FOUNDATION FOR ECONOMIC & INDUSTRIAL RESEARCH

The Greek Economy

Quarterly Bulletin

03-2013

14 October 2013

Greek economy is nearing a stabilisation point

- Double deficits approach an equilibrium point
- Prices are falling
- Six-year contraction seems to be gradually coming to an end

The stabilisation of the economy should not be put in danger since it is the most important factor for any further improvement

Growth cannot be achieved through continuous deficits

- **The Greek society should accept adjustment to two basic prerequisites for consolidation:**
  - Consumption increase should follow productivity growth
  - The public sector should not spend money that it does not have
- **If the necessary structural reforms are not implemented with clarity, persistence and urgency then:**
  - Anemic growth rates
  - Low levels of productivity and income

Better overall macroeconomic performance of the Greek economy compared to expectations for Q2'13

- GDP is expected to increase during third quarter (partly due to positive developments in tourism)
- Some signs of weakening of the GDP growth rate in Q4'13
- **Recession is expected to stand at around 4% in 2013**
- **The scenario that the recession is most probably to end in 2014 is plausible**

Caution: There are significant uncertainties and pending issues that could lead either to weaker economic activity or to a positive surprise

Stabilisation and expectations’ recovery generate salutary effects for the economy

- Tourism holds a vital role in weakening the contraction
- Significant labour cost reduction
- Prices fall in a wide range of sectors
- Private consumption contracts at s rate smaller than expected during the second quarter

Stabilisation and gradual increase of the consumers’ spending are the necessary conditions for exiting recession

Reasons for concern

- Investment dynamics are extremely weak
- Further contraction of production leading to unemployment increase
- The positive trend in the external balance seems much weaker than expected

Strengthening outward entrepreneurship
→New investments
→Positive external balance of payments

Low level of investments is attributed to at least three reasons:

- Absence of favorable financing conditions

- Idle productive capital in many sectors

- Considerable uncertainty in:
  - ✓ Macroeconomic environment
  - ✓ Taxation
  - ✓ other policies

Improvement of the investment climate: The main condition for return to growth

Economic policy priorities:

• Gradual smoothing of the funding terms

• Containment of the reduction of the domestic private consumption

• Achievement of a more effective public investment programme for projects on the necessary basic infrastructure

• Boosting of structural reforms, especially of those that clarify the roles of the public sector, of the private sector and of households

Requirements:

- **Stable** and **simple** tax system
- Effective stamping out of **tax evasion** and **tax avoidance**
- Functional utilisation of new ICT technologies in the public services

Overall view

- **Adjustment achieved thus far under the bilateral risk of a disorderly Greek default and its contagion to other parts of the Euro area**

- Initial threat is fading and the stabilisation point is nearing. The Euro area and Greece are both liable for the fact that a reform momentum hasn’t been created

- **Economic crisis is a real opportunity to correct deep structural flaws that lead over time to low competitiveness and deficits**

- The Euro area policies should not only focus on the isolation and fiscal discipline of the least competitive and most indebted member-states

- **Properly and jointly designed additional broad-ranging programmes for funding reform and growth projects could be a mutually beneficial solution**

Quarterly Overview

Recovery signs in the Euro area

Q2 2013

- Recession slows down in the Euro area **(-0.5%),** positive rates compared to the first quarter **(+0.3%)** due to exports contribution
- Unemployment in EA17 contracted for the first time since 2012 to 11.9% (12.6% at Q1'13)
- Slightly accelerating growth for the **USA (1.6%),** due to the recovery of the housing sector and the continuous financial support by the monetary policy that compensated for State budget cuts
- Recovery in **Japan (0.9%)** following strengthened private demand, weakening of the yen currencies and expansionary monetary policy
- China slows down because of lower domestic demand for infrastructure and also of moderate demand from Europe

Uncertainties in the global economy

Mid term forecasting:

- **Global economy:** Slight deceleration of the GDP growth (**2.9%** compared to 3.2% in 2012)
  - Small growth acceleration in 2014 : 3.6%
- GDP growth slows down in the **USA (1.6%),** increases in **Japan (2.0%)**
- **Europe is facing recession in 2013 (-0.4% compared to -0.6% in 2012)**
  - Change of the economic trend in 2014: (+1% IMF forecasts)
- Revised forecast for **China: 7.6%**

Main risks:

- Possible disagreement in the upcoming negotiations in the USA on the issue of the debt ceiling
- Delays in government formation in Germany, leading to possible delays in the passing of the legislation for crucial issues for the Euro area (i.e. ECB policies for banks consolidation, debt sustainability in Euro area)

Current progress in domestic political and economic environment

- **Intensive public sector's restructuring through the mobility programme**
  - Necessary for the state rationalisation - yet delayed
  - Earlier initiation of the programme would have enabled its better preparation
- Boost in the tourism industry, high demand from abroad as expected. Can it substitute the losses from smaller domestic demand?
- **Completion of the systemic banks' recapitalisation**
- Negotiations with the troika for the fiscal measures of the final phase of the fiscal consolidation (2014 to 2016) and for ensuring the debt sustainability
- **Fiscal measures implementation continues (abolition of holiday allowances to civil servants- pensioners, higher tax liabilities)**

Recession slows down significantly in Q2'13

GDP contracts (Apr-Jun 2013): -**3.8**% to -5.6% in Q1'13 and -6.4% in Q2'13

➔The smallest decline since Q3 2010 that stemmed from:

- Smaller contraction of the **household consumption** (-6.3% from -8.7% at Q1), despite the 2013 fiscal measures implementation:
  - Stabilisation of the political and economic environment since end-2012 may have encouraged some expenses
  - Slight unemployment decline, for the first time since Q2'09
  - Statistical adjustments to GDP data(?), high negative GDP deflator
- **Improved results in the external sector: total exports** increase slightly against a weaker fall of **exports of services,** mainly because of tourism (-1.6% instead of -12.4% Q1). **Exports of goods** increase (+3.1% from +5.1%), mostly because of the booming oil demand
- **Further decline of the demand for imports**: -11.8% in Q2 from -7.7% in Q1.

Recession slows down significantly in Q2’13

− Lower cuts in public spending (-6.1% from -8.8% in Q1’13)

- The investment trend is negative (-15.2% from +8.5%). Limitation of the differences in the stocks’ formation relative to the same quartet the previous year.
    - Fixed capital formation kept falling at the same rate as in Q1’13 (approximately -11.0%)
- **Recession in the first half of 2013 was 4.7% against 6.6% in the same period of 2012**
- **High contraction of GDP at current prices (-6.6% at the first half compared to -6.8% a year ago)**

Fiscal targets achieved in the first eight months: central government's deficit decreases, mostly because of the fall of interest payments

- **State Budget Deficit**: €2.5 bn. for Jan.-Aug. (compared to €12.5 bn last year)
  - **Primary surplus** of €2.9 bn. (compared to a €1.4 bn deficit a year ago)

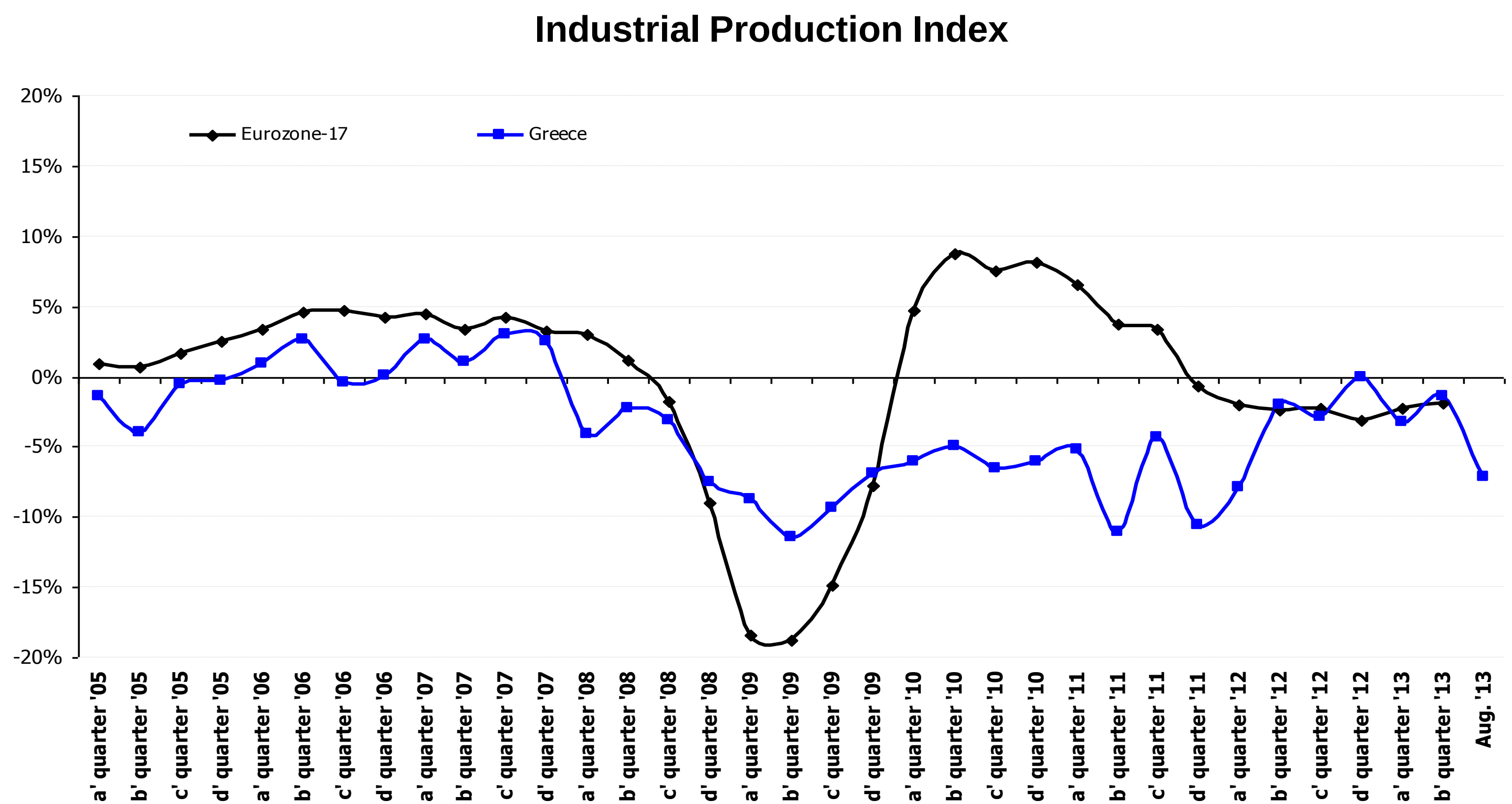
- The main sources of the deficit reduction were €5.7 bn **less interest payments** due to PSI, €2.4 bn less primary expenditure (salary-pensions cuts, social security costs) and €1.8 bn revenues increase
- **The revenue growth didn't come from tax revenues increase** (-10.6%), but from the higher Public Investment Programme inflows (€1.5 bn), from lower tax refunds (-€1.2 bn) and €2.2 bn inflows from ANFAs-SMPs.

