Hard to hold the line

Greece A year on from bail-out, as risk premiums rise on its debt and a full economic revamp remains absent, Athens faces the prospect of being forced into a restructuring, write **Ralph Atkins** and **Kerin Hope**

Athenian anger: shields splattered by paint bombs, riot police stand guard during a December general strike. The mood has since calmed. Below, George Papaconstantinou, finance minister

Eyevine

Each evening, as darkness descends on Athens, police in riot gear wait in buses that line the side streets of the city centre. Some fidget with mobile phones, others stare into the night. What they are waiting for, nobody is sure. But everyone in the Greek capital agrees something could happen any time.

A year after agreeing a €110bn European Union and International Monetary Fund bail-out and economic reform plan, times are hard. Greece is in deep recession: its economy contracted by 4.5 per cent last year; a further 3 per cent fall is expected in 2011. The capital's boarded-up shops and piles of uncollected rubbish testify to the scale of the economic shock and the angry mood of trade unionists.

Beyond Greece, fears are intensifying that the socialist government of George Papandreou – scion of a family that produced two previous left-of-centre prime ministers – will fail to modernise the country's sclerotic economy, or even bring it close to rivalling European peers.

If Mr Papandreou fails, policymakers in other European capitals and Washington will face a dilemma – whether to give Greece another chance or let the country fall into the abyss of default, with potentially devastating consequences on financial systems and economic confidence across the eurozone. The risk premium demanded on Greek debt by international investors has rocketed. Greece's banks are scurrying to shore up their finances.

"What is really sad is that a government with a big majority and the perfect excuse of outsiders imposing all these things hasn't pushed through all the reforms that we needed," says Alexandra Papalexopoulou, a director at Titan, an Athens-based cement company. "If we don't proceed as soon as possible with major reforms, we will have wasted the golden opportunity offered by a huge crisis."

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Greece's plight has wider global significance because its bail-out package was followed by similar moves to rescue Ireland and Portugal, and where fears about "reform fatigue" and the need for further billions of euros in outside help could quickly spread.

A year ago the mood in Athens was different. After a few months of denial, Mr Papandreou's newly elected government recognised the potential catastrophe facing the country. The low interest rates and currency stability Greece had enjoyed for a decade as a eurozone member had led to the country spending far beyond its means – public debt soared to 143 per cent of gross domestic product last year, the highest in the EU. Tax collection was haphazard at best, the economy was overshadowed by public controls and widespread corruption, and soaring wage and other costs had led to a massive loss of international competitiveness.

Under the rescue plan drawn up by the "troika" of the IMF, European Commission and the European Central Bank – given the stamp of approval exactly 12 months ago – Athens was ordered to implement a programme of reforms to bring its public finances back under control, boost economic competitiveness and ensure the stability of its financial sector. "All modernisers in Greece say 'thank God for the troika'," says Yannis Stournaras, director-general of Iobe, a think-tank.

The imposition of the plan suggested Europe's 12-year-old monetary union was not doomed to fail – as some investors feared. "The eurozone is not a perfect machine that always runs on time and without any hiccups," admits George Papaconstantinou, Greek finance minister. "It is a collection of national interests that we try to mould in a common interest, but it has electoral calendars, local populations, public sentiment. So given all these, I think it is a miracle that we are here."

In a series of early and widely applauded successes, Athens overhauled a state-funded pension system that had been one of the most generous in Europe (it allowed workers at public corporations to retire in their late 50s on 90 per cent of their final salary). Average pensions fell by more than 20 per cent and the retirement age was raised to 65. Civil servants' salaries were slashed by 15 per cent and their Christmas and Easter bonuses cut. In total, fiscal saving measures equivalent to 8 per cent of GDP were achieved.

But since late last year, the reform agenda has lost momentum, raising the prospect that the progress made so far will be squandered.

Fears of a repeat of violent street protests last summer that culminated in the death of three bank employees have prompted Mr Papandreou's government to delay or dilute structural reforms. A deeper-than-expected recession – exacerbated by the squeeze on public finances – set back hopes of boosting tax revenues, although compliance appears to have improved a little. Local government spending has overshot targets. The result of all this was evident in figures released last week by Eurostat, the EU's statistical office, that showed 2010's public sector deficit was worse than forecast at 10.5 per cent of GDP.

