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Sovereigns

Special Report

# Greek Public Finances

## A Credibility Gap

### Ratings

| | |
|---|---|
| **Foreign Currency** | |
| Long-Term IDR | BBB+ |
| Short-Term IDR | F2 |
| **Local Currency** | |
| Long-Term IDR | BBB+ |
| Country Ceiling | AAA |

### Outlooks

| | |
|---|---|
| Foreign-Currency Long-Term IDR | Negative |
| Local-Currency Long-Term IDR | Negative |

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### Related Research

- *Global Economic Outlook (October 2009)*
- *Sovereign Rating Methodology (October 2009)*
- *Greece (research)*

## Summary


Fitch Ratings says that while the sharp deterioration in Greece's public finances has sharpened market perceptions of fiscal sustainability and injected a new sense of urgency into Greek politicians' policy statements, credibility remains the missing ingredient. Doubts endure about the authorities' ability to implement austere fiscal policies on a sustained basis, necessary to ensure that debt is stabilised and reduced over the next three to five years. General government debt currently stands at 113% of GDP and is likely to approach 130% in the next two to three years.

Fitch downgraded Greece's ratings by a total of two notches between October and December, to 'BBB+'/Negative Outlook from 'A'/Negative Outlook. The downgrades reflected huge revisions to the 2008 and 2009 fiscal deficits due, in part, to earlier financial misreporting, a weak initial policy response to this shock, and concerns about the authorities' capacity to implement fiscal consolidation on a sustained basis over the medium term.

Sustained fiscal consolidation over the medium term will require enduring domestic political commitment to austere fiscal policies. Yet the decision to impose mild restrictions on public pay and the suggested withdrawal of new measures to assist the low-paid have already attracted fierce opposition from both within the governing party itself and militant public-sector trade unions.

Fiscal slippage relative to current plans could result in a further downgrade, while the emergence of a much stronger policy commitment and its consistent implementation over the medium term could see the Outlook revised to Stable.

This report reviews Greece's track record of fiscal management, the draft 2010 budget that is currently passing through parliament, its public indebtedness and fiscal funding needs, and the pressures on the Greek authorities to deliver a strong and credible medium-term fiscal adjustment programme.


## Track Record Is All

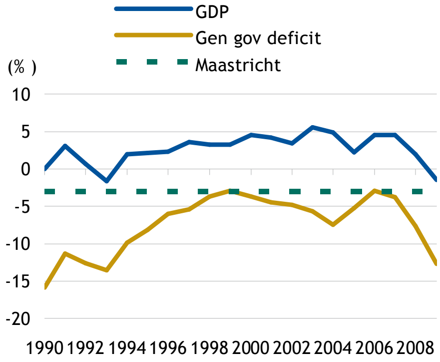
The fiscal track record of previous Greek governments has been poor and the present position — a large deficit and high and rising debt — is exceptionally weak. The new government has clearly been shaken by recent events and has brought forward the publication of its medium-term plans in an effort to satisfy both its fellow euro area governments and the markets.

Greek public finances have been the weakest in the euro area since the country joined in 2001, a year late because of difficulties in meeting the entry criteria. The poor Greek fiscal performance, especially the high and now rapidly rising public debt, cannot be attributed exclusively, indeed hardly at all, to poor macroeconomic performance, as the present finance minister has publicly recognised.

In fact, between 2000 and 2008, GDP grew at an average real rate of 4% a year, about double the EU average. Even in 2009, Fitch expects the fall in GDP to be a relatively restrained 1.5%. Yet in all but one of these years, the Greek deficit exceeded the Maastricht target of 3% and the growth in public debt was only marginally checked, falling from 103% of GDP at end-2000 to 99% at end-2008.

A downgrade from 'A' to 'A–' with Negative Outlook in October this year was a response to chronic official misreporting of the public finances and further fiscal surprises reminiscent of 2004. The newly appointed finance minister announced that on the basis of nine months' actual figures, he was doubling the estimated 2009 deficit to 12.7% of GDP and raising the end-year debt estimate to 113% of GDP. As well as some loss of revenue due to the decline in GDP, he blamed poor controls, inadequate accounting and over-optimistic initial forecasting for a 4% of GDP shortfall in revenue and unbudgeted increases in expenditure including 1.5% of GDP in one-offs. This new-found transparency is welcome and the authorities are promising more regular fiscal reporting in the future: frequent revisions in the past have undermined confidence in Greece's fiscal data and rendered budget projections meaningless.