Draft 2014 State Budget: General Government deficit to fall below 3% - it still remains unclear if additional fiscal measures will be needed

- General government deficit for 2013 (ESA-95): €4.3 bn or 2.4% of GDP, compared to the MTFS's 2013-2016 €7.9 bn target
- **Stabilisation of the deficit in 2014** (€4.4 bn or 2.4% GDP) ➔ not clear if the implementation of already taken measures will be extended (duration, tax base, etc) and/or new measures will be imposed

- **Limited reduction in General Government Debt: -€1.6 bn**. (from 175.5% GDP this year, to 174.5% for 2014)
  - The impact on debt from the current execution of the privatisation – concession programme, as well as from its 2014 goals of is not specified
  - High GDP contraction (calculated in current prices -6.6% in first half of 2013, compared to -6.8% the previous year while the annual target is -5.6%) hampering debt sustainability.

The contraction of the industrial production follows last year's rates…



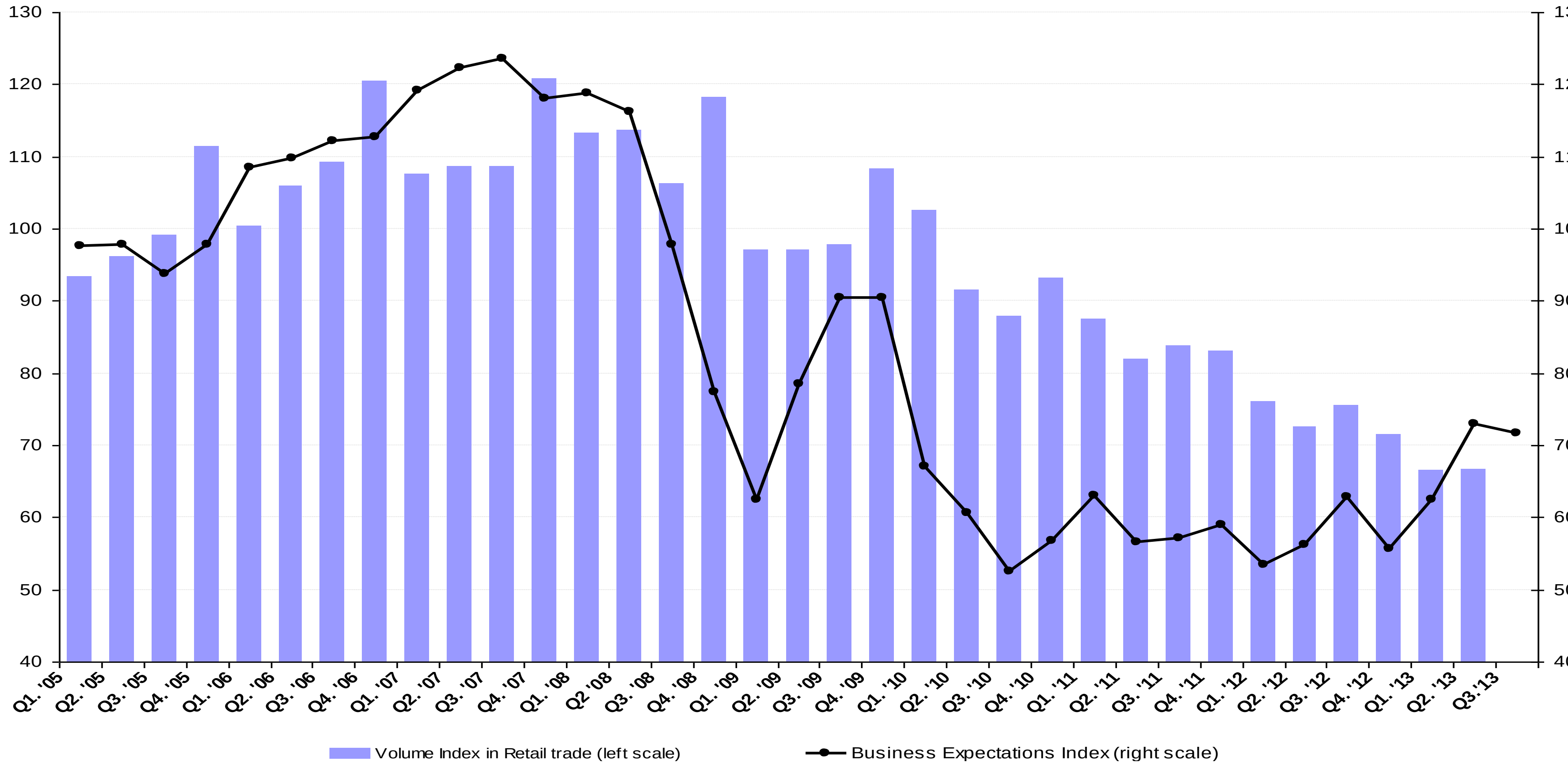
First quarter 2013: -3.8%

Jan.-Aug. 2012: -3.9%

Aug. 2013: -7.2% compared to +2.9% in Aug. 2012

- Mines-Quarrying: -9.7%
- Manufacturing: -0.8%
- Electric energy production: -13.3%

…The volume index in retail trade declines at the same rate as last year, despite improvement in the sector's business sentiment

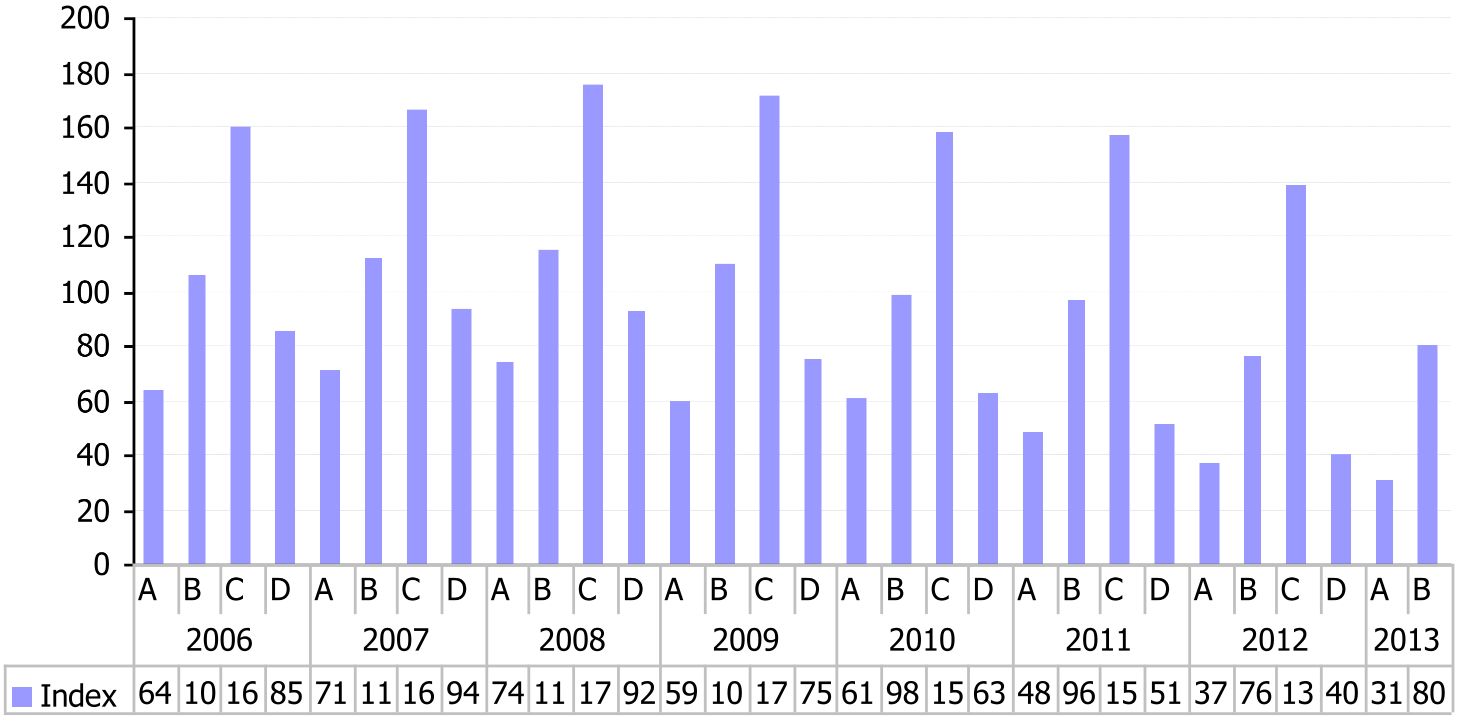


Historically low levels:
Jan.-July 2013: -11.0%
Jan.-July 2012: -11.8%

Overall Index has dropped 34% from its 2005 level

Turnover declined further in most of the Services' constituent subsectors during the first half of 2013, however to a significantly smaller extent than in 2012

