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The Economic Adjustment Programme for Greece
Third Review - Winter 2011

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European Commission

Directorate-General for Economic and Financial Affairs

The Economic Adjustment Programme for Greece Third Review - winter 2011

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EXECUTIVE SUMMARY

A joint Commission/ECB/IMF mission met with the Greek authorities in Athens on 27 January–11 February 2011. The mission assessed compliance with the terms and conditions of the Third Review under the economic adjustment programme and updated conditionality for the next reviews. Completion of the review will release the fourth tranche of financial assistance from euro-area Member States to Greece (EUR 10.9 billion) according to the pooled-loan agreement. Completion of the IMF review under the stand-by arrangement is expected to release an additional EUR 4.1 billion.

The programme's objectives remain intact. The objectives of the adjustment programme are to preserve financial stability and adequate liquidity in the banking sector, a front-loaded reduction in fiscal deficit to restore public debt sustainability, and a change to a growth model based on exports and investment, to ensure growth and jobs and the sustainability of the external accounts. As this Compliance Report documents, these objectives remain intact. The programme is broadly on track and has made further progress towards its objectives.

Going forward, there are major challenges. A number of important hurdles have emerged. They include a tense financial situation, contagion from other peripheral economies, persistent deficiencies in tax collection, some delays and capacity problems in delivering complex and far reaching structural reforms. Delivering on programme targets will require much stronger resolve to implement the agreed policies than in the past two quarters.

The main features of the macroeconomic scenario remain unchanged, but growth composition needs reshaping. Economic activity contracted by 4.5 percent in 2010, broadly as expected when the adjustment programme was designed in May 2010. However, available data suggest that the downturn in domestic demand, mainly private consumption, was deeper than expected, while exports and non-domestic orders were strong at the end of 2010. The inflexion point of activity is estimated to sit in the last quarter of2010, while positive growth is expected to be recorded in the second half of 2011. Underlying inflation, wage settlements and unit labour costs are moderating, leading to improved competitiveness. The progressive rebalancing of the economy, supportive external demand and growth-friendly reforms are expected to move the economy back to its potential. Growth rates for 2012–14, which underlie the programme, are prudent.

Most fiscal criteria for 2010 have been met. A severe contraction in payments towards the end of the year offset large shortfalls in tax collection, thus resulting in the compliance with the cash-based quantitative criteria. The ESA fiscal deficit – which has a wider coverage and refers to underlying expenditure commitments rather than cash outflows – is estimated to have exceeded its ceiling by 1½ percent of GDP, as already projected at the time of the previous review in November. This slippage was in part due to the revision of historical statistics in autumn.

Fiscal policy in 2011 aims to further reduce the deficit-to-GDP ratio to EUR 17 billion (7½ percent of GDP). However, there are significant negative risks: current projections indicate a gap of ¾ of a percent of GDP, due to base effects, as tax revenues at the end of 2010 were below previous estimates, and a downward revision for the yield of some fiscal measures. The government is committed to offset this gap. It will specify permanent fiscal measures once it

finalises its medium-term fiscal strategy in end-March (adoption in early May). In the interim, to ensure to ensure compliance with the fiscal targets, it will compress expenditure – the same strategy of last year, which showed increased strains through the year as arrears built up.

The government is preparing its medium-term fiscal strategy. The medium-term strategy document will set annual spending ceilings for individual line ministries and fiscal balance targets for all general government entities. Greece is still swimming against the recession and the tide of increasing interest payments. As a result, to bring the deficit below 3 percent of GDP in 2014, some 8 percent of GDP in permanent measures will be needed over the period 2012-14, of which 2 percent has already been identified in the May 2010 programme. This additional fiscal consolidation effort will require structural reforms in several key areas, tackling the root causes of Greece's fiscal imbalances. These reforms will need to cover public enterprises, healthcare, tax policy, public employment, extrabudgetary funds, investment and military spending.

The foreseen very ambitious privatisation and real estate development programme will be of great support to the fiscal consolidation efforts. The government has committed to considerably scale up its privatisation and real estate development programme, and the objective is to realise EUR 50 billion in privatisation proceeds from now to 2015. This has the potential of cutting the debt ratio by more than twenty percentage points of GDP over the next five years. Furthermore, the privatisation programme is likely to increase economic efficiency and support higher investment and exports. The government's commitment to this process, including determination to tackle privileges and vested interests, will be critical. If successful, this new initiative has the potential of substantially improving the market sentiment vis-à-vis Greece.

Following a slowdown in momentum in autumn, a wave of structural reforms is now underway. After some important reforms adopted before the summer 2010, including a landmark pension reform and a first leg of labour reforms, structural reform efforts lost traction, and there have been delays compared to earlier policy commitments. A law to further liberalise the labour market was adopted at the end of the year, with a reform of collective bargaining and other associated measures. However, its ambition was below expectations, though time is necessary to assess its effectiveness. Several other reforms are being prepared. The removal of unnecessary hurdles to the entry and exercise of professions is a flagship reform of the whole adjustment programme; its implementation requires political determination against incumbents. The reform of the national healthcare system aims at reducing costs without endangering the quality of care. A number of business environment-related measures, such as a new investment law, a new competition law and new rules on licensing have been adopted or are approaching parliamentary proceedings. Irrespective of the urgency in adopting these reforms, it is critical to ensure the quality and ambition of legislation, as well as determined and effective implementation.

The programme has been effective in safeguarding financial sector stability. However, tight liquidity and rising non-performing loans are putting strains on the banking system. In line with the slowdown of economic activity and continuing deposit outflow, the annual growth rate of credit to private sector has recently turned negative. Encouragingly, some private banks have recently enjoyed some success in raising capital, but efforts need to be further intensified. Several initiatives are under way. Firstly, the government will adopt a new tranche of government guarantees in an amount of EUR 30 billion. Secondly, the Bank of Greece has asked banks to devise and implement medium-term funding plans. The plans will aim at reducing banks' reliance on Eurosystem refinancing operations and state guarantees over a

medium-term horizon, at a pace consistent with the program's macroeconomic and fiscal framework. Finally, the restructuring of state banks is moving forward whilst the authorities encourage private banks to raise capital and restructure as needed. It is essential that the government address without delay the stability and efficiency of the banks under its control.

There is an intense debate on debt management operations to reduce the stock of sovereign debt. These operations could cover buy-backs, the roll-over of debt or the voluntary extension of maturities. Irrespective of the merit of those actions – which this report does not discuss – they would only provide a modest and one-off contribution to debt sustainability in Greece. Therefore, this debate and those actions, if implemented, must not reduce the political determination to, or distract the public opinion from, fiscal consolidation, privatisation and growth-enhancing structural reforms.

Subject to approval by the Eurogroup, the positive assessment of compliance with programme conditionality will release the fourth tranche of the loan from euro-area Member States (EUR 10.9 billion). Overall, the mission concluded that the conditions for the fourth disbursement were broadly met. The fiscal target for 2011 is within the interval of credible outcomes, and a wave of structural reforms is being prepared. The swift elaboration and approval of a medium-term fiscal strategy is imperative. There is no guarantee of success. More than ever, the next steps in the implementation of the programme will require the government's determination, political coordination and the consensus of the Greek society.

1. INTRODUCTION

1. **This report assesses compliance with the conditions of the third review of the Greek economic adjustment programme.** The assessment is based on the Greek government's quarterly progress report and the findings of the joint Commission/ECB/IMF review mission to Athens (27 January-11 February 2011). The mission assessed compliance with conditionality associated to the fourth disbursement and progress towards the key programme objectives of safeguarding the stability of the financial system, securing fiscal sustainability, and boosting competitiveness, potential growth and jobs. The mission discussed policy challenges and updated conditionality requirements for the next quarters. Updated memoranda were agreed with the authorities on 11 February 2011 and are attached to this Compliance Report.[*]

2. **In May 2010, the euro-area Member States and the IMF provided financial support to Greece in the context of a sharp deterioration of its financing conditions.** On 2 May 2010, the Eurogroup agreed to provide bilateral loans pooled by the European Commission for a total amount of EUR 80 billion to be disbursed over the period May 2010-June 2013. The financial assistance provided by euro-area Member States is part of a joint package, with the IMF financing additional EUR 30 billion under a stand-by arrangement. This financial assistance package fully covers the government's financing needs related to its fiscal deficit and maturing medium- and long-term liabilities until the beginning of 2012, and progressively less thereafter. During the whole programme duration, Greece keeps its access to short-term market financing.