Some argue that the government lost its nerve. In fact, only a few protests since the violence of last summer have resulted in clashes with riot police – although Mr Papandreou has faced protests on trips to the provinces to explain his policies and Theodore Pangalos, deputy prime minister, was recently splattered with yoghurt. "Many foreign ambassadors expected Athens to be set ablaze. But it wasn't – because people know that things have to change," says Mr Stournaras at Iobe. "If you ask anyone in the streets, they will say the real problem has been the bloated public sector."

Instead, a conflict looms between Greece and its international backers. In its last progress report, issued in February, the IMF warned that the programme "remains at a crossroads". Privately, some officials involved in the talks fume that this was a massive understatement. IMF and European teams arriving in Athens this month for the next review are expected to stress the urgency of delivering on reform pledges and ensure the budget returns quickly to surplus, at least before interest payments.

Greece's taskmasters have a powerful weapon – the threat that future tranches of bail-out funds will not be paid. Under pressure, Athens has in the past two weeks outlined a fresh medium-term financial plan to overhaul the public sector and its financing. Its centrepiece is a €50bn ($74bn) privatisation programme – enough to cut debt by the equivalent of 18 per cent of GDP by 2020. Included would be the sale of stakes in companies, concessions on airports, ports and marinas and leases on land.

But eurozone policymakers are privately scathing that it took so long to recognise the scope for raising funds. Privatisation experts are sceptical, meanwhile, whether formidable technical and legal challenges will allow progress any time soon – all the more so given the programme of sell-offs has divided Mr Papandreou's cabinet and mobilised trade unions. The power workers' union, for example, which provided crucial support for his leadership of the socialist party, has threatened a national blackout in protest at plans to sell a stake in the PPC state electricity utility.

Mr Papaconstantinou, the finance minister, argues against underestimating "the willingness of the government to push forward", pointing out that it still enjoys broad public support. But behind the scenes, Greek business leaders and eurozone policymakers worry that he is not in control of events. "Nobody is managing the government," says one business executive. "The troika sets constraints and ministers try to get around the constraints. It is 100 per cent a leadership issue." Another jokes: "The best thing that could happen would be to put the administration of Greece in the hands of Brussels or Berlin."

There are some bright spots. The Greek tourist industry expects a good season, with the country benefiting from unrest in north Africa and the Middle East. Goods exports, largely of agricultural products, have staged a recovery although they still account for less than 8 per cent of GDP.

Evidence is scant, however, of an economic turnround that would turn international sentiment in Greece's favour. For every example of progress, there is at least one tale of setbacks.

An early step forward was the opening up of the road freight industry – in the face of protests by militant truckers, who blocked roads and suspended food and fuel deliveries. But the government yielded to the pharmacists' lobby, which has kept its guaranteed 35 per cent profit margin on prescription drugs. In tourism, cruise tour operators hoped for deregulation measures that would encourage holidays starting and ending in Greek ports, thus boosting local hotel and restaurant revenues. Instead, they have faced increased bureaucracy – including a requirement that they sign annual contracts with the state on the frequency and duration of calls at Greek ports – an obstacle not faced elsewhere in the Mediterranean. "Greece is losing income and the law needs to be amended," says Michael Nomikos, Greek representative of Royal Caribbean International, the world's second largest cruise operator.

Athens has failed noticeably to liberalise its energy sector – adding to costs faced by industry and leaving one of Europe's sunniest countries behind in solar technology. Investors complain that gaps remain in a new framework investment law. "The only way out is to encourage private investment, foreign direct investment and export-oriented growth," says Nikolaos Karamouzis, deputy chief executive of EFG Eurobank.

The risk is of a vicious circle. Until economic uncertainty over Greece's future abates, there is little incentive for the investment needed to boost long-term growth. Dangers are rising rapidly.

The longer Greece is unable to tap global financial markets, the more the country's banks will have to rein back their domestic lending – adding to a credit crunch that is already crippling the economy. "We are the victims of a state that has lost international credibility," says Mr Karamouzis. Greek banks are dependent on the ECB for liquidity – currently borrowing about €90bn in short-term loans. But the ECB wants to exert maximum leverage on Athens to speed up reforms and could cut its liquidity lifelines if not satisfied.

