Athens, May 3, 2010

Focus-Greece

New 3-year economic stabilization programme

Key measures and assessment

Prime Minister George Papandreou told a televised cabinet meeting on May 2 that his government sealed a deal with the EU and the IMF on a multi-billion euro rescue package, aiming to address the immense funding problems the country is presently facing and contain the spillover effects of the debt crisis to other EU countries featuring deteriorated public finances.

Mr. Papandreou characterized the rescue deal as ''an unprecedented support package'' that requires ''an unprecedented effort'' by the Greek people. Finance Minister George Papaconstantinou gave details of the agreement, before heading to a Eurogroup meeting later on Sunday, where the aid package won the bloc's formal approval.

Greek government bonds reacted positively to the news, with yield spreads over the corresponding German securities tightening by around 50bps-130bps across the spectrum of maturities and short-dated paper outperforming. An ECB announcement earlier today that it would continue to accept all Greek government bonds as collateral in its liquidity-provision operations, even if their credit ratings continues to fall, provided additional support.

The Greek equity market was recording marginal losses at the time of writing (FTSE/ASE 20 down 0.18%), mostly on *a buy-the-rumor-sell-the-fact* type of reactions and, potentially, discounting a further deterioration in the domestic economy in the period ahead.

Part A

Greece announces new austerity program to eliminate excessive deficit by 2014

According to a **Finance Ministry document** distributed to reporters after the conclusion of the May 2 cabinet meeting, the **new stabilization program** Greece has agreed with a recent trilateral EC/ECB/IMF mission in Athens **features the following projections and conditionality**:

New fiscal targets and macroeconomic projections: The new programme is framed on considerably more pessimistic macroeconomic forecasts about the domestic economy relative to those envisioned in the country's latest Stability and Growth Progamme that was submitted to the European Commission in January 2010 *(Table 1).*

Table 1: New stabilization programme vs. SGP pesimistic scenario: *Projections & tragets*					
New Fiscal Adjustment Programme					
	2010	**2011**	**2012**	**2013**	**2014**
Real GDP growth (%)	-4.0	-2.6	1.1	2.1	2.1
General gvnt deficit (% GDP)	8.1	7.6	6.5	4.9	2.6
Public debt (% GDP)	133.3	145.1	148.6	149.1	144.3
Previous (pesimistic) scenario - SGP					
	2010	**2011**	**2012**	**2013**	**2014**
Real GDP growth (%)	-0.8	1.0	1.5	2.0	n.a.
General gvnt deficit (% GDP)	8.7	5.6	2.8	2.0	n.a.
Public debt (% GDP)	120.4	120.6	117.7	113.4	n.a.

Source: SGP, FinMin

Understandably, the new macroeconomic projections reflect with a greater degree of precision the present views of the IMF and the European Commission regarding the future prospects of the Greek economy under the agreed fiscal consolidation programme. These are also broadly in line with the current market consensus and Eurobank EFG Research´s latest forecasts published in late March 2010[1].

Back then, we presented a ''feasible'' scenario envisioning a 2.8 percent real GDP contraction in 2010, followed by a further 1.0 percent output decline in 2011 and a return to positive, but still below-potential, growth trajectory in the period 2012-2013. We also emphasized that risks to our *feasible* scenario were determinedly skewed to the downside and presented a number of conditions under which domestic growth could contract by at least 4 percent points in 2010 (and recover thereafter at a pace slower than that projected in the more optimistic scenario).

Our forecasts also envisioned a peak in the public debt-to-GDP ratio at levels around 133% by the end of 2013. However, as we noted in late March, our forecasts on the evolution of the debt ratio were surrounded by considerable upside risks, not least because of a number of potential additions to the debt stock as a result of outstanding state liabilities to various suppliers and state guarantees on debts assumed by entities in the broader public sector.

Note also that in the late April, Eurostat revised upwards its estimates for Greece's 2009 general government deficit and debt figures (to 13.6%-of-GDP from 12.7%-of-GDP and to 115.1% from 112.6%, respectively) and left the door open for additional revisions (to the tune of 0.3-0.5ppts-of-GDP for the general government budget deficit and 5-7ppts-of-GDP for the public debt ratio). *Obviously, these developments render our earlier forecasts on Greece generally consistent with the new stabilization program's projections and thus, our preliminary assessment is that the latter are broadly realistic.*

New austerity package envisions €30bn in additional budgetary cuts over a three-year period: Greece's new stabilization programme aims to cut the budget deficit by €30bn over a three-year period and contains a range of new measures , besides these envisioned in the SGP and the auxiliary budget for 2010, announced by the government in early March. Reflecting a more realistic view of the present situation and incorporating the recent upward revisions to the 2009 fiscal data, the new programme targets a reduction in the general

