Greece: Staff Concluding Statement of the 2021 Article IV Consultation Mission

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Mission Concluding Statement

June 2, 2021

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC: *The IMF mission wishes to express its condolences and solidarity with the people of Greece who have been impacted by the pandemic and to recognize the effort made by workers at the frontline of the pandemic, in healthcare and other essential sectors.*

1. The government's response to the pandemic was swift and proactive. Greece entered the pandemic with an unfinished recovery, but the country has demonstrated resilience in facing COVID-19. The economy contracted by 8.2 percent in 2020, better than expected given Greece's high dependence on tourism and pre-existing vulnerabilities. The government provided among the largest on-budget fiscal stimuli in the euro zone, which prevented a spike in corporate distress and kept workers attached to the labor market although young and part-time workers experienced a sharp drop in employment. Supervisory and ECB accommodation shielded the banking sector and kept financial conditions highly supportive.

2. The economy is expected to rebound in 2021-22. Investment through Next Generation EU (NGEU) grant funding, pent-up consumption funded by deposit drawdown, and tourism resumption are expected to be the main drivers of the recovery, with growth projected at 3.3 percent this year, accelerating to 5.4 percent in 2022. The permanent output loss from the pandemic ("scarring") is projected to reach 3 percent, suggesting policy efforts should focus on facilitating both debt workouts and resource reallocation.

3. Substantial uncertainties and downside risks continue to cloud the outlook. While full vaccination is progressing at a rate above the European average, a more prolonged pandemic would add significant downside risks to all sectors of the economy. Further, the uncertain extent of pandemic-related Non-Performing Exposures (NPEs) could affect banks' securitization plans and curb credit growth. Other risks include weaker-than-anticipated absorption of NGEU funding, while on the external side, key risks include a reversal of global accommodative financial conditions and the manifestation of geopolitical risks.

4. Upside risks to growth stem primarily from full execution of the authorities' Recovery and Resilience Fund's (RRF) plans. The strategy could unlock synergies that would address multiple challenges. Higher investment, economies of scale from greater firm size, and increased export orientation would keep the current account deficit in check and together with the RRFs structural reform agenda raise productivity growth, move the country to investment grade, and anchor long-term debt sustainability. The expansion of output, lower tax rates, and digitalization would widen the tax base and avoid cliff effects when NGEU funding dries up. Increased lending opportunities would support interest margins and declining NPE ratios would allow banks to improve the quality of bank capital organically. While such a virtuous cycle cannot be ruled out, in the mission's view it is subject to significant execution risks.

5. Public debt levels are projected to decline over the medium term, and gross financing needs and IMF repayment capacity remain adequate under a variety of downside risks. Following a spike in 2020, Greece's public debt is projected to peak in 2021 and decline gradually over the medium-term, albeit remaining at higher levels than forecast before the pandemic. Greece's public debt remains sustainable over the medium-term, predicated on the negative interest rate-growth differential and a gradual return to primary surpluses. The government's large cash buffer and active liability management further mitigate refinancing risks, while Greece's ability to service its debt under a severe shock depends on continued regional support.

6. Uncertainty is too high to reach a definitive assessment on long-term debt sustainability. While a feasible set of policies and interest rate trajectories could deliver sustainable debt dynamics over the long-term, alternative scenarios suggest that the uncertainty about the long-term neutral rate and risk premia is too high to reach a firm conclusion. This marks a departure from staff's previous long-term DSA, published in 2018, which also acknowledged large uncertainty, but nonetheless concluded that public debt sustainability was not assured under a realistic set of macro-fiscal assumptions. While concerns about Greece's capacity to sustain high primary surplus targets have deepened in light of the pandemic and uncertainty about the potential growth path remains, these are more than offset by the significant decline in the risk-free rate and the very sharp compression of Greek bond spreads. This yields compression started before the pandemic and continued following the roll-out of Europe-wide economic and financial support packages. However, uncertainty whether sufficiently low market rates can be maintained in the future amid an unprecedented transition from official to market funding is the key factor behind the mission's updated assessment.

7. Policy discussions focused on preventing economic scarring and nurturing an inclusive recovery by bridging the transition from lifelines to investment financed by NGEU funds . The mission emphasized that the near-term focus should be on health outcomes and that medium-term fiscal sustainability objectives should not be achieved at the expense of growth, especially considering the impact of two crises on youth experiencing high unemployment rates. Any materialization of downside risks should be accommodated through automatic stabilizers as well as further targeted support if warranted. In tandem, the authorities should step up structural and financial sector reforms prioritizing those that encourage the swift, sustainable reallocation of capital and labor and inclusive growth.