3. **Three instalments have already been disbursed under the programme.** After the fourth disbursement, which, if approved by the Eurogroup and IMF board, is expected to take place by mid-March 2011, four tenths of the full package will have been disbursed. Two euro-area Member States – Ireland and Slovakia – are currently not participating in the disbursement of bilateral loans to Greece. Given the conditions of the loan facility agreement between Greece and the euro-area partners, this has no material impact on amounts that have already been paid or that are planned to be paid to Greece in 2011, as the relatively small shares of those two countries to the total euro-area loan to Greece are being redistributed among other partners. Following the Eurogroup's statement of 28 November 2010, technical work is ongoing to align the maturities of the financing for Greece to that of Ireland.

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[*] This Compliance Report is released together with the Commission Communication "Follow-up to the Council Decision of 10 May 2010 addressed to Greece" (COM (2011) 85, of 24 February 2011).
The quarterly report submitted on 12 February 2011 (revised 23 February), by the Greek Ministry of Finance is available for download at: http://ec.europa.eu/economy_finance/sgp/deficit/ countries/greece_en.htm.
During the review mission in Athens, the Commission/ECB/IMF staff teams met with the ministers of Finance; Regional Development and Competitiveness; National Defence; Environment, Energy and Climate Change; Labour and Social Security; Health and Social Solidarity; Interior, Decentralisation and e-Government, as well as with the governor of the Bank of Greece. Moreover the teams met with staff of these ministries and the central bank, as well as of the ministries of Infrastructure, Transport and Networks; Culture and Tourism; Education, Lifelong Learning and Religion; Public Debt Management Agency, Hellenic Financial Stability Fund, Hellenic Statistical Authority, Hellenic Capital Markets Committee and Hellenic Competition Commission. Meetings also took place with social partners, think-tanks and several banks.

Table 1. Disbursements under the economic adjustment programme (EUR billion)

Past disbursements					
	Euro-area Member States		**IMF**		**Total**
1st tranche	18 May 2010	14.5	12 May 2010	5.5	20.0
2nd tranche	13 September 2010	6.5	14 September 2010	2.5	9.0
3rd tranche	19 January 2011	6.5	21 December 2010	2.5	9.0
Total past disbursements		27.5		10.5	38.0

Planned disbursements					
	Euro-area Member States		**IMF**		**Total**
4th tranche	March 2011	10.9	March 2011	4.1	15.0
5th tranche	June 2011	8.7	June 2011	3.3	12.0
6th tranche	September 2011	5.8	September 2011	2.2	8.0
7th tranche	December 2011	3.6	December 2011	1.4	5.0
8th tranche	March 2012	7.3	March 2012	2.7	10.0
9th tranche	June 2012	4.4	June 2012	1.6	6.0
10th tranche	September 2012	4.4	September 2012	1.6	6.0
11th tranche	December 2012	1.5	December 2012	0.5	2.0
12th tranche	March 2013	4.4	March 2013	1.6	6.0
13th tranche	June 2013	1.5	June 2013	0.5	2.0
Total planned disbursements		52.5		19.5	72.0
Total programme					**110.0**

Source: Commission services and IMF.

Table 2. Contributions by the euro-area Member States to disbursements to Greece (EUR million)

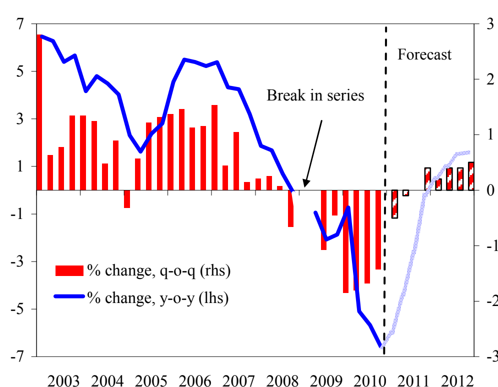
	BE	**DE**	**IE**	**ES**	**FR**	**IT**	**CY**	**LU**
May 2010	0.0	4427.9	0.0	1941.6	3325.2	2921.9	32.0	40.8
September 2010	758.8	1495.9	347.4	656.0	1123.4	987.2	10.8	13.8
January 2011	238.8	1864.4	0.0	817.5	1400.1	1230.3	13.5	17.2
	MT	**NL**	**AT**	**PT**	**SI**	**SK**	**FI**	**Total**
May 2010	14.8	932.5	454.0	409.3	0.0	0.0	0.0	14500.0
September 2010	5.0	315.0	153.4	138.3	102.9	0.0	392.2	6500.0
January 2011	6.2	392.6	191.2	172.3	32.4	0.0	123.4	6500.0

Source: Commission services.

2. MACROECONOMIC DEVELOPMENTS

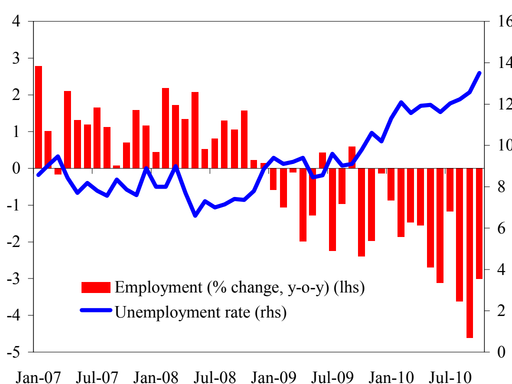
4. **The economy is contracting as expected and the quarter of deeper contraction should be already behind us.** After an average contraction of 5½ percent (year-on-year) in the second and third quarters of 2010, economic activity is estimated to have declined by 6½ percent in the last quarter of the year. For the year as a whole, real GDP growth was -4.5 percent. In 2010, private consumption fell by more than 4 percent, with a particularly strong contraction in the fourth quarter, consistent with a drop in consumer sentiment and a fall in credit to households, which resulted in a sharp deterioration in retail sales. In addition, employment and wage developments weighted on households' disposable income, in particular at the end of 2010. The full effect of public sector wage and pension cuts, including the year-end seasonal bonuses, which used to have a very large propensity to consume, materialised only at the end of the year. In addition, investment recorded very negative readings, as business sentiment was depressed, capacity utilisation fell well below the historical average and the supply of credit was restrained.

Graph 1. Real GDP growth



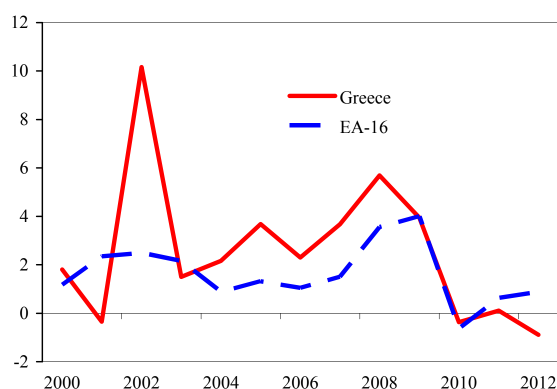
Source: EL.STAT (flash estimate of 15 February 2011) and Commission services (forecasts).
Note: According to EL.STAT, the quarterly figures for 2009-10 are not comparable with the figures up to 2008.

Graph 2. Employment and unemployment rate



Source : EL.STAT.

Graph 3. Nominal unit labour cost (annual growth rate)

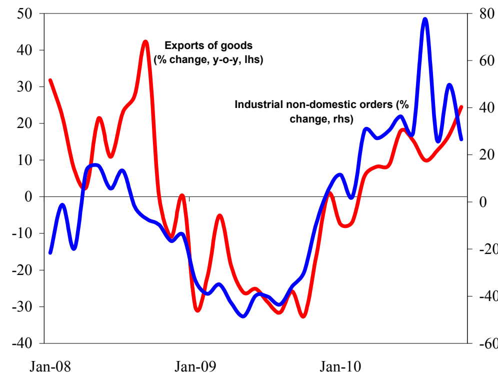


Source : EL.STAT.

5. **The strength of external demand at the end of 2010 is encouraging.** Although complete data on the composition of demand are not yet available, high frequency indicators – such as monthly data on exports of goods and non-domestic orders – suggest a rebound in exports in autumn. This reflects an improvement in the economic climate of Greece's main trading partners and gains in Greece's price and cost competitiveness. Moreover, asymmetric developments in the domestic and global markets

are prompting a diversion of Greek firms to foreign markets. This bodes well for the change in the economy's growth model, with a shift of resources from the sheltered to tradable sectors.

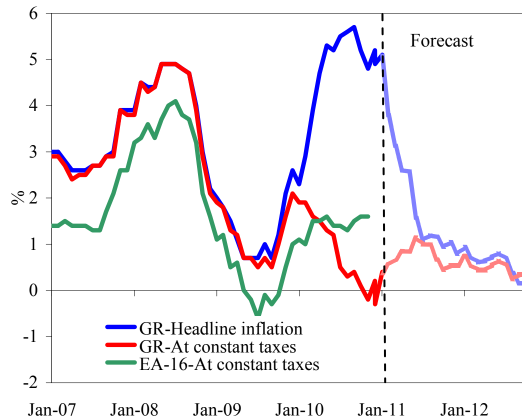
Graph 4. Exports and non-domestic industrial orders



Sources: EL.STAT and Bank of Greece.

