EXECUTIVE BOARD MEETING ON GREECE

FOURTH REVIEW UNDER THE EFF
JULY 29, 2013

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A. Political Developments

1. Since the last Board meeting on May 31st, the government of Prime Minister Samaras was reorganized on the basis of two coalition parties: New Democracy as the main party and PASOK (the traditional socialist party) as the junior partner. The reshuffling of the cabinet included the appointment of two new ministers in the key posts of Administrative Reform and Health, which bodes well for a more cohesive decision-making in the reform of public administration and health services. These two areas were among the focus of the latest review of the program.

B. General Outlook and Market Sentiments

2. The Fund-supported adjustment program has entered the fourth year of implementation and is proceeding at a steady, if slower than expected in some areas, pace. The reforms are going deeper and deeper and are touching upon broad sections of the Greek society—not just macroeconomic policy, but also public administration, labor market, product market, pensions and social benefits, justice, education and health. Many of them continue to require shared sacrifices by the Greek people, but Prime Minister Samaras and Finance Minister Stournaras have consistently declared their intention to proceed towards the modernization of the Greek economy, as evidenced by the recent bold step to overhaul overnight the Greek Public Broadcasting Company, thus breaking the taboo against dismissals of public sector employees.

3. Confidence is returning. The Economic Sentiment Indicator, at 93.5 in June, is at a level not seen since September 2008. The Purchasing Managers Index for June, at 45.4, also improved for the third consecutive month and is on a 24-month high, in reflection of a more moderate slowdown in new orders and employment. Improved market sentiment is also visible in the significant decline of bond yield spreads; spreads of 10-year Greek government bonds vis-à-vis bunds now stand at around 950 bps, down from over 3000 bps a year ago.

C. Macroeconomic Framework and Structural Reforms: Main Issues and Achievements

4. The economic outlook remains largely unchanged from the previous review and no contractionary measures are foreseen for the remainder of the calendar year. In fact, on July 17, the government announced a temporary reduction in the VAT rate on restaurants and

catering from 23 percent to 13 percent. This measure, which will be in effect between August 1 and December 31, 2013, comes on top of recent disinflation indicators: Greek prices fell 0.4% year-on-year in June, the only EU country to record outright deflation on the CPI measure; the on-going acceleration of product market reforms appears to be bearing fruit, with a successful transmission from cost savings to lower prices. The reduction in the VAT rate is based on the expectation that price moderation in this area will also help boost demand in other sectors, especially during the tourist period, and will help sustain confidence. Given the persistent reduction in domestic demand, a GDP contraction of 4.2% continues to be expected in 2013. However, the authorities are hopeful that a moderate recovery led by investment and exports will take place next year, leading to annual GDP growth of 0.6% in 2014 and accelerating in 2015 and beyond.

5. Increasing public revenues through **reforming the revenue administration** continues to be a vital priority. New tax audit techniques were introduced in May to be used by tax auditors against tax evasion by individuals. Institutionally, the legal framework has been modified to transfer more powers to the Secretary General for Public Revenue Administration (SGPR). The process for its budget allocation has been clarified and the SGPR has been authorized to determine a grading and promotion system for staff in the revenue administration offices. The process for its budget allocation has been clarified and the SGPR has been authorized to determine a grading and promotion system for staff in the revenue administration offices. In addition, the High Wealth Individual Audit Centre has been established and the Large Tax Payers Office has also been transformed into a fully functioning audit centre.

6. An important milestone in tax policy and administration was achieved in the past two months: Following extensive and fruitful consultations with Fund staff, **a simpler and less distortionary taxation system is being introduced,** which will help reduce tax evasion and combat fraud and corruption. The comprehensive income tax reform legislated in January 2013 is being complemented with the adoption of the Income Tax Code and the Tax Procedures Code in July 2013, which consolidate a very large number of regulations dispersed in separate laws, while modernizing the relations between the government and the taxpayer. Key innovations in the new Income Tax Code are tighter and more transparent rules concerning eligible business expenditures and benefits in kind, new rules to avoid tax evasion (e.g. through off-shore companies), and modern rules concerning business capitalization and transfer pricing. The Tax Procedures Code consolidates and streamlines provisions dealing with tax registration, auditing, collection and enforcement, including internal review procedures. Significant progress is also being made with a revised and greatly simplified set of business tax accounting rules, known as the Code of Tax Recording (the former Code of Books and Records), which will be adopted in October, and which would complete a fundamental recodification of the whole tax system. All three codes will require significant preparation and are planned to enter into force as of January 2014.

