Council of the
European Union

**Brussels, 24 February 2021
(OR. en)**

6483/21

**ECOFIN 175
UEM 40**

COVER NOTE

From:	Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director
date of receipt:	24 February 2021
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	COM(2021) 97 final
Subject:	COMMUNICATION FROM THE COMMISSION Enhanced Surveillance update - Greece, February 2021

Delegations will find attached document COM(2021) 97 final.

Encl.: COM(2021) 97 final

EUROPEAN
COMMISSION

Brussels, 24.2.2021
COM(2021) 97 final

COMMUNICATION FROM THE COMMISSION

Enhanced Surveillance update - Greece, February 2021

{SWD(2021) 43 final}

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BACKGROUND

Economic developments and policies in Greece are monitored under the European Semester for economic policy co-ordination and under the enhanced surveillance framework according to Regulation (EU) No 472/2013 ([1]). The implementation of enhanced surveillance for Greece ([2]) acknowledges the fact that Greece needs to continue implementing measures to address the sources or potential sources of economic and financial difficulties, while implementing structural reforms to support a robust and sustainable economic growth.

Enhanced surveillance provides a comprehensive framework for monitoring economic developments and the pursuit of policies needed to ensure a sustainable economic recovery. It allows for a regular assessment of recent economic and financial developments in Greece, as well as for monitoring sovereign financing conditions and updates of the debt sustainability analysis. Enhanced surveillance also provides the framework for assessing the general commitment given by Greece to the Eurogroup of 22 June 2018, to continue and complete reforms adopted under the European Stability Mechanism programme and to ensure that the objectives of the important reforms adopted under the financial assistance programmes are safeguarded. In that context, enhanced surveillance monitors the implementation of specific commitments to complete key structural reforms started under the programme, in six key areas by agreed deadlines up to mid-2022, namely: (i) fiscal and fiscal-structural policies, (ii) social welfare, (iii) financial stability, (iv) labour and product markets, (v) Hellenic Corporation of Assets and Participations and privatisation, and (vi) the modernisation of public administration ([3]).

This is the ninth enhanced surveillance report for Greece. The report is based on the findings of a mission held remotely on 26-27 January 2021 and regular dialogue with the authorities. The mission was conducted by the European Commission in liaison with the European Central Bank ([4]); the International Monetary Fund participated in the context of its Post-Programme Monitoring framework, while the European Stability Mechanism participated in the context of its Early Warning System and in line with the Memorandum of Understanding of 27 April 2018, on working relations between the European Commission and European Stability Mechanism. The current report assesses the implementation of Greece's commitments to the Eurogroup regarding reform completion up to end-2020. This report is not linked to a release of policy-contingent debt measures, which – in line with the agreed biannual schedule – could take place on the basis of the tenth report. The tenth report is expected to be published in May.

([1]) Regulation (EU) No 472/2013 of the European Parliament and the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, OJ L140, 27.5.2013, p. 1.

([2]) Commission Implementing Decision (EU) 2021/998 of 17 February 2021 on the prolongation of enhanced surveillance for Greece.

([3]) https://www.consilium.europa.eu/media/35749/z-councils-council-configurations-ecofin-eurogroup-2018-180621-specific-commitments-to-ensure-the-continuity-and-completion-of-reforms-adopted-under-the-esm-programme_2.pdf

([4]) ECB staff participated in the review mission in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs. The review mission was preceded by a technical mission, also held remotely, from 13 January to 20 January 2021.

OVERALL ASSESSMENT

The report was prepared against the backdrop of the second wave of the pandemic, which has led to a general tightening of containment measures before the end of 2020 and, more recently, to a closure of schools and retail businesses and personal mobility restrictions in certain regions including Athens. The Greek economy is expected to have contracted by 10% in 2020 compared to 2019 with only a partial recovery forecast for this year. The fallout of the tourist season in 2020 on the back of the pandemic negatively affected Greece given the weight of the tourism sector in the economy. The government continued adapting the existing fiscal measures supporting the unemployed and wage earners, whose contracts have been suspended, prolonged the support measures for companies and adopted new targeted measures to protect households and corporates. So far, the employment protection measures, supported by the EU notably through the new financing instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) and the European Social Fund, appear to have been effective, and the unemployment rate has remained broadly stable in spite of the sizeable economic contraction. The number of persons out of jobs is nevertheless growing as hiring of new workers remains subdued. Firms and workers have benefited from public support measures; however, the full size of the challenge faced by the corporate – and the financial – sector is expected to become apparent only at a later stage with the phasing out of support measures, as in other Member States. This will need to be carefully managed to avoid cliff effects.

