



GREECE

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

January 23, 2016

KEY ISSUES

Context. Despite the policy constraints imposed by its membership in the currency union, Greece has made significant progress in unwinding its macroeconomic imbalances. But extensive fiscal consolidation and internal devaluation have come with substantial costs for society, which contributed to delays in reform implementation and to policy reversals since the last Article IV Consultation, culminating in a renewed crisis of confidence in 2015. Since then, the situation has stabilized, and growth is estimated to have resumed modestly in 2016. Notwithstanding the substantial progress achieved by Greece, it still faces fundamental challenges: (i) a vulnerable structure of the public finances; (ii) significant tax evasion and an ineffective tax administration; (iii) impaired bank and private sector balance sheets; and (iv) pervasive structural obstacles to investment and growth. Moreover, its public debt remains highly unsustainable, despite generous official relief already provided by its European partners. Addressing these remaining challenges and restoring debt sustainability are essential to creating a vibrant and dynamic private sector capable of generating sustainable and equitable growth and employment.

Policies. After major policy reversals in early 2015, the authorities commenced a new adjustment program supported by the European Stability Mechanism in August 2015, which has helped reverse the policy backtracking since then. The program aims to strengthen the public finances, restore the health of the banking sector, and boost potential growth. In this context, the authorities have legislated important fiscal, financial sector, and other growth-enhancing reforms, which constitute important steps forward. However, fiscal policies rely on high tax rates on narrow bases and on a compression of discretionary spending not supported by reforms. These policies are not growth-friendly and may prove difficult to sustain, which could lead to concerns about their credibility.¹ Moreover, structural and financial sector reforms are not sufficiently ambitious to rapidly resolve the large stock of debt to the banks and the tax authorities and to remove bottlenecks to growth and competitiveness.

Recommendations. To achieve sustainable and more equitable growth and ensure that Greece can become competitive within the currency union, while providing adequate protection to vulnerable groups, the authorities must deepen and accelerate reform implementation:

¹ Staff's assessment is that the fiscal surplus will reach around 1½ percent of GDP on the basis of current policies, compared to the authorities' target of 3½ percent supported by the ESM program.

GREECE

- **Fiscal policy:** Given its cyclical position, Greece does not require further fiscal consolidation at this time beyond what is currently underway. Medium-run fiscal targets should be supported by preferably fiscally-neutral high quality reforms that broaden the personal income tax base and rationalize pension spending to allow the public sector to provide adequate services and social assistance to vulnerable groups, while creating the conditions for investment and more inclusive growth. Fiscal reforms should be complemented by efforts to address tax evasion and the large tax debt owed to the state.
- **Financial sector:** NPLs should be reduced rapidly and substantially to allow for a resumption of credit and growth. This requires additional efforts to strengthen and implement fully the debt restructuring legal framework and enhance supervisory tools. At the same time, bank governance needs to be further strengthened and capital controls eliminated as soon as prudently possible, while preserving financial stability.
- **Structural reforms:** More ambitious labor, product and service market reforms are needed to enhance competition and support growth. A return to the previous less flexible labor market framework should be avoided, as this would put at risk the potential gains for investment and job creation.
- **Debt relief:** Even with these ambitious policies in place, Greece cannot grow out of its debt problem. Greece requires substantial debt relief from its European partners to restore debt sustainability.

Approved By
Philip Gerson and
Hugh Bredenkamp

Discussions for the Article IV consultation were held during September 17-22, 2016. The mission met with Minister of Finance, E. Tsakalotos, Governor of the Bank of Greece, Y. Stournaras; other Cabinet Ministers, and staff of their ministries. Mission members included D. Velculescu (head), I. Petrova, E. Flores, A. Kangur, A. Roitman, S. Saksonovs (all EUR), I. Razafimahefa (FAD), A. Kokenyne Ivanics, O. Wuensch, J. Yoo (MCM), W. Bergthaler, C. El Khoury, J. Garrido (LEG), R. Perrelli, and C. Saborowski (SPR). D. Botman, G. Gatopoulos, N. Kalavrezou, M. Kalimeri (IMF, resident representative office) assisted the mission. S. Chen, E. Rojas and J. Yang (EUR) assisted from headquarters.

CONTENTS

CONTEXT	5
RECENT ECONOMIC DEVELOPMENTS	11
OUTLOOK AND RISKS	12
POLICY DISCUSSIONS	15
A. Toward More Credible and Sustainable Fiscal Policies	15
B. Combating Tax Evasion	19
C. Enhancing the Viability of the Banking Sector	21
D. Regaining Competitiveness within the Currency Union	23
DEBT SUSTAINABILITY	26
STATISTICAL ISSUES	27
STAFF APPRAISAL	28
BOXES	
1. Recent Reforms and Implementation of Past IMF Recommendations	32
2. Revisions to the Greek Statistics	34
3. An Assessment of Greece's Prospects for Convergence	35
FIGURES	
1. Private Sector Balance Sheets	36
2. Competitiveness Indicators	37

GREECE

3. Macroeconomic Developments	38
4. Fiscal Developments	39
5. External Developments	40

TABLES

1. Medium-Term Macro Framework, 2014–21	41
2. Summary of Balance of Payments, 2014–21	42
3. General Government Operations, 2014–21	43
4. Modified General Government Cash Balance, 2014–16	44
5. Monetary Survey, 2011–16	46
6. Monetary Financial Institutions (excl. BoG)—Uses and Sources of Funds, 2014–21	47
7. Core Set of Financial Soundness Indicators for Deposit Taking Institutions, 2011–16	48

ANNEXES

I. Risk Assessment Matrix	49
II. External Sector Assessment	50
II. Debt Sustainability Analysis	53
IV. The Greek Capital Controls Framework as Applied to Current International Transactions	69

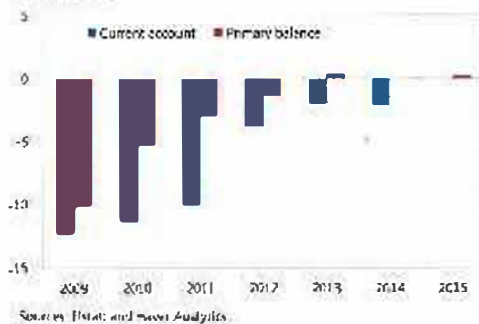
APPENDIX

I. Draft Press Release	71
------------------------	----

CONTEXT

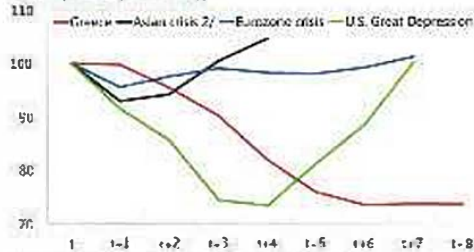
1. Despite significant progress in unwinding its macroeconomic imbalances, Greece's economy has not yet recovered. Greece entered the crisis with exceptionally large fiscal and external imbalances. Policies supported by its two previous adjustment programs helped to address these imbalances, with both the primary and current account deficits having declined from double digits to around balance in recent years. This is an impressive adjustment, especially for a country belonging to a currency union. Exceptional official financing totaling around €260 billion (147 percent of GDP) helped to buttress the adjustment and keep Greece in the euro-zone. Nonetheless, Greece has not managed to return to sustainable growth, with output having contracted by more than 25 percent since 2008, investment down by more than 60 percent, and unemployment at the highest level in the euro-zone.²

Greece: Current Account Balance and Primary Balance
(Percentage of GDP)



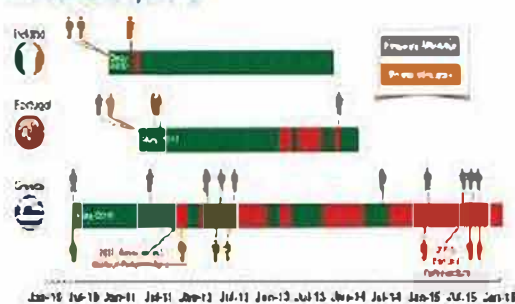
Real Output

(Index, pre-crisis peak = 100 %)

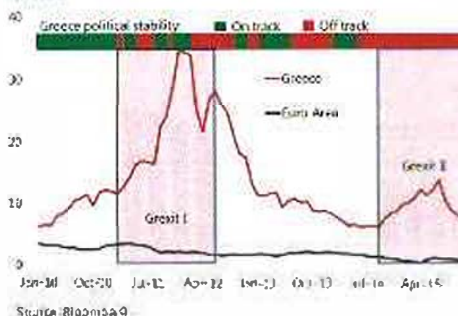


2. The reform momentum has slowed, however, in part reflecting fatigue associated with the social costs of adjustment. Greece implemented important reforms early in the adjustment program. However, implementation of structural reforms has since slowed, and fiscal reforms have relied increasingly on one-off and ad-hoc adjustments. This reflects the inability of the political system to maintain popular and political support for the reform effort amid an increasingly frayed social and political fabric and a perception that the adjustment costs were unequally borne by some groups (e.g. wage-earners) while others were protected (e.g. the self-employed, current

Political Developments



10-Year General Government Bond Yields, 2010-15
(Percent)



² Gourinchas et al ("The Analytics of the Greek Crisis," NBER, 2016) find that the fiscal correction accounts for 50 percent of the output drop, and the increase in funding costs for firms and the sovereign for the bulk of the remainder; the persistence of the recession was attributed to high NPLs and product market rigidities.

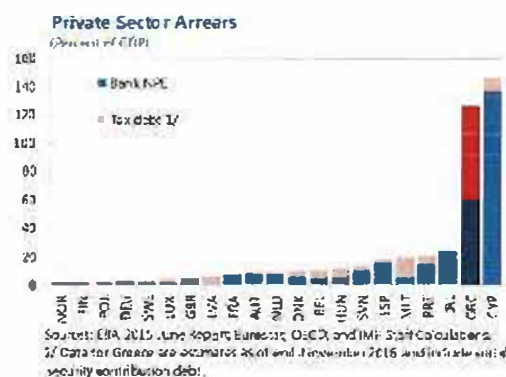
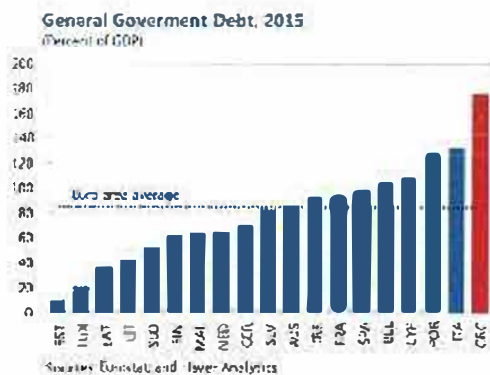
GREECE

pensioners). Over the last six years, Greece had seven governments, including from the center right, and center left, as well as technocratic (including two caretaker governments), but none was able to successfully mobilize the broad political support necessary to complete the two previous Fund-supported programs (only 10 out of 24 planned reviews were completed). The uncertainty associated with frequent political crises paralyzed decision-making or led to unwinding of reforms. Against the background of a somewhat weak external environment, such unwinding of reforms fueled occasional fears of Greece's departure from the euro zone ("Grexit"), leading to confidence shocks and exacerbating the downturn.

