GREECE

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ECONOMIC RESEARCH DIVISION

ALPHA BANK

Market Confidence Improves on the back of Solid Budget Execution and Positive Growth Dynamics

The strong dynamics seen in the Greek stock market, alongside the downward trend of the 10-year Greek government bond spread, reflect the strengthening of investor sentiment towards the Greek economy and the stability of its public finances.

In the first months of 2019, the Athens Stock Exchange (ASE) General Index embarked on a strong upward trajectory, rebounding in April 2019 to levels above the summer 2018 average and recovering the losses sustained during the short-lived period of market volatility in autumn 2018 (Graph 1). Since the beginning of 2019 through to the end of April, the ASE General Index increased by 26.1%. During this period, the 10-year Greek government bond spread narrowed by 80 basis points, at a faster pace than the respective Portuguese spread (-38 basis points), most significantly after the new 10-year sovereign bond issuance in March 2019, which partly reflects a stronger demand for Greek government bonds.
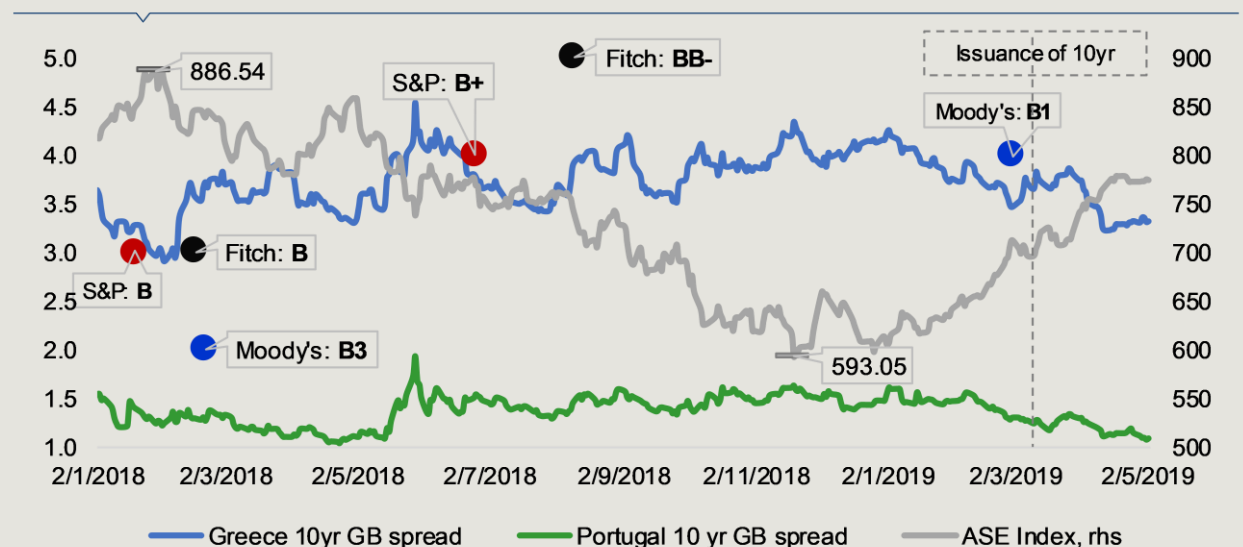
These developments, in tandem with the strengthening of the ongoing economic recovery and the overachievement of fiscal targets, are reflected in Greece's sovereign credit rating upgrades since the beginning of 2018, albeit remaining below investment grade. The prospect of Greek sovereign debt returning to an investment grade rating has improved as the yields on Greek government bonds have returned to pre-crisis levels; the 10-year and 5-year sovereign bond yields stood at 3.37% and 2.26% respectively on April 30, close to their 2005 levels.