Despite the challenging circumstances, the authorities managed to progress well in a number of areas, including education, management of state assets, privatisation projects and energy policy. Notably:

- **Two ambitious reforms in the area of education were adopted in the past three months.** A vocational education and training reform was adopted in December 2020 aiming at improving the attractiveness of that path and better linking vocational education and lifelong learning with labour market needs. The Higher Education Law from February 2021 aims, in turn, at modernising the operation of the universities and enhancing the quality of education offered. Moreover, internal and external evaluations of schools have been launched.

- **The Hellenic Corporation of Assets and Participations** completed the review of the boards of all state-owned enterprises, which was a specific commitment. The strategic plan of the Corporation continued to be implemented as planned, and the authorities completed the preparation of the updated Ministerial Guidance for the Corporation.

- **Privatisation tenders** have progressed with the successful closing of the transaction of Marina of Alimos on 31 December 2020, good prospects for concluding the Hellinikon project in the coming months, and some long-awaited progress on pending actions necessary for the Egnatia concession – all of which are specific commitments.

- **In the area of energy policy,** the authorities have launched the market test with a view to closing the long-standing anti-trust case against the Public Power Corporation in the coming months, which is a specific commitment.

Reforms continued also in other important areas. Public financial management reforms, including of the public investment budget, have re-gained the much needed momentum through progress made on the administrative, economic and functional budget classifications.

Close monitoring will be needed, as this is key to enhancing the efficiency of payment procedures. The legislation for the human resources reform of the tax administration was adopted and the reform remains on track for its full implementation by the next review. Public administration reforms have also been progressing as planned, including the adoption of a new legislation for faster and more efficient recruitment of civil servants.

Nevertheless, the overall pace of implementation seems to have slowed down in a number of areas, due notably to the pandemic context, and the implementation of measures to address several commitments has been delayed. In addition to the continued difficulties posed by the pandemic, the authorities also pointed to a reshuffle of several key posts in the administration at the beginning of this year and the increased workload due to the preparations of the Recovery and Resilience Plan as a cause of some delays, and this is duly acknowledged. A number of detailed specific roadmaps have been agreed to prepare the ground for decisive progress by the tenth report in May. These include a continued delivery of the financial sector reforms, full implementation of the human resources reform of the Independent Authority for Public Revenues, operationalisation of the Project Preparation Facility and the Strategic Projects Pipeline for major investments, prevention of the creation of new arrears and reduction of the existing stock following the delays observed including through the reinforcement of the Steering Committee for the clearance of arrears and simplification of the legislative framework for the conduct of fiscal procedures, completion of the reform of the further simplification of investment licensing in agreed areas, and the adoption of the modernised Labour Code. In addition, the authorities committed to a number of specific steps in the areas of health care, fighting corruption, public administration reform and the implementation of the chart of accounts. Given its importance in the context of the overall recovery strategy, the justice reform needs to be relaunched, as reforms linked to the effectiveness of the justice system contribute to ensuring a swift implementation of investments, including from the private sector.

The implementation of some key financial sector reforms has also been delayed but an ambitious timeline for the next review was agreed. The entry into force of the insolvency code was partially postponed at the end of last year, with some elements envisaged to enter into force on 1 March, and others postponed to 1 June 2021. This code represents a major reform of the insolvency framework but requires substantial implementation work related to its detailed specification as well as to the setting up of an IT platform interconnected with those of the banks. Implementation of other agreed reforms continues but at a slower pace than previously agreed and will require close monitoring, particularly with respect to the clearance of the backlog of household insolvency cases (the end-2021 target appears at risk) and with respect to the clearance of called state guarantees, which has been further delayed in the last quarter of 2020 also on account of difficulties with hiring of new staff amidst the tightening of containment measures. The authorities are preparing additional measures to support the financial sector, in particular an extension of the asset protection scheme Hercules, which is welcome. In the context of the tightening of containment measures towards the end of 2020, the authorities have suspended all enforcement measures across all categories of debtors, including the conduct of e-auctions and its preparatory steps, which can take several months. Such a generalised freezing of all enforcement steps, if protracted, may impinge on a swift and efficient handling of non-performing loans by Greek banks and servicers going forward. The authorities are thus invited to adopt temporary and more targeted solutions in a timely manner, while protecting vulnerable households.

