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Assessment of the 2011 national reform programme and stability programme for GREECE

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

on the National Reform Programme 2011 of Greece and delivering a Council Opinion on the updated stability programme of Greece, 2011-2014

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1. INTRODUCTION

The strong growth performance of Greece over the last decade was based on unsustainable drivers. With average real GDP growth at close to 4% per year between 2000 and 2009, against 2% in the euro area, Greece's income gap with the euro-area average was reduced from 25 to about 10%. This reflected a domestic demand boom, in particular in consumption and residential investment. High real wage increases, rapid credit growth supported by financial sector liberalisation and low real interest rates associated with euro adoption and loose fiscal policy contributed to buoyant growth. Over the period 2000-2009, external trade imposed a drag on growth and the share of exports in GDP declined from 25 to 19%.

The absorption boom and weak external competitiveness caused a fast increase in external imbalances. Real wage growth consistently outpaced productivity gains over the past decade, in part reflecting spillovers from very high public wage increases. The resulting increase in ULC (unit labour costs) eroded external competitiveness, not least with respect to the rest of the euro area. Greece's real effective exchange rate (REER) appreciated by some 10-20 percent, depending on the deflator used, over 2000-2009 and according to Commission services' calculations was overvalued by 10 to 20% in 2009 (Box 1, Figure 4). The combination of high domestic demand growth and deteriorating external competitiveness translated into a rapid worsening of the current account deficit, which peaked at 14% of GDP in 2008.

Fiscal imbalances remained persistently high. Since Greece submitted its first stability programme in December 2000 (shortly after the decision that Greece would adopt the euro), which set a medium-term objective (MTO) of a balanced budgetary position, this target has never been reached. Worse, the headline balance has never been below 3% of GDP (Figure 2). Fiscal targets were consistently missed, despite the benign economic environment, due to systematic overspending, endemic tax evasion and persistently overoptimistic tax projections. The size of the government sector grew from 44% of GDP in 2000 to over 50% in 2009, not only absorbing available external financing, but also crowding out private-sector resources and therefore weakening economic performance (Figure 3). In addition, unreformed health and pension systems posed a threat to the long-term sustainability of public finances.

Persistent fiscal and external imbalances led to a significant increase in government and external debt. In 2009, gross government debt reached 115% of GDP, up from 103% of GDP in 2000, and net external debt almost 100%of GDP, up from 45% of GDP in 2000 (Figure 5). Around three quarters of total external debt pertains to the public sector, and has relatively long maturities. Overall, the accumulation of macroeconomic imbalances, large stocks of public and external debt, weak external competitiveness, an unsustainable pension system, and weak institutions made Greece vulnerable to an increase of risk aversion in the international capital markets.

In addition, Greece has rigid product and labour markets. Greece underperforms in many structural policy areas. This has had an impact on past economic performance, as shown in Greece's relatively low employment and labour productivity levels, which were only partly compensated by a high number of hours worked. Unless tackled in earnest, structural rigidities may undermine the Greek economy's capacity to adjust to the current situation.

The 2008-2009 global crisis exposed Greece's vulnerabilities. As a result, market sentiment vis-à-vis Greece worsened sharply in early 2010. The downturn took a heavy toll on public finances. Significant overspending and a sharp fall in government revenue pushed the general government deficit to an estimated 13.6% of GDP in 2009. Government debt reached 115% of GDP at the end of 2009. Moreover, the extent of the deterioration in the fiscal position was revealed quite late due to serious deficiencies in Greece's accounting and statistical systems (Table 1). This delayed implementation of corrective measures surprised the markets, which became concerned about fiscal sustainability. Leading rating agencies downgraded the sovereign, and the yield on sovereign bonds and CDS spreads increased sharply since the end of 2009.

Table 1. Revision to 2009 deficit estimates

	2009 deficit (% of GDP)
Budget 2009	2
SGP January 2009	3.7
EDP notification April 2009	3.7
EDP notification October 2009	12.7
Budget 2010	12.7
SGP January 2010	12.7
February 2010	12.9
EDP Notification April 2010	13.6

Sources: Greek authorities, Eurostat.