8. The mission offered qualified support for maintaining fiscal accommodation in 2022. Pandemic-related measures imply a primary deficit of around 7¼ percent of GDP in 2021 with much of the support frontloaded ahead of NGEU disbursements in line with previous staff recommendations. While the headline primary deficit for 2022 is expected to recover to 1 percent of GDP, the underlying fiscal stance, excluding temporary COVID-19 measures, remains expansionary by about 2 percent of GDP. From a cyclical perspective, the case for further stimulus is weak given the rapid closing of the output gap under the baseline, but it could help reduce scarring risks and support job creation which is expected to lag the output recovery provided the stimulus is properly spent.

9. The authorities should use the additional support to initiate a durable improvement in the fiscal policy mix. The reductions in the corporate income tax (CIT) rate and advanced CIT payments are welcome as they strengthen investment incentives and preserve firm liquidity. However, the mission urged equal emphasis on the long-standing objective of improving the expenditure mix of the budget. In the near term, this entails addressing gaps in the Guaranteed Minimum Income scheme as support should transition from job retention towards targeted income support and worker reactivation, as well as addressing unmet needs in healthcare provision. As these measures have a structural fiscal impact, they should be matched by renewed impetus to create fiscal space over the medium term including through personal income tax base-broadening, tackling VAT compliance gaps, and aiming for expenditure savings in less-well targeted entitlement programs (including pensions), in the public wage bill (with the number of civil servants creeping back to pre-crisis levels), and in State Owned Enterprises (which continue to be a drain on the budget).

10. The slow progress with restoring banking sector health prior to the pandemic reflected deep-seated institutional and policy constraints. Weak core profitability, market values of NPEs below book valuation, and lukewarm investor interest given the risk of dilution from the high and rising share of Deferred Tax Credits (DTCs) in bank capital impeded faster organic solutions. On the policy front, the Greek and European authorities relied on financial engineering to reduce NPEs without triggering DTC conversion or high, upfront, fiscal costs, while adhering to EU-wide state aid rules.

11. The Hercules securitization strategy could achieve a rapid reduction in NPEs provided capital-raising efforts are successful. The pandemic could delay further the normalization of bank balance sheets, requiring a proactive government approach backed by a comprehensive cost-benefit analysis of all available options. The overarching goals should be to reduce financial sector risks and avoid a prolonged and muted credit-less economic recovery. In this regard, the mission welcomed the extension of additional government guarantees for NPE securitizations (“Hercules-II”) but suggested that backup plans should be formulated in case fresh capital raising efforts by banks are insufficient and/or other execution risks materialize. As the Bank of Greece’s proposal to establish an Asset Management Company (AMC) has been shelved, the mission encouraged the authorities to work with European partners to find a solution for the weak quality of bank capital. Amid increasing bank differentiation, stand-alone DTC conversion could be considered as a last resort if it restores investor confidence for those banks that are unable to fully utilize existing tools. The mission also encouraged the authorities to swiftly finalize a DTC law amendment to ensure that the instruments are loss absorbing in resolution. Effective implementation and use of the new Insolvency Code, including by servicers, will be critical for meaningful debt resolution.

12. Structural reform implementation will be essential to minimize scarring risks and leverage NGEU resources. Reforms have progressed in a number of areas and the widening of Greece’s external imbalances last year reflects mainly temporary factors related to the pandemic. Nonetheless, addressing the overvaluation of the Real Effective Exchange Rate and strengthening convergence prospects in the Eurozone requires accelerating structural reforms that boost productivity, reduce non-wage costs, and close the investment gap. Improving the fiscal policy mix would help achieve the authorities’ labor force participation objectives by encouraging female labor participation (particularly by funding childcare) and investing in youth’s prospects and older worker reskilling. NGEU funds have the potential to support Greece’s transition to a job-rich, fairer, and greener growth model provided the public investment framework is upgraded. The mission recommended that the upcoming labor codification should foster labor market flexibility and that the minimum wage adjustment should be prudent. The mission also encouraged the authorities to implement proper safeguards to ensure the transparency and accountability of COVID-19-related emergency spending and to protect the independence and credibility of the statistical agency and its staff, making every effort to uphold the “Commitment on Confidence in Statistics” endorsed by the government in 2012.

The mission is grateful to the authorities for the constructive discussions.

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