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GLOBAL ECONOMIC & MARKET OUTLOOK
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FOCUS NOTES

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Greece- 2nd programme review

State of play, dynamics between the parties involved

The December 5 Eurogroup did not produce a staff level agreement on the conditionality underlying Greece's 2nd programme review although it did acknowledge the significant progress that has been achieved. On Wednesday 13 December the mission heads returned to Athens to resume negotiations against a background characterized by an unusual tension in the relationship of all the parties that are involved in Greece's bailout programme, namely Greece, the European institutions and the IMF. The events of the past few days brought to the fore the different interests of all stakeholders, which will apparently affect various parameters of the programme such as Greece's medium term fiscal target, the nature of the medium and long term debt relief measures and, ultimately, the timing of the conclusion of the current review.

Below we present the views of the IMF, the European partners and Greece and asses their potential impact on the ongoing review.

The IMF

Ever since the beginning of the 3rd Economic Adjustment Programme for Greece in August 2015, the IMF had expressed its reservations regarding the adequacy of the programme in bringing Greece's long-term growth and public debt on a sustainable path. As a matter of fact, the criterion for the Board of the IMF to decide to financially participate in any programme, with Greece being no exception, is the sustainability of the programme in the medium to long term context. In the case of Greece in particular, a number of IMF officials have at various occasions stated that "the numbers don't add up" and have stressed that the solution is of dual nature comprising both debt relief and reforms. In the absence of these conditions the Fund has so far reserved for itself the role of technical advisor, actively participating in all reviews without, however, contributing any funds.

In September 2016, the IMF released its Staff Concluding Statement of the 2016 Article IV Mission on Greece where it argues that more needs to be achieved in order for the country to make its economy more resilient and prosper within the currency union without long-term financial support from its European partners. In particular, the Fund claims that there should be a fiscally-neutral rebalancing of policies over the medium term toward lower pensions and a fairer distribution of the tax burden. In addition, action should be taken to curb the evasion of tax and social security contributions by avoiding further installment schemes and instead putting in place tailored and durable restructuring solutions for viable debtors in line with their capacity to pay, concentrating audits on large taxpayers and continuing to strengthen the use of enforcement tools against those who can but do not pay. With regard to the banking system, the IMF stresses the importance of rapidly reducing NPLs and strengthening the governance of banks. On the structural reforms front it is argued that labour market reform should not be reversed rather it should be complemented by more ambitious efforts to fully open up remaining closed professions, foster competition, and facilitate investment licensing and privatizations, as well as bring Greece's collective-dismissals and industrial-action frameworks in line with international best practices. Finally, the IMF reiterates its position that even with full implementation of the policy agenda, debt relief will be required to restore sustainability and it should be calibrated on realistic assumptions about Greece's ability to generate sustained surpluses and long-term growth.

In a more recent note signed by the Fund's Chief Economist Maurice Obstfeld and the European Department Chief Poul Thomsen, it is among others argued that the primary surplus target of 3.5%-of-GDP for 2018 and beyond would require "a degree of austerity that could prevent the nascent recovery from taking hold" and added that the Fund would support the existing Greek bailout with a primary surplus target of 1.5%-of-GDP. It is also claimed that Greece needs radical restructuring of its public sector as well as tackling the dual problem of a very narrow tax base and an overly generous pension system.

Finally the note calls on European partners to do more to make Greece's debt sustainable on the grounds that the short-term debt relief measures that were endorsed at the December 5 Eurogroup are not sufficient.

Taking into consideration these views it is evident that the IMF staff is more than reluctant to submit to the Fund's Board a proposal in favour of financially participating in the programme. In any case, the Fund's updated Staff Concluding Statement of the 2016 Article IV Mission on Greece and its debt sustainability analysis due to be published in the coming weeks may provide some clarity on the issue.

European partners

The political agenda of the European Union in 2017 is marked by the elections in the Netherlands, France and Germany, which to a large extent determine these countries' – and particularly Germany's – stance towards the Greek bailout programme. In broad lines, governments in these countries apparently think that too much leeway in the implementation of the 3rd Economic Adjustment Programme for Greece would not be well received by their constituents.

A number of euro area countries and particularly Germany and the Netherlands require the participation of the IMF in the programme as a prerequisite for their Parliaments to approve further official funding to Greece. This requirement was circumvented at the 1st programme review with Germany accepting the IMF temporarily staying in the programme under the capacity of technical advisor. This time around, however, Germany appears more determined to bring the Fund into the programme claiming that without it the Bundestag is unlikely to approve any further disbursements without, however, being willing to accept any all of the Fund's preconditions.