3. Greece experienced its latest crisis in 2015 and narrowly avoided Grexit with support from the European Stability Mechanism (ESM). Reflecting reform fatigue and weak ownership, reforms stalled in mid-2014, as signs of macroeconomic stabilization and incipient market access emerged. Following the election of the Syriza government in early 2015 on an anti-program and anti-austerity platform, reforms were unwound across the board. This led to a confidence and liquidity crisis, which culminated in Greece running temporary arrears to the IMF and requiring the imposition of capital controls in June 2015 to stem deposit outflows. Grexit was ultimately avoided with the help of a new ESM-supported program of up to €86 billion (49 percent of GDP) agreed in August 2015, in return for which the government reversed the policy backtracking and reaffirmed its commitment to the basic objectives of the program (Box 1).

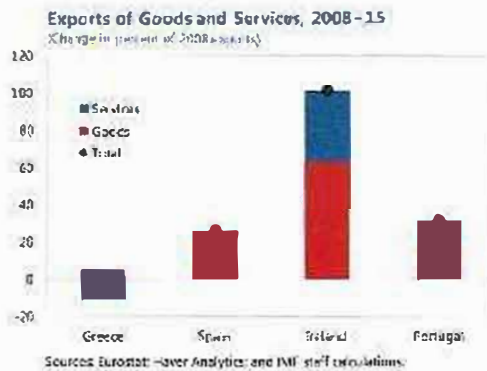
4. While the new ESM-supported program has helped stabilize the economic situation, the underlying issues hindering the recovery have not yet been fully addressed:

- First, public and private balance sheets remain deeply impaired.** Public debt has continued to rise, reaching some 180 percent of GDP by end-2015, almost double its pre-crisis level. This was due to sizeable fiscal deficits and declining growth, notwithstanding the large private sector debt restructuring in 2011-12 and significant flow relief from official creditors. The fiscal problem migrated over time to the private sector balance sheets (Figure 1), with private sector arrears to the banks and the state reaching the second highest level in the euro-zone.



- Second, the economy remains fundamentally uncompetitive.** Despite commitments in its adjustment program to undertake several rounds of structural reforms, Greece has not managed to fully regain competitiveness. In large part, this is due to a weak investment climate, not least

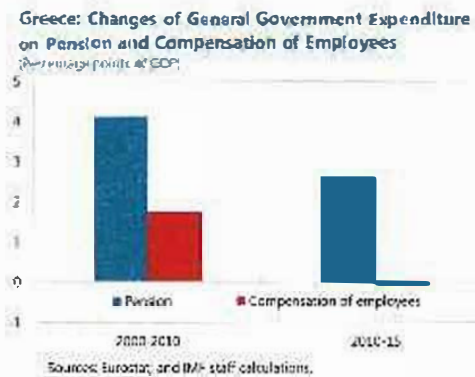
because of insufficient progress in opening up the economy in the face of resistance from vested interests, which hampered the price adjustment needed to restore external competitiveness within the currency union.^{3,4} As a result, exports continue to lag those of peers, and, despite some improvement, Greece still ranks poorly on broadly accepted structural indicators relevant for growth (Figure 2).



5. Greece thus faces four key challenges:

Challenge 1: An unsustainable fiscal policy mix based on unaffordable pensions financed by high tax rates on narrow bases

- Greece implemented an impressive fiscal structural adjustment of around 16 percent of GDP during 2010–15. While more than half of the legislated measures have been on the spending side, only about a quarter of the overall adjustment was directed at reducing public sector wages and pensions, which had grown rapidly before the crisis, with the rest being discretionary spending cuts and increases in tax rates on narrow bases. Although the wage bill declined somewhat as a result, the problem migrated to the pension bill through early retirements, leading to a further rise in pension spending relative to GDP from 2010 to 2015.



- The most recent consolidation package adopted under the ESM program illustrates the political difficulties in tackling key remaining structural weaknesses. The package, expected to yield close to 4 percent of GDP in savings by 2018, is heavily reliant on revenue measures (about 3 percent

³ Only about a third of structural benchmarks under the EFF-supported program have been fully completed until now, with the rest either not done or only partially completed.

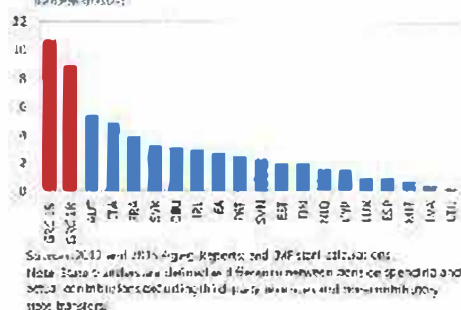
⁴ The shift of resources from the non-tradable to the tradable sectors has been modest, with only tourism having experienced an increase in employment during 2010–15, while manufacturing saw a sharp decline, also given concentration in low value added segments subject to competition from developing countries (see WP/12/236).

GREECE

of GDP), of which the bulk constitutes further increases in already high tax rates on narrow bases. Reductions in pension spending amount to less than 1 percent of GDP (relative to a system deficit of close to 11 percent of GDP). Greece's new automatic contingency mechanism—which provides for ex-post across-the-board cuts in discretionary spending in case of deviations of outturns from fiscal targets—adds to distortions, as it does not address underlying weaknesses through structural reforms, but relies instead on further ad hoc temporary cuts.

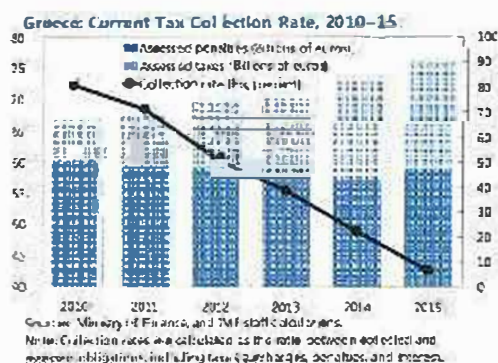
- As a result of the sub-optimal policy mix, the pension system remains highly imbalanced (with a deficit four times the euro-area average of 2.5 percent of GDP), discretionary spending is compressed to unsustainable levels, and the tax burden is unevenly distributed due to exceptional exemptions that relieve the middle class from any personal income tax obligation (more than half of wage earners are exempt from paying personal income tax compared to the euro area average of 8 percent).⁵ Thus, the current structure of public finances is fundamentally inefficient, unfair and ultimately socially unsustainable, as it favors current pensioners and middle-class households while denying lower-income and unemployed individuals access to the adequate and well-targeted social benefits and other essential public services they need and that are the norm elsewhere in the euro area. Consequently, during the crisis, relative poverty rates declined substantially for retirees, while they soared for the working-age unemployed.^{6,7}

State Transfers to the Public Pension System
(Percentage of GDP)



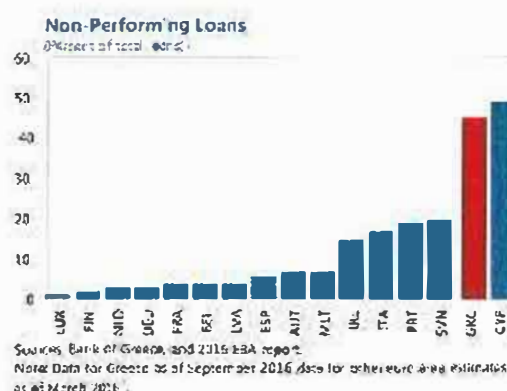
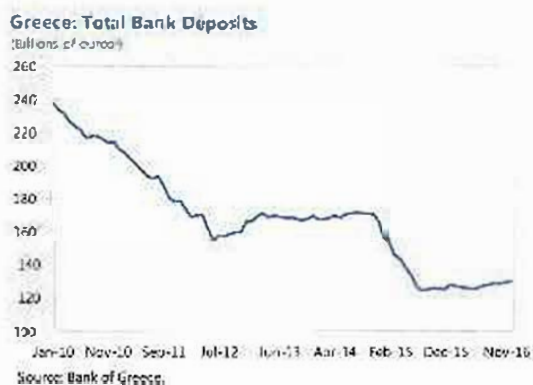
Challenge 2: An ineffective tax administration, weak payment culture, and rising tax debt

- Despite multiple rounds of institutional reforms, tax collection rates have plummeted, while private sector debt to the state has reached 70 percent of GDP, the highest level in the euro-area.⁸ Tax debt was already high prior to the crisis, indicative of a weak payment culture and enforcement capacity. Around half of the population is in arrears to the state, also well above the ratio in other countries. The economic downturn was a key factor in the accumulation of arrears. But the high tax rates and punitive penalties and fines added to the debt. The problem has been exacerbated by an ineffective tax administration frequently subjected to political interference, which has been unable to enforce collections, relying instead on outright amnesties or untargeted installment schemes, which have only served to further weaken incentives to pay and are thus self-defeating.



Challenge 3: Weak bank balance sheets and governance

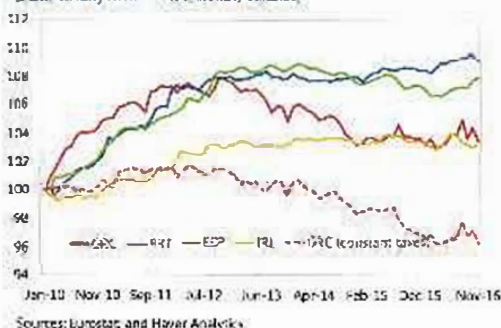
- Despite three rounds of recapitalizations since 2010 and massive liquidity support from the ECB, confidence in the banking sector is yet to return, and capital controls are still in place. The quality of bank capital is weak, with half being comprised of deferred tax assets (DTAs), which could add to contingent liabilities for the state. Moreover, non-performing loans (NPLs) have continued to



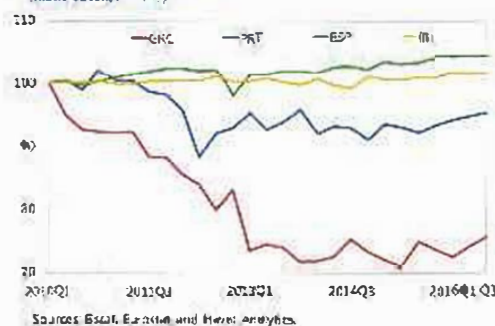
⁸ The tax collection rate is defined as the ratio of collected to assessed obligations, including taxes, penalties, and fines, the latter of which are largely uncollectible, pointing to a highly ineffective tax administration.