The authorities are engaging closely with the European Commission in the context of the preparation of the Recovery and Resilience Plan. This is welcome as the significant funds that Greece is entitled to receive via the Recovery and Resilience Facility, if used efficiently and appropriately, would support growth, job creation and the twin transitions in the coming years. The EU Recovery and Resilience Facility will make available €30.5 billion to Greece during the period 2021-2026, out of which €17.8 billion through grants. Reforms and investments that will be part of the Plan are expected to build on and complement past and ongoing reforms in the context of the enhanced surveillance process. Coupled with the additional envelope of €1.7 billion under the React-EU instrument and the €2.7 billion already disbursed by the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) as well as any possible additional amount ([5]), these substantial financing resources will help cushion the economic and social impact of the pandemic and provide the necessary support for a sustainable and inclusive recovery.

Overall, this report concludes that Greece has progressed well with the implementation of a number of reform commitments yet notes that reform momentum has slowed down, acknowledging the challenging circumstances caused by the pandemic. The European institutions welcome the continued close and constructive engagement of the authorities and the agreement on a number of revised timelines for critical reforms. The authorities are encouraged to continue to mobilise resources with a view to taking all necessary steps to achieve their due specific commitments in time for the tenth enhanced surveillance report, to be issued in May and for which a disbursement of the next set of policy-contingent debt measures is foreseen.

MACROECONOMIC DEVELOPMENTS

The coronavirus pandemic continues to have a strong negative impact on the Greek economy. The economy expanded by 2.3% on a quarter-on-quarter basis in the third quarter of 2020 after a decline of -14.1% in the previous period. The recovery in the third quarter was substantially less dynamic than the sizable rebound in the euro area, largely on account of the sharp fall of value added in the tourism sector. Growth was driven by private consumption, with the exports of goods showing some resilience. Unemployment continued to decline, reaching 16.2% in the third quarter of 2020, which indicates that the support measures in place are successful in protecting jobs. At the same time, employment decreased compared to a year ago, primarily due to the lower number of hires in the tourism sector. Youth unemployment also decreased but remains very high at 34.2% in the third quarter.

Following the tightening of containment measures towards the end of 2020, the economic recovery is expected to remain anaemic in the first half of this year. The containment measures announced in November 2020 remain in place, implying severe restrictions for the services sector, while industrial production continues with limited disruptions albeit facing disrupted supply chains and curtailed demand. These necessary measures to save lives are expected to further delay the economic recovery. The Commission 2021 winter forecast, prepared before the recent regional tightening of containment measures, expects real GDP growth to reach 3.5% in 2021 and 5% in 2022, driven mainly by domestic demand. The projection assumes that vaccination will gradually succeed to protect the most

([5]) The Council has already approved a total of €90.3 billion in financial support to 18 Member States. Member States can still submit requests to receive financial support under temporary Support to mitigate Unemployment Risks in an Emergency (SURE) which has an overall firepower of up to €100 billion.

vulnerable by mid-2021, allowing for a lasting, if only step-wise relaxation of the containment measures in the second quarter. The external sector is also projected to provide a positive contribution to growth, albeit less strong than previously expected as tourism may take longer to recover fully. The projection assumes that fiscal policy in 2021 will continue to support the economy with targeted interventions towards businesses and households. The slack in the economy is expected to weigh on price growth, which is expected to remain mildly negative also in 2021, with a subsequent recovery in 2022.

Uncertainty surrounding the outlook remains high. Projections are subject to significant uncertainty predominately linked to the evolution of the pandemic and the success of vaccination campaign. Progress with the fight against the pandemic, both domestically but also internationally, is also critical for the recovery of the tourism industry. Uncertainty also concerns the speed of recovery of the private sector after the expiry of the support measures, which will need to be carefully designed to avoid cliff effects, which could lead to corporate distress, including bankruptcies. Weaknesses in the balance-sheet structure of the Greek corporate sector compound downside risks to the recovery. The geopolitical tensions in the region and the lingering migration crisis add further uncertainty to the macroeconomic outlook. On the upside, the Commission forecast does not incorporate the economic impact of the Recovery and Resilience Plan for Greece, the implementation of which is expected to provide a significant boost to growth.