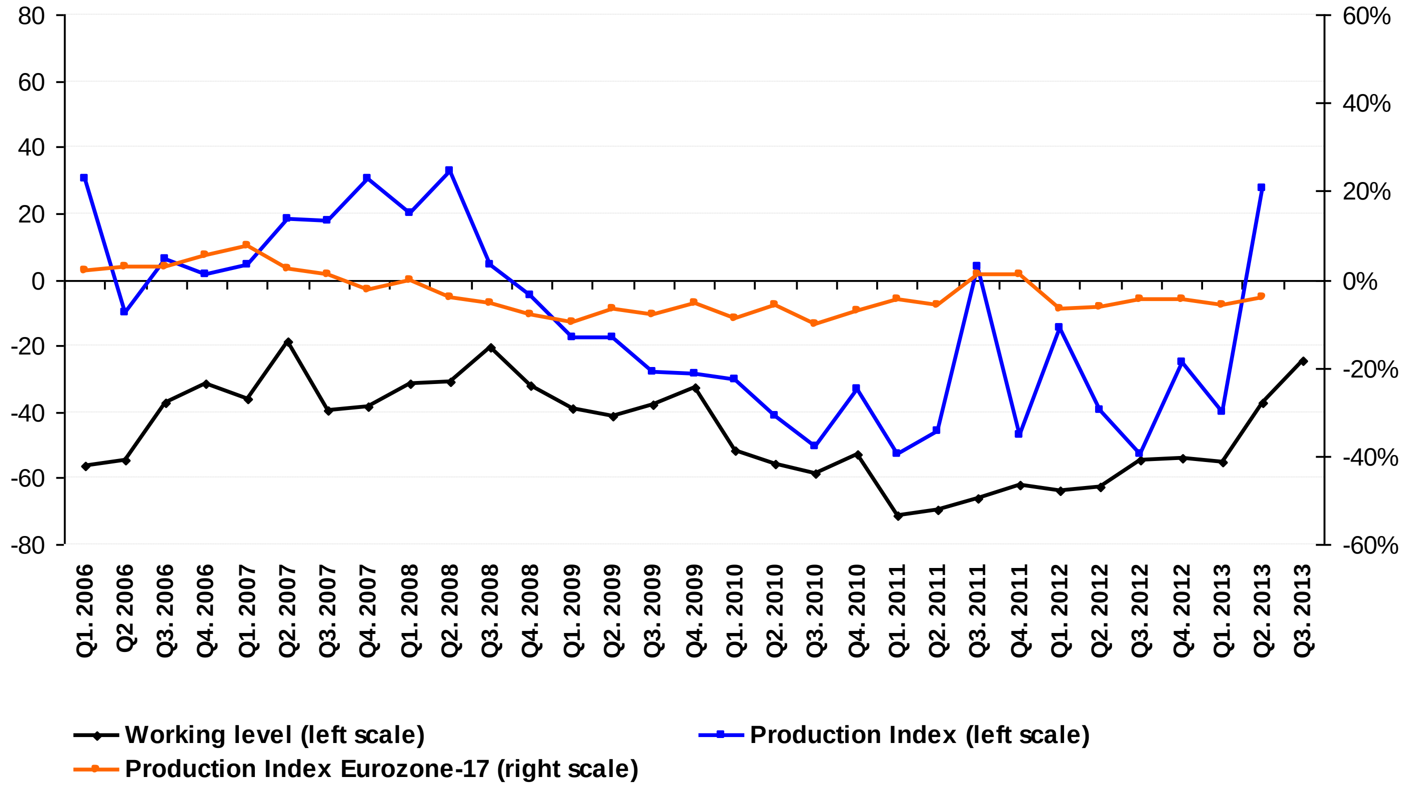
Turnover index in tourism
(accommodation and food service activities)



First half of 2013: -1.9%
First half of 2012: -21.9%

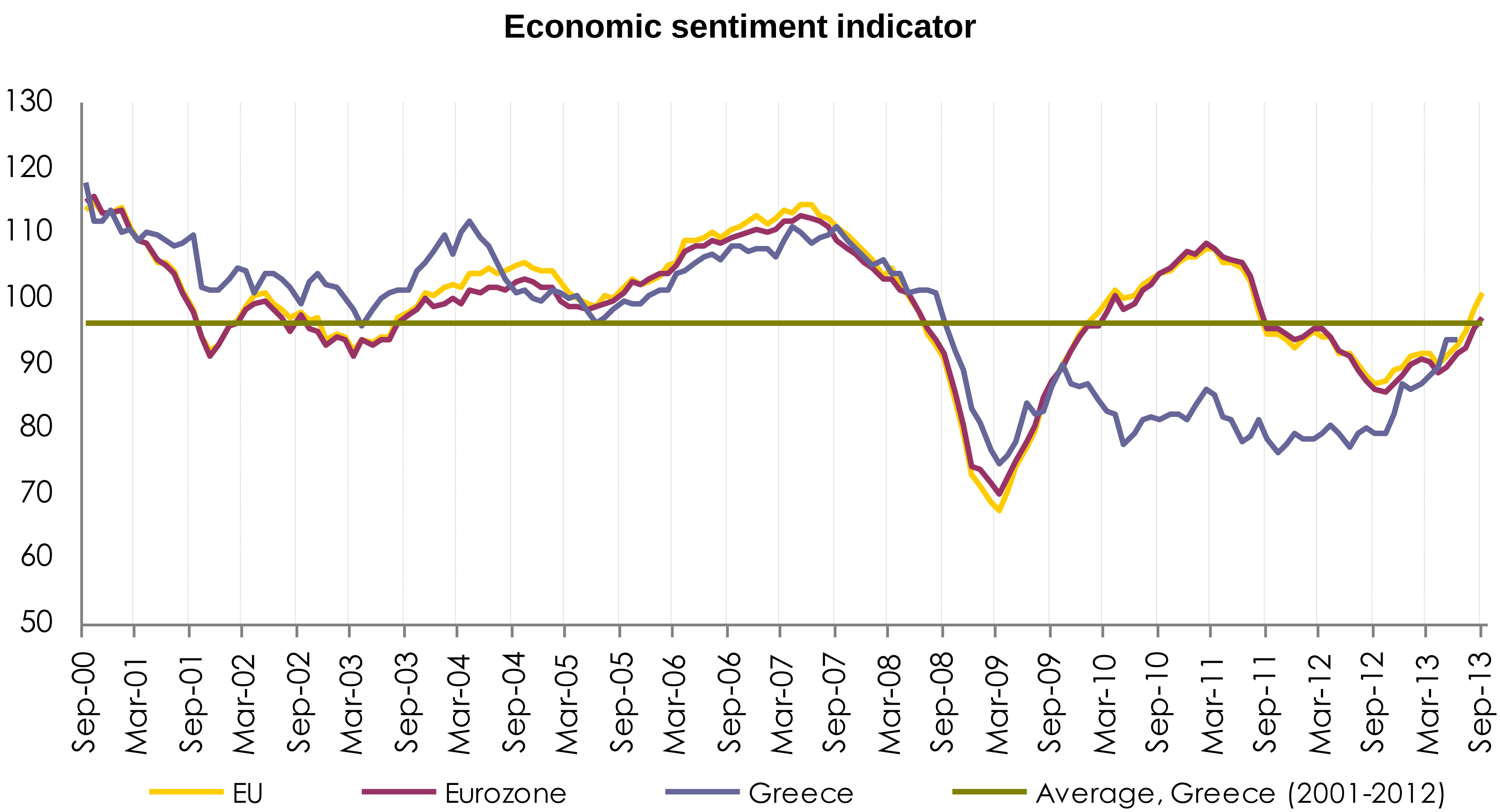
Construction output index exhibits a slower drop during Q1'13 - 65% overall reduction compared to 2005

Construction Production Index (annual % changes) in Greece and the Euro area-17 Business Level Index in Greece (1996-2006=100)



