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Country report

GREECE

Summary: still too hot to handle

The Greek austerity and reform programme has been broadly successful in making a running start in 2010. For 2011 the programme is at a cross-roads as the distance yet to cover remains impressive, in terms of both budgetary consolidation and structural reforms. Within the Herculean task of reducing the budget deficit from 15.4%-GDP in 2009 to below 3% in 2014, taxes remain the Achilles heel. Therefore we still perceive the probability of some kind of public debt restructuring in the medium term to be elevated, all the more so with high-ranking German officials now publicly considering the costs of sovereign debt restructuring. Although restructuring –even before 2013– is a real option, we believe that an exit from the euro is not. Nevertheless, the continuation of the austerity and reform programme pose substantial economic risks in the short term.

Things to watch:

- IMF/EC/ECB quarterly reviews under the stand-by arrangement
- Advances made in raising tax revenues and pushing through service sector reforms
- Public support for the ambitious reform and austerity agenda

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Greece

National facts	
Type of government	Parliamentary republic
Capital	Athens
Surface area (thousand sq km)	132
Population (millions)	11,0
Main languages	Greek (99%)
	Other (1%)
Main religions	Greek Orthodox (98.0%)
	Muslim (1.3%)
	Other (0.7%)
Head of State (president)	Karolos Papoulias
Head of Government (prime-minister)	Georgios Papandreou
Monetary unit	EUR

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	304	0.49
Nominal GDP at PPP	306	0.41
Export value of goods and services	58	0.31
IMF quotum (in mln SDR)	823	0.38
Economic structure	*2010*	*5-year av.*
Real GDP growth	-4.5	2.1
Agriculture (% of GDP)	3	4
Industry (% of GDP)	18	19
Services (% of GDP)	79	78
Standards of living	*USD*	*% world av.*
Nominal GDP per head	27694	281
Nominal GDP per head at PPP	27863	238
Real GDP per head	22875	286

Social and governance indicators	rank / total
Human Development Index (rank)	22 / 169
Ease of Doing Business Index (rank)	109 / 183
Index of Economic Freedom (rank)	88 / 179
Corruption Perceptions Index (rank)	78 / 178
Press Freedom Index (rank)	70 / 178
Gini index (income distribution)	34.3
Population below $1.25 per day (PPP)	N/A

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	10	Germany	12
Italy	11	Italy	11
UK	6	Russia	3
Bulgaria	5	South Korea	6

Main export products (%)	*2008*
Food, drinks and tobacco	23
Chemicals and related products, n.e.s.	17
Machinery and transport equipment	16
Mineral fuels, lubricants, and related materi	13
Main import products (%)	*2008*
Machinery and transport equipment	22
Chemicals and related products, n.e.s.	16
Food, drinks and tobacco	11
Mineral fuels, lubricants, and related materi	8
Openness of the economy	*2010*
Export value of G&S (% of GDP)	19
Import value of G&S (% of GDP)	22
Inward FDI (% of GDP)	0.8

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Domestic recession

The Greek recession is expected to be a protracted affair, with activity down by a further 3% in 2011, although a return to growth (on a quarterly basis) during the year is expected. The recession is being led by domestic demand –the main growth engine prior to the global financial crisis– that has seen a peak-to-trough contraction since 08Q4 of 13½% so far, easily outstripping the GDP contraction of 'only' 8¼% over the same period. Unemployment is rising sharply as a result, reaching 15.1% in January 2011 (up from 8.3% on average during 2006-08). Household purchasing power is further being eroded by two consecutive VAT-hikes in 2010 that brought the VAT rate up to 23% from 19%. Inflation is soaring as a result, reaching 5% in early 2011, of which half is the result of the indirect tax hikes. The upside is that Greece exports a substantial part of its recession; import volumes are down almost 35% since 08Q4. Export volumes have contracted by 'merely' 21% in the same period and more importantly are showing tentative signs of stabilisation in 2011 against the backdrop of easing wage growth and a modest initial improvement in export price competitiveness. The result is an impressive improvement in the current account balance from about 15%-GDP deficit in 2007-08 to single digits in 2011 (about 8%-GDP deficit according to EC, the EIU estimates in accompanying table may be a bit too optimistic). And that's really important, as Greece is running a negative net international investment position of around 100%-GDP.

Public finances stabilising to some extent

Deplorable public finances and weak reporting standards triggered the Greek tragedy, although this was perhaps 'only' a manifestation of decades of postponed required structural fiscal and economic reforms. In April 2009, the Greek 2009 budget deficit was expected to be around 3.7%-GDP. In October 2009 the newly elected government confessed that it would more likely turn out 12.6%-GDP and EUROSTAT recently finalised the adjustments by declaring a 2009 deficit of 15.4%-GDP.

Looking ahead, authorities (under the stand-by arrangement with the IMF and the emergency loans from the euro countries) are aiming to reduce the deficit to below 3%-GDP in 2014, stabilising the public debt ratio around 160%-GDP before setting it on a sustained downward trajectory. The road to sound public finances is paved with severe spending cuts, tax hikes and fiscal and economic reforms. The deficit has been (is to be) brought back to 10.5%-GDP in 2010 (7.5%-GDP in 2011). Tax hikes are prominently felt in terms of the twin VAT-hikes in 2010. And the pension reforms are exemplary for the severity of reforms that have yet to be legislated and implemented; the Greeks now have to work two years longer, for substantially lower pension entitlements (cut by up to 50%-points of income replacement) that are also now expressed as average-wage rather than end-wage benefit-levels. This reform alone improves the long-term budget balance by more than 10%-GDP.

