EXECUTIVE BOARD MEETING ON GREECE

THIRD REVIEW UNDER THE EFF AND 2013 ARTICLE IV CONSULTATION

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I. THE THIRD REVIEW OF THE EFF-SUPPORTED PROGRAM

Economic Developments and Prospects. Greece is currently in its sixth year of recession: GDP declined by 6.4 percent in 2012 for a cumulative contraction of 22 percent between 2008 and 2012; it is forecast to decline further by 4.2 percent in 2013. The unemployment rate is close to 27 percent and youth unemployment now exceeds 60 percent. Inflation is anticipated to be steadily lower than the euro area average for both 2013 and 2014. The current-account deficit has declined from 11.2 percent of GDP in 2009 to 3.4 percent in 2012, and is expected to decline further to 0.8 percent in 2013.

These outcomes are the result of an unprecedented adjustment effort, which began strongly in 2010, continued at a slower pace in 2011, was bolstered with the PSI in early 2012, and was reinvigorated under the government of Prime Minister Samaras that has been in power since last June. Thanks to the determined efforts by the authorities, the economic outlook during the last review remained largely unchanged from the previous review, with continued prospects for a gradual return to growth in 2014, supported by inflation well below the euro area average and improved wage flexibility, both of which are helping to restore the competitiveness of the Greek economy.

Fiscal Policy and Management. Fiscal performance is on track to meet the program targets, and the government is committed to fully implement all agreed fiscal measures for 2013-14 that are not yet in place; recent legislation extended the collection of the real estate tax through 2013 via the Public Power Company to ensure an uninterrupted stream of good revenue performance. A very important step towards enhancing the revenue collection mechanism, which the authorities recognized as a weak link in the adjustment effort, was a major reform of the revenue administration to provide it with significantly more autonomy, powers and resources, and the adoption of more effective and enforceable installment schemes. The authorities share the staff views that improved tax collections and minimization of tax evasion and corruption are essential ingredients for a more balanced and fair distribution of adjustment, which would generally enhance the ownership of the adjustment program.

The Banking Sector. Most systemic banks completed the basic steps of the recapitalization process at the end of April; the subscription process is expected to be finalized in the coming weeks. The recapitalization included the purchase of branches of three Cypriot banks that had come under distress in recent months by one Greek bank. The funds provided by the Hellenic Financial Stability Fund should provide adequate capital, even under a significantly adverse scenario, and will thus ensure the safety and soundness of the banking system and its deposits. More generally, the authorities have undertaken to develop a comprehensive strategy for the banking sector following recapitalization by July 15, 2013; the strategy will address, *inter alia*, the issue of possible further mergers among the four systemic banks and the timetable for disposing the shares held by the Hellenic Financial Stability Fund to the private sector.

Structural Reforms. With the macroeconomic adjustment under control, the authorities are turning their attention to deeper structural reforms, which have been under consideration since the beginning of the program, and which required rigorous analysis and extensive consultations with social partners. One important commitment that had lagged behind is well under way: the administrative reform to improve the quality of the public service and to strengthen accountability by streamlining its structures, removing positions, and reallocating staff. This major reform includes dismissals that are targeted at disciplinary cases and cases of demonstrated incapacity, absenteeism, and poor performance, or that result from closure or mergers of government entities. Other areas of continued structural reforms are (a) continued liberalization of product and service markets, including transport and retail trade, private education, fuel distribution; and (b) electricity sector reforms to ensure financial sustainability and promote competition and efficiency.

Safety Net. The government is committed to protect the most vulnerable segments of the population during these turbulent times. The government is making progress in strengthening the social safety net, including through targeted employment and training programs supported by the EU, pilot programs to extend unemployment benefits and provide minimum income support, a program to provide access to primary health care for the uninsured, and a scheme to reduce the financial burden on indebted low-income households which have been severely affected by the crisis.

In sum, this review succeeded in shifting the focus from further macroeconomic adjustment through recessionary channels to the prospect of viable growth through extensive structural reforms, which will help achieve an annual primary surplus at an early time. When this is realized, the authorities look forward to earlier commitments by Euro Area Member States to consider further initiatives and assistance, if necessary, for achieving an additional and credible reduction of the Greek debt-to-GDP ratio, which should help ensure the long-term sustainability of Greece's public debt.