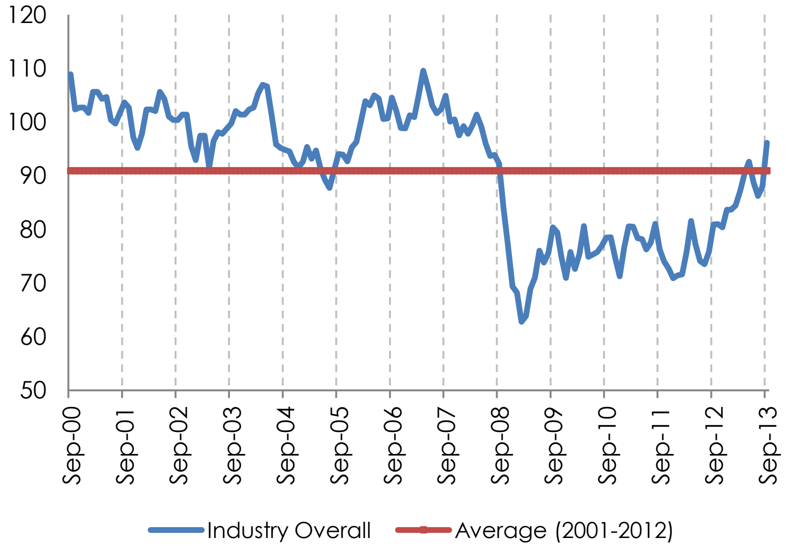
First half of 2013: -5.2%
First half of 2012: -26.9%

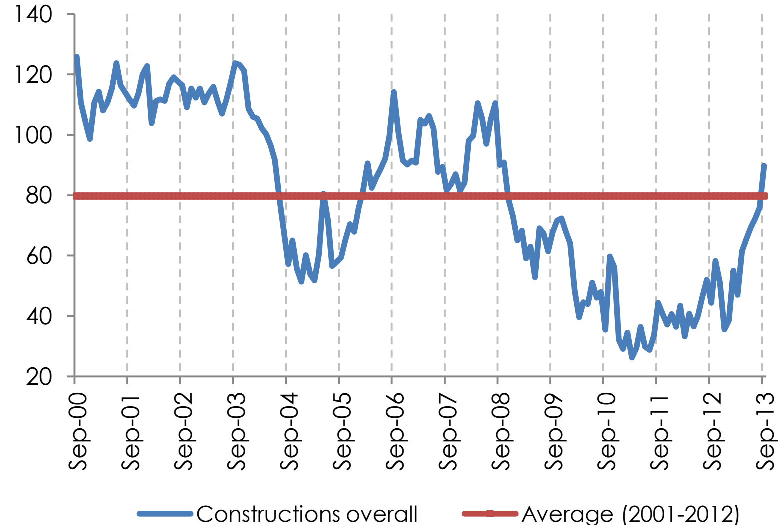
Economic sentiment improves, despite the summer's correction