Challenge 4: Pervasive structural rigidities, which prevent inclusive growth

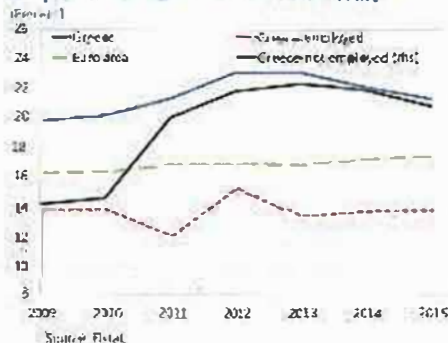
- Harmonized Index of Consumer Prices
2005: January 2010 = 100 seasonally adjusted



Labor Cost, Wage Index
(Index 2010:01 = 100)



- ### People Below 60 Percent of Median Income



Evolution of Inequality, 2008-15



10 INTERNATIONAL MONETARY FUND

their payrolls rather than close down, Greece's poverty level remains unacceptably high, especially compared to that in the rest of the euro area. At the same time, inequality is relatively high in cross-country comparison and has further increased during the crisis (although to a lesser extent than in other countries, such as Cyprus, Ireland, or Spain), suggesting that while better-off interest groups have been relatively protected, the brunt of the adjustment has been borne by wage earners and the unemployed.

RECENT ECONOMIC DEVELOPMENTS

6. Macroeconomic outcomes remain weak, reflecting the lingering uncertainty about the prospects for success of the authorities' current policy package:

- Growth** (Figure 3): After a temporary spell of small but positive growth in 2014, output contracted by 0.2 percent in 2015, with private consumption and investment falling following the introduction of capital controls in June 2015. Output has started to recover since mid-2016, supported by net exports and the authorities' efforts to clear the state's spending and tax refund arrears with the private sector. The current account remained close to balance in 2016, with both imports and exports declining further by end-September (Figure 4). Harmonized consumer prices fell by 1.1 percent in 2015 and were stable in 2016, notwithstanding recent VAT hikes. The labor market is recovering gradually, with the unemployment rate having declined to 23 percent (seasonally adjusted) at end-October 2016 from a peak of close to 28 percent in 2013Q3, while wages per employee increased by 2.6 percent (y-o-y) through end-September 2016.
- Fiscal outcomes** (Figure 5): After Greece managed to achieve a small primary surplus in 2013, spending pressures built up in 2014 and the first half of 2015. The ensuing easing was arrested with the introduction of new consolidation measures, which helped achieve a small primary surplus of 0.2 percent of GDP in 2015 (ESA2010 basis, excluding bank recapitalization costs). In 2016, the cumulative general government's primary surplus (cash basis) through end-November was higher by 0.8 percentage points than a year ago. This outcome reflects higher tax revenues due to the new measures coming into effect in 2016 and the

Greece: Contributions to Real GDP Growth

(Percent, quarter-over-quarter, seasonally adjusted)



Sources: Elstat, Haver Analytics, and IMF staff calculations.

Consolidated General Government Accounts

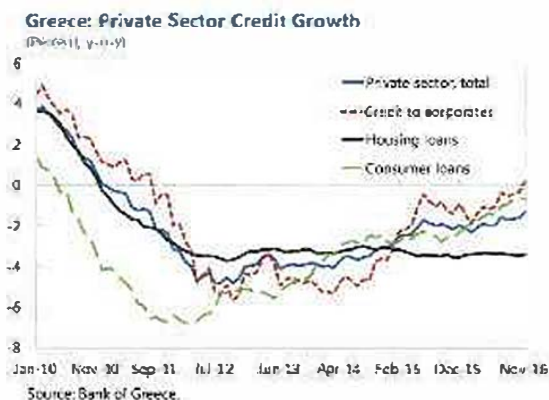
(Cash Basis)

	2015 Jan-Nov	2016 Jan-Nov	Difference (2016-2015)
	(Percent of GDP)		
Revenue	37.6	39.5	1.9
Direct Taxes	8.7	9.2	0.6
Indirect Taxes	13.2	14.7	1.5
Social Contributions	9.9	10.2	0.3
Other Revenue	5.8	5.4	-0.4
Primary Spending	34.7	35.9	1.2
Social Benefits	19.9	20.1	0.2
Compensation of Employees	8.1	8.1	0.0
Other Current Expenditure	4.5	5.6	1.1
Investment	2.2	2.1	-0.1
Cash Primary Balance	2.8	3.6	0.8

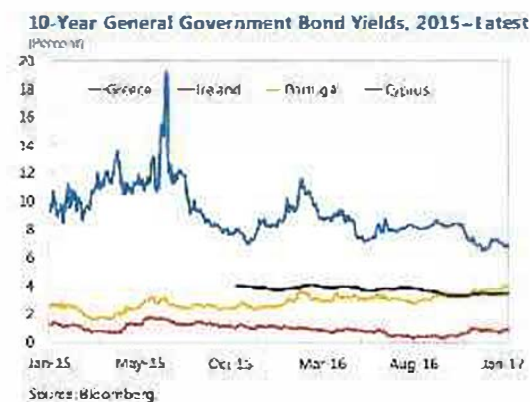
Source: Greece, Ministry of Finance.

relatively better macroeconomic performance, partly offset by higher cash spending related to the government's clearance of its arrears to the private sector.

- Banking sector.** Banks lost 27 percent of deposits in the first half of 2015 and had to resort to capital controls and emergency liquidity assistance (ELA). Since then, deposits have stabilized and banks have reduced central bank exposure. The banking sector required a fresh round of recapitalization in 2015 (€15 billion, or 8½ percent of GDP) to help bring capital ratios from 8 percent Common Equity Tier 1 (CET1) in mid-2015 to around 18 percent at end-September 2016. NPLs have reached 45 percent of total loans in 2016Q3, almost four times as high as in 2010. Provisioning stands at 50 percent of total NPLs. Credit continued to contract in 2016, bringing the total credit decline to 20 percent since 2010.

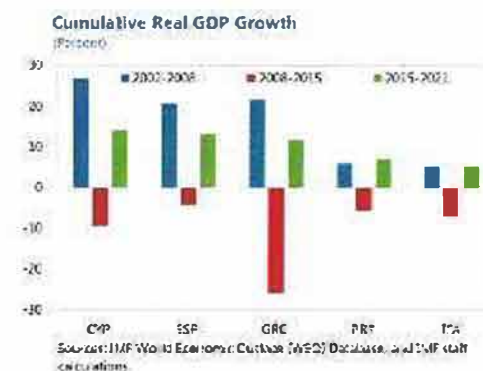


- Political support for the authorities' policies remains weak.** The Syriza government initially achieved broad support for their new program. However, the government has found it increasingly difficult to maintain the support of opposition parties for the adjustment program now underway. Lingering political uncertainty and specter of new elections have kept yields elevated. The ECB, while having restored Greek banks' eligibility for monetary policy operations, has not yet added Greece to its QE program.



OUTLOOK AND RISKS

- After modest growth in 2016, output is projected to rebound over the medium term.** Growth is expected to have reached around 0.4 percent in 2016, and to accelerate to 2.7 percent this year. Projections are predicated on full and timely implementation of the authorities' adjustment program, which is expected to be accompanied by rising confidence following agreement on debt relief, access to the ECB's QE program, and rapid elimination of capital controls. Projections also presume continued clearance of the government's

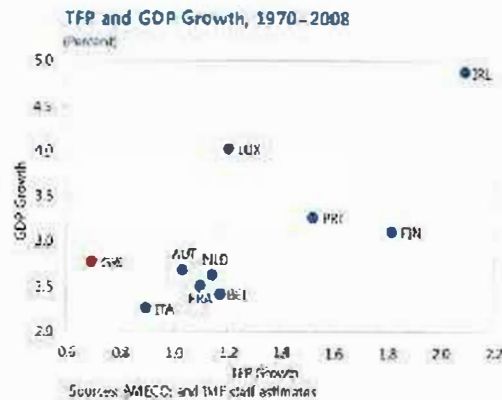


spending and tax refund arrears to the private sector, which would help offset the drag from the ongoing fiscal consolidation.¹⁰ GDP is expected to grow above potential during 2018-20, closing the output gap. The projected recovery is slightly smaller than that projected for Spain and Cyprus, and Greece's 2020 real output and investment are expected to remain below pre-crisis levels by 15 and 45 percent, respectively. Inflation is expected to stay below the ECB target, reflecting slower productivity growth, and unemployment will fall to just below 19 percent by 2020, given high structural unemployment.

Key Economic Indicators						
	2015	2016	2017	2018	2019	2020
(Percent change unless otherwise indicated)						
Real GDP	-0.2	0.4	2.7	2.6	2.4	2.0
Total Domestic Demand	0.2	-0.4	2.2	2.2	2.3	1.9
Private Consumption	-0.2	0.8	1.5	1.4	1.2	1.0
Public Consumption	0.0	0.7	0.5	0.5	2.0	1.7
Gross Fixed Capital Formation	-0.2	3.0	9.5	9.0	8.0	6.2
Foreign Balance (contribution)	0.9	-0.1	0.5	0.4	0.0	0.1
Exports	3.4	1.0	6.5	6.0	4.8	4.2
Imports	0.3	1.2	4.6	4.6	4.7	3.7
Unemployment Rate (percent)	24.9	23.2	21.3	19.8	19.0	18.1
HICP (period average)	-1.1	0.0	1.2	1.4	1.6	1.7
GDP Deflator	1.0	0.1	1.4	1.5	1.5	1.6

Sources: Bank of Greece; and IMF staff estimates.