II. THE 2013 ARTICLE IV CONSULTATION

Areas of Agreement. My authorities are grateful to the staff for the comprehensive and rigorous Article IV consultation report. They consider it a useful and important supplement to the program discussions. They also appreciate the analytical chapters in the Selected Issues paper, which they consider important contributions to the debate about the development model of Greece "the day after".

My authorities agree with most conclusions in the staff appraisal, and appreciate the emphasis on three major achievements accomplished by Greece: exceptional fiscal adjustment in a short period of time, fundamental changes in the labor market, and preservation of banking sector stability. Combined, progress in these areas has improved Greece's competitiveness and has contained the runaway increase in public debt. With the help of the Fund and its European partners, Greece has begun the process of (re)gaining sustainability within the Euro zone and is now looking forward to reaching a sustainable growth path based on an economically viable model.

Some Amplification to Staff Conclusions. While the authorities agree with the thrust of the staff remarks and recognize that major challenges remain ahead, they wish to qualify some of the conclusions that are presented in the staff analysis regarding structural reforms.

First, as a matter of general principle, structural reforms are more difficult to implement than macroeconomic adjustment measures, not only because of political considerations but also due to severe capacity constraints. The latter, which should not be underestimated during the early phases of the program, are gradually being overcome thanks to massive technical assistance from Fund staff, the European Task Force, and several bilateral donors. As a result, progress under the coalition government that came to power one year ago has been steadfast: the Spring 2013 Update of the Euro Plus Monitor, produced by Berenberg Bank and the Lisbon Council, *placed Greece on the top spot of its Adjustment Progress Indicator*. In addition, Greece has been ranked as the country with *the highest responsiveness to OECD recommendations between 2010-12.*

Second, the authorities would qualify the characterization that "limited progress has been made in tackling Greece's notorious tax evasion" as follows: while tax compliance and collections remain a formidable challenge, in the past six months there are weekly reports about individuals who have been arrested for major tax evasion offenses. More generally, tax compliance is expected to be strengthened considerably with the January appointment of an independent General Secretary of public revenues, who, as noted earlier, was vested with more autonomy, power and resources to carry out effectively the tax collection process. However, resolution of tax offenses lies with the tax courts, which are beyond the reach of the executive branch, and the government has identified this as an area for further improvement. As staff acknowledges in the Article IV report (para. 33), the authorities, while mindful of the huge task of reforming tax administration within a short time horizon, have "emphasized their political commitment to see the process through".

Third, the authorities recognize the considerable delays in the implementation of employment reforms in the public sector. However, with the April 29 passage of the Omnibus Law, which included quarterly plans for 4,000 mandatory exits in 2013 and 15,000 cumulative through end-2014, the taboo against dismissals in the public sector has in principle been lifted, and the door has been opened for mandatory redundancies. The government sees this new avenue as a long-overdue opportunity to revamp the quality of public services through the replacing of laid-off public servants with qualified staff in key areas such as bank supervision and tax administration.

Doing Business, Privatizations, and the Banking Sector. Beyond tax administration and public sector reforms, the government intends to focus on invigorating Greece's export and import competing industries. The government is committed to reduce barriers to entry into various markets, including opaque and lengthy licensing procedures, and, more generally, to improve the business environment. *The World Bank Group Doing Business Report has raised the rank of Greece to 78 in 2013 from 89 in 2012*.

The privatization process has picked up. The Hellenic Republic Asset Development Fund recently approved the sale of a 33 percent stake in the Football Betting Organization to a private concern for over €700 million. Other privatizations recently completed are State Lotteries (€190 million), Mobile Telephony Licenses (€381 million) and the International Broadcasting center (€81 million). There are also 14 privatizations in the final stages of completion, including the National Gas Utility Corporation, for which established foreign companies have tendered bids. In sum, since the beginning of the program the authorities expect cumulatively €4.2 billion privatization receipts by end-2013, €6.5 billion by end-2014, €7.7 billion by end-2015 and €11.1 billion by end-2016.