Some European partners have at times appeared more open towards the IMF's views. A few weeks ago, while addressing the European Committee of Economic Affairs, Eurogroup President Jeroen Dijsselbloem stated that there is a need to be realistic and that indeed the IMF has a point when it says that "running a primary surplus of 3.5%-of-GDP for a very long time is a huge thing to ask". On the same wavelength, ECB President Mario Draghi has recently stated that there are still concerns as to the sustainability of Greece's public debt and it is to the benefit of the Eurozone as a whole to come up with a lasting solution that will ensure both its short- and its long-term sustainability. Nevertheless, these remarks have been overshadowed by Germany's firm stance that what was agreed at the May 24 Eurogroup cannot be changed meaning that the medium-term primary surplus target shall be kept at 3.5%-of-GDP for 2018 and potentially for a few years after. With regard to the medium-term period beyond 2018, various opinions were expressed at the December 5 Eurogroup. The German FinMin suggested the primary surplus target remain at that level for ten more years while other Ministers expressed milder views proposing that the target remain at such high levels for about 3 to 5 years after 2018. On its part, Greece, would rather the primary surplus target be reduced at 2.5%-of-GDP after 2018 whereas the IMF considers even this lower target unproductive let alone unattainable and suggests it be set at 1.5%-of-GDP. A decision on this issue has not yet been reached.

Another matter where the European partners hold a different stance compared to the IMF and Greece is the medium and long term debt relief measures. European partners, Germany in particular, insist on strictly abiding by the May 2016 Eurogroup agreement, which foresees that the medium term debt relief measures will be implemented, if necessary, after the successful completion of the programme (i.e. after mid 2018). Therefore, according to Germany, the further specification of these measures at this point would be too premature. The IMF and Greece on the other hand would want more detail on the nature of these measures upfront as this would allow the Fund to conduct its debt sustainability analysis. Such a development would also facilitate the conclusion of the ECB's independent DSA analysis opening the way for Greece to be included in the quantitative easing (QE) programme.

Greece

The swift and successful conclusion of the 2nd programme review is considered a top priority by the Greek government as it will open the way for a number of positive consequences including the disbursement of the next loan tranche and, most importantly, the inclusion of the country into the ECB's QE programme. The latter will itself send a strong signal to the markets that Greece is solidly back on the sustainable growth path and confidence has been restored. In spite of the inherent difficulties in the implementation of the programme related to the political cost of a number of prior actions as well as other impediments, the country's efforts towards the completion of the 2nd review have lately also stumbled on the institutions' own discord on the issues of debt relief and medium term primary surplus targets, both of which still remain open. With regard to the primary surplus targets in particular, Greece would want them lowered as the IMF suggests, but if its European partners object to that, Greece categorically rejects any possibility to legislate additional austerity measures in order to attain the 3.5%-of-GDP primary surplus after the expiration of the current adjustment programme.

Another complication arose in the past few days after the Greek PM announced a Christmas bonus to be granted to particularly weak social groups. Given the projection of a significant over-performance of the 2016 budget with a forecast primary surplus of 1.1% -of-GDP – well above the 0.5%-of-GDP programme target – the Greek PM decided to grant a one-off payout of €617mn to low-income pensioners and postpone the VAT increase on the refugee-hit border islands. This decision, however, was considered a unilateral action because the Greek government had not previously consulted with its official lenders as the bailout programme foresees that it should have done. As a result the ESM announced that the short – term debt relief measures that had been agreed at the 5 December Eurogroup would temporarily freeze to allow for the institutions to assess the fiscal impact of the Christmas bonus first. Nevertheless, the incident triggered yet another dispute between Greece's European partners as, according to press reports, the European Commissioner for Economic and Financial Affairs Pierre Moscovici and French President Francois Hollande backed Greece whereas Germany reportedly appeared less conciliatory and asked the institutions to check if indeed Greece's decision was contrary to the bailout programme terms. At the time of writing it was yet unclear whether the short-term debt relief measures would indeed be temporarily suspended or not. Greek officials reportedly claim that they would not, but no statement by any of the European institutions had yet been made.

Official creditors returned to Athens to resume discussions with Greek authorities in the context of the 2nd programme review – Pending prior actions

After a nearly three-week hiatus, the ECB/IMF/EC/ESM mission heads returned to Athens earlier this week to resume discussions with Greek authorities in the context of the 2nd programme review. Official discussions commenced on Tuesday, December 13th and are scheduled to last for about a week as the mission heads are scheduled to depart for Christmas holidays. Speaking at a regular press briefing, European Commission spokeswoman Annika Breidthardt expressed optimism that taking under consideration the progress made so far, a staff level agreement is possible "very soon if all parts participate constructively in the negotiations."