9. Long-term growth is expected to reach around 1 percent. Adverse demographics are projected to render the contribution of labor to long-run potential growth slightly negative, even as labor force participation is assumed to improve and the unemployment rate to decline gradually to single digits by 2040. Investment growth is expected to remain modest, as financial sector and structural reforms take time to fully materialize. Capital accumulation is thus expected to have a positive but small contribution to growth. Export growth is predicated on a shift of resources from the non-tradable to the tradable sector that occurs only gradually, helping to offset the negative growth impact of higher imports. Ultimately, long-term potential growth will depend on TFP growth, which, given the slow pace of implementation of structural reforms, is projected to reach 0.9 percent, higher than Greece's long-term average, but below the euro-area average.



10. The primary fiscal balance is projected to reach close to 1 percent of GDP in 2016 and rise to 1½ percent by 2018. This is predicated on full implementation of the package of measures legislated in 2015-16 (estimated to yield 3¾ percent of GDP), entering into effect gradually

¹⁰ The authorities plan to clear 3.8 percent of GDP in expenditure and tax refund arrears to the private sector during 2016-17 (of which about 1 percent has been already cleared), while 3 percent in new measures enter into effect. As noted below, fiscal projections are based on staff's estimate of the primary balance given the authorities' current fiscal policy package.

during 2015-18. However, given that some of these measures replace expiring measures or other one offs, their net effect represents an improvement of only around 1½ percent of GDP in the primary balance by 2018.¹¹ Specifically, in 2016, the balance is projected to increase by 0.7 percent of GDP relative to 2015 on account of ongoing consolidation measures, which are partly offset by a recently legislated one-off bonus to retirees and by the expiration of one-off revenues related to bank liquidity support. The primary surplus is projected to increase to 1 and 1½ percent of GDP in 2017 and 2018, respectively, also on account of new measures, which are partly offset by expiring measures, and a further decline in non-tax revenues, and assuming that the authorities fully finance the rollout of the GMI in a budget neutral way, in line with their ESM program commitments.¹²

General Government Operations, 2015-18 (ESA 2010)				
	(Percent of GDP)			
	2015	2016	2017	2018
Total Primary Revenue	47.8	49.3	47.5	46.3
Indirect taxes	16.1	16.9	16.7	16.5
Direct taxes	9.4	9.9	9.0	8.7
Social contributions	13.9	13.8	14.0	13.8
Other revenue	8.4	8.6	7.7	7.3
Total Primary Expenditure	47.6	48.4	46.5	44.8
Social benefits	22.2	22.2	21.4	20.2
Compensation of employees	12.3	12.3	12.1	11.7
Other expenditure	13.1	13.9	13.0	12.9
Primary Balance	0.2	0.9	1.0	1.5

Sources: Ministry of Finance, and IMF staff estimates.

11. Significant downside risks weigh on the outlook (Annex 1). The key risks remain domestic, related to an insufficient or slow pace of implementation of the authorities' reform agenda. A stylized scenario based on current policies with no further reform implementation (e.g. incomplete financial and structural reforms, persistence of capital controls, lack of access to QE and absence of a solution to debt), would imply much lower investment and TFP, resulting in growth of only about 1 percent in the medium term and 0.3 percent in the long term.¹³ Such a scenario, if prolonged, could lead to renewed liquidity squeezes, which, in the absence of further official support, could rekindle Grexit concerns. But even if the authorities' policy program stays on track, high risks to the baseline remain, given the four challenges noted above. Frequent and large downward data revisions and uncertainty associated with the size of the output gap complicate the analysis and add to downside risks to the outlook (Box 2). External risks have also increased following the UK referendum, which could affect Greece's exports, FDI, and growth. Finally, a further intensification of refugee flows could add to fiscal costs and increase political risks.¹⁴

Downside Scenario					
	2017	2018	2019	2020	2021
Real GDP Growth (percent)	1.1	1.2	1.2	0.8	0.6
Contributions (percentage points)					
Final Consumption	0.5	0.7	0.5	0.2	0.1
Gross Fixed Capital Formation	0.3	0.6	0.6	0.5	0.5
Foreign Balance	0.3	0.1	0.1	0.1	0.1
Primary Balance (percent GDP)	0.5	0.6	0.4	0.4	0.4

Source: IMF staff estimates.

¹¹ This is in line with experience during 2010-14, when legislated measures of close to 28 percent of GDP resulted in an improvement in the primary balance of 10 percent, also on account of temporary measures and one off effects, among other factors.

¹² Projections also take into account the recently-legislated budget for 2017.

¹³ The contribution of investment to GDP growth is assumed at ½ percent, in line with the 2001-2009 and 1961-2015 averages. This is around half of the level assumed under the active policy baseline scenario.

¹⁴ Costs related to the refugee crisis are difficult to estimate, with preliminary estimates suggesting 2016 costs at around 0.2 percent of GDP. European partners have indicated an intention to help cover such costs.

12. The authorities broadly agreed with staff's growth projections, but had a more sanguine view of fiscal outcomes and risks. They concurred that growth is likely to rebound strongly this year, supported by a return of confidence following an expected solution to debt and the inclusion of Greece in the QE program. The authorities had more optimistic medium-term growth projections than staff (averaging close to 3 percent during 2017-19), also on account of confidence effects, notwithstanding significantly higher projected fiscal primary surpluses, which they expected at 0.7, 2.0, and 3.5 percent of GDP for 2016-18. In the long run, they expected potential growth to be higher than staff's projection, at around 1½ to 2 percent, given expected growth dividends from ongoing structural reforms. The authorities saw risks more balanced, and considered that downside risks are linked to delays in an agreement on debt relief and in Greece's inclusion in the ECB's QE program.

POLICY DISCUSSIONS

13. Discussions focused on addressing the four challenges noted above to repair public and private sector balance sheets and restore competitiveness. There was broad agreement that progress has been made in reinvigorating the reform agenda since August 2015. However, it was recognized that impediments to growth and fiscal sustainability remain, posing risks to the outlook. Discussions focused on four main themes: (i) the appropriateness of medium- and long-term fiscal targets and the policy mix; (ii) fiscal structural reforms to address tax evasion; (iii) financial sector reforms to repair bank and private sector balance sheets; and (iv) growth-enhancing structural reforms. It was agreed that even with implementation of ambitious reforms, Greece will not be able to restore sustainability without significant debt relief from its European partners.

A. Toward More Credible and Sustainable Fiscal Policies

14. Greece's current fiscal strategy remains anchored in an ambitious medium-term primary surplus target of 3½ percent of GDP, but the policies underlying it appear unduly optimistic, especially given pent-up demands for spending. In particular, the authorities' assumptions about the yield of recently legislated measures and about revenue buoyancy seem excessive, and the assumed further sharp compression of discretionary spending of 2 percent of GDP is not underpinned by structural reforms. Reaching and sustaining such a high surplus for an extended period will be challenging, in view of pent-up spending pressures, some of which are already materializing (e.g. the recent bonus to pensioners, budget overruns in healthcare spending, etc.), and given that double-digit unemployment rates are expected to persist for several decades. Cross-country evidence suggests that few countries having managed to maintain such high surpluses for extended periods of time, and even fewer (one in Europe) have done so while also experiencing double digit unemployment rates.¹⁵

¹⁵ Since 1945, only five euro-area countries have ever been able to maintain an average primary balance higher than 1.5 percent of GDP for a period longer than 10 years, and only one (Italy) in the context of double digit unemployment rates.

15. The authorities should avoid further pro-cyclical consolidation at this time and ensure that their medium-run fiscal targets are supported by credible reforms. As noted above, the current package of fiscal reforms is expected to result in a primary surplus of around 1½ percent of GDP by 2018. This is appropriate in view of Greece's own track record and the current cyclical position.¹⁶ Aiming for a higher target would necessitate further net fiscal consolidation, which is not advisable at this time, as it would be detrimental to the nascent recovery. Relying on one-off factors or the contingency mechanism to temporarily achieve higher targets is equally undesirable, as it would not only pose a drag on growth, but would also obscure the underlying fiscal position and add to risks down the road. Should the authorities choose to maintain a medium-term primary surplus of 3½ percent of GDP, then they will need to implement additional credible and high quality reforms. These reforms should be implemented only once the output gap closes, to mitigate the impact on the recovery. Still, such a policy will undoubtedly have an adverse impact on growth, as it will constrain demand.

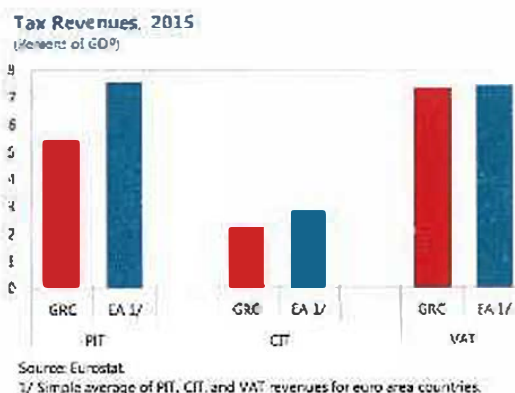
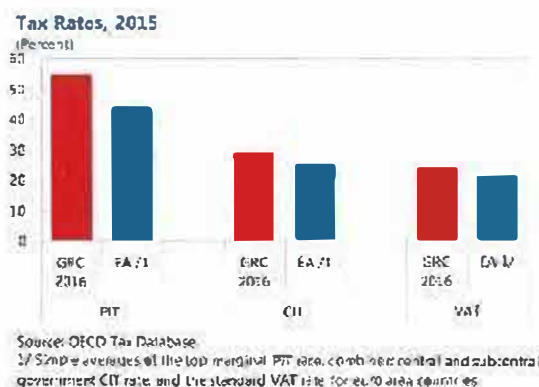
16. Regardless of fiscal targets, the authorities should aim to rebalance the policy mix toward more growth-friendly and equitable policies. A rebalancing of the policy mix away from spending on entitlements and excessive taxation on narrow bases and toward better-targeted social transfers and spending on other essential public services and investment can help to strengthen the sustainability of the public finances and mitigate downward risks to growth by promoting jobs and more inclusive growth. While the rebalancing is necessary in any case, the sequencing of its various elements would depend on the fiscal target chosen. Specifically, with a target of around 1.5 percent of GDP, such a rebalancing should be implemented as soon as possible, and in a fiscally neutral manner, to maximize the growth and re-distributional benefits and reduce policy uncertainty. If the medium-term target is higher than 1.5 percent of GDP, measures that boost revenues or reduce expenditures would need to be implemented first (but only once the output gap closes) to support the higher targets, while growth-enhancing rebalancing measures would need to be postponed, to be implemented only as fiscal space allows. Cross-country experience shows that fiscal adjustments based on tax-base broadening and expenditure rationalization have lower growth costs and are more durable.¹⁷ This is because when the tax burden is already high, further tax increases create disproportionately higher efficiency losses by reducing labor supply and investment.