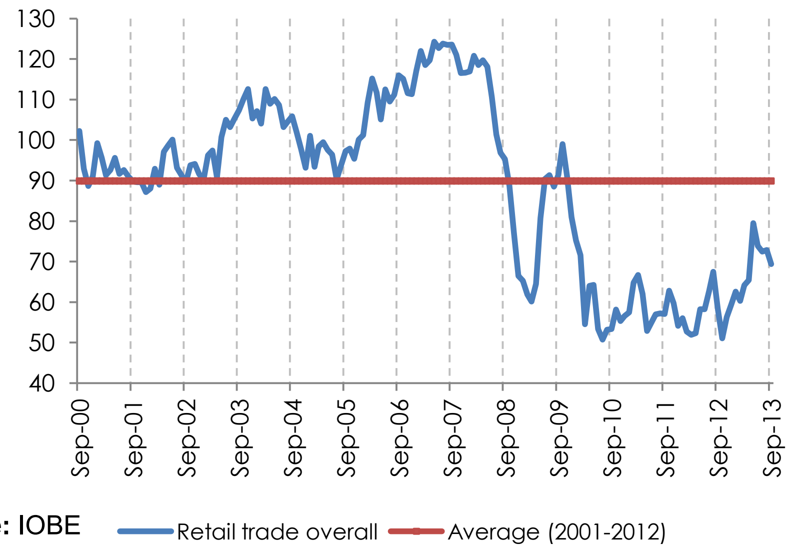


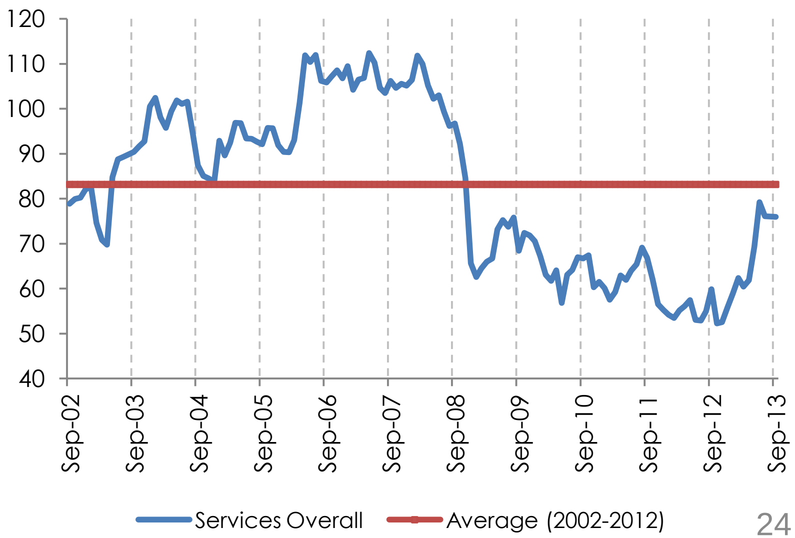
Source: IOBE, European Commission

Smoothing of pessimism in all sectors



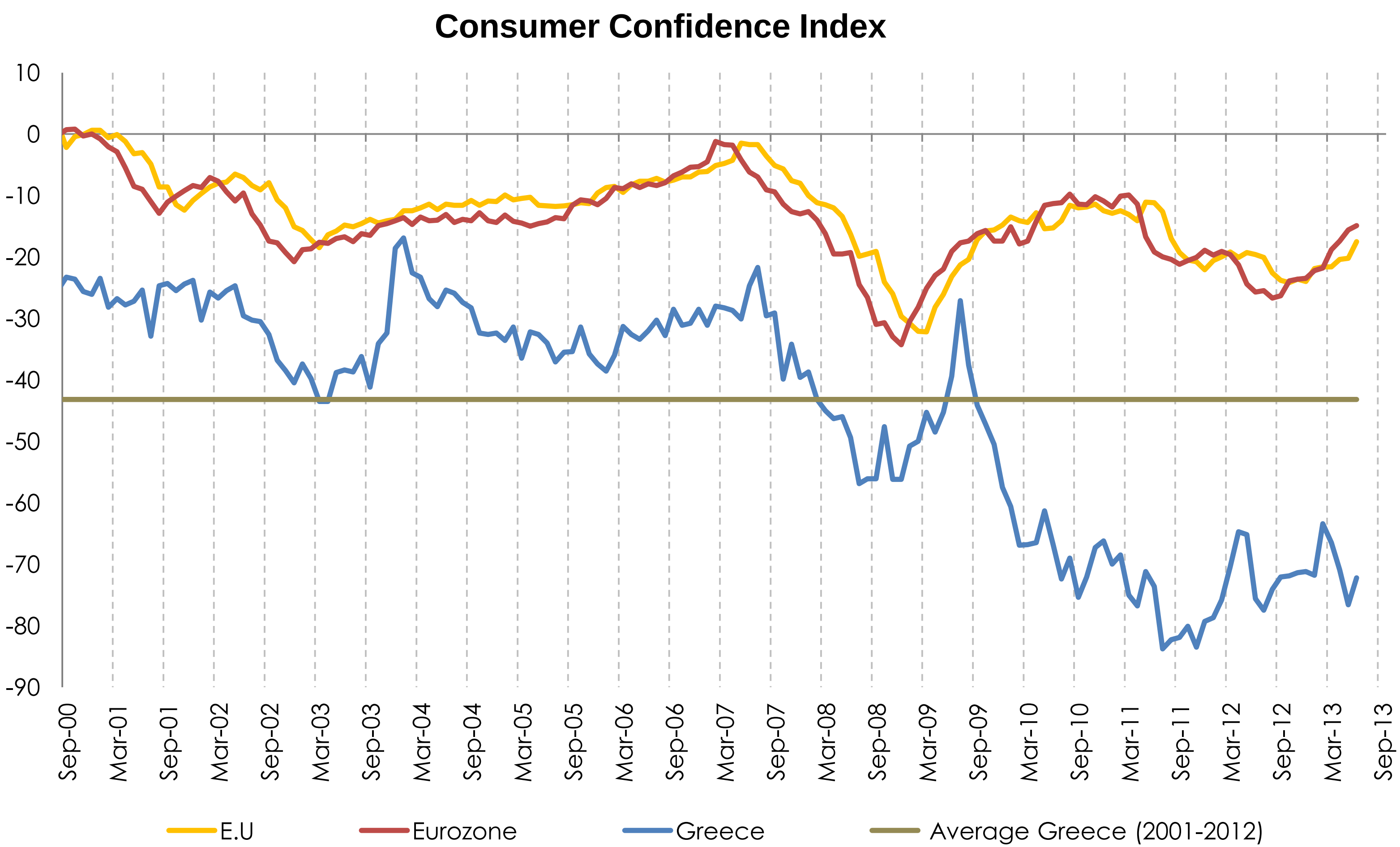






Source: IOBE

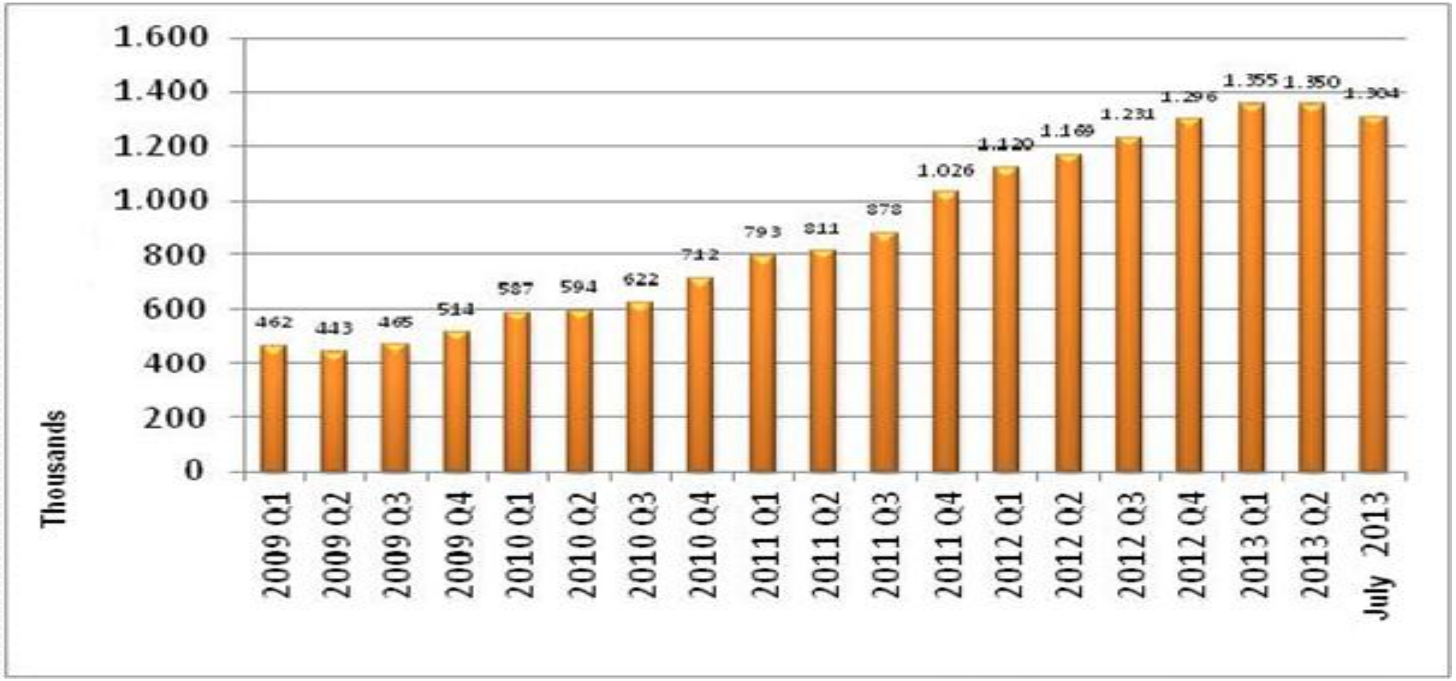
Consumer Confidence index remains unstable: fear of unemployment dominates



Source: IOBE, European Commission

Number of unemployed stabilised for the first time since Q2'09

Unemployed in Greece

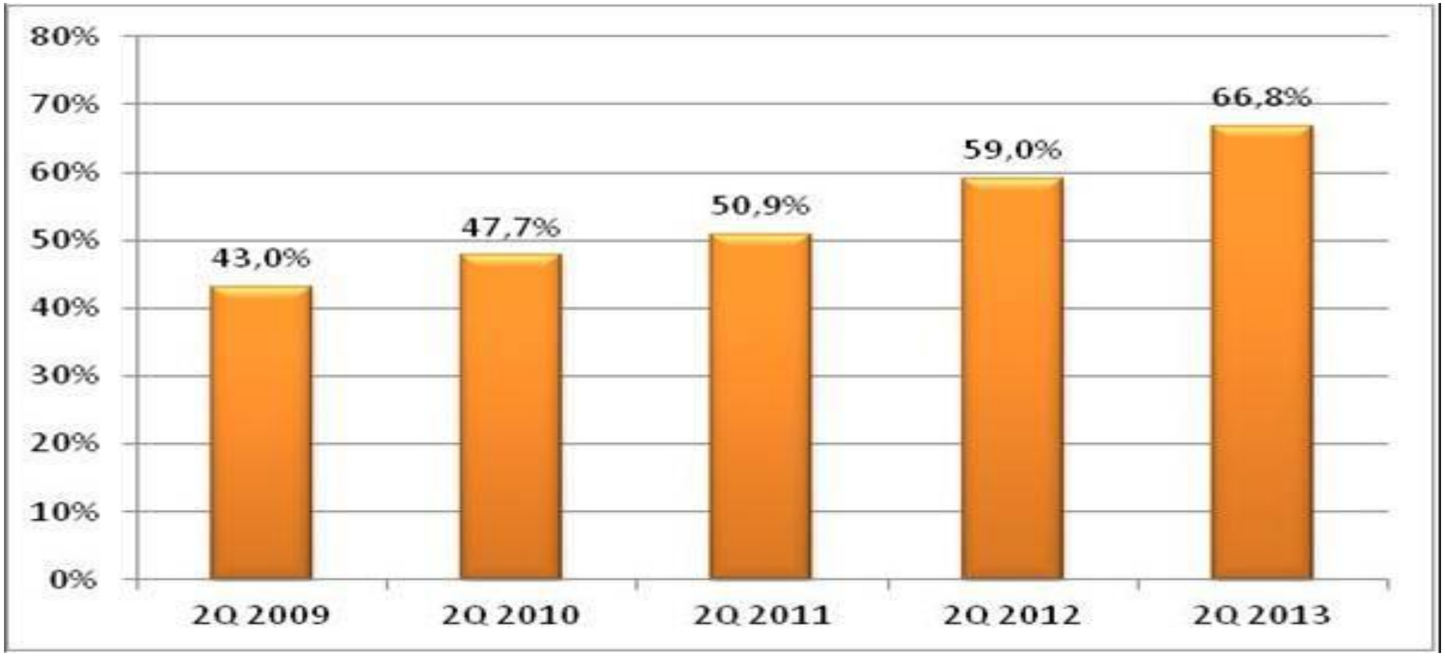


Source: ELSTAT

- Q2'13: Unemployment at 27.1% (compared to 27.4% Q1'13)
- Former employed persons shift to the non active population
- Employment rises at: Public administration/defense forces (+3.0%), Media & communications (+9.1%), Water supply (+17.2%), Mining and quarrying (+7.8%), Electricity and natural gas (5.8%)
- <u>On the other hand, employment in the tourism industry contracted by 3.6% (Q2'13)</u>