In what follows we provide an updated analysis on the most contentious issues in the agenda of current negotiations for the successful completion of the 2nd programme review.

Size of projected fiscal gap for 2018 and sources of funding

EU officials seem to question the attainability of the fiscal target for a primary surplus of 3.5%-of-GDP for FY-2018 and request the adoption of additional measures (i.e., besides those already agreed under the existing MoU), opposing the Greek side's argument that any fiscal shortfall could be fully covered through permanent savings identified by the spending review.[1] In more detail, EU officials reportedly project a fiscal gap of between 0.2% to 0.4%-of-GDP mainly due to the lack of adequate funding for the implementation of the Guaranteed Minimum Income (GMI), scheduled to be launched nationwide in January 2017.[2] In an attempt to reach a compromise, the Greek government has reportedly submitted to official creditors a package of measures, including: (i) reduced heating oil allowance; (ii) dilution or abolishment of the tax discount stemming from healthcare expenses; (iii) dilution or abolishment of the special income tax regime applied on officers and junior crew of merchant navy; (iv) abolishment of the 1.5% discount on the tax withheld every month from employees' salary; and (v) imposition of tax on short-term rental accommodation (e.g., Airbnb-style vacation rentals). According to some press reports, official creditors have yet to respond to the adequacy of the aforementioned proposed measures.

Adopting a more pessimistic stance, the IMF argues that, should the 3.5%-of-GDP medium-term primary fiscal target for 2018 be maintained, then new measures of "high quality and credibility" will be required. In more detail, the Fund is said to argue that under a no-policy-change scenario, the general government balance will yield a primary surplus of 1.5%-of-GDP in FY-2018 and requests

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

[2] According to the existing MoU, the cost of the aforementioned scheme is estimated at 0.5%-of-GDP annually and has to be covered through permanent savings in areas of non-discretionary spending identified either by the World Bank (i.e., elimination or/and reduction of certain welfare benefits & tax deductions) or by spending reviews.

the Greek side to upfront specify, qualify and legislate structural reforms with an estimated net fiscal impact of 2.0%-of-GDP to cover the projected fiscal shortfall along with an additional 0.5%-of-GDP (or c. €4.5bn cumulatively) to offset the estimated recessionary effect of those measures. In line with the IMF's Article Four report (Sept 2016), the World Bank's recent proposals and a recent note published by IMF Chief Economist Maurice Obstfeld and Director of the IMF's European Department Poul Thomsen[3] the proposed reforms would mainly include: (a) a lower tax-free threshold to €5,000-€6,000 from €8,636 currently to broaden the tax base. The Fund argues that the current Greek income tax regime exempts more than half of households from any tax obligation compared to a 8% average in the rest of the euro area; and (ii) a further reduction in existing pensions through the abolishment of the so-called "permanent difference" on the view that the current pension system is deemed as "extremely generous" that costs the budget nearly 11%-of-GDP annually versus a 2¼-of-GDP average in the rest of the euro area. The Greek government vehemently opposes the aforementioned proposed reforms arguing that any remaining fiscal gap could be covered via the activation of the existing fiscal contingency mechanism that was adopted in the context of the 1st programme review to ensure that when Greece deviates from the annual primary surplus target during the programme period, a package of specific measures would be automatically activated.

The 2017-2020 Medium Term Fiscal Strategy (MTFS)

Before the Greek government proceeds with the legislation of the Medium Term Fiscal Strategy (MTFS) for 2017-2020 that constitutes a prior action for the completion of the 2nd review, some clarity by official creditors may be needed on how long beyond the expiration of the current bailout programme the medium-term fiscal target of 3.5%-of-GDP should be maintained. Euro area finance ministers were reportedly divided on the issue at the December 5th Eurogroup. The German side reportedly appeared the main proponent of maintaining the duration of the post-programme period of 3.5%-of-GDP surpluses to 10 years, as envisaged in the initial agreement. Others, including France and Italy, were understood to favor the 3.5%-of-GDP fiscal target for a shorter period of time (3-5 years) amid concerns over Greece's political and economic stability. According to the official Eurogroup statement, "the primary surplus target of 3.5%-of-GDP (…) should be maintained for the medium-term" without specifying the exact time period. At the press conference following the conclusion of the meeting, Eurogroup President Jeroen Dijsselbloem stated that the IMF is not concerned about the duration of the medium-term fiscal target, but about the necessary structural reforms required for sustaining it. The IMF has long argued that even if Greece reaches a surplus close to 3.5%-of-GDP in the short-term, it is unlikely to sustain it for many years considering the country's still weak policy making institutions and projections suggesting that unemployment will remain at double digits for several decades. In addition, the Fund has claimed that a fiscal target so high is inconsistent with Greece's ambitious long-term growth target delaying the onset of the needed implementation of a more growth friendly budget. Instead, the IMF has recommended the medium-term primary surplus target to be set at 1.5%-of-GDP and not to be upward reassessed until Greece's economic recovery takes better hold. However, as IMF Communications Director Gerry Rice clarified in a recent interview, the Fund could go along with a compromise between the Greek government and EU creditors for a 3.5%-of-GDP medium-term fiscal target provided that it is "underpinned by credit and high quality structural reforms". To this end, the Eurogroup December 5th Eurogroup explicitly read that "in order to ensure compliance with the fiscal targets in a sustainable manner after the completion of the programme, the Greek authorities committed to agree with the institutions on a mechanism and structural measures" that would ensure fulfillment of the 3.5%-of-GDP fiscal target.