[1] Please see Eurobank EFG Research. Greece: Macro Monitor, March 2010.

government budget deficit to sub-3.0%-of-GDP levels by the end of 2014 *i.e., two years later than projected in the SGP.* To that end, the targeted fiscal adjustment for 2010 is strengthened with additional *(cost-saving & revenue-generating)* measures, expected to reduce the fiscal deficit by a further €5.8bn *i.e.,* in addition to the adjustment that was foreseen earlier. For the next 3-years, the total fiscal adjustment is expected to be ca €10bn in 2011, €5bn in 2012 and €4.8bn in 2013.

The measures and policies included in the new austerity package cover the following three general areas:

- Measures to facilitate fiscal adjustment
- Measures to boost competitiveness and economic developments
- Measures to strengthen liquidity and capitalization of domestic banks

(Table 2 at the last page of this document provides a detailed quantitative assessment of the programme over the period 2010-2011)

A.1 Fiscal Measures

On the receiving side, the measures are expected lift the general government revenue-to-GDP ratio by 4ppts till the end of 2013, from 37% in 2009. These include:

- A further rise of 2ppts in the main VAT rate to 23% from 21%, presently. The two lower VAT rates will also be raised (by 1ppt for the current 10% rate and by 0.5ppts for the current 5% rate). The government expects the new VAT hikes to generate additional revues of €0.80bn (or 0.3% of GDP) in 2010 and €1.00bn (or 0.4% of GDP) in 2011.

- Measures to broaden the VAT tax base

- A 10ppts hike in the special taxes on fuels, tobacco products and alcoholic beverages, expected to bring to state coffers additional revenues of €0.45bn (or 0.2% of GDP) in 2010 and €0.60bn (or 0.3% of GDP) in 2011.

- A rise of 10ppts in the special tax applied to a range of luxury goods.

- A one-off tax will be imposed on profitable domestic firms, aiming to generate some €0.60bn ((or 0.3% of GDP) in 2011.

- Licensing and taxation of domestic betting and gaming firms

- Introduction of a ‘‘green’’ tax

On the cost side, the new austerity package aims to reduce the general government expenditure-to-GDP ratio by ca 7ppts by the end of 2013, from around 50% in 2009. The measures include further steep cuts in pensions and public sector wages as well as additional reductions in public investment expenditure. Specifically,

- The Public Investment Budget (PIB) for 2010 will be reduced by €0.5bn *(or 0.2% of GDP).*

- The 13th and 14th annual salary installments will be abolished for civil servants earning a gross salary in excess of €3,000/month. For those earning less than the latter amount, the 13th and 14th salary installments will each be reduced to €500/per employee. Special allowances, which constitute a significant part of the total wage bill, will be cut by a further 8% for civil servants and by 3% for employees in state-controlled public corporations. These measures are officially expected to generate additional savings of €0.8bn (or 0.3% of GDP) in 2010 and €0.4bn (or 0.2% of GDP) in 2011.

- A 3-year freeze in wages and pensions.

- State- and private-sector pensioners receiving monthly pensions in excess of €2,500 will lose their 13th and 14th annual pension payments. The rest will be receiving €400 for the 14th installment (Christmas bonus) and another €400 for the 13th installment (€200 in the form of an Eastern bonus plus €200 for the Summer holiday bonus). According to government´s estimates, this measure will generate additional cost savings of €1.5bn (or 0.6% of GDP) in 2010 and €0.5bn (or 0.2% of GDP) in 2011.

- Private-sector employees will continue to receive their 14h and 13th annual salary payments.

- Postponement of the second tranche of a *solidarity* bonus *(to around 2.5mn lower-income earners),* which is expected to save some €0.4bn (or 0.2% of GDP) in 2010.

- Further cut backs in central government operational costs

- Objective values on property will be raised and will be brought closer to current market levels, in a bid to boost taxable income.

- A tax will be introduced for the legalization of *semi-open* building spaces

- A new law will be introduced to reduce the total number of municipalities to one-third of the existing number.

A.2. Measures to boost competitiveness and enhance medium-term economic growth potential

The package includes a range of reforms aiming to boost labor market flexibility, enhance competitiveness and restructure the social security system. Among others, these include:

- A new framework for lay-off benefits, the minimum percentage of allowed private sector lay-offs, the minimum wages for persons entering the labor market and chronic unemployed persons.

- New rules for part time employment as well as for the reduction of overtime employment.