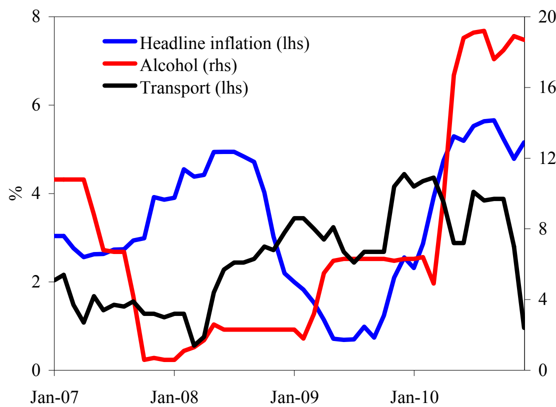
6. **Inflation has surprised again on the high side**. Whilst inflation seems having passed its peak in September 2010 (when the annual growth rate reached 5.7 percent) it has remained stubbornly high. For 2010, average consumer price inflation was 4.7 percent. In January 2011, the HICP increased by 4.9 percent (year-on-year). Persistently high headline inflation is driven by increases in indirect taxes, adopted in several waves over the last twelve months. For 2010 as a whole, the tax component of the inflation rate was in excess of 3½ percentage points. Constant-tax inflation touched negative territory in November, and this indicator is expected to be moderate in the near future, in spite of high commodity prices.

Graph 5. HICP inflation developments and projections (% change, y-o-y)

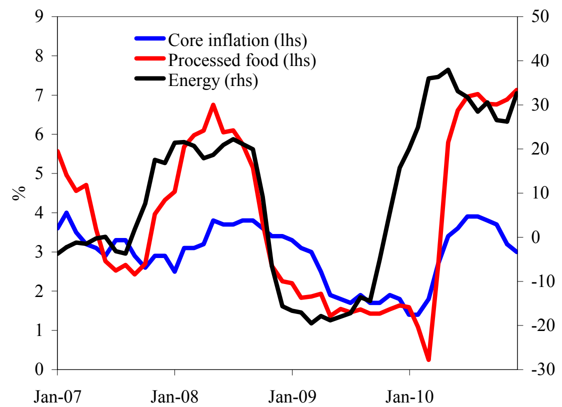


Source: EL.STAT.

Graph 6. HICP inflation main drivers developments (% change, y-o-y)



Source: EL.STAT.



Source: EL.STAT.

7. **The mission revisited the macroeconomic scenario in light of new, albeit limited, evidence:**

- **Economic activity should start growing in the second half of 2011.** GDP is projected to decline by 3 percent in real terms in 2011. This remains unchanged as compared to the previous Compliance Report. The average growth rate for the year as a whole hides substantial differences in quarterly growth rates – positive growth rates are expected for the second half of the year – and a strong negative carryover coming from 2010. The composition of demand has changed with stronger net exports and weaker internal demand as higher consumer prices compress disposable income. Risks to the macroeconomic scenario for 2011 and onwards are balanced. These risks are related to both the strength of external demand and domestic developments. In particular, risks to net exports are on the upside, but less favourable employment could depress income and consumption.

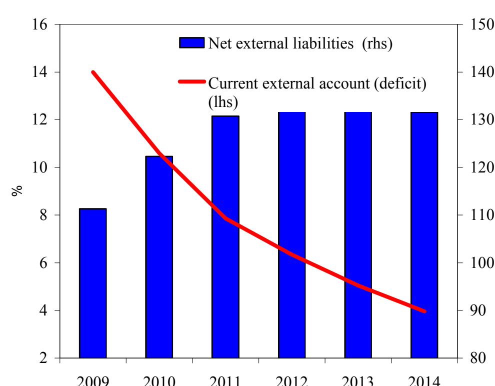
- **The inflation outlook has been revised upwards.** HICP inflation is projected to moderate from 4.7 percent in 2010 to 2.4 percent in 2011, despite a VAT increase in January 2011, plans to increase excises on heating oil in autumn and the cost recovery in the tariff policy of state-owned enterprises. The forecast has been slightly revised upwards, mostly due to revised prospects for commodities and oil prices. Constant-tax inflation is expected to be very moderate in 2011 and thereafter. This forecast does not yet fully reflect the impact of the ongoing structural reforms, which will contribute to higher productivity, strengthened competition in product markets and greater price flexibility. Disinflation could be stronger than in the central scenario. However, there are also upward risks in relation to import prices. Headline inflation is expected to decelerate in the course of 2011 and to remain below or around 1 percent in 2012-13.

- **The labour market is adjusting fast.** There is evidence of strong downward pressure on labour costs, in particular non-basic pay, as the cuts in public sector wages spill over to the private sector and firms endeavour to recover competitiveness, and to absorb indirect taxes in their margins and costs. Employment contracted in 2010 and is projected to decline further by some 2½ percent in 2011, with the unemployment rate peaking at above 14¾ percent – higher than previously projected. On the other hand, a symmetric faster rebound of employment in the recovery phase is possible, especially if ongoing labour market reforms are implemented as planned, and the economy is successful in swiftly reallocating resources from the non-traded sectors to tradables. Wage growth is projected to remain very subdued in line with the national collective agreement of July 2010 (for minimum wages, but which also plays a guiding role for other wages as well).

- **The external deficit is narrowing, but remains high.** The current account deficit was marginally below 11 percent of GDP in 2010, three points below 2009. The improvement in 2010 resulted mainly from a contraction in imports (by more than 6 percent in real terms), while the strong exports in the last months of 2010 have only partially offset anaemic external demand in the first half of the year. The current account deficit is estimated to decline to about 8 percent in 2011 and to fall to 6¼ percent of GDP in 2012 and 5 percent in 2013. The net external debt-to-GDP ratio is projected to increase to 134 percent in 2012 and to stabilise thereafter.

8. **The success of the programme and the orderly adjustment of the Greek economy depend crucially on a strong recovery from 2012 onwards.** The economy is currently projected to grow by 1 percent in 2012 and by slightly above 2 percent in 2013 and 2014. These growth rates are well below potential growth rate for the Greek economy, especially once important growth bottlenecks are removed, markets are liberalized, credit flow normalizes and confidence returns. After three years of contraction in economic activity, the potential for a more vigorous rebound is substantial, provided implementation of programme policies proceeds as planned. However, given the necessary change in the growth model and the need to improve price and non-price competitiveness of Greek firms, prudent medium-term projections appear appropriate and contribute to robust fiscal planning.

Graph 7. Current account and net external liabilities (percent of GDP)



Source: EL.STAT and Commission services.

Table 3. Macroeconomic scenario: main features

	2010	2011	2012	2013	2014
Real GDP (growth rate)	-4.5	-3.0	1.1	2.1	2.1
Domestic demand contribution*	-8.0	-6.2	-1.0	0.8	1.0
Net trade contribution	3.9	3.1	1.8	1.4	1.1
Employment (growth rate)	-2.8	-2.7	0.1	0.9	1.2
Unemployment rate (percent of labour force)	12.1	14.6	14.8	14.2	13.5
Unit labour cost (growth rate)	-1.1	-0.5	0.2	-0.3	0.0
HICP inflation	4.7	2.4	0.5	0.7	1.0
Current account balance (percent of GDP)	-10.6	-7.9	-6.3	-5.0	-4.0
Net borrowing vis-à-vis RoW (percent of GDP)	-9.5	-6.6	-5.0	-3.6	-2.4

** Excluding change in inventories and net acquisition of valuables*

Source : Commission services.

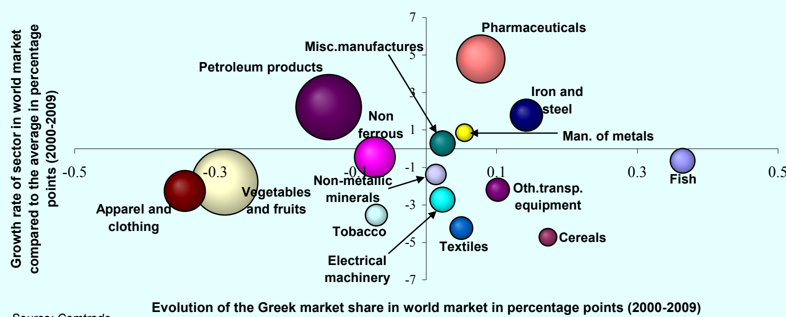
Box 1: **Export growth drivers**

In Greece, economic growth over the medium term is expected to be primarily driven by external trade, as the economy shifts to a more sustainable model. GDP growth rates have been negative since Q4-2008 and activity is expected to shrink further in the first half of 2011, on the back of contraction in private and public consumption and sluggish investment. Net exports is the only GDP component which is estimated to have exhibited a positive contribution to growth in 2010. This reflected both strongly falling imports, and slightly positive growth in exports in 2010, after a 20 percent slump in the previous year. Exports are expected to rise by around 5 percent in real terms in 2011, as demand from trade partners accelerates and Greece gradually restores competitiveness. Given the accumulated losses in export market shares during the pre-crisis decade, exploiting the potential of the underdeveloped external sector of Greece will play a key role in driving economic activity in the coming years.