17. Specifically, tax rates need to be reduced, while tax bases are broadened. As a result of repeated waves of tax hikes, rates for all major taxes are higher than the euro-area average. However, Greece's revenue yields lag behind peers', as high marginal tax rates applied on narrow bases encourage tax evasion, discourage labor participation in the formal economy, and provide incentives for firms to relocate to low-tax neighboring countries. At the same time, as noted earlier, more than half of wage earners are exempt from paying personal income tax (PIT). To

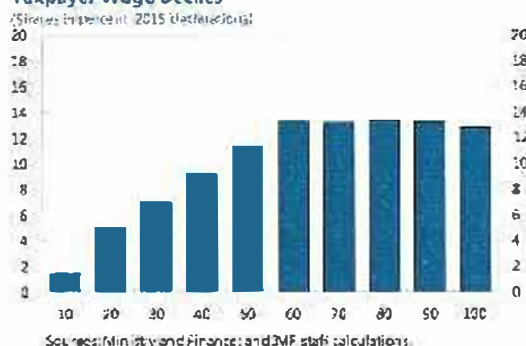
¹⁶ Staff assess that this remains broadly in line with the European fiscal framework, under a sufficiently ambitious debt restructuring.

¹⁷ IMF 2015, "Fiscal Policy and Long-Term Growth", and IMF, 2013, "Reassessing the Role and Modalities of Fiscal Policies in Advanced Economies", and IMF, 2013, "Fiscal Monitor: Taxing Times".

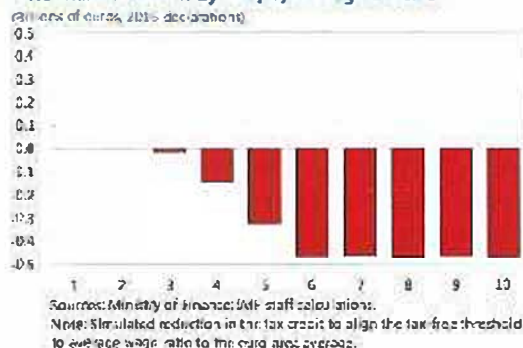
address these distortions, the authorities should lower marginal tax rates, while at the same time reducing the generous tax credit and remaining exemptions. For example, aligning Greece's personal income tax credit relative to the average wage to the euro-area average could create space to lower the marginal CIT rate by up to 10 percentage points and the PIT rates to as low as 15-20 percent, and, to the extent feasible, also the top VAT rate by up to 1 percentage point, helping to support investment, growth, and job creation in the formal economy. As benefits of the tax credit accrue mostly to the wealthier taxpayers, lowering the tax credit while reducing PIT rates for lower incomes would help ensure that the increased tax burden is borne by the relatively better off groups.



Greece: Distribution of Personal Tax Credit Benefit by Taxpayer Wage Deciles



Greece: Distribution of Losses from a Reduction in Personal Tax Credit by Taxpayer Wage Deciles



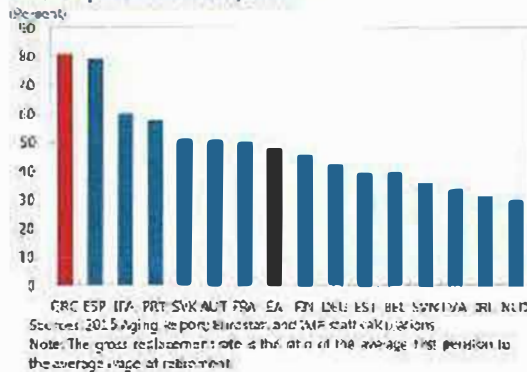
18. Spending should be rebalanced away from pensions toward protection of vulnerable groups and other essential public services and investment. While recent pension reforms have helped address expected long-run pressures from population aging, pensions for current retirees remain un-affordably high.¹⁸ This is in part because in Greece, pensions not only serve to protect incomes in old age, but also act as an informal social safety net in the absence of an adequate and well targeted welfare system. However, this arrangement has not been effective in addressing the rise in poverty: as noted above, poverty in old age has been declining even as

¹⁸ Also see Selected Issues Paper "Pension Reform in Greece and Remaining Policy Challenges."

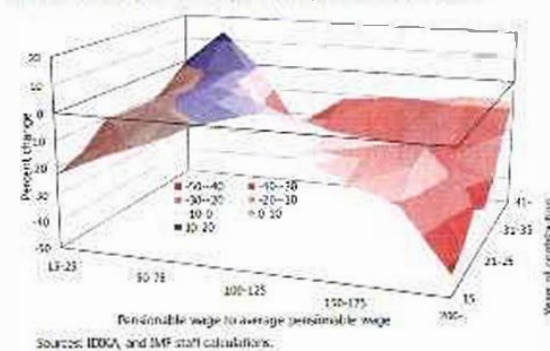
GREECE

that for the working-age population, especially the unemployed, has been rising.¹⁹ In this context, the authorities should consider rationalizing current pension spending further by applying the benefit formula introduced by the recent pension reform to current pensioners. This would result in lower benefits for those with higher pensions and shorter working histories and higher benefits for some retirees with lower pensions and longer contribution periods. The savings could be used to finance a well-designed social safety net, as well as health and transportation services (where shortages of critical inputs have been reported) and growth-enhancing public investment. Rationalizing pension benefits of current retirees would also ensure a fairer intergenerational burden-sharing of the reform costs.

Gross Replacement Rates, 2013

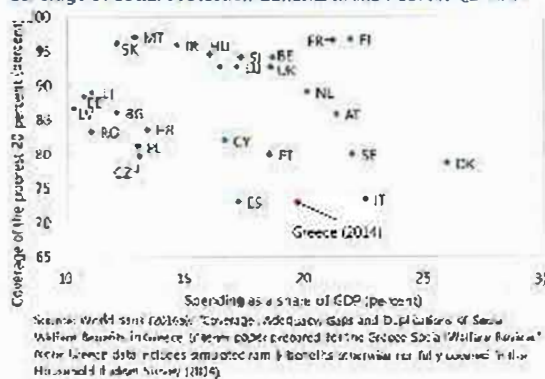


Distribution of Losses from Applying the New Benefit Formula to Current Retirees (Percent change in monthly median pension benefit)

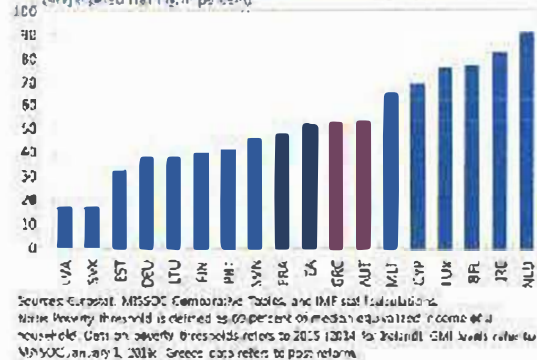


19. Social spending on welfare should be reformed as a matter of priority to ensure that the most vulnerable groups can be adequately protected. Given the protracted recession, and with unemployment expected to remain in the double digits for the foreseeable future, there is an urgent need to address the high level of poverty. As noted above, neither the current system of social assistance nor the pension system has been able to cope with the problem, given that they are not well targeted. As a result, social protection covers only

Coverage of Social Protection Benefits in the Poorest Quintile



Ratio of the GMI Benefit to Poverty Threshold, 2015-16 (for 4-person family, in percent)



¹⁹ Indeed, a recent World Bank report points to the inadequacy of the pension system to stand in lieu of a well targeted social safety net. For example, while the working-age population with children is identified as a group with a high risk of being in poverty, only 12 percent of such households include a pensioner.

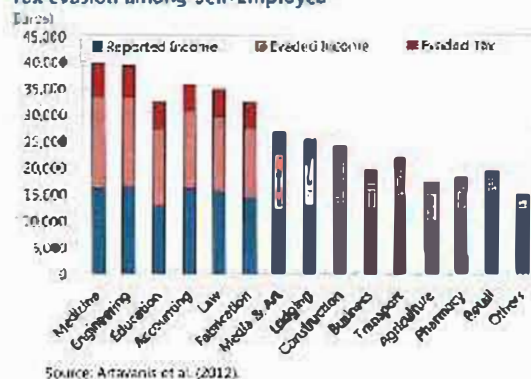
73 percent of the poorest 20 percent of the population, the lowest level in the euro area (the average is 87 percent). Moreover, Greece is one of two countries in the euro-area that has not provided a last resort poverty support to the working-age poor. The authorities should thus ensure that the new Guaranteed Minimum Income (GMI) scheme—expected to provide income equivalent to about 50 percent of the poverty threshold to vulnerable groups (in line with the euro area average)—being rolled out is fully implemented. For the new scheme to be effective and adequately financed, existing overlapping and poorly targeted social schemes should be eliminated; the pension savings noted above could also be used to finance part of the cost of the GMI.

20. The authorities saw scope for lowering long-term fiscal targets below 3½ percent of GDP, but did not see a need to reduce pension spending or the income tax credit. While they considered medium-term fiscal targets achievable, the authorities indicated that a long-term primary surplus target of 2-2½ percent of GDP would be more realistic, in light of political and social considerations. As to the fiscal policy mix, they sought to preserve the current revenue-oriented consolidation, which they considered more equitable in that high marginal income tax rates on the top deciles allowed for protecting a large share of the middle classes. Thus, the authorities did not see a need to lower the income tax credit. Nonetheless, the authorities concurred with the importance of lowering the high corporate tax rate to support investment and jobs, but saw scope to focus on improving tax compliance as a way of broadening tax base. The authorities also agreed that reforming the welfare system is a priority, but were not willing to consider further reductions of current pensions or a major overhaul of existing benefits to finance it, seeing instead scope to achieve further savings through revenue over-performance, limited rationalization of existing social benefits, and a future spending review.