While not the root cause of financial stress, the banking sector was affected by the economic and confidence crisis. The average capital adequacy ratio of Greek banks improved to 11.7% at the end of 2009, partly thanks to public capital injections on top of banks' own efforts to bolster their capital buffer. However, nonperforming loans increased from 5% in 2008 to 7.7% in December 2009 (Table 2). Furthermore, rising concerns about the creditworthiness of the sovereign affected the banking system through various channels (Box 2), feeding worries of a disorderly adjustment. These developments called for a rapid policy response.

In April 2010, the authorities asked for official financial assistance. The government was confronted with sizeable fiscal financing needs in April and May 2010. The April needs were met through issuances of bonds – EUR 8 billion in five-year bonds on 25 January, EUR 5bn in ten-year bonds in early March and EUR 5 billion in seven-year bonds in late March – but at a high price (the average interest rate exceeded 6%). Following the further worsening of market conditions in the course of April, the authorities requested bilateral financial assistance from euro-area Member States and a Stand-By Arrangement from the IMF. A joint EC-ECB-IMF mission was sent to Athens on 21 April 2010 to discuss a policy package to restore macroeconomic stability and sustainable long-term growth. Agreement at technical level was reached on 2 May 2010 on a comprehensive policy package for the period 2010-13 supported by official financing for a total amount of EUR 110 billion. On the same day, the Eurogroup endorsed the policy programme and approved bilateral loans from Euro area Member States amounting to EUR 80 billion. On 9 May, the IMF Board approved a EUR 30 billion Stand-By Arrangement

2. MAIN FEATURES OF THE PROGRAMME

Euro-area Member States provide financial support to Greece through pooled bilateral loans, managed by the Commission on their behalf. On 2 May, the Eurogroup agreed on a financing

package of up to EUR 80 billion over three years to meet Greece's financing needs, in conjunction with an IMF stand-by arrangement of up to EUR 30 billion. The assistance is provided in quarterly instalments, whose respective size reflects the forecasted profile of financing needs. Disbursements are made pari passu by the euro area and the IMF based on their shares in the total assistance package (8:3). Stringent conditionality is an integral part of the support package, to ensure that Greece effectively tackles underlying fiscal and macroeconomic imbalances. The key elements of policy conditionality have been enshrined in a Council Decision under Articles 126(9) and 136 TFEU.[1] The specific conditions for the release of loan instalments are further detailed in a Memorandum of Understanding agreed with the Greek authorities. Conditionality is consistent across the euro area and IMF programmes. Compliance with policy conditions is reviewed by the Commission, in liaison with the ECB, on a quarterly basis. Close co-ordination with the IMF is maintained. Based on a report by the Commission, the contributing Member States decide unanimously on the release of each instalment.

The Economic Adjustment Programme provides for an unprecedented fiscal consolidation effort in 2010-2014. The fiscal balance is projected to be reduced from almost 15,5% of GDP in 2009 to below 3% of GDP in 2014. Out of the measures with an impact on 2010 fiscal accounts 4.4% of GDP were on expenditure and 4% of GDP on the revenue side of the budget. The reduction in the deficit fell short of the annual target, given the higher-than-anticipated 2009 general government deficit, the underlying upward pressure on expenditure (e.g. interest, old-age pensions) and the impact of the recession on taxes and social spending. The measures include *inter alia*: nominal wages and pensions cuts (13th and 14th monthly payment), cuts in intermediate consumption and public investment, elimination of the solidarity allowance, and increases in VAT and excise duties on fuel, cigarettes and alcohol.

In parallel, the government launched ambitious pension and healthcare reforms that should underpin the long-term sustainability of public finances in Greece. The pension reform bills adopted by the Parliament in July 2010 provide for very short phase-in periods for increasing retirement ages and contributory periods and parametric changes that should significantly improve the long-term sustainability of the pension system. The reform simplifies the current highly fragmented pension system; enhances transparency and fairness, postpones the retirement age and decreases the generosity of benefits, while preserving an adequate pension for low-middle income earners. Healthcare reforms are underway, with the aim of keeping public health expenditure at or below 6% of GDP, while maintaining universal access and improving the quality of care delivery.

The structural reform agenda is geared towards recovering competitiveness. The reforms adopted in 2010 include a first leg of labour reforms. 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. The removal of unnecessary hurdles to the entry to and exercise of professions is being prepared. 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.