7. **The downsizing of the public administration** aims at improving the efficiency and effectiveness of the public sector, and includes the closing, merging or restructuring of public entities by outright dismissing their staff or transferring them to other entities according to new staffing plans. This essential reform is a prerequisite for both building a more effective civil service and supporting the government's medium-term fiscal targets**,** and has continued through attrition of permanent staff. It also included the direct dismissal of over 2,500 employees of the Public Broadcasting Company, which was shut down in June with the expectation to replace it with a much leaner entity. The authorities remain strongly committed to achieve the targets of the public administration reform, which is being carried out in phases during 2013 and 2014. However, as noted below (see section D), some quantitative targets were missed and the authorities are redoubling their efforts to catch up with the original plan.

8. **The recapitalization of the Greek banking system has been completed.** All four Greek core banks have been recapitalized, with the Hellenic Financial Stability Fund (HFSF) becoming the largest shareholder. Three core banks managed to attract at least 10 percent of the required additional capital from private sources and will remain under private control. The two bridge banks were acquired by one of the core banks, a positive development for maintaining the stability of the financial system. One non-core bank has been fully recapitalized through the market and another is in the final phase of negotiations with foreign investors. In addition, the Greek authorities are in the final stages of completing a comprehensive banking sector strategy, which will outline the targeted medium- to long-term landscape to create a leaner, cost efficient, competitive and well capitalized banking sector. Moreover, the governance of the HFSF has been improved, by including two independent members in its General Council. Relationship frameworks have been signed between the HFSF and each of the four core banks and monitoring trustees oversee the banks' governance and operations.

9. The authorities recognize that a **further deepening of product market reforms** remains crucial for strengthening investment, innovation and competition, and for enhancing the beneficial effects of the successful labor market transformation. Retail market monitoring shows that reforms may have started to increase competition and have led to lower prices. Further action has been taken to liberalize sales periods and trading days and hours. Some progress has been made in the transport sector to relax restrictions on road haulage and to restructure the railways sector, and new strategies for liberalization and growth are being implemented in the airport and maritime sectors. In general, two on-going in depth studies under the auspices of OECD have identified barriers to entry, limited incentives for suppliers to compete, and restriction of choices and information available to consumers. All these issues are currently being studied by the authorities with a view to adopting appropriate reforms by the end of 2013.

D. Challenges, Corrective Measures and Next Steps

10. Despite the progress in the various areas noted earlier, serious challenges remain. While the very large and highly front-loaded package of fiscal consolidation measures (totaling over 6.7% of GDP over 2013-14) continues to be largely implemented, **shortfalls emerged in three areas**. First, expenditure overruns in the main health care fund EOPYY in the area of diagnostics and private clinics; second, delays in the issuance of property tax bills that were expected to be paid during 2013; third, a downward revision in the yield of some measures, most notably in the area of social security contributions.

11. The authorities, in close consultation with Fund staff, have identified the **measures needed to close the fiscal gap** in 2013-14 for adoption in the course of July, so as to reach the targets of a primary balance in 2013 and a primary surplus of 1.5% of GDP in 2014. **A comprehensive omnibus legislation was adopted by parliament on July 17** that aims at frontloading some measures initially planned for 2014 and also recouping the losses reflected in certain expenditure overruns. In particular, the authorities are undertaking corrective actions to address the healthcare overruns, through a set of structural measures aimed at rationing the healthcare provision and preventing misuse of publicly funded services. In the short-run, to ensure that expenditures are brought in line with the budget by the end of 2013, a claw-back mechanism is being introduced, which will be applied to diagnostics and private health care clinics, by reimbursing invoices only up to the level of the annual budget targets. Besides the actions in the healthcare sector, a set of revised fiscal measures (such as shortening the pay period for the property tax collected by the Public Power Company and the establishment of a Center for the Collection of Overdue Social Security Contributions) will generate additional moderate revenue. Some measures planned for 2014 will be frontloaded, such as the luxury tax on cars, swimming pools and airplanes, and an increase in court fees for lawsuits, while a docking fee for leisure boats will apply from October 2013. A streamlining in defense expenditures will also be implemented from the autumn.

12. **A disappointing development has been the slow progress in selling public assets through privatization, and proceeds to date have been clearly below expectations**, although in at least one important area (state gas company) the shortfall was due to exogenous factors. In particular, in the case of the *natural gas* company DEPA, and despite some early encouraging signs, there were no bidders in the tender process concluded in June 2013; therefore, the privatization process has been delayed until later in the year. On the other hand, the *gas transmission operator* DESFA received a successful bid and its privatization is proceeding swiftly. The government is fully aware of the importance of privatization not only for financing purposes, but also for the important benefits that privatization would yield in the form of additional investment, managerial expertise and better governance of the assets. Together with the Hellenic Privatization Fund, the government is considering a number of other initiatives to address shortfalls in receipts, mainly by speeding up earlier approved

privatization projects, such as regional ports, and by promoting the sale of assets previously not included in the pipeline.