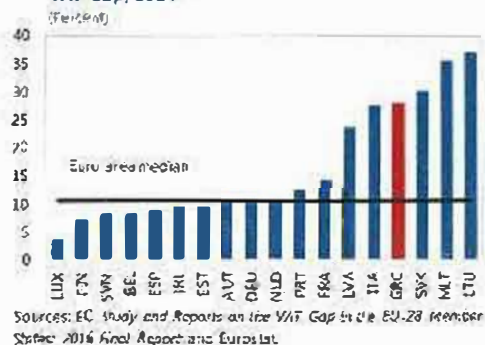
B. Combating Tax Evasion and Addressing Tax Debt

21. The ongoing fiscal consolidation should be complemented with stronger efforts to fight tax evasion. As noted above, tax evasion—especially among the self-employed and related to VAT—was a problem even before the crisis, putting pressure on the budget and

Tax Evasion among Self-Employed



VAT Gap, 2014



leading to an unequal distribution of the tax burden.²⁰ The authorities should thus redouble their efforts to strengthen institutions and practices in this area to send a strong signal that Greece can no longer tolerate evasion. Amnesty schemes should be avoided, as they encourage moral hazard. Instead, the authorities should fully operationalize an independent revenue agency that employs modern risk-based taxpayer compliance principles and is insulated from political interference. Tax administration practices also need to be brought in line with best practices by adopting a risk-based framework that prioritizes cases of new debt, large taxpayers, and high net-wealth individuals, and by strengthening the use of enforcement tools against strategic defaulters, including AML tools that can facilitate collection and sharing of information with domestic and foreign tax authorities.

22. The authorities must also tackle decisively the large stock of tax debt to help clean up the private sector's balance sheet.²¹ The high and growing private sector debt to the state—of which a large part has become uncollectible—suggests that the problem has reached endemic proportions and is hampering economic activity. Rather than resorting to punitive fines and installment schemes not linked to capacity to pay, the authorities should re-examine the system of fines to ensure that they can act as an effective deterrent to tax evasion, but without bringing the tax debt burden to unsustainable levels. Moreover, the revenue administration should focus on tax debtors' economic situation and undertake an assessment of their viability. On this basis, the authorities should develop restructuring modalities in line with individual taxpayers' ability to pay and integrated within a holistic framework that includes bank debt (in the context of the out-of-court debt restructuring framework, see paragraph 24). For viable borrowers, such modalities could encompass selective write-downs of public claims, provided they are adequately tailored and limit moral hazard. Write-downs may also be needed for uncollectible claims of unviable debtors after full use of liquidation and enforcement tools.

23. While concurring with the need to strengthen efforts to combat tax evasion, the authorities believed that installment and other schemes could help boost revenues. They considered that efforts underway to implement the recently legislated revenue agency and to boost enforcement were already producing promising results. Moreover, the authorities were open to considering modalities of restructuring select public claims along with bank debt, while stressing the importance of minimizing moral hazard concerns. However, the authorities continued to believe that new types of installment schemes and voluntary disclosure initiatives, as well as other measures to freeze current debts or allow some bank accounts to be exempted from enforcement, could help improve short-term revenue collections without harming the payment culture. Indeed, a voluntary disclosure initiative and incentives for electronic payments have already been recently legislated.

²⁰ Artavanis et al. in their 2015 paper "Measuring Tax Evasion using Bank Credit: Evidence from Greece" estimate that close to half of self-employed income goes unreported and untaxed. For 2009, this implies €28 billion (near 12 percent of GDP) of unreported income, with significant implications for foregone revenue.

²¹ See Selected Issues Paper "Addressing the Burden of Large Tax Debt and Social Security Debt."

C. Enhancing the Viability of the Banking Sector

24. Decisive action is needed to repair bank and private sector balance sheets to facilitate a return of sustainable credit growth. Without reducing NPLs rapidly, banks will not be able to provide new lending to vibrant firms, putting the recovery in jeopardy.²² Similarly, the non-financial private sector needs to strengthen its balance sheet to be able to borrow and invest again. Banks and companies cannot simply grow out of their NPL problems. In this context, the authorities need to intensify their efforts to tackle NPLs and incentivize debt restructuring along three key dimensions:

- **Debt restructuring legal framework:**²³ An effective enforcement process represents a powerful incentive for the negotiation of restructuring solutions and the restoration of a payment culture that has been severely eroded. To this end, the authorities should ensure that the recently legislated insolvency and debt-enforcement framework is made fully operational, including by establishing the insolvency administrator profession and facilitating auctions. Given weaknesses in the judicial system, the formal insolvency system alone is likely insufficient to deal with the massive over-indebtedness problem facing Greece. The authorities should thus revamp the out-of-court debt restructuring framework to allow for the restructuring of both private and public claims and provide for the possibility of debt write-downs to preserve viability, where possible, in line with individual debtors' capacities to pay. Across-the-board solutions should be avoided, as they encourage moral hazard and do not provide effective and durable solutions that restore borrower's viability.
- **NPL supervisory framework:** Even if the above mentioned legal tools are fully available, banks still need incentives to make full use of them. The Bank of Greece, together with the Single Supervisory Mechanism (SSM) should fully operationalize a framework to set NPL targets and monitor banks' strategies and performance against these targets, similarly to what has been done in Ireland and Cyprus.²⁴ The banks' current strategies imply a reduction in the aggregate NPL ratio to 48, 42, and 34 percent by 2017, 2018, and 2019, respectively. These back-loaded NPL reductions do not appear consistent with the authorities' ambitious investment and growth assumptions—which would seem to require a more ambitious clean-up of bank balance sheets—and are subject to significant downside risks. Thus, the BoG, together with the SSM, needs to



²² Reducing NPLs has been associated with higher corporate credit growth, thus supporting economic growth (Annex 1.3 of the GFSR, April 2014; Box 1.1 of the WEO, April 2014).

²³ See also Selected Issues Paper "Insolvency and Debt Enforcement in Greece."

²⁴ An alternative to bank led NPL restructuring would be the set-up of an AMC, as in Ireland or Spain. However, this could be difficult in Greece, as there is little demand to establish a private AMC. As to public AMC options, they carry risks, given stringent State Aid and other European rules that could trigger bail in if additional capital is needed in the short run. Moreover, governance concerns for a public AMC remain significant.

review banks' strategies and targets and ensure that they are credible and sufficiently ambitious. Such strategies should focus on sustainable restructuring measures rather than the short-term loan ever-greening that has been the norm so far and on strengthening banks' operational capacity to address NPLs decisively.

- **Capitalization:** The sheer scale of the NPL problem, coupled with uncertainty regarding the effectiveness of the legal framework, suggests that upfront measures to reduce NPLs will likely be costly in terms of capital. The recent liberalization of NPL sales will provide a first market test in this regard (so far, there have not been any successful sales, indicative of depressed market prices). The authorities should thus ensure that capital remains adequate over the medium term to facilitate a rapid reduction in NPLs.

25. Over the medium run, policies should focus on enabling the provision of credit to the economy. Looking beyond the immediate need to address legacy NPLs, the authorities should develop policies to allow savings to be channeled to the most productive uses. In this regard, they will need to strengthen the existing frameworks (e.g. credit register, real estate transactions register) and incentivize banks to move to modern practices to assess credit risk (e.g. credit scoring, etc.). Private solutions should be given precedence over public ones, as they can be most easily aligned with the needs of creditors and debtors. However, adequate safeguards for consumers need to be retained.

26. Bank governance must also be strengthened. Ensuring that lending and restructuring decisions are taken on commercial principles and without undue political interference is key to the long-run viability of the banking sector and the success of the economic recovery. The authorities should thus implement their plans to fully reconstitute bank boards on the basis of revised eligibility criteria in line with prudent internal practices that go beyond supervisory fit-and-proper criteria as defined by the SSM, so as to uproot the linkages between the Greek banks, politicians, and powerful vested interests. Over the medium term, the authorities will also need to divest public ownership in banks to reputable international financial institutions to take advantage of international banking expertise and minimize the contingent liabilities of the state.

27. Capital controls should be eliminated as soon as is prudent, while preserving financial stability. Exchange restrictions and capital controls introduced in June 2015 continue to hamper economic activity, in particular with respect to export and import activities, and impede rebuilding confidence in the banking system. Although the authorities have taken some recent steps to relax the controls, they remain pervasive and are giving rise to three exchange restrictions under the Article VIII, Section 2(a) (see also Annex 4).²⁵ Their removal as soon as

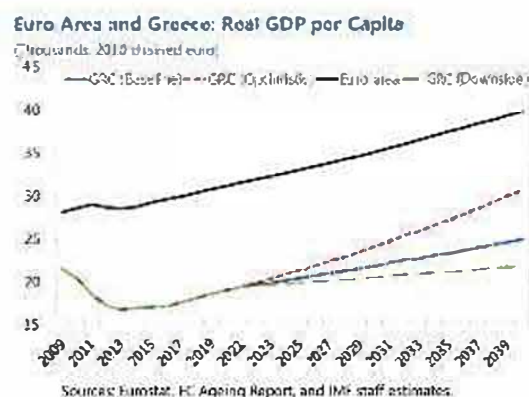
²⁵ Greece has introduced measures that give rise to following exchange restrictions subject to Fund approval under Article VIII, Section 2(a): (i) An exchange restriction arising from absolute limits and discretionary Bank Transactions Approval Committee (BTAC) approval on the availability of foreign exchange for certain payments and transfers for (a) current international transactions related to normal business activities and (b) invisible transactions and remittances (such as travel, except for tuition fee and medical expenses) (ii) An exchange restriction arising from the discretionary BTAC approval of transfers abroad of moderate amounts for the amortization of loans and of income from investments including dividends and interest payments of non-financial entities to non-residents. (iii) An exchange restriction arising from absolute limits on withdrawal of

feasible is thus essential to support the economic recovery. The authorities should aim to fully eliminate them on the basis of a milestone-based roadmap taking into account confidence trends and key steps in the implementation of their financial sector strategy, such as the continuing return of deposits and normalization of funding conditions, and progress toward resolving NPLs. Key liberalization steps will need to focus on abolishing restrictions on domestic wire transfers and cash withdrawals, as well as on the gradual facilitation of cross-border transfers. To preserve financial stability, the Bank of Greece, with support from the ECB, should ensure sufficient bank liquidity to cope with the possibility of increased outflows, including by allowing for slower ELA repayment.

28. The authorities broadly agreed with the priorities noted above, although they raised concerns that the bank governance reform is going too far. While they concurred with the need to tackle NPLs, the authorities saw the European financial architecture (e.g. State Aid rules and the BRRD framework) as constraining and considered that a more gradual pace of NPL reduction would be more feasible and appropriate. They remained committed to further improving their debt restructuring legal framework and strengthening the supervisory NPL framework. However, the authorities considered that automatic solutions (rather than tailored ones) may be better suited to deal with the large number of small debtors, given capacity constraints. As to governance, they considered the current framework for selection of bank board members as overly restrictive, in that it does not allow for boards with sufficiently broad expertise. The authorities agreed that a milestone-based roadmap could be helpful in guiding the liberalization of capital controls, and on this basis have requested the approval of the retention of temporary exchange restrictions, which they intend to remove as soon as conditions allow.

