GREECE

Highlights

- **The economy has been hit by uncertainty in 2015.** Following a return to modest growth in 2014, the economy grew further in the first two quarters of 2015, but investment and confidence were badly damaged in the third quarter by political uncertainty, capital controls and fears of a possible exit of Greece from the eurozone (or "Grexit"). The situation stabilised after the September elections and market confidence is recovering.
- **A third bailout programme has been agreed.** The Memorandum of Understanding (MoU) signed by the Greek authorities and the European Commission (EC) in August 2015 contains a raft of far-reaching and ambitious reforms designed to restore fiscal and financial stability, reform the state and public administration, and promote growth.
- **Capital controls have been introduced.** These measures followed fears of a full-blown bank run. Although some of the most stringent measures have been relaxed, existing controls continue to place a burden on businesses, especially importers and exporters.

Key priorities for 2016

- **Reforms agreed under the MoU should be respected and implemented.** The reform agenda is ambitious and far-reaching, but evidence of a firm commitment to the main elements represents the best chance for Greece to attract investment and restore confidence and growth.
- **The banking sector has urgent capital needs.** The recommendations of the assessment of recapitalisation needs should be carried out promptly by year-end so that banks can start functioning normally again and supply much-needed credit to the economy.
- **The privatisation programme under the new Fund needs to show visible results in 2016, through sales and other means.** A new momentum in the process became evident in 2015, and if important state assets are brought to sale through open, competitive tenders, it would send an important positive signal regarding the authorities' commitment to encouraging private sector involvement in the economy.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	-8.9	-6.6	-3.9	0.7	-1.5
Inflation (average)	3.1	1.0	-0.9	-1.4	-1.0
Government balance/GDP	-10.1	-8.6	-12.2	-2.5	-4.2
Current account balance/GDP	-9.9	-2.4	0.6	0.9	0.7
Net FDI/GDP [neg. sign = inflows]	0.3	-0.4	-1.5	-0.6	-0.2
External debt/GDP	187.5	233.3	234.6	236.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	116.4	114.2	116.4	115.5	n.a.

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Macroeconomic performance

The past year has been another turbulent one for the economy. A glimmer of optimism returned in 2014 when the six-year recession, during which GDP had fallen by approximately one-quarter, came to an end. Positive year-on-year growth returned in the first three quarters of 2014 as confidence indicators improved (although from very low levels), and industrial production and tourism-related services moved upwards. However, the positive direction of economic activity reversed in the fourth quarter, with output contracting by 0.2 per cent quarter-on-quarter (q-o-q). Following a slight rise of 0.1 per cent in the first quarter of 2015, in the second quarter GDP grew by a surprising 0.9 per cent q-o-q (seasonally adjusted). The main driver was consumption, especially of durable goods, possibly driven by people's fears of a "Grexit" and/or confiscation of bank deposits. Tourism numbers have held up well and may reach record levels in 2015. Net exports also rose in the second quarter of 2015 as imports fell by nearly 5 per cent, reflecting trading difficulties faced by many importers. But the third quarter was almost certainly strongly negative (pending the release of data in November) after the uncertainty caused by the temporary bank holiday, imposition of capital controls and fears of a Grexit. Gross fixed capital formation fell in the second quarter by nearly 11 per cent.

A third bailout programme has been agreed. The programme will run from August 2015 to August 2018 and envisages new loans from the European Stability Mechanism (ESM) of up to €86 billion. A sum of €13 billion was disbursed on 20 August, enabling Greece to meet a €3.2 billion bond redemption payment to the European Central Bank (ECB) on the same day and to return the money from the European Financial Stability Fund's €7.2 billion bridge loan, used earlier in July to clear arrears to the International Monetary Fund (IMF; of around €2 billion) and redeem a €3.5 billion bond to the ECB. Loans from the ESM will be used for four main purposes: debt service; bank recapitalisation (up to €25 billion); clearance of arrears; and budget financing. An International Monetary Fund (IMF) contribution to the programme is expected. However, the IMF has made it clear that it regards Greece's public debt as highly unsustainable and that its participation is conditional on European creditors adopting debt relief measures. The exact form of this debt relief remains to be determined.

New fiscal targets have been set. The government succeeded in recording primary surpluses in 2013 and 2014. Under the MoU between the EC and Greece, the government will aim for a primary deficit in 2015 of 0.25 per cent of GDP, followed by surpluses of 0.50, 1.75 and 3.50 per cent in 2016, 2017 and 2018, respectively. These targets will be achieved by a combination of new measures to raise revenues and others to contain spending, along with a comprehensive programme to strengthen tax compliance and fight tax evasion. However, achieving the 2015 target will be difficult as revenues in the first nine months of 2015 were 8 per cent below those in the same period in 2014 and output may contract sharply in the third and fourth quarters.