Long term unemployment remains a crucial issue

Long-term unemployed as % of the unemployed

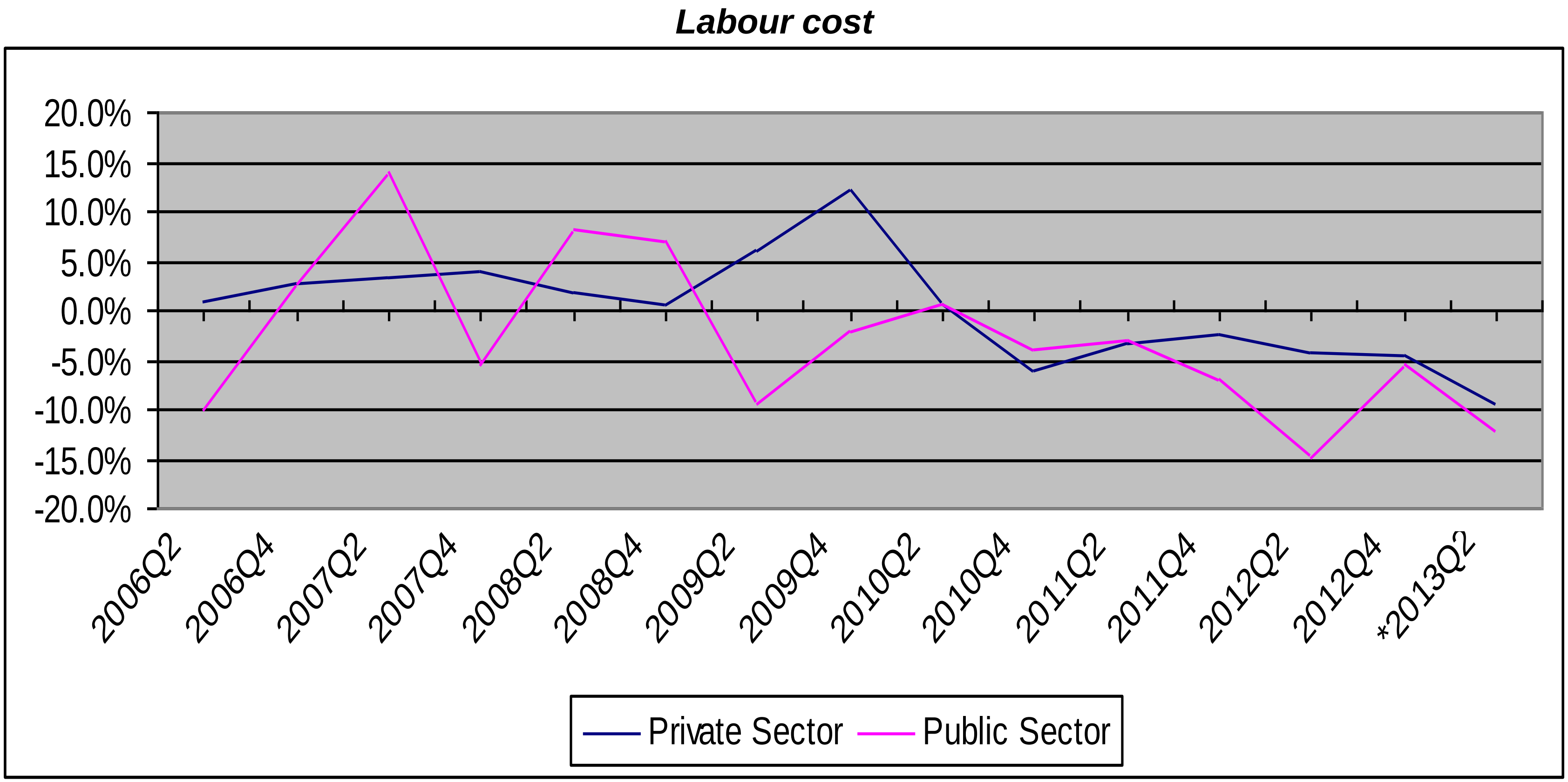


Source: ELSTAT

➢Long term unemployment (>12 months) in Q2'13 (903 thousand people) exhibits a four-fold increase compared to Q2'09 (190 thousand people)

➢ Two out of three unemployed is out of the labour market for more than 12 months

Significant reduction of the labour cost in both private-public sector



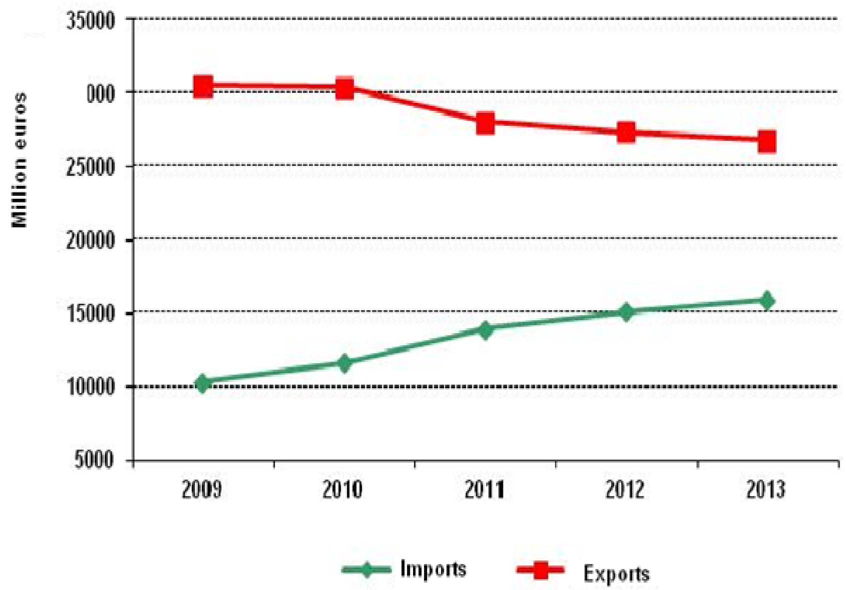
Sources: Eurostat, ELSTAT
(*) Provisional data

Since 2010, the labour cost decreased by 24.1% and 27.6% in the private and public sector respectively

Significant contraction of the trade deficit during the first seven months of 2013

- **Exports**: +6.1 % in Jan.-July 2013 (**€16 bn.**, incl. fuels).
- **Imports**: -5.4% (€26.8 bn).
- **Trade deficit**: -18.4%.

Imports and exports value for Jan.-July



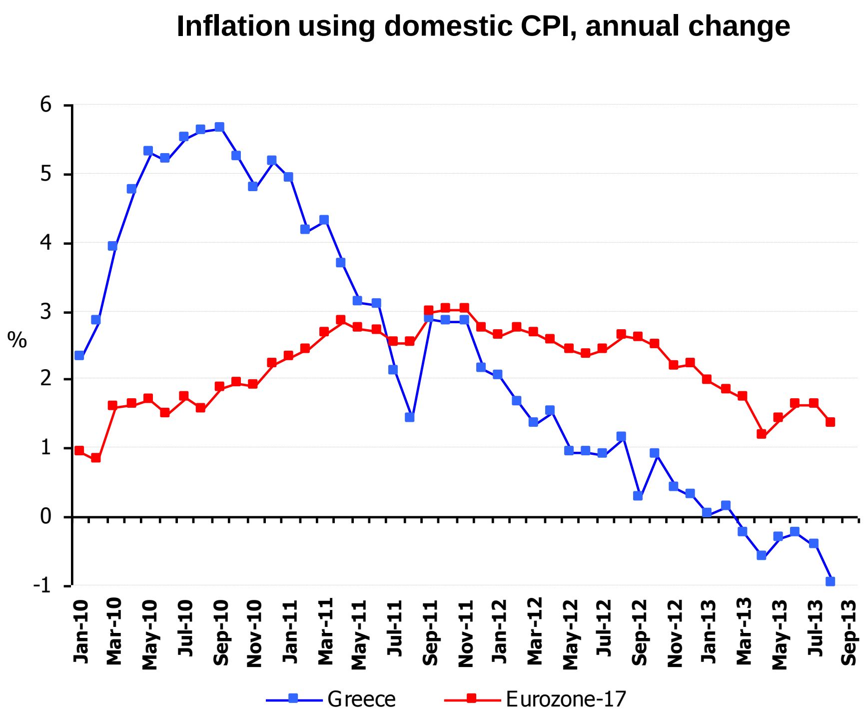
Increased exports of **“agricultural goods” (+10%) and “fuels” (+22%)**

However, decline in “Raw materials” (-19%) and “Industrial Products” (-5.5%)

Markets:
Losses in the Balkans (-5.2%), Cyprus (-23%), USA (-4%) and Russia (-11.4%) but China (+16.6%).
EU15 **grows**(+10.3%)
Significant increase in Turkey (+31%), Croatia (+72.1%)

Greece: Lowest inflation rate in the Euro area, historically low CPI

- CPI: Jan- Sept 2013: **-0.5%** compared to 1.6% for the same period of 2012.



Core Inflation: -1.5%

<u>Deflation</u>: Communications (-4.7%)

Durable goods and education (-4%)
Health (-3.7%)

Leisure (-3%)

Other goods (-3.5%)

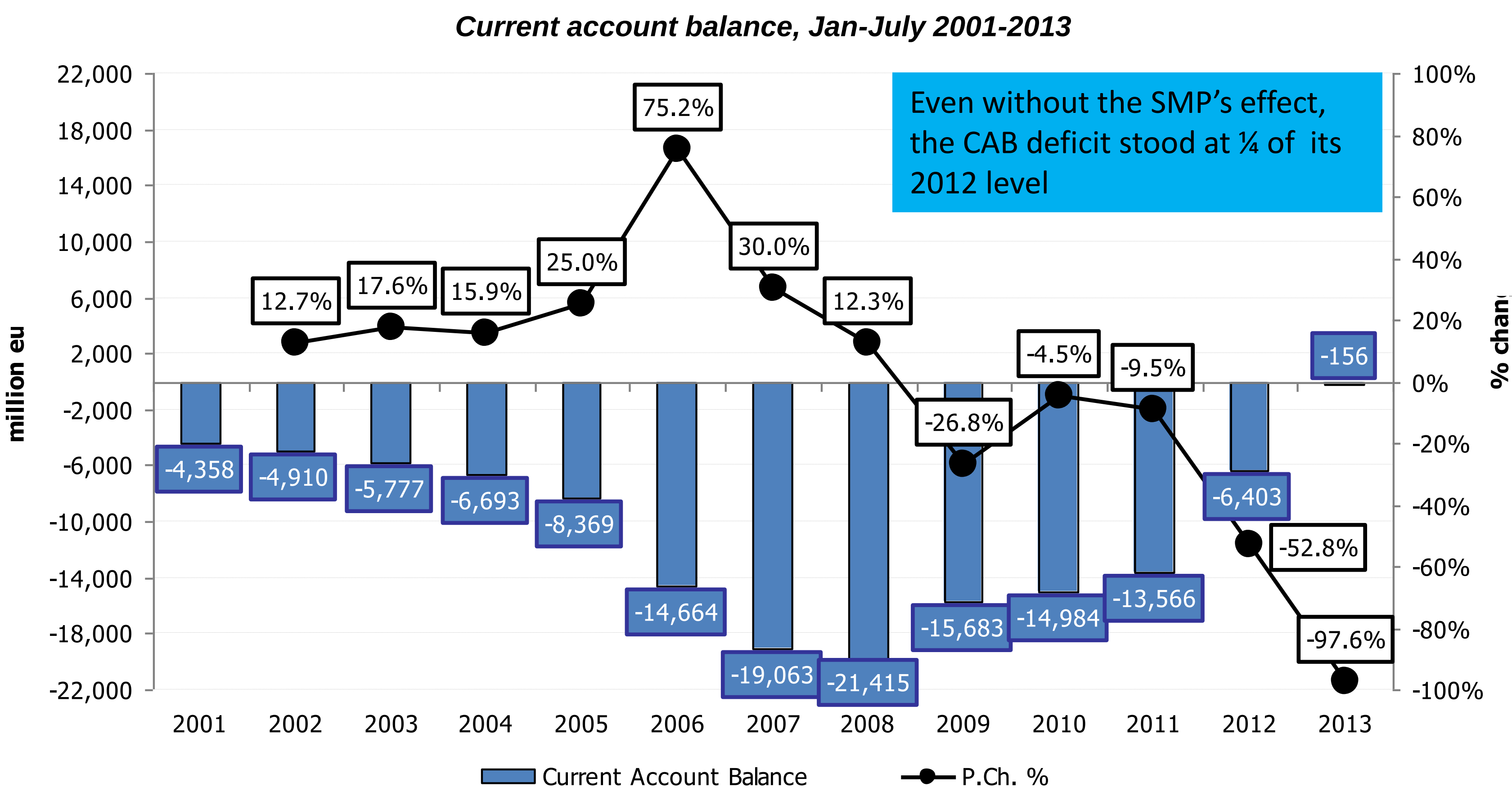
Hotels (-1.8%)

