EXECUTIVE BOARD MEETING ON GREECE
APPROVAL OF EXTENDED FUND FACILITY

MARCH 12, 2012

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Greece is at a historic crossroads. The crisis is economic and social, but the coalition government headed by Prof. Lucas Papademos, a former governor of the Bank of Greece and former Vice President of the ECB, has managed to stabilize the political landscape and to secure the support of the two largest political parties, the Socialist party headed by Mr. Papandreou (PASOK), and the Conservative party headed by Mr. Samaras (New Democracy). Even if elections are held in the near future (the exact date is still uncertain), Mr. Papandreou and Mr. Samaras have provided assurances that whoever succeeds Mr. Papademos will continue the policies agreed under the Fund-supported economic program.

I. ECONOMIC DEVELOPMENTS UNDER THE CURRENT SBA

Since 2009 Greece has experienced a painful recession, with a cumulative decline in GDP of 13.7 percent. As the country enters 2012, GDP is projected to decline further by 4.8%, while the unemployment rate reached 21.0 percent in January. At the same time, CPI inflation, which has risen from 1.2 percent in 2009 to 4.7 percent in 2010, declined to 3.1 percent in 2011.

These macroeconomic outcomes are the result of the wide-ranging economic adjustment program that began in May 2010. The set of measures, unprecedented in Greece's modern history, encompassed **fiscal policy**, **financial sector policies**, and a vast array of **structural reforms**, all aimed at achieving fiscal sustainability, mitigating the financial sector liquidity and solvency issues, and improving competitiveness.

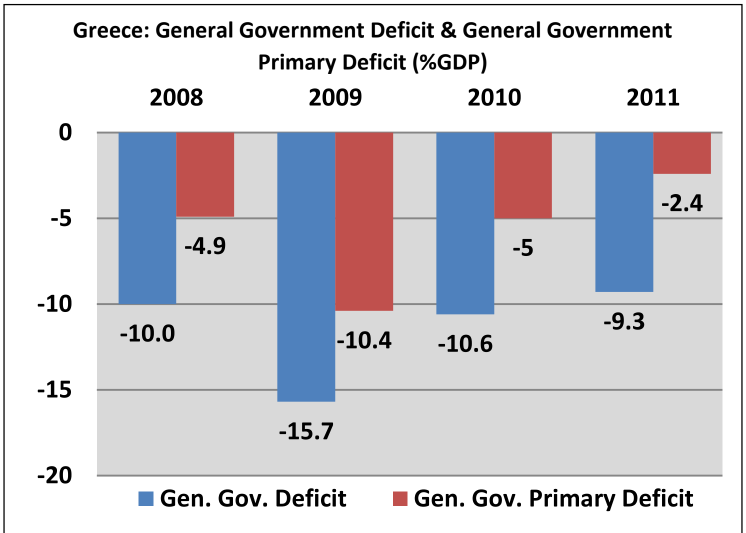
A. Fiscal Policy Measures

The fiscal measures in support of this extraordinary adjustment comprised both tax and expenditure policies. On the **revenue** side, the three VAT rates were increased, while a number of goods and services were reclassified to higher rates; excise taxes on fuel, cigarettes and alcohol were raised by 33%; special levies were imposed on profitable firms, high income individuals, and holders of high-value real estate; and a solidarity tax on annual declared incomes higher than €12,000 was introduced with graduated tax rates ranging from 1% to 5%.

On the **expenditure** side, nominal general government wages were reduced by 30 percent, and the number of employees was reduced by 10 percent or about 85,000; the number of state-owned enterprise employees was also cut by 18 percent, while total personnel spending in the SoE sector was reduced by 29 percent. Public sector pensions were trimmed by 15.7 percent on average.