Athens had hoped to return to financial markets next year, when according to current plans it will need to raise €25bn-€30bn. With yields on its two-year bonds recently at record highs of 25 per cent, that timetable is almost certainly unsustainable. But a fresh bail-out would be hard to stomach especially for taxpayers in fiscally prudent northern European countries such as Germany and Finland.

Unsurprisingly, financial markets have started to believe a debt restructuring is inevitable. It is a scenario that the IMF and European authorities remain determined to resist. The ECB has warned of possible apocalyptic consequences on the country's banking system and beyond. Jürgen Stark, an ECB executive board member, has said the 2008 collapse of Lehman Brothers on Wall Street could be put "in the shade" by a Greek default. Last month the finance ministry asked Athens prosecutors to investigate rumours of a restructuring – a move that strengthened the impression of a government under siege.

Against a looming crunch, Athens' riot police may be of little use.

Statistics and the state

'There has been pressure but my approach is to work by the rules'

When – or if – Athens says public finances are back under control, will anyone believe it?

The country's crisis erupted in late 2009 after the newly elected Socialist government of George Papandreou revealed the public sector deficit that year would be three times higher than previously forecast. But Athens was already a serial statistical offender. Based on revised budget deficit data, Greece would not have met the criterion of 3 per cent of gross domestic product set for membership of the eurozone, which it joined in 2001.

Since August last year Andreas Georgiou, head of the Hellenic Statistical Authority, has been in charge of sorting out the mess. For 21 years, he worked at the International Monetary Fund in Washington. His return to Greece meant a hefty salary cut but he "wanted to provide help at a difficult time for Greece", he says in a rare interview.

One solution – throwing money at the problem – was not an option. With public spending being slashed, Mr Georgiou faced a hiring freeze. His staff, based mostly in an office block in a rundown suburb of Athens with views of concrete roadways rather than the Aegean, have faced pay cuts.

Instead, Mr Georgiou has focused staff on areas such as statistics on government finances. Backed by experts from other European Union countries, another priority has been to change Greek-style informal working practices. Mr Georgiou has strengthened, for instance, the crucial process of validating data – going back to original sources to check their reliability and cross-checking with other information. "All these things are new, they did not exist before," he says.

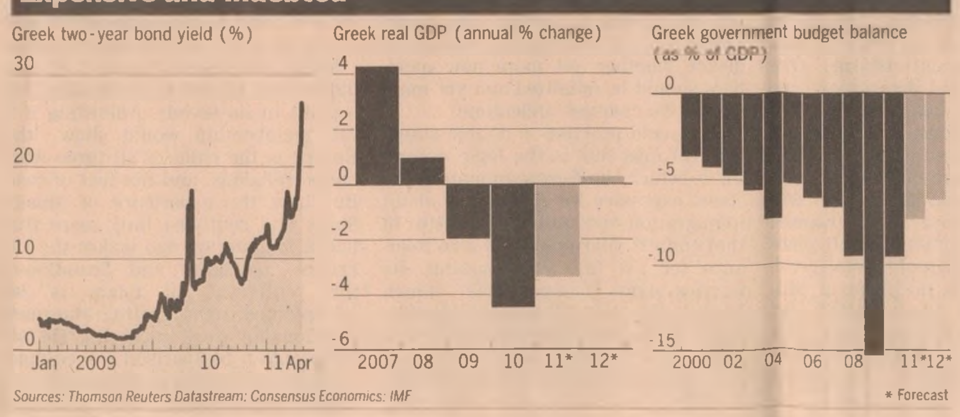
However, he says, "the most fundamental change that moved everything forward" was the granting of his unit's independence – bringing the country into line with standard European practice. Previously, it was a secretariat within the finance ministry.

"Of course, there has been pressure . . . but my approach has been to continue to do my work according to the rules. My aim is to keep our work independent and produce credible data according to the appropriate standards." Greece, he adds, "cannot afford any grey areas".

His efforts have already brought results. In October last year, Eurostat, the European Union's statistical office, dropped its warnings about the reliability of Greek data on public sector finances.

"For anyone to say there will never be any revisions would be very suspect," Mr Georgiou says. "But I expect that any future revisions to our data will be within the normal margins you would see in other European countries."

Expensive and indebted



Sources: Thomson Reuters Datastream; Consensus Economics; IMF

* Forecast