- Measures to confront uninsured employment.

- Changes on the unemployment benefits legislation so as to create a safety net for lower incomes.

- Women's minimum retirement age requirement will be set to 65 years. The new rule will be applied during the period 2011-2013.
- Retirement income (pensions) will be calculated on the basis of income earned over the whole employment period and not on income earned over the last few years of employment.
- Retirement income will be automatically adjusted to life expectancy.
- Increase of the minimum contributions period from 37 to 40 years until 2015.
- Increase in the minimum early-retirement age to 60 years. Up to now a number of minimum early-retirement age requirements existed with an average of 57 years.
- Revisions to the framework concerning disability pensions.
- Minimum retirement income for persons under 65 years of age based on income considerations.

- A reduction in the number of social security organizations (Public Pension Funds)
- A simplification of procedures needed to start-up and operate a new business along with additional measures to reduce red tape in the economy. Note that Greece was ranked in the 109th place in World Bank's 2009 "Doing Business" ranking due to the absence of related reforms[2]. According to MECS, these measures are expected to improve the country´s "Doing Business" rankings by 65 to 70 positions.
- Implementation of the EU Directive for the Services sector. Note here that the EU Services Directive aims to remove the legal and administrative barriers to trade in the services sector across member states. Implementation of the Directive is expected to increase competition in the Greek services sector.
- Revisions to the existing regulatory framework on competition.
- Deregulation of the domestic energy market and reinforcement of the independence of the Regulatory Authority for Energy (RAE).
- Opening up of a range of closed professions. These professions include costal transportation, drugstores, notaries etc. It is expected that the opening up process will increase competition and create new jobs.
- Improvements in the regulatory environment for R&D and innovation.
- Introduction of a new investment law, aiming to attract new foreign investments *(Green investments, telecommunications, etc).*
- Reorganization of the loss-making public railways company, Hellenic Railways Group, and the development of a new business plan in order to make it profitable.

[2] Refer to Greece Macro Monitor (November 2009) for more information on Greece's World Bank "Doing Business" rankings and to Greece Macro Monitor (March 2010) for more information on the measures that intend to boost competitiveness.

A.3. Creation of a Bank Stabilization Fund

According to reports, a bank stabilization fund will be created under the supervision of the EU and the IMF. It will operate as a safety net for domestic banks and the financial system as whole. Its funding will come from two sources. The first is the EU/IMF package. €10bn of the total amount of €110bn will be attributed to the bank stabilization fund. The second source is the Greek government's stimulus plan for the banking sector. This plan was firstly introduced in late 2008 amid the world financial crisis and initially included €28bn. Out of this amount some €17bn still remains unused. The major part of these funds is in the form of loan guarantees by the Greek State to the Greek financial institutions (€ 12 bn still remain). The remaining funds are in the form of special securities issued by the Greek State (€3.4 bn remain) and the purchase of preferred stocks by the Greek State (€1.2 bn remain).

Part B
Size, duration and conditionality of EU / IMF rescue package for Greece

On the basis of what was agreed by euro zone finance ministers at y-day´s Eurogroup meeting, the following are known with respect to the total size and operational characteristics of the rescue package for Greece:

- A total of €110bn in IMF lending and bilateral loans by Euro zone countries will be available to Greece over the 3-year period of the operation of the agreed stabilization programme.
- Euro zone countries will contribute to the loans according to their respective holdings in the ECB´s capital, with total lending from that source amounting to up to €80bn over a three year period. The rest €30bn of loans will come from the IMF.
- In 2010, Greece will receive up to €30bn from the Euro zone, with the first funds being delivered to Greece before May 19, when a €8.5bn bond matures. We do not yet know the IMF´s contribution during the first year of the support programme, but we assume that this will be flexible (and front-loaded) enough so as to facilitate fulfillment of Greece's roll-over and debt financing needs.
- The cost structure and effective interest rate applied to EU bilateral an IMF loans is already known *(see e.g. Eurobank EFG Research, Latest on the Greek Debt Crisis, April 27, 2010).* All in all, **a)** the EU/IMF loans will come at a much lower cost than that implied by current market funding rates **b)** the annual *effective* cost of IMF loans will be lower than that of EU bilateral loans (by at least 100bps) and **c)** the cost structure of EU/IMF loans is such that gives a strong incentive to Greece to do whatever it takes *(in terms of fiscal consolidation)* to be able to return to financial markets before termination of the 3-year aid programme.
- With respect to conditionality and program monitoring, we understand that Greece's progress with respect to the execution of the stabilization program will be monitored by the EU and the Fund on a quarterly basis. The amount of loans to be paid out will be determined after each quarterly review and additional measures will be requested in case of deviations from the program´s targets.