B. Fiscal Outcomes

As the table below indicates, the measures noted earlier led to a substantial reduction of the **budget deficit**. According to the latest Eurostat and IMF/EC/ECB data, the general budget deficit in 2011 declined by 6.4 percentage points compared with 2009. The adjustment is even more impressive if it is measured according to the **primary budget deficit**, which fell from 10.4% of GDP in 2009 to 2.4% in 2011, or by 8.0 percentage points.



Source: Eurostat & IMF/EC/ECB estimates as of January 2012

C. Financial sector policies

The authorities have been adjusting policies to track the evolving situation in the banking system. The Hellenic Financial Stability Fund was established at the outset of the SBA as a capital backstop for viable banks. As the banking sector situation deteriorated, the authorities strengthened the resolution framework and made plans to set aside considerable funds for bank recapitalization. In addition, to assess loan quality, BlackRock, an independent advisory firm, conducted a diagnostic exercise in 2011 to help the Bank of Greece determine the weaknesses of individual banks.

D. Structural Reforms

To enhance competitiveness the Greek government also initiated an unparalleled array of structural reforms. Those included measures in the labor market, the pension system, the restricted-entry occupations, and in local administration.

In the **labor market**, part-time working arrangements with flexible hiring policies and duration of employment were introduced; sub-minimum wages for first-time labor market entrants to facilitate youth employment, and a 20 percent cut in overtime premia were established; and the probation period for new employees was extended to 12 months and permissible layoffs were raised from 2% to 5% per month of the active labor force. Furthermore, the eligibility criteria for unemployment benefits were streamlined and at the same time firms were allowed to opt out from sectoral-level agreements, in order to improve flexibility in their wage structures.

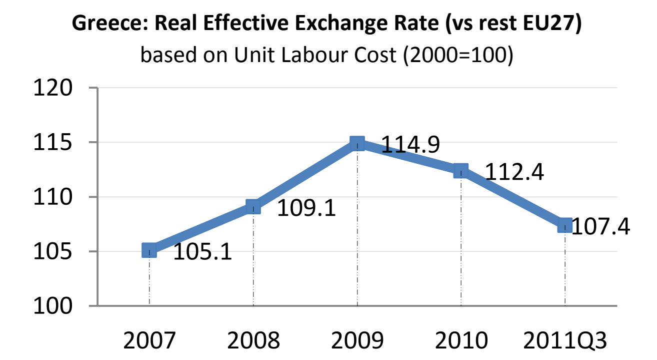
The **pension reforms** have been the cornerstone and the main achievement of the current SBA arrangement. The old pension system, characterized by several segmented funds with diverse benefits, was consolidated in a unified new system for all current and future employees; the effective retirement age was increased substantially to 65 years and linked to life expectancy; the minimum contributory period for retirement on a full benefit rose to 40 years, while pension benefits were tightly linked to life-time contributions; retirement penalties were increased for early pensioners and voluntary exit plans abolished; and disability criteria and respective rules were revised and streamlined.

Bold **reforms to open up restricted-entry professions** have been enacted: 108 professions were liberalized by a single law in 2011, including the long-haul road transport sector, for which no new licenses had been issued since 1971; fees for public notaries were reduced by 30 percent; and the list of hardship and hazardous occupations was revised.

Finally, **reforms in local administration** led to a reduction of municipalities from 1,034 to 325, of local authority entities from 6,000 to 1,160, of local elected officials from 30,795 to 16,657, and in the replacement of 53 prefectures with 17 broader regions.