<u>Domestic market index</u>:

-0.6% (Jan-Aug 2013) instead of +5.7% (Jan-Aug 2012)

IOBE forecast for 2013: -0.6%

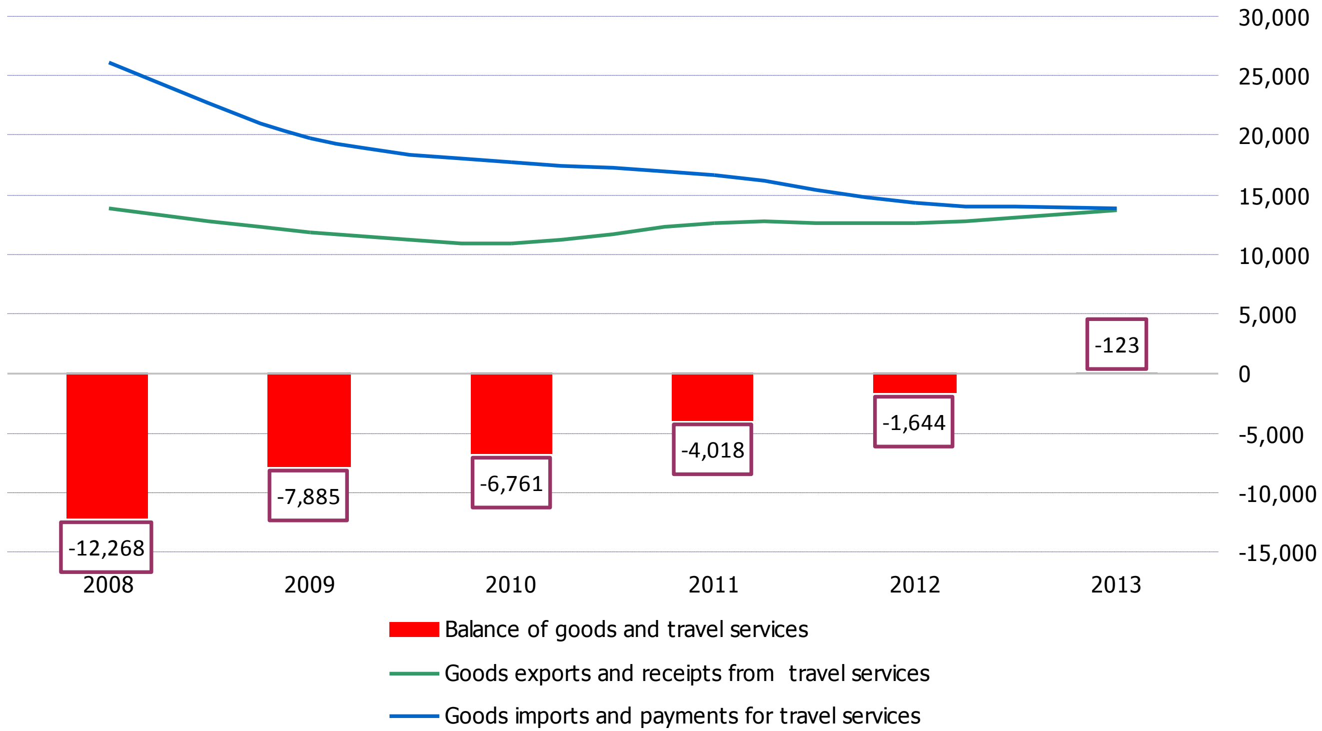
Current account deficit almost disappears* in Jan-July 2013



* Mainly as a result of the 1st installment payback of SMPs by the ECB (€1.5 bn)

The trade account of goods (excluding fuels and ships) & tourism improves between 2008-2013

Balance of goods (without fuel and ships) & tourism 2001-2013 (Jan.-July)



However, it is the imports decrease that led to the deficit improvement

Mid-term developments

- **Public sector mobility programme continues**
  - 2013 commitment : 25.000 public workers on mobility, 4.000 planned redundancies
  - HVI (ELBO), (HDS) EAS ,LARCO restructuring
  - Privatisations are falling behind the initial time schedule
- **Negotiations with troika to be completed**
  - Fiscal policy measures for 2014-2016 to be finalised. Part of the fiscal gap will be covered by:
    - Time extension of existing measures (ex. the social solidarity tax which ends at 2014) and/or
    - Broadening of their application (ex. Real estate property taxes).
  - Ensuring debt sustainability: Since Greece implements its fiscal commitments, our partners have to fulfill their decisions (Eurogroup, 26/11/12)
    - Sustainability has to be evaluated not only by the achievement of a target level but also by taking under consideration the debt trend
    - Low privatisation levels have a negative impact on the debt refinancing
    - High GDP contraction generates great momentum, difficult to overcome

German government formation complicates the decision making process regarding the funding continuation in Greece and Portugal.

Medium-term developments

- Low market liquidity until banks' capital adequacy is confirmed (December's stress tests)
- Fiscal measures – reforms in the labour market put high pressures on the household incomes
  - Lots of tax obligations until the end of year
  - Contraction in the demand, resulting from the abolition of the Christmas benefits for public workers and pensioners

- On the other hand, the external sector (mainly tourism) exhibits some positive results
  - Tourist season extended, but with limited effects on employment
  - Bigger income generation in the islands and other destinations of high international attraction➔strengthening of demand and production in these areas through the winter time

- Higher seasonal employment during Q3'13, not only in the tourism industry but also in the public sector

2013 forecasts

- Household consumption keeps contracting: ~-7.2% throughout the year
  - Fiscal measures, accumulated tax payments, structural changes in the labour market and public sector
  - Limited support from seasonal employment and MEO (Manpower Employment Organisation) programmes
- Structural changes in the public sector: public consumption cuts.
  - Artificial weakening of the contraction in the third quarter, due to base effects (strong contraction in the third quarter of 2012). Nevertheless, -6.0% overall in the current year.
- Investment expenditure contract further (~-9%)
  - Despite the public investment programme's acceleration during the last four months of 2013, privatisations proceed slower than expected.
  - Foreign interest for investment seems positive, yet lacks in implementation
  - Domestic demand will keep moving downwards
  - Global demand lower than the previous year, except from certain products (agricultural, etc)
  - Liquidity remains hard until stress tests are completed
  - Decline of the stock building during this semester

2013 forecasts

External sector

- **Enhancement mainly due to tourism industry: exports increase slightly by ~+1.5%**
  - Moderate increase of the exports will continue, fed mainly by fuels ➔ Demand from Europe strengthens as recession backs down, flows to China are increasing, but not for flows towards the S.E. Asia
- **Significant contraction of imports,** as a result of the descending demand **(~-11.0%)**
- **The external sector deficit shrinks to c. 3% of GDP, compared to 7% last year**

Taking into consideration the most recent trends in the GDP components, the recession will reach 4.1-4.2% for 2013

2013 forecasts

- o Unemployment will rise again during Q4, as a result of the end of seasonal employment, anaemic demand, limited investment and public sector restructuring
- o Counterbalancing effects from the MEO (OAED) programs.

o <u>IOBE' s forecasting for 2013 unemployment: 27.5%</u>

- The declining demand will lead to lower prices ➔ deflation will reach top levels
  - o VAT reduction in food services led to price contraction in Hotels-coffee shops-restaurants during August-September (-3,0%) → however it is not as extensive as expected (~-5.0 to -8.0%)
  - o The prices fall will be less pronounced in case the ticket prices of the Athens Urban Transport Organization (OASA) increase

o <u>As a result, **deflation** is expected to reach -0.6% levels during 2013.</u>

IOBE STUDY
ECONOMIC IMPACT OF RELOCATING MARKET COST EMISSIONS ON CO2 IN ELECTRICITY PRICES FOR THE SECTORS AT RISK OF CARBON LEAKAGE

- Since 01/01/13 power producing companies in the EU are obliged to buy all CO_2 emission rights corresponding to their production
  - Additional cost affecting wholesale price
  - Usually this cost is inserted on electricity bills, overloading end users (indirect emission costs)
- But the rising cost of electricity affects the competitiveness of industries and businesses, especially of those which:
  - Electrical energy is an important component of their production cost and
  - Operate in markets with intense competition from third world companies that do not have to bare the emissions' cost
- Those companies are exposed to the risk of "carbon leakage": Increased likelihood of being unable to cope with the deterioration of competitiveness and thus either stop operation or relocate to countries which do not impose such a cost.

