall thrust of the medium-term plan towards expenditure-side adjustment. Reportedly, the relative contribution of expenditure cuts in the MTFS's envisioned deficit reduction shifts to 2/3rds from a broadly even contribution in the initial program. This appears to have been a key demand by official lenders. Reportedly, the troika now opposes further significant tax hikes, in view of the deepening economic recession and limited success by domestic authorities so far to reduce tax evasion and facilitate a more equitable shouldering of the overall adjustment burden.

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In a statement issued right after the conclusion of yesterday's cabinet meeting, the government highlighted the main parameters of the new austerity program and reinstated its commitment to do whatever it takes to ensure fulfillment of the fiscal and structural targets agreed with official lenders. Our understanding at this point is the measures presented yesterday are only preliminary, with the final announcement expected to take place upon completion of the next programme review in early October. The latter implies, in turn, the possibility of additional austerity measures, in case that this is judged necessary to appease official lenders and facilitate fulfillment of the deficit target. In what follows, we provide a brief assessment of the measures announced yesterday along with some additional information on the government's financing need for the remainder of the year.

Immediate transfer of 30,000 public sector employees to a special Labour Reserve

In line with the projections of the medium-term fiscal plan (MTFS), Greece targets a reduction in public sector employment by 150k employees or ca 20% in the period 2010-2015. Natural attrition (a 1:10 hiring rule in 2011 and 1:5 subsequently), reductions in contract employment and involuntary redundancies are among the main measures to achieve this target. Excess employees will be either separated immediately or transferred into a separate *Labor Reserve*. Time spent in this reserve will not exceed a period of 12 months, during which employees will be paid no more than 60 percent of their basic wage (excluding overtime and any extra payments). Transfers from the labor reserve to other public sector entities will be possible, but only under the attrition-related hiring limit, and with a positive evaluation of the employee from a special selection council (ASEP). At the end of the 12-month period separation will be mandatory. Reportedly, some 30k state workers will be transferred to the labor reserve by the end of the year.

Immediate cuts in public sector personnel via involuntary redundancies and reductions in contract employment

Since early 2010, some 30k-35k employees have reportedly left the public sector (vis. natural attrition or early retirement schemes). However, according to a number of *unconfirmed* press reports, over that period the government hired some 24k new employees in a number of arrears not covered by the 1:10 hiring rule (e.g. hospital doctors, security forces personnel) as well through special contracts.

Further reduction in the tax-exempt thresholds

The tax exempt threshold for personal incomes will be reduced further, to €5,000/annum from €8,000/annum. The measure will involve incomes earned in 2011 and it will be in effect from November 1st. A 10% tax rate will be applied to annual incomes ranging from €5k to €12k. According to some initial estimates, the effects of the new low tax exempt threshold will be as follows: Around 1.2mn people - *mainly, low-income earners, pensioners, but also those who avoided in the past to declare higher incomes* - will pay for the first time taxes ranging from €50 to €300 per annum; tax payers declaring annual incomes between €8k and €12k will pay extra taxes of €300 to €700; tax payers declaring annual incomes in excess of €12k will pay additional annual tax of €700; some 2.9mn tax payers will continue to pay no taxes, as they declare incomes below €5k per annum. Overall, the reduction in the tax exempt threshold is expected to bring some €1bn (~0.45%-of-GDP) in additional revenues to state coffers. The measure comes on top of a number of earlier steps, aiming to reduce tax evasion and broaden the tax base. Note that the government's medium-term fiscal plan that was voted in Parliament last June envisioned, among others, a reduction in the tax-except threshold for annual personal incomes to €8,000 from €12,000 earlier, a special fixed charge of €300 applied retrospectively to self-employed individuals for incomes earned in 2010 and a number of other special levies on higher incomes and property. The new measures are expected to broaden the tax base further at the expense of putting additional strains on lower incomes and pensioners. As a general assessment, tax evasion (ca 4ppts-of-GDP per annum, according to some estimates) remains a big problem hindering the government's fiscal adjustment efforts. Apparently, this partly relates to an inability of the tax collection mechanism so far to generate the expected results.

Equalization of special consumption tax on heating oil with that on motor fuels

The measure will become effective in mid-October 2012, instead of being gradually implemented over a 3-year period, as envisioned in the medium-term fiscal plan. The measure is estimated to bring to state coffers additional revenues of up to €400mn (~0.17%-of-GDP) per year.

Further reductions in pensions

20% reduction in the part of monthly pension payments exceeding €1,200 (and 40% cut in the part of monthly pensions exceeding €1,000 for all pensioners below 55 years of age). Additional cuts in a number of auxiliary pensions and steep reductions (between 20%-30%) in lump sum payments to civil servants upon retirement. The measure is expected to be in effect from November 1, 2011 and affect about half a million pensioners.

Specially levy on property

A special levy on property assets announced by the government earlier this month is likely by extended for two additional years, to 2014 from 2012 envisioned earlier. According to some preliminary estimates, the measure will generate additional annual revenues ranging from €1bn to €1.8bn (0.45% to 0.8%-of-GDP).