D. Regaining Competitiveness within the Currency Union

29. Greece requires a notable increase in productivity to become competitive within the euro-zone. Without a substantial acceleration in the pace of structural reforms, Greece will be unable to narrow the gap in its real per capita income relative to the euro area, raising concerns about the ability of the economy to prosper and remain competitive inside the euro-zone (Box 3). Greece will thus need to make rapid progress to close remaining gaps with best practice both in labor and product market reforms.



cash from bank accounts in Greece in the absence of an unrestricted channel for payments due to discretionary BTAC approval and absolute limits.

30. The authorities should preserve the important labor market gains achieved so far and complement them with additional reforms. With no exchange rate flexibility and a long way to go to reduce unemployment, there is little doubt that further labor market flexibility is needed to attract both domestic and foreign investment and facilitate the restructuring of indebted Greek firms. Reducing unemployment is also essential to lower the high poverty rate. However, calls for unwinding previous labor market reforms have increased, given that the adjustment so far has fallen disproportionately on wage earners. However, heeding such calls would be drawing the wrong conclusion, as this would risk unwinding the competitiveness gains achieved so far, hurting job creation.²⁶ Instead, existing reforms should be complemented with additional measures to bring Greece's collective dismissals and industrial relations frameworks in line with international best practice:

- **Collective dismissals:** While Greece ranks around average among OECD members on employment protection regarding collective dismissals, this indicator does not take into account a much lower threshold relative to the levels indicated in the EU Directive and a restrictive pre-approval requirement for such dismissals, which does not exist in most other advanced economies.²⁷ As a result, only two approvals for collective dismissals have been granted since the early 1980s. A recent ruling by the European Court of Justice found the procedure to be an obstacle to the freedom of establishment and conducting business.²⁸ This makes downsizing operations in Greece very costly, with many firms forced to relocate, enter bankruptcy, or implement costly voluntary exit schemes. In this context, the authorities should consider repealing the requirement for administrative approvals and bringing the threshold for collective dismissals in line with the recommendation in the EU Directive and the European Court of Justice, while making use of EU funds to support retraining programs to reintegrate those unemployed into the labor force.
- **Industrial action:** Greece's rules governing the establishment of trade unions and their decision-making processes, as well as legislation governing strikes, have not been reformed since the 1980s. This could explain the large number of strikes in Greece, which even prior to the crisis far exceeded levels seen elsewhere. While the right to strike should be fully preserved, the

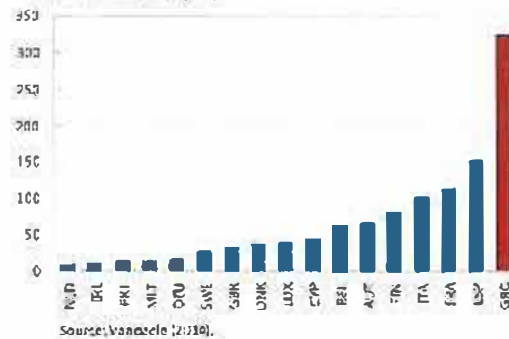
²⁶ The authorities wish to reinstate sectoral agreements with extensions and the after effect of collective bargaining. A body of recent micro evidence suggests that collective bargaining systems including extensions of sectoral agreements to those not represented in the negotiations have adverse employment effects (Diez-Catalan and Villanueva, 2015; Hijzen and Martins, 2016; Martins, 2014; Magruder, 2012), and that "after-effects" are detrimental to credit-constrained firms in need of adjustment (Hijzen and Martins 2016).

²⁷ The threshold for defining collective dismissals is roughly half that recommended in the EU directive for most firms except very large ones. As to the pre-approval requirement for dismissals, only the Netherlands has a similar requirement in Europe (Spain, which had a similar requirement, abolished it a few years ago). A recent ruling by the European Court of Justice also found the procedure to be an obstacle to the freedom of establishment and conducting business.

²⁸ This compares to an average—adjusted for population size—of 160 to 250 per year during the 1990s crisis in Norway, 920 in the UK during the early 2000s boom, and more than 10,500 workers per year in Spain.

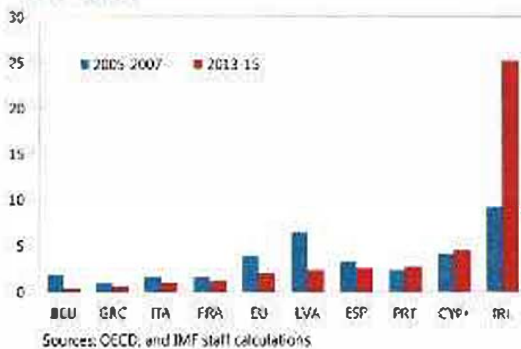
authorities will need to align their industrial action framework with best international practice by setting appropriate quorum requirements for trade unions calling a strike and by allowing for defensive lockouts by employers. These actions can help support investment by limiting costs associated with prospective strikes that may result in the stoppage of production.²⁹

Strikes: 2002-2007
(Average per 1,000 employees)



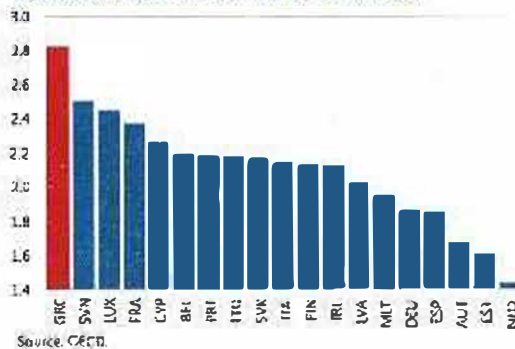
31. At the same time, the implementation of product and service market reforms and privatizations should be significantly accelerated. Despite several laws having been passed over the last six years to open up closed professions, remove obstacles to competition, and facilitate investment licensing, reform implementation has been slow and uneven, reflecting strong opposition from vested interests. As noted earlier, this has exacerbated inequality and resulted in increased social resistance to reforms. Privatization efforts have also lagged, constraining economic efficiency, limiting benefits to consumers, and restricting the potential for FDI flows into the economy. The authorities should thus redouble efforts in all these areas to ensure full and rapid carry through of reforms from the legislative to the implementation stage. They should also take further decisive steps to privatize state assets—including in the area of energy, where costs remain high due to extensive state interference—while avoiding fire sales. Such efforts are essential not only to send a strong signal to investors that “Greece is open for business,” but also to cement support for the remaining labor market reforms noted above and to achieve benefits from reform synergies.

Inward FDI Flows
(Percent of GDP)



State Control, 2013

(if given values correspond to less competition-friendly policies)

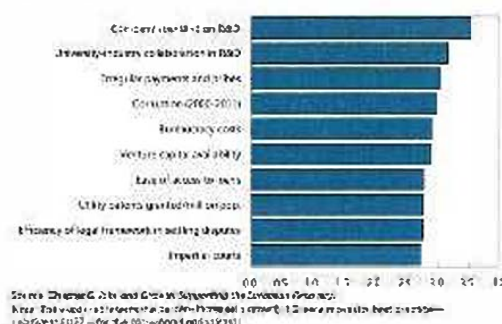


²⁹ In Greece, only 33 to 25 percent (at the second ballot) of first level union members need to be represented in the decision to call a strike. Among European countries a prohibition on lockouts is relatively unusual, existing only in France, Lithuania, Portugal and Slovenia.

GREECE

32. Institutional reforms remain a key priority. There are three key areas where reforms could have a large impact on growth. First, the authorities should strive to improve the efficiency of the judicial system, including by addressing the large backlogs that inhibit enforcement and distort incentives (e.g. with regard to insolvency and competition). Second, they will need to intensify efforts to tackle corruption, where Greece continues to lag behind peers and where, despite efforts (including a new legal and institutional framework), recent World Bank indicators point to a deterioration since 2013. Third, the authorities should develop ways to promote innovation, in particular on spending R&D, patents, and university-industry collaboration, as fiscal space allows.

Greece: Top 10 indicators: Impact on growth

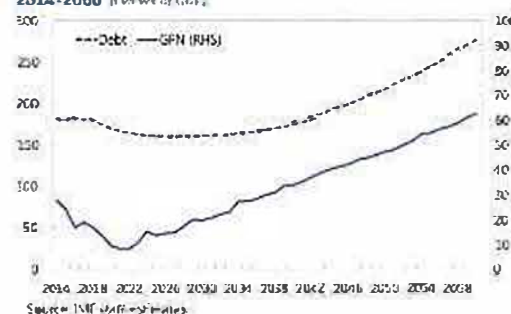


33. The authorities sought to unwind the previous labor market reforms and considered that the current pace of product market reform implementation is adequate. They argued that the 2011 collective bargaining reforms were not helpful and should be unwound to bring Greece more in line with the European social model. At the same time, the authorities did not see the need to fundamentally reform collective dismissals and the industrial action framework, quoting a recent labor market review and an understanding from social partners that the current regime is broadly adequate. In what concerns product market reforms, the authorities pointed to ongoing efforts to implement the OECD's recommendations to remove barriers to competition, investment licensing, and entry into professions, noting that several years would be needed to implement reforms in all these areas, given capacity and other constraints.

DEBT SUSTAINABILITY

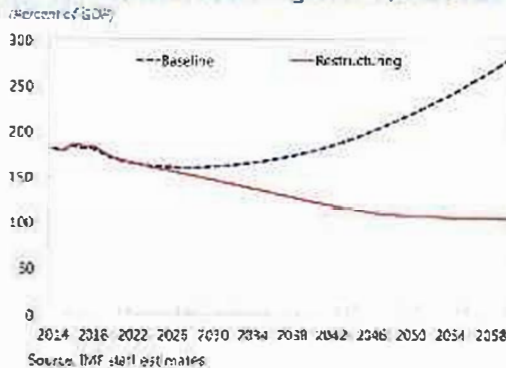
34. Even with full implementation of the above-mentioned policies, Greece's debt is highly unsustainable (Annex 3). Staff's DSA is based on the gross financing needs (GFN) framework, covering a period up to 2060. This framework captures better Greece's true debt burden compared to a stock-of-debt framework, given that the bulk of Greece's debt comprises official loans provided on highly concessional terms and with long maturities. Under staff's baseline scenario, which assumes full implementation of reforms under Greece's adjustment program, debt and GFN are projected to reach around 160 and 20 percent of GDP by 2030, respectively, but become explosive thereafter. The adverse dynamics are due to the need to replace gradually a large amount of concessional debt with market financing at much higher rates, which eventually render debt and GFN unsustainable. In other words, Greece cannot be expected to grow out of its debt problem, even with full implementation of reforms.