Given the distance yet to cover, there is substantial uncertainty about whether the general public will tire of austerity and reforms before the programme starts to deliver in terms of a more flexible economy that is able to generate the required amounts of jobs ... and the required levels of tax revenues. Within the Herculean task of closing the budget deficit from 15.4%-GDP in 2009 to less than 3%-GDP in 2014, namely, tax revenues are turning into an Achilles' heel. Tax revenues have remained behind schedule all through 2010 and the compensation by additional central government expenditure cuts (lower level government also failing to meet expenditure cuts) obviously is no structural solution. Moreover, following the sometimes violent protests in 2010, there now appears to be more passive civilian initiatives to protest, for example the refusal pay for public transport which undermines the very cultural turnaround that the government aims to bring about with its ambitious austerity and reform agenda. In addition, local government spending is still difficult to monitor, let alone control and this also poses budgetary risks going forward. Meanwhile, targets for domestic payment arrears continue to be missed.

Greek public finances clearly are not yet 'under control' and some kind of restructuring in our opinion remains in the table as a potential way out of last resort. The fact that high-ranking German officials are publicly considering the costs of a restructuring in our mind is an ominous sign.

Structural reforms

Legislated reforms to facilitate business start-ups potentially generate a major improvement in the World Bank's Ease of doing business ranking from 109th to 79th (assuming no changes in any of the other countries). Impressive as the improvement is, it still marks the Greek business environment as poor when compared to other OECD countries.
Scheduled reforms for 2011 are predominantly aimed at opening up the services sector in general and closed professions (following up on the opening up of the truckers' sector) in particular. This requires large amounts of reforms aimed at relatively well-organised interest groups, while generating returns only in the medium term. A tedious programme that will test government resolve. Instead of the debt restructuring route that market participants feel would relieve Greek gross financing needs, the government contemplates a broad privatisation agenda while simultaneously

aiming to raise revenues from its real estate holdings. This might eventually lower gross debt (by up to 18%-GDP) and improve revenues to service remaining debt. But the success of the privatisation programme obviously depends on the ability to time asset sales to the right market conditions.

Banking sector remains vulnerable

The funding situation remains tight. Although deposit outflows have slowed down substantially in 10H2, wholesale funding markets have remained closed so far, making the banking sector fully dependent on the ECB's extraordinarily loose liquidity policy. In addition, asset quality continues to deteriorate, led by consumer credit which constitutes the bulk of household debt. Meanwhile, a start is being made with the orderly deleveraging of the banking sector, revolving around an assessment of the options available to dispose of non-core assets.

Greece

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.2	4.3	1.0	-2.0	-4.5	-3.9	-0.1
Consumer prices (average % change pa)	3.2	2.9	4.1	1.2	4.7	2.6	-0.3
Current account balance (% of GDP)	-11.2	-14.4	-14.7	-11.0	-6.5	-4.5	-1.4
Economic growth							
GDP (% real change pa)	5.2	4.3	1.0	-2.0	-4.5	-3.9	-0.1
Gross fixed investment (% real change pa)	10.6	5.4	-7.6	-11.4	-12.3	-10.7	-1.3
Private consumption (real % change pa)	5.6	3.1	3.2	-1.8	-4.5	-5.7	-0.8
Government consumption (% real change pa)	1.3	9.2	1.0	7.6	-6.5	-2.9	-4.2
Exports of G&S (% real change pa)	5.3	5.8	4.0	-20.1	-0.4	-1.1	3.0
Imports of G&S (% real change pa)	9.7	9.8	4.0	-18.6	-12.9	-4.6	-3.4
Economic policy							
Budget balance (% of GDP)	-5.7	-6.4	-9.4	-15.3	-10.6	-8.4	-7.7
Public debt (% of GDP)	105	104	110	126	143	154	163
Money market interest rate (%)	3.1	4.3	4.6	1.2	0.8	1.3	1.5
M2 growth (% change pa)	10	13	15	5	-11	0	5
Consumer prices (average % change pa)	3.2	2.9	4.1	1.2	4.7	2.6	-0.3
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.7	0.8
Recorded unemployment (%)	8.9	8.3	7.7	9.4	12.5	14.9	16.4
Balance of payments (mln USD)							
Current account balance	-29833	-44686	-51173	-35972	-19879	-14250	-4430
Trade balance	-44307	-56880	-64778	-42867	-25625	-20200	-8120
Export value of goods	20284	23911	29137	21342	20966	26120	26900
Import value of goods	64592	80792	93915	64209	46591	46330	35030
Services balance	19258	22741	25199	17611	17911	19060	16770
Income balance	-9052	-12728	-15652	-12518	-12926	-13580	-13230
Transfer balance	4269	2181	4057	1801	760	470	150
Net direct investment flows	1175	-3303	2527	323	307	300	280
Net portfolio investment flows	3000	3000	3000	3000	3000	3000	3000
External position (mln USD)							
Total foreign exchange reserves	566	631	344	1555	1310	N/A	N/A
International investment position	-234649	-315727	-249377	-288789	N/A	N/A	N/A
Total assets	196273	279777	313339	367042	N/A	N/A	N/A
Total liabilities	430922	595504	562716	655831	N/A	N/A	N/A
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-16.7	-18.3	-18.6	-13.1	-8.4	-6.4	-2.6
Current account balance (% of GDP)	-11.2	-14.4	-14.7	-11.0	-6.5	-4.5	-1.4
Inward FDI (% of GDP)	2.0	0.6	1.5	0.7	0.8	0.7	0.7
International investment position (% of GDP)	-88.4	-101.4	-71.6	-88.2	N/A	N/A	N/A

Source: EIU