Greece is a relatively closed economy with a structural trade deficit. Considering its size, the Greek economy is surprisingly closed, with imports at 30 percent, and exports at not more than 19 percent of GDP (2009 data). During the last decade, the goods and services deficit was systematically above 10 percent of GDP, though it fell slightly from 13½ percent in 2000 to 10¾ percent in 2009. The deficit in goods trade of 16½ percent of GDP in 2009 was only partly mitigated by a surplus in services of 5¾ percent. In spite of a large unexploited potential, the currently small size of Greek exports implies that very dynamic growth rates will be necessary for this demand component to pull the whole economy back to growth.

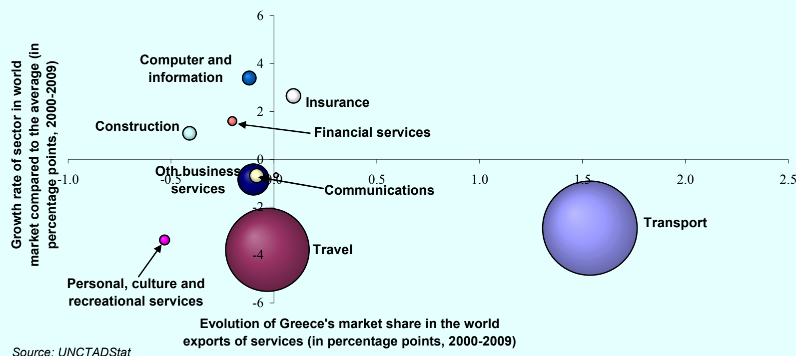
Mapping the sectoral market shares and global export demand helps in identifying the opportunities and shortcomings of the Greek export sectors. Graphs 1 and 2 show Greece's major export sectors in goods and services, in perspective of market shares and global export dynamics. Sectors with above-average growth rates in world markets are shown above the horizontal axis. To the right of the vertical axis, Greek export sectors that have increased their market shares are found. The top right quadrant, therefore, identifies the most promising sectors, benefiting from dynamic world demand and enjoying relatively large market shares. Sectors located in the top left quadrant imply growth opportunities since world demand for these products is above-average, while Greece's market share is still weak and could be expanded. Sectors in the bottom right quadrant, on the other hand, are well represented in Greece's exports and could yield sizeable earnings, but world demand has not been, or is not expected to be, dynamic. Finally, the sectors in the bottom-left quadrant are the least promising, characterised by sluggish world demand and low Greek market shares. The size of the bubbles is proportional to the share of each sector in total Greek exports of goods and services. This mapping suggests that Greece's most promising export sectors are pharmaceuticals, petroleum products and transport services, while the outlook for tourism is mixed.

Graph 1. Mapping of opportunities for Greek exports of goods



Source: Comtrade

Graph 2. Mapping of opportunities for Greek exports of services



Source: UNCTADStat

Pharmaceuticals are among the most promising export sectors. Greek pharmaceuticals are characterised by both a growing market share and above-average world export growth over the last decade. The presence of multinational pharmaceutical companies in Greece offers the opportunity for knowledge spill-overs and access to R&D resources which have been scarce in Greece due to the large share of SMEs. Significant investments are underway in this sector and an effort to promote FDI and improve the R&D framework could help to further improve competitiveness.

Greece's petroleum sector has benefited from dynamic world markets and new projects are in the pipeline. Greece operates ten oil terminals and four major refineries with a total crude oil refining capacity of 490 000 bbl./day, of which one third is exported. Greece's oil product exports increased by 57 percent over the period 2004-09. However, the feedstock is largely imported, thereby limiting the domestic value added. Future prospects of the petroleum sector may be enhanced by an envisaged new oil pipeline connecting Greece and Russia via Bulgaria, bypassing Turkey's Bosporus. The pipeline is expected to commence operation in 2013.

Greece's market share of transport services has grown fast, although global dynamism in this sector was sluggish. Greece's sea transport sector further increased its already dominant market share in recent years. The Greek maritime fleet is the largest in the world in terms of capacity. In the short-term, prospects for shipping remain difficult and uncertain, due to oversupply. In the medium to longer term, however, Greece could strengthen its role as a regional transportation hub and gateway to Southern Eastern Europe, provided that the infrastructure of other means of transport and their connectivity were sufficiently upgraded. The continuing rise in Chinese demand for containerised exports, which already makes up a quarter of the world total, also strengthens Greek potential.

The Greek tourism sector has lost ground but bears the potential for higher growth contributions. The contribution of tourism to GDP has been constant at around 15 percent since 1990. However, Greece has fallen behind its most important competitors. While Greece's tourist receipts grew by 57 percent in 2000-09, they rose by 116 percent in Egypt, 178 percent in Turkey and 219 percent in Croatia during the same period. As a result, Greece's world ranking in tourist receipts fell from rank 11 to 15. Greek tourism suffers from an over-concentration of 65 percent of supply in only four geographical regions and an intense seasonality of demand with 50 percent of arrivals within three months. According to tourism experts, a new growth model to better develop the unexploited potentials of the tourism sector would include facilitating investment in the tourism sector by fast-track procedures and zoning simplifications; improving the coordination of tourism promotion efforts; creating a better marketing infrastructure via web applications and promoting niche markets such as winter holiday homes; developing more synergies with the culture, sports, education, medical and gastronomy sectors, and investing in technology and human resources with a view to improving value-for-money and positioning Greece as a high-quality tourist destination. Moreover, improving airline connections both with the European low-cost network and with long-haul emerging market origin countries has shown to vitalise the tourism industries in other countries and could also enhance Greece's attraction as a holiday destination.

The food and beverage industry has experienced sluggish world market growth but Greek products could capitalise on their high quality. The food and beverage industry is one of Greece's major export sectors, accounting for around 25 percent of manufacturing value added and 12 percent of goods exports. Agriculture and fish add another 13 percent. Greek food products generally benefit from high quality and specific characteristics. However, the sector suffers from small average firm size, low market prices and difficulties in finding markets outside the EU. Greece has been losing ground to its competitors, notably Spain. In Turkey, Greece's market share in the food industry has remained constant at around 1.5 percent since the early 1990s, overtaken by that of Spain which rose from 0.5 to 2.5 percent during the same period. In Germany, Spain's market share increased from 12 percent to 17 percent while Greece's shrank from 3 to 2 percent. Opportunities for the Greek food and agricultural sector could be exploited by developing the market for traditional products, benefiting from the tendency to Mediterranean diets, and healthy and high-quality products.

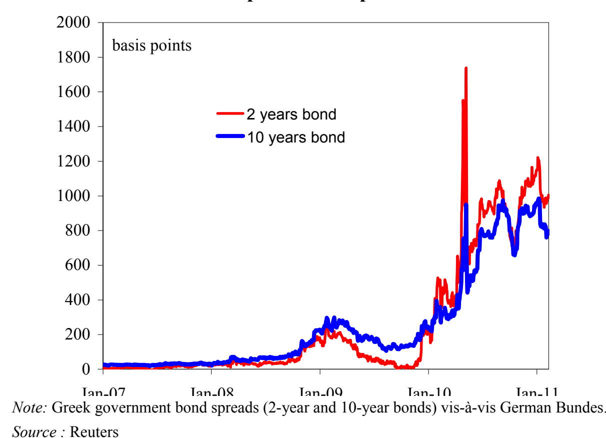
The Greek clothing industry has been facing structural challenges, most notably resulting from low-cost competitors, such as China and other Asian countries. Graph 1 shows that both apparel and textile have been growing below-average on world markets. In 2010, Greek textile exports grew by around 12 percent, catching up after a sharp decline in the previous year. However, unless the Greek textile industry manages to move to a high-quality niche segment, it is unlikely that the textile industry will regain structural competitiveness on world markets.