Greece: GG Debt and GFN -- Baseline, 2014-2060 (in % of GDP)

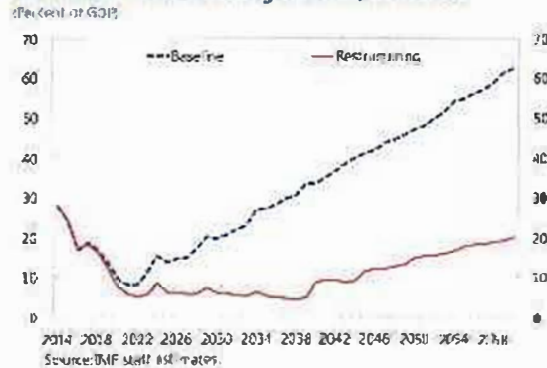


35. Greece thus requires significant debt relief from its European partners to ensure debt sustainability. While debt relief need not be approved upfront, all policy-contingent relief will need to be delivered once Greece's official financing program ends, if Greece is to exit successfully from official financing. In this regard, the Eurogroup committed to provide further debt relief—in addition to the generous flow relief provided thus far—upon the successful implementation of Greece's adjustment program in order to maintain GFN below 15 and 20 percent over the medium and long run. However, to provide more credibility to the debt strategy for Greece, further specificity will be needed regarding the type and scope of debt relief to be expected. In this regard, in addition to those measures that are sufficiently well specified by the Eurogroup, ambitious extensions of grace and maturity periods, a full deferral of interest on European loans, as well as a locking in of the interest rate on a significant amount of European loans will be needed to reduce GFN sufficiently to put debt on a sustained downward path. If Greece's medium term objective (MTO) is also to be met over the long run, debt relief would need to be even more extensive (see Annex 3).

Greece: GG Debt—Restructuring Scenario, 2014-2060



Greece: GFN -- Restructuring Scenario, 2014-2060



STATISTICAL ISSUES

36. The quality of official statistics has continued to improve, and the gains must be preserved in the face of ongoing political pressures. Significant progress was achieved in improving the quality of Greek statistics since the establishment of the independent Hellenic Statistical Authority, ELSTAT, in 2010. In particular, data compilation processes have been improved, including coverage, timeliness, and consistency with international statistical standards, and data provision is broadly adequate for surveillance. Technical assistance from the IMF, Eurostat, and other member states has been important in this regard. Nonetheless, as noted above, revisions of national accounts and fiscal data are frequent, significant, and consistently biased to the downside, and continuing discrepancies in fiscal reporting remain.³⁰ The authorities should protect the gains achieved so far by defending the statistical agency against any efforts to undermine its credibility, guaranteeing its professional independence, and addressing remaining shortcomings in reporting, while firmly respecting the "Commitment on Confidence in Statistics" that was endorsed by the government in 2012.

³⁰ While Eurostat has validated most of the Greek fiscal data without reservation since 2010, it did not validate Greece's general government financial accounts, recently withdrawing existing data from publication.

STAFF APPRAISAL

37. Greece has made significant progress in unwinding its macroeconomic imbalances. The fiscal primary and external current account deficits have fallen from double digits to around zero over the last six years. This is an impressive adjustment, all the more so for a country belonging to a currency union, where policy levers are limited. However, in view of the extraordinary challenges that Greece had to face, the adjustment has tested the social and political fabric and has taken a large toll on society, with unemployment and poverty levels without precedent in the euro zone. This illustrates the difficulty of relying on fiscal consolidation and internal devaluation to address imbalances while remaining inside the currency union.

38. As a result, sustainable growth has been elusive and risks remain elevated. While the adjustment was initially based on important reforms, the costs associated with adjustment have frayed the political and social fabric, eroding consensus, slowing reform momentum, and making the fiscal adjustment increasingly reliant on one-off and ad hoc adjustments. Recurrent political crises and confidence shocks associated with the inability to sustain the reform effort exacerbated the downturn. While growth is expected to resume modestly this year, future growth prospects are highly dependent on a substantial reacceleration of Greece's reform implementation. Even with ambitious reforms, unemployment is expected to stay in the double digits until the middle of the century, and risks to the outlook remain tilted firmly to the downside.

39. To create a private sector capable of generating sustainable growth and employment and to increase the economy's resilience to shocks, Greece must deepen and accelerate reform implementation. Despite successive reforms, not least the latest round legislated since last year, a number of key structural problems remain: (i) a vulnerable structure of the public finances that results from unaffordable pension spending financed by high tax rates on narrow bases and a deteriorating payment culture; (ii) impaired bank and private sector balance sheets; (iii) pervasive structural obstacles to investment and growth, which continue to hamper competitiveness; and (iv) an unsustainable public debt burden despite large debt relief already received. These problems must be addressed decisively to pave the way for a sustained recovery based on a vibrant private sector, to provide the resources necessary to address basic needs of the most vulnerable, and to exit from dependence on official financing.

40. Greece does not require further fiscal consolidation at this time beyond what is currently underway. Thanks to the impressive fiscal consolidation to date, including the most recent fiscal package legislated in 2015-16, Greece achieved primary balance last year (excluding costs for bank recapitalization) and is expected to attain a primary surplus of around 1½ percent of GDP in the medium and long term on the basis of the fiscal package legislated in 2015-16. A surplus of this level is appropriate in view of cross-country experience and Greece's own track record, and also given the expectation that unemployment will remain high for decades. Should Greece choose to target a higher medium-term surplus, this will need to be underpinned by credible reforms, which should be implemented once the output gap closes, to minimize the negative effects on the recovery.

41. The fiscal policy mix needs to be rebalanced to bolster the medium-term sustainability of the public finances and support growth and equity. As currently implemented, fiscal policy is unsustainable, unfair, and unfriendly to growth. Spending remains excessively focused on unaffordable pensions, while the personal income tax system absolves middle class households from contributing their fair share. As a result, lower-income households are denied access to adequate and well-targeted social benefits, as well as to other essential public services, such as healthcare and transportation. A budget-neutral rebalancing of policies is thus essential for the public sector to be able to provide adequate services and social assistance to vulnerable groups, while creating the conditions for investment and more inclusive growth. This can be achieved by lowering the generous income tax credit and eliminating remaining exemptions that benefit the rich and applying to current pensioners the new pension benefit formula introduced with the recent pension reform, with savings going to finance a more modern and comprehensive social safety net and to encourage the private sector to invest to create employment.

42. The authorities should complement their fiscal rebalancing with renewed efforts to combat tax evasion. Pervasive evasion and an ineffective and politicized tax administration have exacerbated the unfair distribution of the tax burden, and contributed to a rising tax and social security debt and to falling tax-collection rates. The authorities should refrain from adopting untargeted installment or amnesty schemes and instead strengthen the use of enforcement tools against those who can pay but choose not to do so, concentrate audits on large taxpayers and high-wealth individuals, and mobilize the AML framework. For taxpayers who no longer can afford to pay fully their tax obligations, restructuring solutions based on capacity to pay need to be found to preserve viability where possible. Establishing an independent revenue agency that is fully insulated from political interference will be critical in this effort.

43. As to the financial sector, non-performing loans (NPLs) must be reduced decisively. With NPLs close to 50 percent of total loans, putting in place policies that support a rapid and deep clean-up of bank balance sheets is essential to achieving a successful recovery. Assuming that banks can simply grow out of the NPL problem is not credible, as growth ultimately depends on the ability of banks to lend to viable firms. The authorities should thus further strengthen the legal framework for debt restructuring, including by providing for out-of-court debt workouts of public and private claims. The supervisory authorities should enhance incentives for banks to set ambitious NPL-reduction targets and implement strategies prioritizing sustainable restructuring measures and NPL sales. Ensuring adequate bank capital is key to allow a rapid reduction in NPLs, even if costly.

44. At the same time, payment conditions should be normalized and bank governance strengthened significantly. Payment restrictions and capital controls persist, hindering confidence and the return of much needed liquidity to the economy. The authorities should relax the controls rapidly and predictably—on the basis of a milestone-based roadmap—while preserving financial stability by ensuring adequate bank liquidity, with support from the ECB. Moreover, lingering governance concerns, related to a legacy of close relations between banks, the state, and powerful vested interests, should be addressed decisively by completing the board overhauls in line with the new legislation both in systemic and non-systemic banks. Staff supports the authorities' request for

GREECE

Executive Board approval for the retention of three exchange restrictions since they are imposed temporarily, for balance of payments reasons, and non-discriminatorily.

45. Greece needs more, not fewer, structural reforms to become competitive inside the currency union. Despite successive attempts to address its weak institutions, Greece has not fully regained competitiveness. The 2011 labor market reforms were major steps forward, as evidenced by the subsequent improvement in labor costs. However, in the absence of implementation of product-market reforms, the burden of the adjustment has fallen disproportionately on wage earners. Reversing existing reforms is tantamount to drawing the wrong conclusions, as this would put at risk the potential gains for investment and job creation. Instead, they should redouble their efforts to fully open up remaining closed professions, foster competition, facilitate investment and privatizations, and bring Greece's collective-dismissals and industrial-action frameworks in line with international best practice.

46. Even with full implementation of the above-mentioned policies, Greece cannot restore debt sustainability through its efforts alone and needs significant debt relief from its European partners. Greece has made enormous sacrifices to get to where it is now. But the significant achievements in balancing the budget, closing the current account deficit, and improving the flexibility of the labor market have taken a heavy toll on the society and tested its endurance. Recognizing that European partners have made considerable efforts to support Greece, including through official financing and generous flow relief provided thus far, further debt relief will be needed to restore Greece's debt sustainability. Such relief should be calibrated on realistic assumptions about Greece's ability to generate sustained surpluses and long-term growth. But ultimately no amount of debt relief can make Greece competitive in the euro-zone without strong policies. Greece, for its part, must also seize the opportunity to make steady but resolute progress toward addressing its remaining challenges.

47. The next Article IV consultation with Greece is expected to take place on a 12-month cycle.