**Growth and General Government Balance**




Source: National authorities

The new PASOK (Socialist) government was confronted at the outset with a major fiscal challenge to some of the key policies that had brought it success and an overall majority in the recent election: expanding the public sector and welfare state, and protecting those on low incomes. Such campaign promises reflect continuing failure to grasp the reality of Greece's unsustainable public finances. The massive blow-out of the 2009 fiscal deficit has invited enhanced European Commission surveillance and greater controls under the Excessive Deficit Procedure (EDP). Nonetheless, Fitch doubts the ability of the new government to sustain fiscal consolidation over the medium term (ie the full life of a parliament) and argues that there are few grounds for giving Greece "the benefit of the doubt" in the light of both major political parties' past records of fiscal mismanagement.

Such concerns are echoed in the Commission's latest assessment of the Greek economy, which makes clear its dismay over the country's apparent inability to implement agreed consolidation policies. A key measure of this frustration is the fact that the Commission now stands on the verge of invoking Article 104.8, meaning that Greece has now reached an advanced stage of the EDP not tested since the inception of the euro.

## The 2010 Budget

**2010 Budget Projections**

| % of GDP | 2009 | 2010 |
|---|---|---|
| Revenue (net) | 21.5 | 23.6 |
| Expenditure | 33.7 | 32.8 |
| Balance | -12.2 | -9.2 |
| **Memo:** | | |
| Gen govt bal | -12.7 | -8.7 |
| Central govt debt | 125.3 | 133.6 |
| Gen govt debt | 113.4 | 120.8 |

Source: National authorities

In broad terms, the 2010 budget looks for a 4% of GDP reduction in the general government deficit, driven by a combination of higher revenue (1.8% of GDP), expenditure cut-backs (1.7% of GDP) and unspecified efficiency gains.

The 2010 budget was presented to the parliament on 20 November and is due to be voted on in late December. Changes are possible during the parliamentary process and a supplementary budget is possible during 2010. Medium-term fiscal plans are due to be published in the Stability and Growth Programme (SGP) in January, while the European Commission's response should be available by February.

Fitch regards the 2010 budget targets as relatively undemanding and believes that they should be attainable, not least because one-off items account for 1.5% of GDP of expenditure overruns in 2009. However, the policy mix is less than ideal.

Revenue-raising measures rely heavily on moves to counter tax evasion — where the pay-off is highly uncertain — and resumption in economic growth, which is likely to be anaemic. Greater emphasis on cutbacks in current expenditure, where structural fiscal weaknesses are most acute, would have been more desirable. As it stands, half the measures aimed at cutting the deficit in 2009 promise to be temporary in nature, a repetition of the previous government's short-sighted strategy. Of the permanent measures, a limited public-sector wage freeze will have little or no impact on spending in 2010 (less than EUR100m), while controls on public-sector recruitment are unlikely to deliver a material reduction in the headcount for some years, judging from experience elsewhere.

Fitch is critical of the fact that the 2010 budget lacks any substantial policy initiatives that such an acute deterioration in the public finances would reasonably seem to demand, the more so given that little of the recent fiscal deterioration can be attributed to the economic downturn, which has been relatively mild, while support for the financial sector has been minimal. Fellow euro member Ireland, which is facing a similar sized deficit to Greece in 2009, has delivered stringent fiscal measures against a much less favourable macroeconomic backdrop.

Admittedly, the Greek government is talking in terms of substantive reforms over the medium term, including tax reform, a medium-term expenditure review and pension reform. However, in the light of Greece's track record, doubts inevitably remain over the government's ability to articulate and deliver such a radical reform programme on a sustained basis.