Significant short-term uncertainties remain. The combination of investor fears about a possible Grexit and the imposition of capital controls in June 2015 has been highly damaging for the economy and for short-term recovery prospects. However, the better-than-expected growth outcome in the first half of 2015 will mitigate the overall decline this year to -1.5 per cent. Prospects for a quick recovery are weak, given the lack of investment in recent years and the need for further short-term austerity measures to put the debt profile on a sustainable path. However, in the medium to long term, a pick-up in growth can be expected, driven by the ongoing shift to a more export-oriented growth model and the development of Greece's potential in areas such as tourism, logistics, energy efficiency and security, food processing and pharmaceuticals. This assumes that Greece builds on some of the reforms introduced in recent years in terms of creating a modern, efficient and market-oriented economy.

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Major structural reform developments

A major reform agenda lies ahead for Greece. Since Greece entered the first bailout programme with international creditors in 2010, progress in structural reforms has been mixed. Before 2015, the authorities had made visible and important advances in several areas (as noted by, for example, by the OECD): tax policy reform (broadening the tax base and improving collection, simplification of tax and accounting legislations); public administration modernisation (streamlining general government employment, improving public financial management); stabilisation of the financial system; improvement of labour market flexibility; and liberalisation of the electricity and transport sectors. However, other areas proved to be contentious and difficult, including reforms to pensions, health care and education, liberalisation of products and service markets, as well as privatisation. Under the MoU reached with the EC in August 2015, the then-government committed to an ambitious reform agenda focused on four areas: restoring fiscal sustainability; safeguarding financial stability; enhancing growth, competitiveness and investment; and building a modern state and public administration.

Privatisation results have been disappointing but a new momentum may be under way. When the first bailout programme was agreed in 2010, ambitious revenue targets of up to €50 billion were envisaged from the sale of state assets. These proved to be far too optimistic; as of late-2014, total transaction receipts amounted to €5.4 billion either received or committed. Little progress has occurred in 2015, with the exception of the government's decision in August to award a 40-year concession worth €1.2 billion to German company, Fraport, to run 14 regional airports, including those on popular tourist islands such as Mykonos, Rhodes, Kos, Santorini and Corfu. Under the MoU with the EC, revenues from privatisation should reach €6.4 billion in the period 2015-17. Promising future state- or partially state-owned assets for sale or long-term concessions would involve major projects, including in energy (Public Power Corporation, Public Gas Corporation – DEPA); roads (for example, Egnatia motorway – a 648 km toll motorway in northern Greece); railways (Trainose); airports (Athens International Airport); regional ports (Piraeus, Thessaloniki); natural resources (Hellenic Petroleum); and real estate.

Greece has taken important steps to improve the business environment. This is reflected in the World Bank's *Doing Business 2016* report, published in late October 2015, where Greece is now ranked 60th (out of 189 countries) in overall ease of doing business, improving from 109th position in 2010. However, the country has the worst overall competitiveness among the EU member states, as measured by the World Economic Forum's Global Competitiveness Index (ranked 81st out of 140 countries). The ranking continues to be dragged down by poor scores on the components relating to the macroeconomic environment, financial stability and labour market efficiency. The new MoU is intended to bring macroeconomic and financial stability, as well as further business environment improvements in line with best EU practices and recommendations from the World Bank and the OECD.

Energy sector reforms are envisaged. This is an area where Greece has lagged behind European standards in terms of competition, innovation and the development of renewable sources of energy. The August 2015 MoU contains a number of commitments by the government to improve the situation. A key part of the reform programme will be either the privatisation of the electricity transmission company, ADMIE, or an alternative scheme with equivalent results in terms of competition and investment. The authorities have also committed to the development of a new framework for renewables.

The financial sector remains vulnerable amid capital controls. The banking system has been hard hit by the overall uncertainty during 2015. Since the beginning of the year, bank deposits, which had peaked at almost €240 billion in September 2009, have been haemorrhaging from the system at an alarming rate (down by almost €40 billion in 2015 alone). By June 2015, total deposits in the system had fallen to €122 billion, and banks were increasingly reliant on liquidity support from the Bank of Greece, subject to limits imposed by the ECB. In June 2015, in the face of a possible full-blown bank run, the government introduced strict capital controls, including a €60 limit on daily withdrawals for depositors in Greek banks and a ban on transactions abroad (with transactions of public interest, such as medical expenses or pharmaceutical imports, approved on a case-by-case

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basis). Banks were closed temporarily on 29 June, but re-opened three weeks later, while the stock exchange re-opened on 3 August. Some relaxation of capital controls has occurred, but significant restrictions remain in place as of mid-October. The August MoU recognises that the banking system as a whole will need major recapitalisation of up to €25 billion. Credit to the economy remains highly constrained and banks are burdened by non-performing loans which reached more than 40 per cent of the total by the end of March 2015 and may have risen further since.

Pension reforms are being (re)introduced. Greece’s pension system is widely acknowledged to be unsustainable, but achieving meaningful reform in this area has proven difficult because of political sensitivities. The authorities have now committed to far-reaching reforms to place the system on a more viable footing. In July 2015, as part of required pre-action for further international support, the government increased the health contributions of pensioners and took steps to ensure that supplementary pension funds will be financed by own contributions rather than from the state budget. Key reforms to be introduced in the coming months and years include the raising of the pension age to 67 for most people by 2022.