The iron/steel and mineral sectors are facing short-term difficulties despite market opportunities. Greece's iron and steel sector enjoyed a growing market share and dynamic world demand over the last decade. However, the Greek steel industry is relatively small, contributing only around 1 percent to the EU's annual production. Despite a strong pick-up in global steel markets of 15 percent in 2010, Greece's output contracted by 8 percent. While Turkey's growing steel sector exports mostly to the Middle Eastern and North African region, Greece does not seem to capitalise sufficiently on these neighbouring dynamic markets. Greece's minerals industry, although among the EU's largest in terms of bauxite, magnesium and nickel, has been suffering from a relatively small industrial base, lack of adequate investment and distance from EU markets. Its world market share has increased since the beginning of the decade, but world markets have been growing below average. In the medium-term future, the emerging Balkan markets could offer new opportunities for growth. The privatisation of a state-owned mining company (LARKO) could also help revitalising the sector.

3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

9. **Investor sentiment towards Greek sovereign debt remains very negative.** The main risk indicators – like CDS spreads and yield spreads vis-à-vis the German government paper for similar maturities – show that financial markets keep a very sceptic view on Greece tapping financial markets from 2012 on. Given investment restrictions and rules by international banks, insurance companies and pension schemes, the current ratings do not help: all three rating agencies now rate Greek government paper as junk. Fitch has recently downgraded the Greek sovereign rating (from BBB- to BB+) and keeps a negative outlook while Moody's (Ba1) and S&P (BB+) are reviewing ratings.

Graph 8. Yield spreads



Note: Greek government bond spreads (2-year and 10-year bonds) vis-à-vis German Bundes.

Source : Reuters

10. **The liquidity situation of banks remains tight.** Bank deposit declined by 16 percent since the beginning of 2010. The sovereign debt crisis and the concomitant rating downgrade have reduced the collateral available for ECB liquidity provision. Market volatility, the changes to the ECB collateral framework and possible downgrades of the sovereign were grounds for further enhancement of the liquidity cushion in the system.

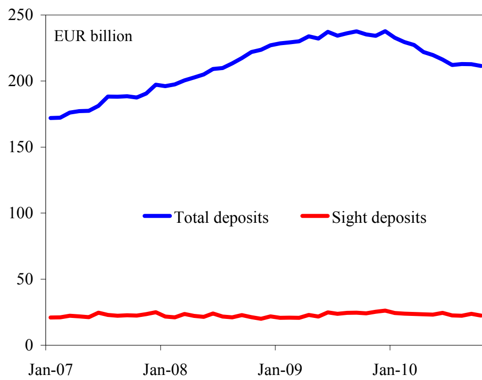
11. **Responding to the need to strengthen balance sheets, some modest deleveraging is ongoing. A** number of banks have expanded their balance sheets in the course of 2010, however**,** despite the contracting economy. The banks increased their exposure to the Government while they modestly deleveraged from the real economy. Total assets of Greek commercial banks increased from EUR 454 billion at the end of 2009 to EUR 465 billion in September, driven by growing holding of government bonds. Total loans and advances of the banking groups decreased from EUR 308 billion to EUR 306 billion at the same time. The average loan-to-deposit ratio in Greece was 120 percent at the end of 2010, up from about 114 percent in 2008-09. The increase was mainly due to the shrinking deposits.

12. **The banking sector remains solvent, though asset quality continued to deteriorate**. Despite better than expected net interest income in the first nine months of 2010, the Greek banks suffered from losses on their loan and trading book. The non-performing loans increased to 10 percent in September 2010, from 7.7 percent at the end of 2009. The corresponding increase in provisioning, especially in the domestic lending portfolio, resulted in a loss for the system on a consolidated basis. Profitability measured by return on assets and equity fell to -0.3 percent and -3.7 percent, respectively, during the first nine months of 2010. The average capital adequacy ration (CAR) at the end of September was 11.4 percent, while the tier I ratio was 10.1 percent.

13. **Some banks carried out successful capital increases on the market.** In October, NBG raised EUR 1.8 billion by issuing shares and convertible equity notes. A similar operation was completed by Piraeus Bank (EUR 0.8 billion in covered bonds) in early 2011. Other

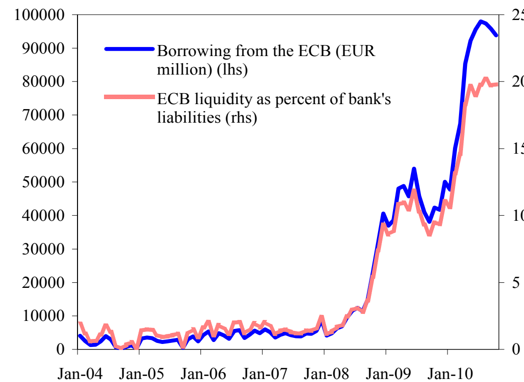
opportunities for improving capital adequacy include reduction of risk-weighted assets, including sales of subsidiaries. The latter refers to the sale by NBG of a minority stake in Finansbank (Turkey) and the Eurobank sale of a majority stake in Polbank (Poland). Moreover, the Hellenic Financial Stability Fund (FSF) remains available as a capital backstop.

Graph 9. Bank deposits



Source: Bank of Greece

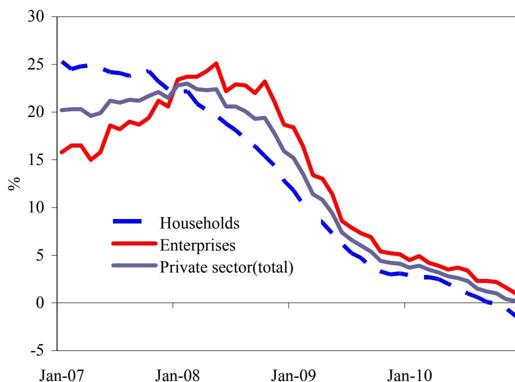
Graph 10. Greek banks' borrowing from the Eurosystem



Source: IMF, FIS

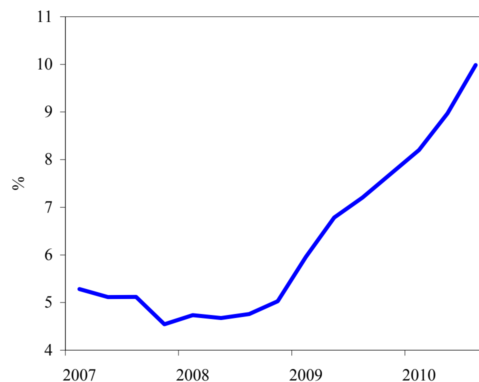
14. The Greek financial system has benefited from various Eurosystem policies in 2010 and 2011. The fixed-rate full-allotment tender procedures in the Eurosystem monetary policy operations have eased the funding activity of all banks in the euro area, including Greek banks. Furthermore, the already very flexible collateral framework was further broadened on 3 May 2010 based on the ECB Governing Council's positive assessment of the Greek adjustment programme. The ECB decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purpose of the Eurosystem credit operations, in the case of marketable debt instruments issued or guaranteed by the Greek State. This suspension, combined with the pre-existing flexible collateral framework, eased the access to Eurosystem funding for all counterparties, in particular the Greek ones. In a similar vein, the ECB's securities markets programme (SMP) helped contain undue volatility in sovereign bond market prices in Greece and other peripheral euro area economies.

Graph 11. Credit to private sector (percent change, y-o-y)



Source: Bank of Greece

Graph 12. Non-performing loans



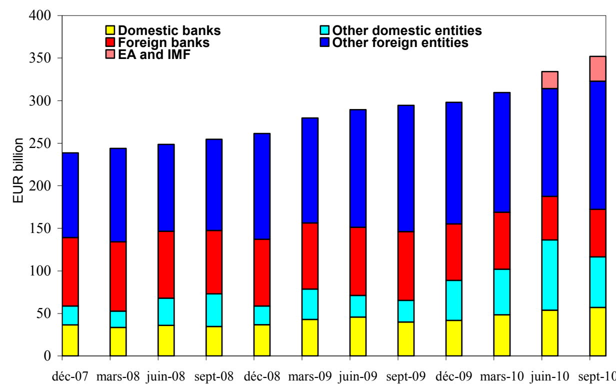
Source: Bank of Greece

Table 4. Banking sector soundness indicators

	basis	2007	2008	2009	2010-Q1	2010-Q2	2010-Q3
Capital adequacy ratio	consolidated	11,2	9,4	11,7	11,7	11,2	11,4
	solo (1)	*12,7*	*10,7*	*13,2*		*12,3*	*12,8*
Tier I ratio	consolidated	9,2	7,9	10,7	10,6	10,1	10,1
	solo	*9,3*	*8,7*	*12,0*		*11,0*	*11,2*
Return on assets (after tax)	consolidated	1,4	0,7	0,2		-0,3	-0,3
	solo	*1,0*	*0,2*	*-0,1*	*-0,6*	*-0,6*	
Return on equity (after tax)	consolidated	17,7	10,0	2,4		-4,5	-3,7
	solo	*14,8*	*3,2*	*-1,5*	*-8,7*	*-9,7*	
Loan to deposit ratio	consolidated	106,0	114,0	113,8		122,4	120,0
Non performing loan ratio (2)	*solo*	*4,5*	*5,0*	*7,7*	*8,2*	*9,0*	*10,0*
Coverage ratio (3)	*solo*	*53,4*	*48,9*	*41,5*	*42,8*	*43,4*	*43,2*

Notes: (1) at the level of the individual entity; (2) Non performing loans as percentage of total gross loans; (3) Provisions as percentage of non-performing loans.
Source: Bank of Greece.