The authorities recognize the importance of effective financial intermediation in achieving a strong recovery and a viable growth path**.** The large injection of public capital to the systemic banks is understood as a temporary measure and the government intends to implement re-privatization at the earliest possible stage. More generally, the authorities are working on a reinforced governance framework, supporting strong oversight and supervision, which would also eliminate undue Government interference and attendant problems of directed credit. Moreover, a key priority for the banking system will be to contain and reverse the mounting tide of non-performing loans. The authorities are committed to put in place a framework for dealing with distressed household borrowers. In addition, deposits are replenished through cash that had been removed from the banking system: Greek private-sector bank deposits are 9 percent up from last June's lows and stabilized in May after some outflows in April on Cyprus fears.

Green shoots. While in several areas the picture is mixed, the government believes that 2013 will be the last year of retrenchment and the recession will bottom out in the next few months. Several recent developments point to hopeful signs for economic recovery. First, the real economy is set to acquire much needed liquidity: the government has paid off €2.2 billion of an outstanding €9 billion in arrears to suppliers and the stock of T-bills held by the banking sector declined, thus releasing resources for the financing of private sector activities. Second, work on some major infrastructure projects is restarting, potentially creating thousands of jobs. Third, tourist spending during the upcoming summer season may rise, as the Association of Greek Tourism Enterprises are anticipating 17 million tourist arrivals in 2013, one million more than in 2012. Fourth, two weeks ago the rating company FITCH upgraded both the sovereign rating and the rating of Greece's four systemic banks by one notch (with a stable outlook), stating that " clear progress has been made towards eliminating the twin fiscal and current account deficits and that 'internal devaluation' has at last begun to take hold".

Growth and the Role of Confidence. The authorities fully share the staff's view that restoring growth remains the overarching precondition for the success of the three-year old adjustment effort**.** In turn, growth cannot be achieved without improvement in sentiment. The authorities' top priority is to continue to enhance confidence in the government's resolve to forge ahead with the required reforms, so as to secure broad political stability and thus elicit domestic and foreign investments. The April 29 Omnibus Law mentioned earlier is a testimonial to the support that the government now enjoys among large strata of the population. The passage of the bill in parliament, despite its far reaching implications for civil servants, has been received only with muted protests, and certainly without vocal street confrontations.

Confidence is rising. The latest euro-zone Economic Sentiment Indicator for Greece rose to 89.2, above the euro-zone average, and the Purchase Managers' Index showed considerable improvement in April (45, up from 42.1 in March), which was the highest level since July 2011. Such improvement in sentiment, coupled with the European partners' commitment to deal effectively with Greece's debt overhang, is the best assurance to dispel Euro exit fears and set the stage for a new page in the country's growth path.

III. THE EX-POST EVALUATION (EPE) OF THE 2010 STAND-BY ARRANGEMENT

The authorities have found the analysis in the paper insightful and balanced; essentially, following initial resistance by European partners, who had considered the Greece problem an "internal affair" of the Euro zone, the SBA was put together in a very short period of time, without adequate political dialogue and, more importantly, with insufficient contributions by the authorities to tailor conditionality to the peculiarities of the economy and the Greek public administration. Moreover, an ex-ante (or, at least, early) debt restructuring that would have helped mitigate the depth of adjustment and the severity of the recession, was ruled out by Greece in agreement with Euro zone partners. In a nutshell, as the EPE report aptly remarks, the SBA-supported program turned out to be a holding operation until the PSI became inevitable and an EFF-supported program replaced the original arrangement.

The authorities' official and detailed comments appear in Appendix I. They found the concluding section "Possible Lessons" reasonable and constructive, and would like to emphasize the following two areas for future consideration by staff and management:

- Although fiscal adjustment was necessary and structural reforms were essential, especially in the absence of monetary and exchange rate policies, the detailed conditionality in many program areas was at times overwhelming. Going forward, it would be helpful always to ensure that prior actions, not only in fiscal policy and management but in all areas with structural conditionality, are macro-critical for the achievement of the program objectives. At the same time, the authorities acknowledge that the TA provided by Fund staff, especially in fiscal management, has been tailored to the needs of a system that required hands-on assistance and has been important to help them improve much needed capacity for implementation; they hope to continue the strong TA engagement with the Fund.

- Relations with Troika members have generally been smooth, and the authorities acknowledge both the synergies in areas of shared expertise and the respective comparative advantage in structural issues. Based on these considerations, the authorities fully endorse the recommendation for streamlining procedures and documents among the Fund staff and EC and ECB officials.