FISCAL DEVELOPMENTS

Fiscal policy will remain accommodative in 2021 as the authorities maintain targeted support to households and businesses affected by the crisis. In response to the unfavourable evolution of the pandemic, the government decided to tighten the containment measures at the beginning of November 2020 and, more recently, to close schools and retail businesses and to impose personal mobility restrictions in certain regions including Athens and announced the prolongation of earlier fiscal measures. The total envelope of the 'repayable advance payments' (public support to companies affected by the pandemic, distributed in the form of loans with a conditional subsidy component) has been increased, the regular and long-term unemployment benefit has been extended and the temporary economic support to suspended wage earners has been prolonged. As the duration of the containment measures turned out to be longer than initially planned, the government also announced a number of new measures in order to support both households and affected businesses. These include a new guarantee scheme and a new loan subsidy programme, both tailored to help small and medium sized enterprises, including in particular very small/micro firms. Furthermore, affected companies will be eligible for compensation on their fixed costs in the form of a tax and social security contribution credit. Greece's policy response has been swift since the beginning of the coronavirus outbreak, and with the abovementioned measures its overall size is expected to reach about 9.4% of GDP in 2020 and 6.5% of GDP in 2021. Overall, according to the Commission 2020 autumn forecast, the size of support measures (as a percentage of GDP) the Greek government adopted to alleviate the socio-economic impact of the coronavirus outbreak is slightly above the European Union average.

The 2021 budget, voted in early-December 2021, expects the deficit monitored under enhanced surveillance to reach 3.9% of GDP in 2021. This compares with a deficit forecast of 3.4% of GDP in the Commission 2020 autumn forecast ([6]). A full update of the fiscal forecast will be prepared in spring in the context of the assessment of the 2021 Stability Programme. To recall, the General Escape Clause will remain active in 2021. This allows for a temporary departure from the budgetary requirements, including Greece's fiscal targets monitored under enhanced surveillance, provided that this does not endanger fiscal sustainability in the medium term. The Council recommended ([7]) that Greece pursues, when economic conditions allow, fiscal policies aimed at achieving prudent medium-term fiscal positions and to ensure debt sustainability, while enhancing investment. The 2021 budget expects the general government debt to reach 209% in 2020 before declining to around 200% in 2021, which is broadly in line with the Commission autumn forecast.

The public finance projections are subject to considerable risks. Uncertainty about the evolution of the pandemic remains large, which translates into substantial fiscal risks as a further prolongation of the containment measures and related fiscal support, which should be both of a targeted and temporary nature, could lead to a further increase in fiscal costs. The probability of drawing on the state guarantees will increase with the duration of the crisis. Beyond the pandemic, rulings on retroactive pensions and litigation cases against the Public Real Estate Company (ETAD) continue to pose fiscal risks. On the positive side, Greece is expected to benefit greatly from the Recovery and Resilience Facility, through large-scale financial support to growth-enhancing reforms and investments, which would provide a substantial support to the economy and boost potential growth, which can facilitate achieving prudent fiscal positions.

SOVEREIGN FINANCING

Financing conditions remain favourable and the government continues holding a large cash buffer. The sovereign yield spreads have decreased further and have been hovering around 70 basis points on the 5-year tenure since mid-November 2020. Their volatility has also been subdued. The favourable financing conditions are supported also by the European Central Bank's accommodative monetary policy stance, including its Pandemic Emergency Purchase Programme. Medium and long-term debt redemption and interest payments will be moderate in 2021, amounting to around €10 billion. Greece is planning to raise €8-12 billion through new bond issuances, which is comparable to the amount raised in 2020. The general government's cash reserves stood around €31 billion at the end of 2020, which would be sufficient to cover the medium and long-term debt redemptions and interest payments of the general government for the next two years ([8]). Since the beginning of the year, the Hellenic Republic raised €3.5 billion through the issuance of a 10-year government bond in January 2021. The achieved yield was 0.81%, a historical low level for this maturity. An additional €2

([6]) The Commission 2020 autumn forecast did not take into account either the economic impact of the second tightening of containment measures started in November 2020, the prolongation of fiscal measures in response to the second wave or the economic impact or, more recently, the closure of schools and retail businesses and personal mobility restrictions in certain regions including Athens. At the same time, while the budget includes the envisaged macroeconomic impact of investments under the Recovery and Resilience Facility, the Commission will evaluate such an impact only in the coming months, when the plans will be presented in sufficient detail.

([7]) Council Recommendation of 20 July 2020 on the national Reform Programme of Greece and delivering a Council opinion on the 2020 Stability Programme of Greece, OJ C 282, 26.8.2020, p. 46.

([8]) The cash buffer account balance remained at €15.7 billion. The cash buffer account was built also through disbursements under the European Stability Mechanism programme and is dedicated to debt service. Greece may use this amount for other purposes as well, following an approval of the European Stability Mechanism's governing bodies.

billion was raised through private placements. The authorities intend to carry out a partial repayment of the loans from the International Monetary Fund, which is a welcome step that helps to reduce the foreign exchange risk and sends the right signal to the markets.