### 2010 Budget Highlights

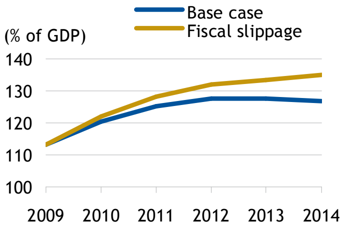
*Expenditure Measures*

- Non-renewal of 30,000 short-term public-sector employment contracts and immediate dismissal of another 11,000 public-sector employees recruited during the September 2009 election campaign
- Wage freeze for public-sector employees earning over EUR2,000 a month
- The abolition of remuneration for committees in the public sector
- Major reduction in overtime in the public sector
- Public-sector recruitment freeze for 2010, expected to reduce public-sector numbers by 8,000 out of a total of about half a million
- Introduction of a 5:1 ratio of retirements/recruitments from 2011 in the public sector, which should reduce employee numbers by about 12,000 a year
- Ending car withdrawal incentives scheme
- Reduction in public-sector operations costs by 25%
- Reduction in the pension system state subsidy

*Revenue Measures (Permanent Nature Only)*

- Abolition of all special taxation rules; taxing of all incomes
- Restructuring of property and inheritance taxes
- Taxation of distributed profits according to scale and not retained profits at a considerably lower rate
- Tax increases on tobacco, alcohol, mobile phones and petrol
- Additional revenue for the Public Investment Programme from the EU Structural Funds
- A small reduction in tax evasion

**General Government Debt**




Source: Fitch

## Public Debt

Fitch believes the latest bout of fiscal slippage has elevated public debt to a new plane and set the public debt/GDP ratio on a course for around 130%. In the light of downside risks to medium-term growth, Fitch expects debt to rise to 120% in 2010 and 125% in 2011, leaving the public finances highly exposed to future shocks. One such shock will be population ageing which, in combination with a highly generous and unreformed pension system, will lead to one of the largest projected increases in age-related expenditure in the EU: 15% of GDP in 2010-2060.

Greece's public debt dynamics are not yet explosive: average debt maturities are still relatively long and the cost of borrowing has fallen in 2009 despite the recent increase in spreads forced upon the Greek government. However, it is notable that the key factor which contained the public debt ratio over the past decade was above-average growth of 4%. Fitch believes medium-term debt dynamics look poor: on reasonable assumptions about nominal growth and interest rates, a fiscal adjustment of 7%-8% of GDP would be necessary just to stabilise the public debt. This would imply a primary deficit close to zero compared with the projected deficit of 7.7% of GDP in 2009. Adjustments contained in the 2010 budget would amount to barely half of this needed adjustment, with 50% of this adjustment in turn attributable to temporary measures.

Furthermore, there is a long-standing practice of passing some items of expenditure (such as some defence procurement costs) not through the income and expenditure accounts, where they would be reflected in the (projected) deficit, but directly to public debt as stock/flow adjustments. The European Commission has calculated that in recent years these adjustments have accounted for 1%-2% of GDP. There is no evidence that this practice has been abandoned.

The government has yet to publish its medium-term outlook for the main fiscal indicators beyond a broad public commitment to reduce the general government deficit to 3% of GDP by 2013. Fitch presents two possible scenarios in the adjacent chart: Greece meets (assumed) targets under the EDP; and fiscal slippage reoccurs over the medium term. While the latter scenario is purely illustrative, it would not be out of line with past Greek experience.

**Fiscal Financing 2010**

| | EURbn |
|---|---|
| Central govt deficit | 23 |
| o/w: interest | 13 |
| | |
| Debt maturities | 31 |
| o/w: medium-/long-term | 21 |
| o/w: T-bills | 8 |
| o/w: commercial paper | 2 |
| **Total** | **54** |

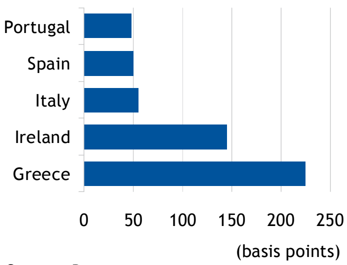
Source: Fitch, national authorities

## Fiscal Funding

Membership of the euro area has cut Greece's cost of borrowing and allowed it to extend its investor base (over 60% of public debt is held by non-residents). Greek debt managers have been adept at exploiting these advantages, extending average maturities to eight years. Because the authorities have resorted to increased short-term borrowing this year, reducing the weighted average maturity of new securities to 5.02 years from 10.96 years in 2008, the cost of borrowing has come down from 4.6% in 2008 to 4.1% in 2009 and borrowing for 2009 is complete.