In an attempt to reach a compromise, some press reports suggest that the Greek government would be willing to accept an extension of the existing fiscal contingency mechanism for a certain period beyond the expiration of the current programme without, however being required to legislate it upfront. On its part, the IMF reportedly argues that the potential activation of that mechanism which entails horizontal cuts would jeopardize growth prospects and instead, insists on the upfront legislation of specific reforms. With respect to the latter, the Greek government has repeatedly stressed that "under no circumstances" will it agree to additional fiscal measures for securing the 3.5%-of-GDP medium-term fiscal target beyond 2018 when the current programme is due to expire.

Labor market reform

In the context of official negotiations on labour market reform, the main issues of discussion include the following:

- ✓ *Collective bargaining*. The Greek government is pushing towards the reinstatement of the previous regime whereby the most favourable for the employee collective agreement, be that sectoral, occupational or other, should have precedence (favourability principle).

[3] For more information refer to: https://blog-imfdirect.imf.org/2016/12/12/the-imf-is-not-asking-greece-for-more-austerity/

- ✓ *Minimum wage*. The Greek government opts for a switch back to a national collective bargaining system for determining the minimum wage (with automatic erga omnes effect). The minimum wage currently stands at €683.76/month in 12 payments or €586 per month in 14 payments. According to the existing legislation (4172/2013) the level of the minimum wage is determined by a ministerial decree based on a number of criteria including the evolution of domestic economy, productivity, competitiveness, employment & unemployment rates, annual income and wages.
- ✓ *Modifications to the existing framework for collective dismissals*. Official creditors push for an increase in the monthly limit of collective layoffs to 10% (from 5%, currently) for companies with more than 150 employees, the abolishment of the Labour, Social Insurance and Social Solidarity Ministers' veto power on such dismissals and the establishment, instead, of the Highest Board of Employment, which will be entitled to perform a legality assessment of dismissals. The Greek government strongly opposes such proposals.
- ✓ *Regulatory framework dictating labor unions' operation*. Official creditors reportedly argue for certain changes in the regulatory framework dictating labor unions' operation including, among others, a potential increase in the time required for a trade union to declare a strike to 48 from 24 hours currently and reassessment of certain trade unionists' privileges,
- ✓ *Industrial action.* Official creditors reportedly favor the reintroduction of the employers' right to stage lockouts during worker strikes in the work place.

Assessment of the privatisation programme

Deviations from the agreed privatization plan's timeline prevail. Under the existing MoU, these incorporate, inter alia:

- ✓ The engagement of advisors – initially planned for Q3 2016 – for the evaluation and recommendation of alternative strategic options for a number of privatisations including: (i) the 35% stake of Hellenic Petroleum (HELPE); (ii) the 65% stake of Public Gas Corporation (DEPA); (iii) the 23% stake of Thessaloniki Water Supply & Sewerage (EYATH), (iii) the 11% minority stake of Athens Water Supply & Sewerage (EYDAP); and (iv) the 17% stake of Public Power Corporation (PPC).
- ✓ The nomination of the Board of Directors of the new Privatisation and Investment Fund so that it becomes fully operational in January 2017.
- ✓ *A* compromise solution to the electricity amounts Greece's Public Power Corporation (PPC) will offer through NOME-type auctions to third parties under the agreed plan for a reduction to the utility's retail market share by 50% cumulatively by 2020.
- ✓ The relaunch of the sale of a 66% stake in natural gas grid operator DESFA (31% owned by the HRADF and 35% by Hellenic Petroleum) after discussions between the Greek government and preferred bidder Azerbaijan's state energy company Socar collapsed last month. The privatisation of DESFA had been pending since 2013, when Socar was announced preferred bidder offering €400mn.

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