The present study will be available at www.iobe.gr within a few days.

Background and purpose of the study

- EU recogniSed the potential danger (Directive 2009/29/EC) and:
  - Provided temporary measures (financial support) to compensate for the hike in electricity prices from incorporating the emission costs
  - Published specific guidelines on the implementation and the compatibility of measures with the public assistance and also identified eligible sectors that can be supported through partial financing of the additional cost until 2020.
- These measures however, are of voluntary nature and their implementation is left to the discretion of each Member State.
- So far, Greece has not drafted such a plan, despite the fact that energy costs for the domestic enterprises have increased notably (while the “carbon footprint” of electricity generation has remained significant), thus greatly undermining their competitiveness.

Purpose of the study

1. **Quantification of the impact on the Greek economy from passing the additional cost of carbon emission rights to electricity prices**
2. **Proposal for a compensatory mechanism**

Increased risk of "carbon leakage" due to indirect emission costs to businesses of certain economic sectors

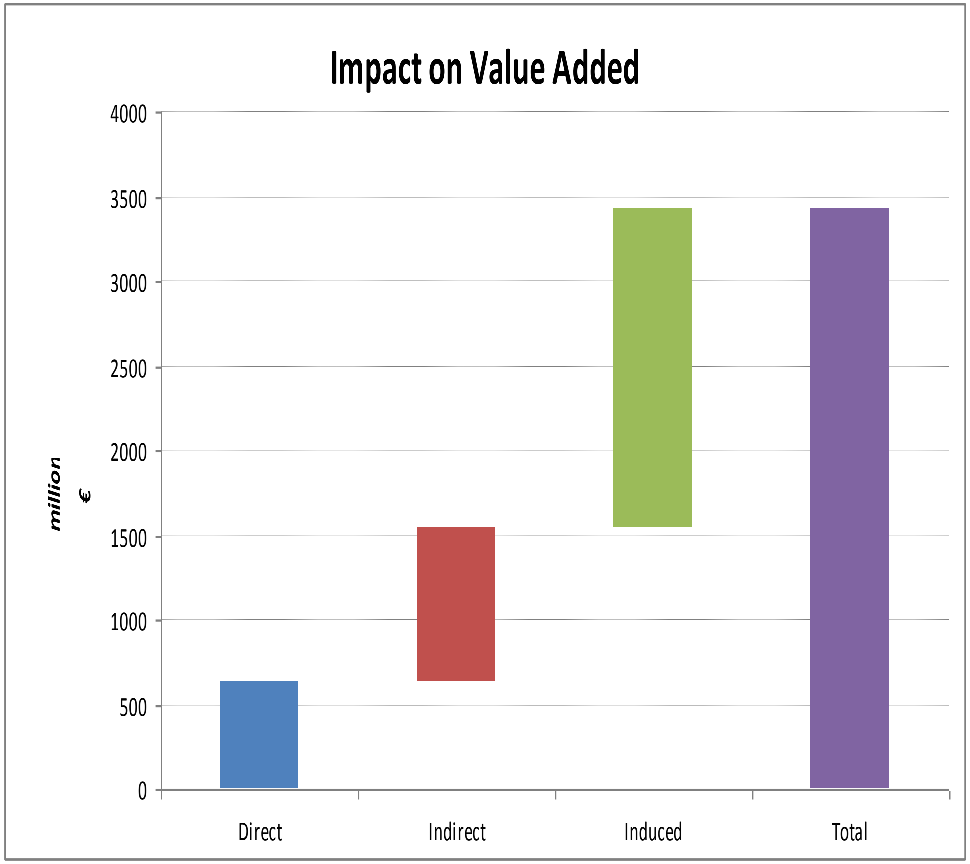
	Nace 2	Description
1	2442	Aluminum production
2	891	Mining of chemical and fertiliser minerals
3	2013	Manufacture of other inorganic basic chemicals
4	1411	Manufacture of leather clothes
5	2410	Manufacture of basic iron and steel and of ferro-alloys
6	1712	Manufacture of paper and paperboard
7	2015	Manufacture of fertilisers and nitrogen compounds
8	2444	Copper production
9	2014	Manufacture of other organic basic chemicals
10	1310	Preparation and spinning of textile fibres
11	2060	Manufacture of man-made fibres
12	710	Mining of iron ores
13	2016	Manufacture of plastics in primary forms
14	2443	Lead, zinc and tin production
15	1711	Manufacture of pulp

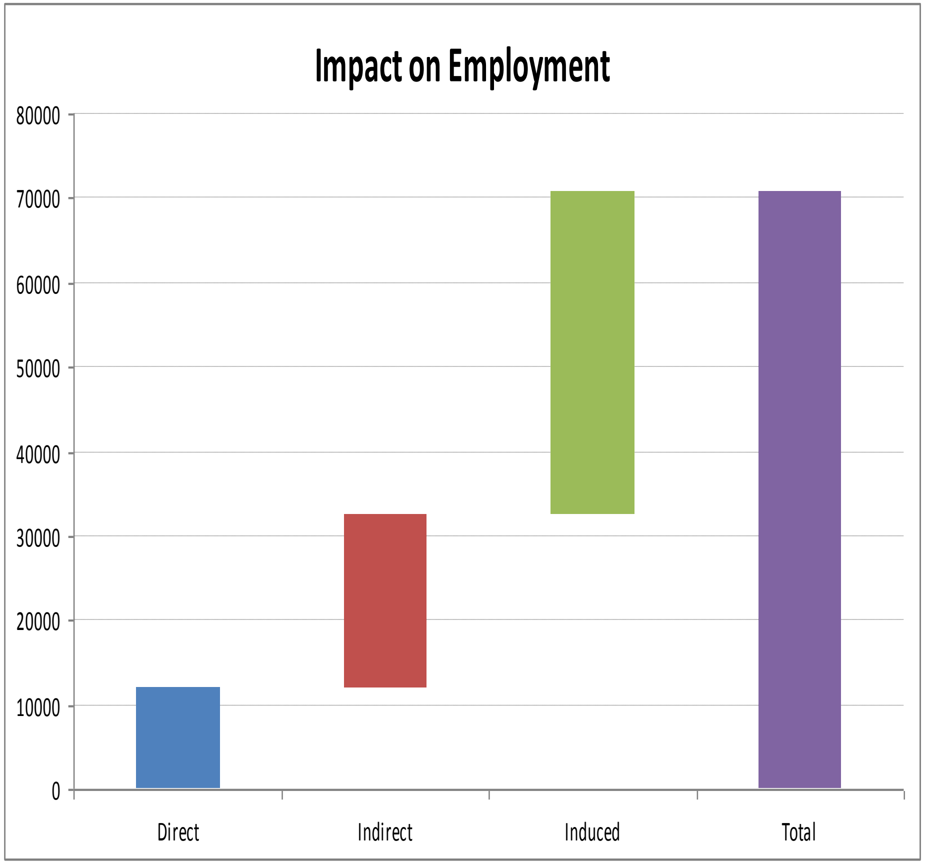
Source: European commission , C(2012) 3230 final

A sector or subsector is considered as exposed to a significant risk of carbon leakage due to indirect emissions cost when:

- The indirect additional cost due to the implementation of the ETS scheme leads to a significant increase in production costs as a percentage of the gross value added (at least 5%)
- The intensity of transactions with non –EU countries (imports and exports) excecountries (imports and exports) exceeds 10%.

Important sectors of the Greek economy mainly because of their linkages with other sectors of the economy, but also because of their productive base





These sectors have high multipliers - each job position and each unit of value added is linked to 6 job positions and 5,5 units of value added in the Greek economy

“Carbon leakage” has important implications for the Greek economy

	Scenario 5€/tCO_2	**Scenario 15€/tCO_2**	**Scenario 25€/tCO_2**
Gross production value	-218	-654	-1.091
Added value	-95	-284	-474
GDP	-100	-300	-501
Work income	-29	-88	-146
Taxes and contributions	-15	-45	-75
Indirect cost of CO_2 privileges	16	47	78
Net exports	-17	-52	-87
Employment	-1.921	-5.764	-9.607

Today: emission right is around 5 € / tCO2

The negative impact can be limited significantly by supporting exposed industries without violating EU rules, through a low cost but high impact intervention

- Difference between indirect cost emissions and losses of tax revenues: less than €2.5 million even in the high price rights (€ 25/tCO2).
- Taking into consideration possible significant losses from bankruptcies, the net result of a compensation mechanism of the indirect emission costs may be positive even in fiscal terms.
- Other countries are already using corresponding support mechanisms (Germany, United Kingdom, Norway)
- Compensation: free distribution of rights to be auctioned by the Greek State.
- The amount of compensation must be set at levels defined by the EU guidelines.
  - In this way, losses for the economy will be minimised, without eliminating the incentive to adapt those production processes that help to achieve the maximum possible reduction of greenhouse gas emissions.

The compensation mechanism must be set as a target in our authorities' direct strategic priorities portfolio, of the same importance as attracting new foreign investment