13. The authorities share the staff view that **public administration reform has lagged behind,** but are confident that the reshuffled cabinet will provide the opportunity for a speedier approach to the achievement of the targets**. A series of corrective measures to catch up with the timetable for public administration reform has been introduced** as part of the July 17 Omnibus bill: over the following months the authorities aim to complete the staffing and mobility plans, including placing at least 4,200 permanent employees in the mobility scheme by end-July, 12,500 employees by end-September and 25,000 employees (cumulatively) by end-December. Employees placed in the mobility scheme will be assessed within a centrally-defined evaluation framework to be established by end-September, before being reallocated to new positions or asked to exit the public service. As part of the revised process, *the mobility scheme is being compressed to eight months from the original twelve,* thus the delay in the past two months will not affect the overall exit targets agreed in April 2013, namely 4,000 employees by end-2013 and 15,000 (cumulatively) by end-2014. In view of the significant possible re-allocation and hiring of staff, reflecting the combined effects of the *attrition rule*, the *mandatory mobility* and the *mandatory exits*, a strategy for the allocation of the staff to be hired or reallocated is currently being considered by the Cabinet to align staffing with the government priorities.

14. All in all, and despite some setbacks, the advancement of structural reforms on multiple fronts is the main objective of government policy in the foreseeable future: strengthening the investment climate and domestic competition through elimination of excessive regulations, reducing the burden of the public sector, and improving the functioning of the judicial system are all essential ingredients towards promoting private sector initiatives supported by a leaner and more efficient public administration.

E. Growth Prospects and International Support

15. In general, growth prospects for 2014 and beyond appear within reach, although they depend crucially on global economic developments. Important recent events point to a rebalancing in favor of investment and job creation. The most important examples are (a) Greece's participation in the Trans-Adriatic Pipeline (TAP) project, which will export natural gas from Azerbaijan to Europe, via a route through Greece, Albania and Southern Italy; the expected FDI is of the order of €1.5 billion and direct positive effects include both job creation and non-tax revenues; and (b) the creation of a development fund, called Institution for Growth (IfG), which will be managed on commercial terms and under a clear governance structure, with the potential to create a good track-record and attract public as well as private investors. The purpose of the IfG is to alleviate credit constraints for SMEs and critical infrastructure projects. My authorities note the staff concerns about such a vehicle, but underscore that the

intention of the Greek government is to participate primarily as a catalyst to successfully attract private and institutional investment funds, such as EIB and the German KfW.

My authorities are grateful for the July 18 visit to Athens by German Finance Minister Schaueble, for his support of the ongoing reform program, his appreciation of the sacrifices by the Greek people in the last three years, and his pledge of €100 million to the IfG on behalf of the German government; and to US Secretary of the Treasury Lew on July 21 for his support of the difficult decisions taken by the government, the recognition of the shared sacrifices by the Greek people, and his emphasis on jobs and growth.

F. Risks and Conclusion

16. The authorities fully recognize the existence of implementation risks, which, as the recent withdrawal from the coalition of the third minor party suggests, become more serious the deeper the reforms and the stronger the reaction by vested interests. Nevertheless, the government is determined to persevere and push along with its plan to modernize the Greek public sector until it is successfully completed and the targets of the EFF-supported program are met. **Downside risks** to this outlook are related mainly to a slowdown in global economic activity, an adverse turnaround in market sentiment, delays in the implementation of the very ambitious structural reforms, and continued anemic credit conditions.

17. However, there are also some **important upside risks**. In particular, sustained strong policy implementation can help reduce uncertainty and prompt a faster return of investment spending, both foreign and domestic. Positive effects on economic activity could also materialize from accelerated utilization of EU funds, in cooperation with the European Investment Bank. An improved institutional environment, as perceived by markets (easier to do business, more efficient public administration, reliable justice system) would encourage FDI. There could also be a somewhat stronger impact from the liquidity injection expected from an accelerated clearance of government arrears, public works programs, and from a more dynamic tourist season. Finally, domestic investment could grow faster with improved financing conditions for enterprises, mainly as a result of the completed recapitalization and ongoing restructuring of the Greek banking system and from the operations of the newly established IfG.

18. Overall, the government is confident that, on the one hand, the *continuity of the core economic team*, and, on the other, *the new blood in key line ministries* will provide the basis for a reinvigorated effort towards achieving the goals of the EFF-supported program. On the basis of these considerations, the unwavering belief in the future of the Euro zone by both the government and the Greek people, and with appreciation for the strong support of the Board, management and staff in the past three difficult years, my authorities are requesting the approval of the Fourth Review, including the waiver of applicability of three QPCs and modification of the end-September performance criterion on privatization receipts.