Gross borrowing is forecast to decline a little to EUR54bn in 2010 (22.1% of projected GDP) from EUR66bn in 2009. However, in contrast to larger euro members, Greece lacks the fiscal flexibility that comes with a deep domestic capital market. With over 60% of public debt held by non-residents, fiscal slippage and concerns about public debt sustainability rapidly feed through to wider spreads and higher borrowing costs.

**Change in 10-year Gov. Bond Spreads over Bunds**
2008-2009




Source: Datastream

Greece matches up poorly to its 'BBB'-category peers on a range of fiscal parameters: general government debt maturities as a percentage of GDP (15%), debt to revenue (300%) and interest payments to revenue (15%) are all several multiples of 'BBB' medians. Weighing in the balance is euro area membership, which affords Greece a degree of comfort that no other 'BBB'-rated sovereign enjoys. Nonetheless, it is not an advantage that the Greek authorities can afford to treat lightly. In the absence of a much stronger policy commitment and consistent implementation, Greece could face rising debt service costs over the medium term and increased peer pressure from within the EU and EMU.

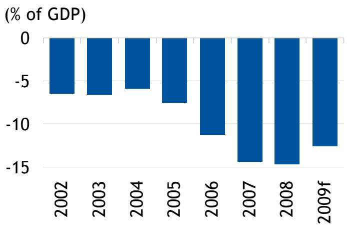
## EU and Euro Area

Greece is testing the patience of its fellow EU members. It has recorded a deficit within the rules (below 3% of GDP) only once since it joined the euro area. In particular, there are doubts that the EU will be prepared to support the new government's welfare aspirations or will look with favour on PASOK's timidity in the face of public-sector militancy. Governments increasingly faced with the need to make major expenditure cuts at home will lack sympathy with problems in Greece, which are seen as largely self-inflicted.

The European Commission has already formally concluded in its assessment of the Greek excessive deficit in 2009 that Greece has not taken effective action to prevent the strong deterioration in public finances this year. Like Fitch, it attributes this largely "to budgetary policies implemented by the Greek government", not to the downturn.

Fitch expects the Council of Ministers to exert growing pressure on Greece in 2010 within the context of its updated Stability and Growth Plan, impressing upon the Greek authorities the need for more specific deficit reducing actions than hitherto. The Commission has already indicated it is likely to advise that the bulk of these measures should involve permanent expenditure reductions and it will not accept temporary measures as sufficient. Failure to comply could mean fines for Greece and possibly other withdrawals of financial assistance.

Current Account Balance




Source: Fitch

## Other Rating Considerations

Greece's sovereign ratings remain supported by its high-income economy relative to rating peers and membership of the EU and EMU, which protects the economy from abrupt shifts in the balance of payments and currency pressures. Conversely, however, euro area membership denies Greece the ability to devalue to restore international competitiveness and address a gaping current account deficit, which remains a downside risk to medium-term growth prospects.

GDP growth has been supported by strong capital inflows in recent times and gross external debt has more than doubled since 2004 to over USD500bn (160% of GDP). Half of this increase has been accounted for by the rise in public external debt, underlining the close link between public sector and current account imbalances.

### Banks and the Economy

The position of the banking system in Greece is sounder than in some other EU countries and state support has been more limited, largely in the form of pre-emptive capital injections. Although the banks have faced increased pressure on profitability and asset quality in 2009 — as might be expected during the current international recession — liquidity is less of an immediate concern.

Greek banks are, however, challenged to reduce reliance on European Central Bank funding, which, despite having come down since H109, remains significant. The use of this facility is generally not aimed at funding loan growth. Loan/deposit ratios are acceptable and toxic assets are minimal, while Greek banks' holdings of government paper are less than 10% of their loans on average.

Greek banks will have to manage a more adverse operating environment not only in Greece but also in other foreign markets in which they operate, mainly in south-eastern European countries.

Regulation has been conservative and Greek banks boast sound Tier 1 capital ratios of close to 9%. Fitch does not consider that the systemically important banks will mount a major demand for further government financial support.