Part C
Our assessment of Greece´s new stabilization programme

- We believe that the agreed rescue package for Greece *(and the ECB´s latest announcement on collateral rules)* provides a powerful signal that the EU and the IMF are determined to do whatever it takes to stop the Greek sovereign crisis from becoming a systemic, an potentially destabilizing, risk for the common currency area and world financial markets.

- We consider the new stabilization programme´s macroeconomic forecasts for Greece to be realistic, and broadly in line with Eurobank EFG Research's latest projections (March 2010).

- Undoubtedly, Greece's new stabilization program is ambitious and likely to prove painful for the domestic economy, at least during the first two years of its implementation. For a medium-term perspective, the measures agreed are necessary to tackle long-standing rigidities in the domestic economy and reduce the severe crowing out of the private sector.

- In our view, there is presently a lot of fat to be cut, especially via measures to downsize the public sector and make it operate more efficiently. A rigorous implementation of such measures and the government´s reforms agenda could translate to significant competitiveness gains for the economy in the medium term.

- The measures announced and the IMF involvement in the rescue package are likely to work as a powerful anchor for market sentiment and the implementation of the government´s reforms agenda in the period ahead.

- We continue to see room for a further de-escalation of Greek sovereign debt spreads. However, this will likely prove a gradual progress, contingent on real evidence of a successful implementation of the stabilization program in the months and quarters ahead.

Important days to watch in the period ahead

This week: According to IMF Director, Dominique Strauss-Kahn, the Fund´s board is expected to approve its €30bn portion of loans to Greece by the end of the present week.

May 5: European Commission (EC) issues Eurozone spring economic forecasts (pay attention to the relevant figures for Greece)

May 7: EU heads of state to endorse May 2nd Eurogroup decisions and exchange information on the progress made in terms of parliamentary approval for the loans in respective countries. *(Eurogroup Chairman Jean-Claude Juncker said y-day there was no possibility of the leaders changing the decision).*

May 9: German regional elections

May 10: Greece needs to pay €2.28bn in coupon payments

May 15: Greece to submit to the EC an official report on the budget execution y-t-d and the time line for the implementation of the structural reforms

May 18: Scheduled Ecofin meeting

May 19: €8.5bn bond redemption in Greece

Table 2

2010 Fiscal Measures (bln euros): Projected fiscal adjustment in excess of that targeted previously	
Revenue side	**1.25**
VAT hike	0.80
Increase in excise tax on fuels	0.20
Increase in the excise tax on tobaco products	0.20
Increase in the excise tax on alcoholic beverages	0.05
Expenditure side	**4.55**
Cuts in public-sector wages and special allowances	1.10
Cuts in government consumption expenditures	0.70
Tax on high retirement income (LAFKA)	0.35
Abolishment of 2nd solidarity transfer to lower incomes	0.40
Pension cuts	1.50
Cuts in Public Investment Budget (PIB)	0.50
Total	**5.80**
2011 Fiscal Measures (bln euros): Overall fiscal adjustment	
Effects from the previous year	**2.50**
VAT hike	1.00
Increase in excise tax on fuels	0.25
Increase in the excise tax on tobaco products	0.30
Increase in the excise tax on alcoholic beverages	0.05
Cuts in public-sector wages and allowances	0.40
Cuts in Public Investment Budget (PIB)	0.50
Revenue side	**5.00**
Taxation of unlinsenced buildings	1.30
Taxes on luxury goods	0.10
New accounting framework for the determination of taxable income	0.05
New taxes on gaming companies	0.20
Revenues from gambling licenses	0.50
One-off tax on profitable firms	0.60
Revenues from changes in VAT legislation and the enlargement of the tax basis	1.00
Green taxes	0.30
Revenues for a new accounting system for the determination of taxable income (Objective Criteria)	0.40
Increase of real estate objective values	0.40
Taxes on in kind income	0.15
Expenditure side	**2.15**
Intermediate consumption	0.30
Reduction of wage expenditures	0.10
No pay rises in retirement income	0.10
Reduction in expenditure via the "*Kallikratis*" programme for municipalities	0.50
Tax on retirement income (LAFKA)	0.15
Cuts in Public Investment Budget (PIB)	1.00
Total	**9.65**

Source: Finance Ministry

Written by:

Gikas Hardouvelis
Chief Economist &
Director of Research
Ghardouvelis@eurobank.gr

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

Theodore Stamatiou
Research Economist
Tstamatiou@eurobank.gr

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