Graph 13. Holding of Greek government debt



Source : ECB and Commission services.

Box 2: **State aid to financial institutions in the context of the financial crisis**

State aid control is an integral part of the EU's competition policy. Since the beginning of the current crisis, the Commission's interventions have contributed to maintaining financial stability while preserving a level playing-field across Member States and financial institutions and safeguarding the real economy and the internal market. From the competition and state aid standpoint, the Commission achieved this objective by giving legal certainty to the support measures given by Member States and by making possible that real economy had access to credit. The absence of state aid rules could have led to a costly and distortive subsidy race between Member States at taxpayers' expense. Uncoordinated national action would have seriously undermined the internal market and financial stability.

Exceptional circumstances and systemic risk. From the viewpoint of competition policy, the European Commission approached the resolution of the financial crisis in different steps. During the first phase, before the Banking Communication was published in mid October 2008, the Commission tackled the individual state aid cases according the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (the so-called 'R&R Guidelines'). The general erosion of confidence within the banking sector and the serious difficulties to access liquidity, in October 2008, led to a systemic dimension of the crisis, justifying the application of the legal basis that allows for remedying a serious disturbance to the economy of a Member State.

The Commission's communications. The 'Banking Communication' of 13 October 2008 provided an appropriate European framework to allow rescue operations in order to stop or prevent runs on financial institutions. It indicates how the Commission intends to apply state aid rules to state support schemes and individual assistance for financial institutions. Support schemes such as guarantees or recapitalisation schemes must be well-targeted and proportionate to the objective of stabilising financial markets and contain certain safeguards against unnecessary negative effects on competition. In a second step, the 'Recapitalisation Communication' of 5 December 2008 identified a set of standards and safeguards allowing Member States to recapitalise banks in order to ensure adequate levels of lending to the economy. The third step was the clean-up phase of financial institutions' balance sheets by removing toxic assets and underperforming loans. The 'Impaired Assets Communication' of 25 February 2009 provided the framework for this phase. The 'Restructuring Communication' of 14 August 2009 addressed the follow-up to such support measures. It builds on three fundamental principles: (i) aided banks must be made viable in the long term without further state support; (ii) aided banks and their owners must carry a fair burden of the restructuring costs and (iii) measures must be taken to limit distortions of competition in the Single Market.

The phasing out process. On 2 December 2009, the ECOFIN Council emphasised the need to phase out from various forms of temporary support for the financial sector, starting from the guarantee schemes. Since 1 July 2010, the Commission has applied tighter conditions for the compatibility of government guarantees, by introducing (i) an increased guarantee-fee based on a bank's creditworthiness and (ii) the new requirement of a viability plan for beneficiaries that have recourse to new guaranteed and exceed a certain threshold of total outstanding guaranteed liabilities. As of 1 January 2011, a restructuring plan is required from every beneficiary of a new recapitalisation or an impaired asset measure, thus creating an incentive to accelerate the necessary restructuring.

State aid to financial institutions in Greece. In 2009, before the sovereign debt crisis, Greece had already put together a banking rescue package which provided for liquidity and capital support to banks in Greece. This support package has been used by all major Greek banks. Tzn banks were recapitalised in May and July 2009. As a consequence of the capital support, the recapitalised banks have to present restructuring plans.

In 2010, following the sovereign debt crisis, euro area Member States and IMF provided financial support to the country. In order to strengthen the Greek financial system, two important schemes with relevance in terms of State aid control were put into place: (i) Issuance of additional government guarantees to be used as collateral in order to obtain funding from the ECB. An additional amount of EUR 25 billion was authorised by the Commission under State aid rules in June and December 2010. (ii) The establishment of an independent Financial Stability Fund (FSF) as a safety net to preserve the solvency of the financial sector by providing capital support to banks. The granting of aid was subject to a scheme which was authorized by the Commission under state aid rules in September and December 2010.

4. PROGRAMME IMPLEMENTATION AND POLICY DISCUSSIONS

15. **Implementation of the programme has encountered a number of barriers.** Fiscal consolidation was held back by a less than successful fight against tax evasion and incomplete expenditure control. The implementation of a wide and ambitious agenda of structural reforms stretched the capacity of the Greek administration, all the more as reforms have become more complex and therefore more difficult to design. Also, many reforms have met fierce resistance by vested interests. Moreover, while Greece was a source of financial contagion in the first half of 2010, it is now suffering from contagion from other peripheral economies and the political uncertainty in relation to the EU-wide facility mechanisms.

16. **The government remains committed to the programme.** In 2011, this commitment will be tested in the implementation of fiscal policy, including preparing a credible medium-term fiscal strategy and in overcoming interest groups that oppose growth-enhancing reforms. Polls suggest that the Greek society understands the need for, and supports, fiscal austerity and other measures to liberalise the economy and modernise institutions.

Table 5. Summary of compliance with conditionality for end-December 2010

	Overall assessment	Comments
Fiscal policy	Partially observed	The ESA-based fiscal deficit was missed. Cash-based spending and deficit ceilings were respected.
Structural fiscal reforms	Partially observed	A key healthcare reform has been adopted. A tax policy act has been tabled in Parliament. The government announced its privatisation plan for 2011, and decided to substantially scale it up.
Financial sector policy	Largely observed	A EUR 25 billion tranche of government guarantees on bank bonds was made available in November. The FSF is operational, though there are lingering problems in staffing.
Other structural reforms	Partially observed	A new wave of structural reforms is ongoing, though with some delay compared to previous policy commitments
Data provision	Largely observed	There are still issues in the prompt availability of data on expenditure commitments and payment arrears.

Source: European Commission.

4.1. FISCAL POLICY

4.1.1. Fiscal developments in 2010

17. **The ESA-based government deficit for 2010 is estimated at 9½ percent of GDP** or EUR 22 billion. This is in excess of the target of EUR 18.5 billion (8 percent of GDP). There is still some uncertainty about the 2010 outcome as data on the financial performance of state-owned enterprises, extra-budgetary funds, social security and hospitals, and local government are not yet complete. There are also uncertainties about the differences between cash and accrual accounting. For Greece, as for all other EU Member States, the first complete set of ESA-based annual data will be available by end-March, and validated by Eurostat in April.

18. The quarterly quantitative performance criteria on a cash basis for the Q4- 2010 were met. While the criterion on state primary spending (cash) for the fourth quarter of 2010 was met with a large margin reflecting an under execution of payments compared to plans, the criterion on government primary balance (cash) was respected by a very thin margin. The outcome for both criteria was better than projected in the previous Compliance Report. However, it may have been distorted by the accumulation of arrears and other payables. The central government debt criterion has also been respected.

Table 6. Quantitative performance criteria and outcomes (EUR billion)

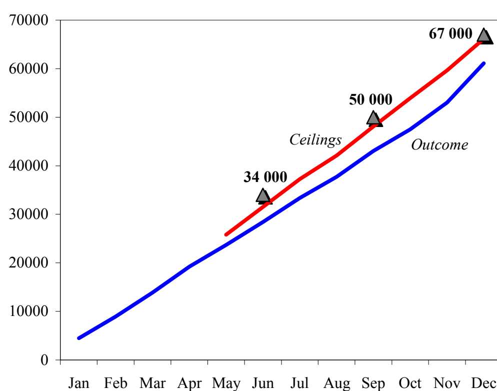
	end June 2010		end September 2010		end December 2010	
	Actual data	QPC	Actual data	QPC	Actual data	QPC
General government primary cash balance[1]	-3,9	-5.0 (floor)	-3,6	-4.0 (floor)	-5,5	-5.7 (floor)
State budget primary spending	28,4	34 (ceiling)	43	50 (ceiling)	61.1	67 (ceiling)
Overall stock of central government debt	317	342	328	342	340	366*
New guarantees granted by the central government	0,3	2,0	1,2	2,0	1,3	2,0
Accumulation of external payment arrears on external debt contracted or guaranteed by general government	0	0	0	0	0	0
Accumulation of domestic arrears (indicative)	1	0,0	0,8	0	3,0 (estimate)	0,0

1/ Available general government: it does not include extra-budgetary funds and public enterprises.