Financial sector stability has been supported by the creation of a Financial Stability Fund. The Fund's capital amounted to EUR 10 billion, financed by the international financing package. Still, 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. Several new initiatives are

[1] Council Decision of 10 May 2010 (2010/320/EU), (OJ L 145, 11.6.2010, p. 6) under Articles 126(9) and 136 TFEU, addressed to Greece, with a view to reinforcing and deepening the fiscal surveillance and giving notice to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit by 2014.

under way. Firstly, to support the liquidity of the banking system the government will adopt a new tranche of government guarantees amounting to EUR 30 billion. Secondly, the Bank of Greece has asked banks to devise and implement medium-term funding plans setting out ways to reduce their dependence on Eurosystem credit. Finally, the restructuring of state banks is moving forward while the authorities are encouraging private banks to raise capital and restructure as needed.

3. PROGRAMME IMPLEMENTATION

Based on a quarterly compliance report by the Greek authorities, the Commission prepares an assessment of compliance in the form of a Communication to the Council, as well as a recommendation for an amended Council Decision. Council Decision 2010/320/EU was amended three times up until March 2011.[2] The Decisions include detailed quarterly policy requirements in a number of areas, such as fiscal consolidation, fiscal structural reforms, labour and product market reforms, etc.

The most recent assessment (dated 24 February 2011[3]) concluded that *'All in all, despite the 2010 fiscal slippage, Greece is getting ready to take the necessary actions and to implement the required policies to remain on track, with a view to putting an end to the excessive deficit by 2014, as required in the Council Decision. Therefore, the Commission concludes that Greece is satisfactorily complying with the Council Decision of 10 May 2010, responding to the Council Recommendation of 16 February 2010 and implementing the measures outlined in the updated MEFP and MoU of 22 November 2010.'*

On 2 May, the fourth review of the implementation of the economic adjustment programme started. Commission, ECB and IMF staff are participating.

4. MONITORING, PROCEDURAL ISSUES AND GOVERNANCE

Greece submitted a National Reform Programme that was drafted in line with the "Economic Adjustment Programme for Greece". Stakeholders' were not involved in the drafting of the NRP. Greece has set targets in the five headline areas defined in the Europe 2020 strategy; however, the R&D target, previously set at 2% of GDP, will be revised to more realistic levels that take into account the current economic environment. The employment rate target could also be revised in the event of unforeseen developments.

Table 1: Greek Europe 2020 targets

Europe 2020 targets	Current situation in Greece [4]	Greek Europe 2020 target in the NRP
R&D investment (% of GDP)	0.58% (2007)	
Employment rate (%)	64% (2010)	70%
Early school leaving (%)	14.5% (2009)	9.7%
Tertiary education attainment (%)	26.5% (2009)	32%
Reduction of number of people in or at risk of poverty or exclusion	539.000 (2009)	Reduce by 450 000 number of people at risk of poverty or social exclusion.

[2] Council Decision 2010/486/EU of 7 September 2010 (OJ L 241, 14.9.2010, p. 12); Council Decision 2011/57/EU of 20 December 2010 (OJ L 026, 29.1.2011, p. 15); Council Decision 2011/257/EU of 7 March 2011 (OJ L 110, 29.4.2011, p. 26).

[3] http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/op77_en.htm

[4] Eurostat figures

Energy efficiency – reduction of energy consumption in Mtoe[5]		Reduction in primary energy consumption: 2.7 Mtoe
Reduction in greenhouse gas emissions (from sources not covered by the Emission Trading System)	- 7%[6]	- 4%[7]
Renewable energy (% of total energy use)	8% (2008)	18% of gross final energy consumption

[5] As estimated by the Commission. Mtoe = Million tonnes of oil equivalent.
[6] This quantity corresponds to the 2005-2008 evolution of the emissions not covered by the EU Emissions Trading System. As the scope of the Emissions Trading System evolved between 2005 and 2008, these emissions are estimated on the basis of the main relevant UNFCCC source categories (as opposed to the difference between total emissions and EU ETS verified emissions).
[7] The national emissions limitation target defined in Decision 2009/406/EC (or "Effort Sharing Decision") concerns the emissions not covered by the EU Emissions Trading System. It is expressed as the minimum relative decrease (if negative) or the maximum relative increase (if positive) compared to 2005 levels.