The 2020 Debt Sustainability Monitor presented a debt sustainability analysis for all Member States based on the 2020 autumn forecast ([9]). The baseline scenario of that analysis is identical to the one published in the 8th enhanced surveillance report. An updated debt sustainability analysis will be presented in the next enhanced surveillance report.

FINANCIAL SECTOR DEVELOPMENTS

Bank profitability is likely to remain under pressure as favourable liquidity conditions and significant non-recurring revenues on the trading portfolio have only partially offset increased provisioning needs. Banks have maintained ample cash buffers and a low cost of funding due to a steady upward trend in deposits coupled with accommodative monetary policy conditions. In addition, they have benefitted from extraordinary trading gains from their government bonds portfolio. However, the frontloading of provisioning to take into account the expected impact of the pandemic, among other factors, has led the banking system as a whole to post a loss after taxes in the first nine months of 2020. The profit outlook will remain challenging, and thus limiting the internal capital generation capacity. The securitisations of non-performing loans will have a positive impact on the banks' cost-of-risk and free up space in banks' balance sheets for new lending, but also entails an initial one-off capital loss and a recurring loss on net interest income. At the same time, the expiry of the moratoria may lead to further impairments due to a deterioration in asset quality.

The stock of non-performing loans has continued to decline, mainly thanks to the Hercules scheme and the temporary impact of moratoria. Non-performing loans at the end of September 2020 amounted to €58.7 billion, down by €9.8 billion from December 2019 but only €1 billion from the previous quarter. As a result, the non-performing loans ratio came down to 35.8%, which remains the highest in the euro area. The continuous improvement in 2020, despite the pandemic and the resulting drop in the number of cured loans, is mainly due to non-performing loan sales of €6.8 billion and a limited inflow of new bad loans (down by 58% year-on-year in the nine months) thanks to the moratoria in place. Loans under moratoria amounted to €20.8 billion as of November 2020, i.e. above 12% of the loan book, roughly evenly split between corporates and households. The deleveraging of non-performing loans by banks has also led to an increased role for non-bank servicers, with €33 billion of loans under management as of end-September 2020, up by 40% since the end of 2019.

As in other Member States, the expiry of the moratoria could be accompanied by a renewed deterioration in asset quality going forward. The large amount of loans under moratoria and the lacklustre track record of banks in viable loan restructurings point to a material risk for asset quality, as moratoria mostly expired at the end of 2020. This could lead to new impairments, in case provisions booked so far not fully capture the eventual impact of the pandemic on the loan book. However, the temporary instalment subsidy scheme set up by the authorities for coronavirus-affected debtors with primary residence loans (the "Gefyra" scheme) will mitigate this risk for this type of loans, which represent a large part of the retail

([9]) Debt Sustainability Monitor, European Economy Institutional Paper, No. 143, February 2021.

loan portfolio. Subsidy payments under the scheme have been initiated. The authorities are setting up a similar scheme for business loans. The scheme will need to be carefully designed, including appropriate moral hazard safeguards. Moreover, the banks will try to stem any migration of loans currently under moratoria to a category of increased credit risk, that would imply higher provisioning needs, through the offering of intermediate products, allowing for a gradual restoration of payment patterns. The exact supervisory treatment and related capital cost of these products will need to be discussed with the supervisory authorities. Going forward, the planned securitisations under the Hercules scheme remain the main driver of the reduction of non-performing loans.

The support measures adopted by the authorities have further bolstered credit growth to businesses, facilitating access to credit also for smaller firms. The Covid-19 enterprise guarantee scheme and the interest subsidy scheme (TEPIX-II) operated by the Hellenic Development Bank have resulted in €4.6 billion and 2 billion, respectively, of loan disbursements to corporates and small and medium sized enterprises in 2020, contributing with approximately 40% to the total gross corporate loan flows over the year. This has resulted in the average monthly gross loan flows ([10]) more than doubling for large corporates, while increasing substantially also for small and medium-sized enterprises. This credit growth has been used by firms to mostly cover their working capital needs and build up their liquidity buffers. In terms of cost of credit, although nominal lending rates are near their historical lows for corporates, they have been on the rise since September 2020, particularly for smaller loans, reflecting increased credit risk. As for lending growth to households, it remains in negative territory and comes at a steadily higher cost.

The authorities are preparing an amendment of the governing law of the Hellenic Financial Stability Fund. The amendment will allow for the Fund to participate as a private investor in future share capital increases of the banks where it maintains a shareholding.

([10]) Defined maturity loans. Source: Bank of Greece.