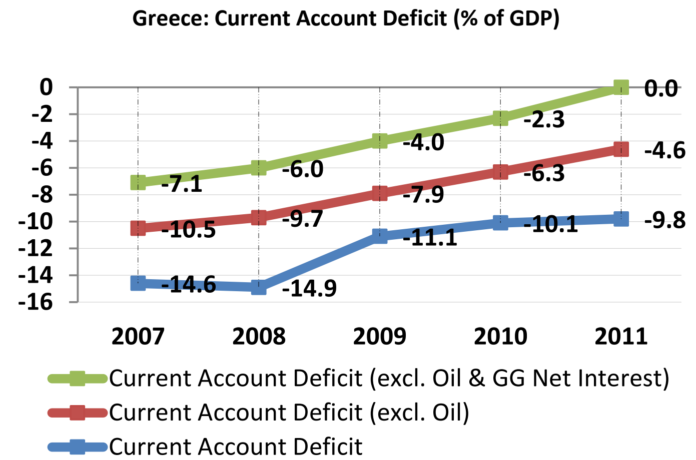
E. Macroeconomic Outcomes

Under the SBA-supported program, fiscal retrenchment and broad structural reforms were the main tools for Greece to **improve its competitiveness** and gradually eliminate the **external sector imbalances.** On both grounds, the Greek economy has taken strides in achieving these objectives. As the table below indicates, within two years (2010-11), Greece managed to regain over 50 percent of the competitiveness lost between 2000 and 2009. From 2009 to 2011, the Real Effective Exchange Rate (vis-à-vis its 26 EU trade partners), as measured by Unit Labor Costs, fell from 114.9 to 107.4 index points.



Source: European Commission

In parallel, as the table below demonstrates, the current account deficit fell from 14.9 percent of GDP in 2008 to 9.8 percent of GDP in 2011. The deficit reduction is even more significant if we exclude the oil trade balance and the general government interest payments: in this case the deficit in 2011 was around 0 percent of GDP, down from 6 percent in 2008.



Source: Bank of Greece

F. Implementation Issues

Despite the far-reaching reforms in all areas of economic policy, the outcomes in some areas have been mixed. In particular, while the pension reform was successfully implemented in a timely manner, reforms in the labor market lagged behind. This outcome has been the result of two main weaknesses: first, a delayed implementation of measures that were formally approved either by parliament or through ministerial decisions; and, second, an incomplete or unsatisfactory process of implementation, which has reflected limited administrative capacity and lack of specialized knowledge in certain areas.

II. New Economic Program, Policies, Risks and Expectations

The new program, to be supported by an extended arrangement, has three main objectives. First, to continue fiscal consolidation and thus attain debt sustainability, but by switching the policy emphasis *from tax increases to further expenditure retrenchment, while intensifying the efforts to improve revenue administration.* Second, *to push forward with deep and broad structural reforms, which would enhance aggregate supply by reducing economy-wide costs.* Third, *to initiate reforms in the financial sector aiming at achieving commercial bank solvency, improving supervision, and modernizing the governance of the central bank.* In terms of quantitative objectives, the new program aims at achieving primary surpluses beginning in 2013 and reaching a debt-to-GDP ratio of about 120% by 2020. The program assumes that GDP growth will return to positive territory in 2014.

A. PSI, OSI and Prior Actions

The program, which has been put together after the **launching of the PSI** and assurances about **OSI contributions,** has a four-year duration and reflects no increase of Fund resources compared to peak exposure under the Stand-by arrangement. The PSI was completed successfully, with an 85.8 percent voluntary participation and a nearly 97 percent participation after the activation of the Collective Action Clauses. The PSI and OSI together are expected to help reduce the debt-to-GDP ratio by about 8 percentage points.

The program incorporates an unprecedented number of **prior actions**, under five general areas: (a) tax, expenditure and public wage policy, all embedded in a supplementary budget for 2012; (b) new extensive tax administration reforms; (c) far-reaching labor market reforms, including drastic cuts in the minimum wage and an overhaul of the collective bargaining system; (d) a comprehensive assessment of banks' capital needs, and (e) new framework for bank resolution and recapitalization. All these policy actions, which comprised over 40 individual measures and many required parliamentary approval, were fully implemented by March 8 through well-coordinated and very effective procedures, demonstrating the ownership of the new program by both government and parliament.