The key factors contributing to these positive developments in the bond market and improved performance of the stock market can be summarized as follows:

First, the two successful bond issuances during the first months of 2019 were crucial as they marked the country's return to the debt capital market. The €5 billion received up to date covers a significant part of the bond issuance target for 2019 (€5 - €7 billion according to the Public Debt Management Agency (PDMA)), while Greece is expected to tap the markets again in the next couple of months to draw further liquidity.

GRAPH 1

Greek Government 10-year Bond Spread De-escalates while the ASE Index Recovers

Second, the ''green light'' given by the Eurogroup for the first tranche of the SMP-ANFA income equivalent amounts, combined with the move by the Greek government to repay in part the IMF loans which translate into a significant annual fiscal gain, have improved sovereign creditworthiness of the Greek State and contributed to the gradual normalization of sovereign financing conditions.

Third, the introduction of a primary residence protection scheme, which was partly responsible for the Eurogroup approving the SMP-ANFA transfer, is expected to contribute to a decline in the NPE stock and so is expected to allow for the gradual increase in the supply of credit to the real economy.

Fourth, the current political stability in Greece allows for optimism that the necessary reforms will continue to be implemented at an unabated pace, as such the upcoming general elections do not act as a destabilizing factor.

In addition to the above, the international environment also significantly affects developments in the bond market. The projected slowdown in global economic activity and the contained inflation expectations led major central banks, such as the Federal Reserve and the European Central Bank, to adopt more accommodative monetary policy stance. This, combined with a series of international developments including the US-China trade dispute and the uncertainty surrounding Brexit, shifted investor appetite to relatively safer investment options such as bonds, leading to an increase in prices and a decrease in yields. In such an environment, Greek government bonds can be viewed as more attractive given that their yields are significantly higher compared to the bond yields of other Eurozone countries.
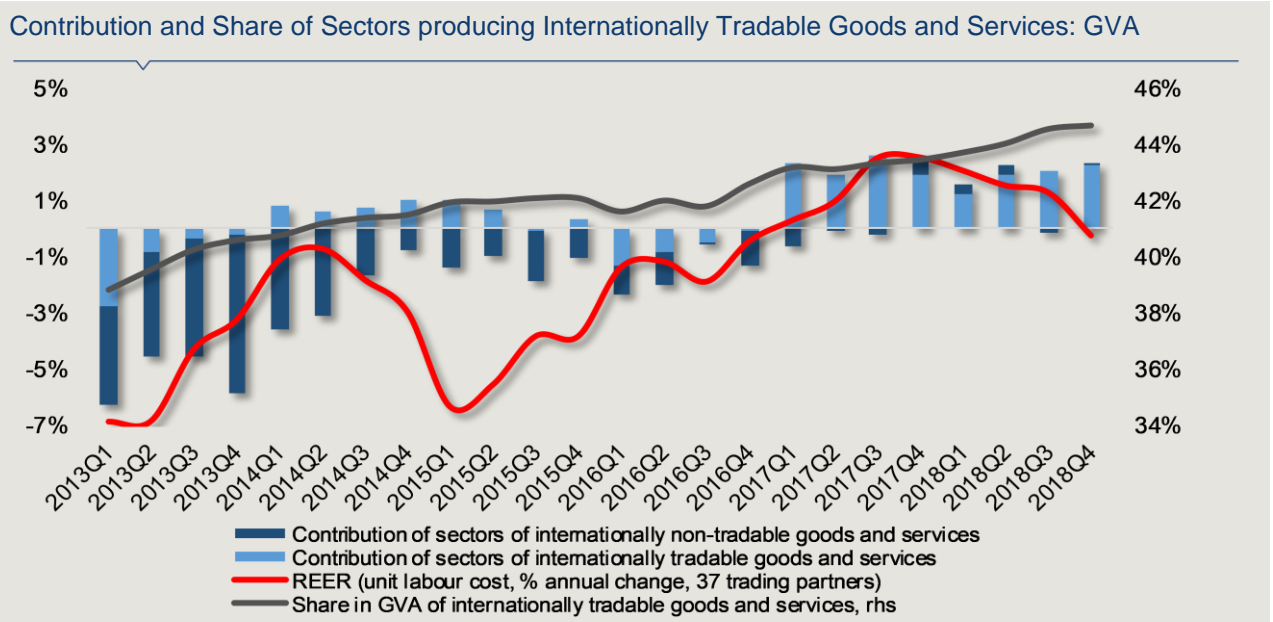
Extroversion, Competitiveness and the Growth Model of the Greek Economy