Measures to reduce the wage bill further

(A government draft report on the new measures handed to journalist yesterday did not provide specify info on the new "equal pay for equal work" scheme that will apply to the broader public sector; The figures and estimates we quoted below are drawn from the medium-term fiscal plan and a number of recent press reports).

Further reductions in state sector salaries (between 10% and 40%) will apply through by the imminent introduction of an "equal pay for equal work" scheme. These measures are estimated to reduce public sector salaries by between €150 and €1,500 per month. The so-called Single Payment Authority was earlier expected to start being implemented in July 2011; initially at a central government level and, eventually, in the broader public sector. The scheme is now expected to become operational next month, aiming to result into a significant rationalization and simplification of the public sector pay structure. Presumably, the latter remains overly generous for certain groups of public workers, who are currently receiving basic wages and special benefits well in excess of other private and public sector employees with comparable qualifications. According to a recent IMF report (No. 11/175, July 2011), Greece's public sector wage premium over the private sector used to be about 11%, after controlling for employees' and jobs' characteristics. Furthermore, the premium was as high as 32% without controls. Although the 2010 wage reductions contributed to reduce these premiums, they have not fully disappeared yet.

Assessment

The new fiscal measures announced yesterday came on the heels of a sudden decision by Greek Prime Minister George Papandreou on Saturday to cancel a planned visit to the U.S., in a move to better focus on fiscal reforms and "ensure that all of Greece's commitments (to its official lenders) are fulfilled". As a reminder, the government announced earlier this month its decision to: **(i)** speed up implementation of a number of key structural reforms envisioned in its medium-term fiscal plan and **(ii)** impose of a special levy on property in order to generate additional revenues of more than €2bn/annum this year and the next. Apparently, the EC/IMF/ECB technocrats conducting the 5th programme review had not been entirely convinced that the earlier announced austerity package would be adequate to generate the expected results and thus, they requested additional measures.
Reportedly, the troika has identified respective budgetary shortfalls of ca €2bn (~0.9ppt-of-GDP) and up to €4.5bn (~2ppt-of-GDP) in 2011 and 2012. Purportedly, these will be bridged with the new austerity measures in order to facilitate fulfillment of the headline deficit targets (along with an envisioned shift of the primary balance from a deficit of ca 0.8%-of-GDP this year to a surplus of 1%-of-GDP or higher in 2012).

Our view at this point is that the newly announce measures increase considerably the chances of a successful completion of the 5th programme review, which comprises our baseline scenario. Looking further down the road, a rigorous implementation of the EU/IMF agreed reforms will be crucial for securing the uninterrupted flow of official funding and, more imminently, the ratification of the July 21 EU Council announcements by national EU parliaments.

Importantly, the successful completion of the 5th programme review constitutes a rigid prerequisite for the release of the next tranche (€8bn) under the existing Greek Loan Facility. A swift disbursement of the new loan tranche is critical for avoiding unforeseen disruptions in primary deficit financing or even the proper debt servicing of interest and principal obligations. Reportedly, state cash reserves are nearing depletion again and, as deputy finance minister Filippos Sachinidis admitted recently, the next EU/IMF loan tranche should be released by mid-October at the latest to avoid cash flow problems.

Luckily, the next major bond maturities do not come until mid-December *(€1.17bn on December 19 followed by €5.2bn on December 30).* In the meantime, of course, the government will still need to continue to finance its primary deficit *(e.g. pay pensions and civil servant wages),* meet interest rate payments and roll-over maturing T-bill issues (see table below). In addition, a considerable volume (~2.8ppts-of-GDP as of July 2011) of accumulated outstanding debts to various state suppliers need to be settled by the end of the year, so as to more fully comply with the EU/IMF programme's requirements.

Greece's finanical needs in terms of overall principal and interest payments

	T-bills Maturities (€ bn)	Bond maturities (€ bln)	Coupon Payment (€ bn)	Total servicing cost (€ bn)
Sept. 2011 (21st-30th)	2.00		0.01	2.01
Oct. 2011	3.63		1.11	4.73
Nov. 2011	3.30		0.07	3.37
Dec. 2011	3.63	8.10	0.43	12.15

Source: Eurobank Research, Bloomberg

On a more comforting note, the new fiscal measures and an earlier auxiliary austerity package that came into effect in early September *(see e.g. Eurobank EFG Greece Macro Monitor September 12, 2011)* are likely to improve revenue collection and reduce public spending during the fourth quarter of this year. This should facilitating adequate government funding until the release of the 7th EU/IMF loan tranche (~€5bn) that is scheduled for December 2011. That is, provided that the 5th EC/IMF/ECB programme review will be completed successfully.

More worryingly though, the new austerity measures are likely to meet strenuous resistance from trade unions and vested interests and also exaggerate the domestic economic recession. On the latter issue, the IMF now forecasts real GDP to contract by 5.5% this year and by 2.5% in 2012. These compare with respective output growth forecast of -3.9% and +0.6%, projected in the July 2011 IMF report for Greece.

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