B. Emphasis on Growth

In parallel, renewed emphasis is being placed on **growth**, which is the ultimate objective of the past and current stabilization efforts. In particular, the Greek government is committed to:

- Accelerate the elimination of rigidities in labor, product and service markets;
- Reduce the footprint of government in the economy through the elimination of bureaucratic impediments to FDI and the privatization of public assets;
- Continue to implement wide ranging administrative reforms aiming at improving the quality of public services; and
- Strengthen the efficiency and effectiveness of civil service, including in its ability to mobilize structural funds. In this important growth-enhancing area the Greek government has recently focused on the timely implementation of actions to absorb and utilize effectively the available **Structural and Cohesion Funds** from the European Union. These funds, which help start or complete investment projects, cover a wide range of sectors:

  ✓ In infrastructure, the extension of the Athens Metro and the completion of several sewerage and wastewater treatment plans;

  ✓ In banking, the financing of SMEs; and

  ✓ In education and human resources, the continuation of Lifelong Learning Programs, which was inaugurated in 2010.

These and other similar projects should help Greece absorb about €4 billion in Structural and Cohesion Funds in 2012.

C. Financial Sector Policies

Under the EFF-supported program, the government will create a viable private banking sector and improve governance in financial oversight agencies. In particular, the Greek government is committed to complete an assessment of banks' capital needs; enact legislation to support bank recapitalization and resolution; improve the structure of the Hellenic Financial Stability Fund and strengthen the funding of the Hellenic Deposit & Investment Guarantee Fund; and reform governance arrangements in the Bank of

Greece. The bank recapitalization will be key not only to restore confidence but also to the supply response, which is the linchpin of the new program.

D. Mitigation of Remaining Risks

The Greek authorities are aware that some implementation risks, mainly of a technical nature, might linger on during the duration of the EFF arrangement. However they are confident that such potential risks will be mitigated thanks to three factors: (a) the strength and front-loaded nature of the program, notably through the prior actions already implemented; (b) the endorsement of the program by the leaders of the two major political parties; and (c), the consistently improving administrative capacity of the public sector, thanks to the extensive technical assistance that has been provided, and will continue to be provided, through missions and on the ground by resident staff from the Fund and European agencies.

It is also noteworthy that on March 1, 2012 Greece was the first member of the European Union to sign the "**Commitment on Confidence in Statistics**", which had been propagated by the European Commission in April 2011 as a means to improve the governance of European statistics. In its Commitment, the Greek government makes a number of pledges with a view to ensuring that statistics are reliable, timely and professionally compiled. An independent statistical advisory board will be created to oversee the implementation of the European Statistics Code of Practice by the Greek statistical system.

E. Expectations

Greeks aspire to play a constructive role within Europe, are proud of their European identity, consider themselves an integral part of the Eurozone, and are determined to deliver on their country's commitments, with the support of the international community. In addition, the cost-reducing structural reforms and FDI-encouraging privatization plans, coupled with fiscal retrenchment and liquidity assistance to the banking sector, will help set the stage for sustainable growth of the Greek economy within the Eurozone. The proposed program under the EFF is expected to help the Greek people achieve their aspirations, while the ownership of the politically difficult set of structural reforms has already been demonstrated by the speedy adoption of the prior actions and the endorsement of the program by the major political parties.

In sum, a new program under the EFF could be seen as a "structural shift" in the political, economic and social environment of Greece: the government will obtain financing for four years, the banks will be recapitalized, and, in general, uncertainty about the prospects of the Greek economy will diminish. My authorities firmly believe that a new program under the EFF, following the successful implementation of the PSI, will extend the planning horizon of both the government and the private sector, will help build confidence in economic management, and will enhance liquidity in the banking sector through the repatriation of deposits. In short, a new program will provide the necessary "breathing space" to help return the economy to normalcy.

In closing, I wish to extend my authorities' appreciation for the hard and diligent work of the Fund staff, both on the ground and on mission, and for their patience and professionalism that has made the difficult road so far a good basis for the success of the new program. In my authorities' view all conditions are in place for a successful implementation of a Fund-supported program under the EFF.