* Adjusted for upward revision to end-2009 stock of central government debt (original ceiling EUR 342 billion)

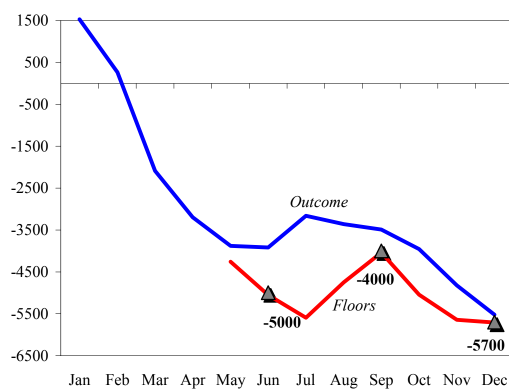
Source: Commission services.

Graph 14. State primary payments - 2010 (cumulative balance, EUR million)



Sources : GAO and Commission services

Graph 15. (Available) government primary balance - 2010 (cash basis, cumulative balance, EUR million)



Sources : GAO and Commission services

19. Three main features characterised the fiscal year 2010:

- **The implementation of several waves of deficit-reducing measures.** The full-year impact of total measures implemented in 2010 reached EUR 22 billion (or 10 percent of GDP), of which EUR 19.5 billion were reflected in the 2010 accounts, and EUR 2.5 billion carry over into 2011. Out of the measures with an impact on 2010 accounts EUR 10.4 billion (or 4.4 percent of GDP) were on expenditure and 9.2 billion (or 4 percent of GDP) on the revenue side of the budget. The reduction in the deficit fell short of the total amount of measures, given the underlying upward pressure on expenditure (e.g. interest, old-age pensions) and the impact of the recession on taxes and social spending.

- **Large shortfalls in tax collection.** Revenue collection disappointed and was revised downwards on several occasions. For the year as a whole, state revenue was EUR 4.5 billion (2 percent of GDP) less than projected in May 2010, when the adjustment programme was designed. This result reflects a weaker-than-projected domestic demand, and households' and corporates' liquidity constraints. However, there is also evidence that the measures against tax evasion in the course of 2010 were not insufficiently successful and need considerable strengthening. A tax settlement organised in the autumn 2010 was only partially successful: it collected EUR 1 billion, much above plans, but this was at the costs of underperformance of regular tax collection.

- **Underexecution of the state's spending plans.** In order to offset revenue shortfalls, and unfavourable local government and social security accounts, the Government under executed ordinary state primary spending and military procurement-related payments by around EUR 4.9 billion (more than 2 percent of GDP) compared to the plans of May 2010. Despite this effort, the incompleteness of the data on arrears and accounts payable do not allow to assess to what extent this payment compression reflects durable expenditure savings or simply delays in payments.

4.1.2. Fiscal policy in 2011

20. **The implementation of fiscal policy in 2011 will be challenging.** In the budget for 2011 voted by Parliament in December, the Government confirmed its commitment to meet the ESA-based fiscal deficit target below EUR 17 billion (or 7½ percent of GDP), fully recouping the slippage of 2010. The reduction in the government deficit-to-GDP ratio in 2011 will, therefore, amount to 2 percentage points of GDP, instead of 0.4 points planned at the inception of the adjustment programme. Most of the fiscal measures underpinning the 2011 deficit target have been legislated and are being implemented.

21. **Additional measures are necessary to secure the 2011 deficit target.** The mission and the government have updated the fiscal projections for 2011. The revised projections, based on current trends, indicate that the 2011 fiscal deficit ceiling would be exceeded by ¾ of a percentage point of GDP, unless corrective action is undertaken. This gap stems mainly from the less favourable expectations for the tax bases (weaker internal demand), downward revisions for the yield of fiscal measures in the state budget, as well as a base effect from the worse-than-expected 2010 outcome for several revenue categories. Higher-than-previously projected interest expenditure also contributes to the fiscal gap.

22. **The government is committed to offset this fiscal gap.** The additional budgetary savings are expected to come from structural measures to be prepared in the context of the medium-term fiscal strategy. In the meantime, the government will continue the strategy of compressing ordinary spending – a strategy that was not fully successful in 2010.

23. **Important results from the fight against tax evasion are indispensable in 2011.** The structural improvement of tax collection remains a crucial element of the programme, not only given its direct impact on the fiscal accounts, but also on equity grounds. The achievement of the 2011 budgetary targets is contingent upon an increase in total tax revenue of more than EUR 1.5 billion or some ¾ percent of GDP, compared with 2010. EUR 1.6 billion of receipts have been specifically projected in the budget for 2011 from the fight against tax evasion, an increase in the efficiency of the tax collection mechanism and other measures to accelerate tax-related court cases. The mission has encouraged the Ministry of Finance accelerate and reinforce actions against tax evaders, as well as against inertia and specific interests inside the tax administration.

Box 3: **From cash accounts to ESA95 accounts**

As in previous reports, this box provides estimates and forecasts on the difference between available cash figures and the ESA95 data.

Cash and accruals. The government accounts that are monitored with a monthly frequency, and on the basis of which compliance with quarterly performance criteria are assessed, are compiled on a cash basis. The annual ESA accounts are compiled on an accrual basis, i.e. at the time of the underlying transactions. Thus, while a delay in payments to suppliers may temporarily improve the cash-base data, it has no direct impact on the ESA-based accounts. An improvement in the ESA accounts from the saving side of the budget is only possible if there is an effective deceleration in expenditure commitments.

Scope. The data available with high frequency cover only part of the general government sector. In particular, monthly data for state-owned enterprises that are classified in the government sector and for most extra-budgetary funds are not available, or are not yet of appropriate quality for continuous monitoring. Also the monthly local government and social security monthly data are compiled from banking statistics, which may limit their exhaustiveness. It is expected that data on state-owned enterprises and on extra-budgetary funds will become progressively available on a monthly basis. Thus, the differences in scope between the data series are expect to narrow progressively .

Table 1 shows estimates for 2010, and forecasts for 2011, of the several variables that establish the link between the cash figures that are monitored monthly under the programme and the ESA accounts.

To be continued next page

Table 1 : From cash to ESA accounts -- 2010 and 2011 (EUR million)

	2010	2011
Extrabudgetary funds	72	0
Military deliveries (difference with cash payments)	-223	800
Single Treasury account	227	200
Tax-related time adjustment	70	-550
Direct taxes	50	-550
Indirect taxes	20	0
Social contributions	0	0
EETT (Post-telecommunication authority)	-36	30
EU funds time adjustment	1271	248
Hospitals spending, accrued in 2009 and paid in 2010	375	0
Guarantees called	-972	-1468
Interest accrued	-715	640
Privatizations account	-324	0
Intergenerational fund, Agricultural Fund (ELEGEP) and ATE Bank	276	763
Special fund for unauthorised buildings (ETERPS)	151	230
Tax refunds	300	0
Bond payments	0	-420
Accounts payable	-1673	450
Health (public hospitals)	-1708	450
Health (private clinics and suppliers)	-70	0
Other-than-state sectors	105	0
Reclassified Public enterprise balance	-360	245
Lump sum payment to public sector retirees	-524	-240
Other	-7	-42
Total	**-2092**	**886**
General government modified cash balance	**-19937**	**-19693**
General government balance (ESA 95)	**-22029**	**-18807**
General government balance (ESA 95): Ceiling	**-18508**	**-17065**
difference	3521	1742

Source: Commission services

24. **Fiscal management on the expenditure side of the budget also needs to be improved.** While cash payments were comfortably below the ceiling in 2010, the accumulation of arrears in other-than-the-state sectors was only marginally restrained, reflecting shortcomings in the expenditure monitoring and control. The commitment registers in each government department are still not fully operational, with progress having been limited to the state entities. The registry needs to be made operational shortly, and include the commitments taken by local governments, social security funds, hospitals, state-owned enterprises and other extra-budgetary entities.

25. **Reforms of budgetary institutions are progressing slowly**. In line with the provisions of the organic budget law of July 2010, the government has set expenditure ceilings for 2011 for the State and deficit targets for the several government sectors. There has been progress in the timely provision of fiscal data, although there are still some quality issues: monthly data availability for the government entities other than the state remains clearly below par and prevents adequate monitoring of intra-year budgetary developments for the government as a whole. While the situation has somewhat improved in the social security sector and state-owned enterprises, fiscal information on local governments remains very limited.

4.1.3. Fiscal policy in 2012 and beyond

26. **The medium-term budget strategy is under preparation.** In November 2010, the government committed to announce by March 2011 the medium-term fiscal structural measures to ensure meeting the annual fiscal targets for 2012-14. To ensure wider consultation of a technical complex document, the government has eventually decided to finalise the medium-term fiscal strategy by May 2011. A first draft is expected to be available for public consultation in the second half of March. The subsequent steps in the preparation of the medium-term strategy include approval by the Council of Ministers before mid-April and the vote of Parliamentary resolution by mid-May. The medium-term targets are unchanged: deficits below EUR 14.9 billion (6.4 percent of GDP) in 2012, EUR 11.4 billion in 2013 (4.8 percent) and EUR 6.4 billion (2.6 percent) in 2014. Although there is no official target for the 2015 deficit, the government indicated to aim at a 2015 fiscal deficit of 1 percent of GDP or below.

Table 7. Deficit accounting: from the deficit in one year to the next

	EUR million			% of GDP		
		cumulative measures			cumulative measures	
		2010-2014	2012-2014		2010-2014	2012-2014
2009 deficit	**36150**			**15,4**		
Nominal deficit drift in 2010	3880			1,7		
Identified measures	18000	18000		7,8	7,8	
Impact on ratio of nominal GDP growth	--			0,4		
2010 deficit	**22030**			**9,6**		
Nominal deficit drift in 2011	11626			5,1		
Identified measures /1	14850	32850		6,6	14,5	
Unidentified measures	1741	1741		0,7	0,7	
Impact on ratio of nominal GDP growth	--			0,1		
2011 deficit (target)	**17065**			**7,6**		
Nominal deficit drift in 2012	5455			2,4		
Identified measures*	5575	38425	5575	2,4	16,8	2,4
Unidentified measures	2029	3770	3770	0,9	1,6	1,6
Impact on ratio of nominal GDP growth	--			-0,1		
2012 deficit (target)	**14916**			**6,5**		
Nominal deficit drift in 2013	2218			0,9		
Identified measures*	575	39000	6150	0,2	16,5	2,6
Unidentified measures	5160	8931	8931	2,2	3,8	3,8
Impact on ratio of nominal GDP growth	--			-0,2		
2013 deficit (target)	**11399**			**4,8**		
Nominal deficit drift in 2014	491			0,2		
Identified measures*	-1050	37950	5100	-0,4	15,6	2,1
Unidentified measures	5573	14504	14504	2,3	5,9	5,9
Impact on ratio of nominal GDP growth	--			-0,6		
2014 deficit (target)	**6385**			**2,6**		

1/ Including carry-over of fiscal measures enacted before May 2010.

* Measures for 2012-14 identified and quantified in the original programme of May 2010 are subject to revision.

Deficit in year t equals deficit in year t-1 plus nominal deficit drift in year t minus identified measures minus unidentified measures (and for the ratios: plus impact on ratio of nominal GDP).

Deficit drift includes the increase in the deficit level that would take place without measures. It includes in particular the structural increase in pension expenditure, the increase in interest expenditure and other structural increase in spending. The deficit drift has been calculated assuming wage freeze and the implementation of the 1-to-5 rule between recruitments and exits. It also reflects the increase/decrease in revenue because of developments in tax bases.

27. **The medium-term budget strategy is a cornerstone of the programme.** In 2012-14, 8 percent of GDP of measures will be necessary to reach the deficit targets. Of this total, around 2 percent of GDP of measures were previously identified. However, the mission advised the government to revisit the measures planned to feature in the 2012, 2013 and 2014 budgets, and in any case to review their yields. Given the scale of the required additional measures, continuous increases in tax rates and across-the-board cuts in expenditure are not sustainable. The budgetary measures to reach the targets will have to come from structural actions articulated in plans covering several areas of government expenditure and revenue:

- **Tax policy reform.** It will aim at simplifying the tax system, broadening tax bases and facilitating more effective tax administration to fight tax evaders, while supporting growth and investment. Business tax code, corporate taxation, tax exemption, tax incentives and capital income tax are expected to be the principal areas of focus. Implementing legislation is expected to be tabled in Parliament by end-September.

- **State-owned enterprises**. The objective is to bring the enterprises' efficiency into line with well-run private companies and other EU public companies. Tariff increases, restructuring, reductions in operational costs, reprioritization of investments, and adjustments in wages and employment are expected to reduce deficits and increase dividends.

- **Extrabudgetary funds.** The plan should aim at identifying entities with overlapping mandates that can be merged, restructured, integrated into the state budget, privatised or closed.

- **Public employment and public wages**. The system of wages and benefits in the Greek administration is inordinately complex and inequitable. It also provides remunerations above the private sector for similar tasks, as revealed by a recent government report. The government will adopt by end-June 2011 a plan which will identify ways to simplify the wage grid, including allowances. Furthermore, the government expects that through the strict implementation of the rule of not more than 1 recruitment for 5 exits, public employment will be reduced by more than 20 thousand per annum until 2013. The implementation of this rule requires a substantial improvement in the government's capacity to monitor staff movements in real time. The mission welcomed the government's recent initiative of aligning working hours in the public sector with those prevailing in the private sector.

- **Public administration.** This restructuring plan for public administration should identify services to be rationalised, eliminate overlapping responsibilities and ensure efficient lines of command. The plan will benefit from the findings of the ongoing functional review of central administration.

- **Social spending reform.** A number of social programmes may be eliminated because they overlap with other initiatives or will be better targeted, while keeping the appropriate safety net. As for public administration, the ongoing functional review of social programmes will contribute to identify priorities and quantify potential savings.

- **Public investment.** The objective is to prioritize projects and identify budgetary savings. Moreover, the financial oversight of the public investment programme by the Ministry of Finance needs to be strengthened. A reassessment of public investment will also contribute to a faster absorption of EU structural and cohesion funds.

- **Military spending.** Greece is one of the EU countries with the highest per capita spending on defence. The medium-term military programming should durably contribute to the fiscal consolidation needs, whilst preserving national defence capability.

- The medium-term fiscal strategy will also be articulated with the ongoing **healthcare and pension reforms**.

28. **The government has decided to substantially scale up its privatisation programme.** The government aims at collecting EUR 50 billion in privatisation and real estate development receipts. Such a plan will contribute to reduce the debt-to-GDP ratio by almost 20 percentage points of GDP by 2015, and may help in regain investor confidence. Such an ambitious privatisation plan should be able to put the debt ratio on a declining trend much faster than it could be achieved solely via accumulation of primary surpluses. Although privatisation proceeds themselves do not substitute for fiscal

consolidation efforts, they contribute to fiscal sustainability, as the reduction in debt will lead to a reduction in interest expenditure. Moreover, an ambitious privatisation plan will contribute to increase the overall productivity and competition of the economy and attracting foreign capital. Privatisation should also contribute to reduce corruption potential.

29. **The mission encouraged the government to set up an appropriate governance system to accelerate privatisation.** Experience shows that large privatisation plans are more effective when a single entity is in the lead of the whole process and takes full ownership of the assets to be privatised. The current set-up where each ministry and a myriad of smaller entities manage and control government assets is less effective in extracting value from assets. The mission welcomed the fact that the government has started preparations for the compilation of a comprehensive inventory of state assets – stakes in listed and unlisted companies, buildings and commercially-viable land – on the basis of which the privatisation plan will be made more specific.

30. **High primary surpluses and privatisation ensure sustainability.** The chart below shows three pairs of long-term debt scenarios, until 2025. For each pair there are two assumptions on nominal interest rates 4.5 percent and 5.5 percent. Both assumptions are much below market yields, but not unrealistic if financial markets stabilise and the determination of Greece to keep fiscal accounts in order beyond the programme horizon is credible.

- In **scenario 1**, growth remains anaemic not exceeding 2 percent, and the primary surplus does not exceed 3¼ percent of GDP (level projected for 2013): it is a scenario of insufficient and unfinished fiscal consolidation and structural reforms. In this case, debt developments are not sustainable. This scenario suggests that, to ensure sustainability, consolidation needs to continue in coming years and structural reforms should be implemented with ambition to contribute to potential growth.

- In **scenario 2**, nominal growth beyond 2014 is 3½ percent, practically the same as the prudent one currently projected for 2014, while the primary surplus from 2014 onwards is 5.5 percent: a high value, but not higher than some other high-debt EU countries managed to keep for relatively long periods. The primary surplus is the one that is currently projected for 2014. In scenario 2, government debt is sustainable and declines, though it will remain above 100 percent o GDP by 2025.

- **Scenario 3** is the most favourable scenario: it is a derivation of scenario 2, talking into account the government plans of privatising EUR 50 billion of assets in 2011-15. In order to reach the same debt ratio by 2025 without privatisation, the primary surpluses would have to be above 7.5 percent of GDP, from 2014 on, a level that does not seem realistic.