The recovery of Greek economic activity accelerated further in 2018, with real GDP growing by 1.9%, up from 1.5% in 2017, on the back of the positive contribution of increased private consumption and net exports. Private consumption is expected to accelerate further in 2019 underpinned by an increase in employment as well as the recent hike in the minimum wage and the VAT reduction on food products and services and energy bills.

While the pre-crisis era was marked by private consumption-led growth, the solid performance of exports during the past two years is considered important for Greece to develop a viable growth model. In addition, sustaining and accelerating growth dynamics necessitates both the increase of gross fixed capital formation and the further strengthening of the extrovert orientation of the Greek economy.

During the economic adjustment programmes, Greece has made significant progress in increasing competitiveness and export activity, the latter increasing by 8.7% in 2018 against 6.8% in 2017.

GRAPH 2

Contribution and Share of Sectors producing Internationally Tradable Goods and Services: GVA

Source: Eurostat

Legend:
- Contribution of sectors of internationally non-tradable goods and services
- Contribution of sectors of internationally tradable goods and services
- REER (unit labour cost, % annual change, 37 trading partners)
- Share in GVA of internationally tradable goods and services, rhs

In particular, exports of goods (based on national accounts data) rose by 8.4% contributing 1.5 pps. to GDP growth in 2018. Exports of services rose at a slightly higher pace (9%), driven by the rise in travel and sea transport receipts, though contributed less to GDP growth (1.3 pps.) given their smaller share of GDP compared to the exports of goods. The evolution and structure of gross value added (GVA) over time reveals the gradual strengthening of the sectors producing internationally tradable goods and services compared to non-tradable sectors. Graph 2 depicts (a) the annual contributions of tradable and non-tradable sectors to GVA growth (vertical bars) and (b) the share of tradable sectors in GVA, as a measure of the degree of extroversion of the Greek economy. For the purpose of this analysis, internationally tradable sectors include agriculture, industry, trade, tourism and transportation.

The increase in the share of internationally tradable goods and services is due to two key factors: the first relates to the acceleration of EU-28 growth ranging from 0.9% on average over 2005-2009, to 1.1% on average in 2010-2014 and further to 2.2% on average in 2015-2017. The second factor pertains to the improved competitiveness of the Greek economy, supported by structural reforms in labour and product markets as well as the internal devaluation policy pursued during the economic adjustment programmes.

In the past two years, the impact of the first factor was particularly strong, counterbalancing the small decline in competitiveness over this period. As illustrated in Graph 2, the change in the real effective exchange rate (REER-37 trading partners), which signifies an inverse measure of competitiveness (i.e. a rise in REER suggests a loss in trade competitiveness), was positive over the past eight quarters. Nonetheless, the share of internationally tradable goods and services continued to increase at an unabated pace during this period.

However, sustainable export dynamics require the recovery of investment that incorporate technological innovation and develop competitive advantages. Investment recovery is vital, especially when taking into account that the main factors that led to the improvement of the extrovert orientation of the Greek economy during the past five years are expected to contribute to a lesser extent in the following years. EU growth is expected to decelerate in 2019 according to the latest EC forecasts, which is likely to result in a slowdown in external demand. Moreover, unit labour costs, after remaining on a downward path for a protracted period, are expected to be higher as productivity rises at a slower pace compared to nominal wages.

In this context, investment in Information and Communication Technology (ICT) and energy infrastructure is crucial in order for the Greek economy to converge with other European countries. Investment in these sectors is needed to mitigate the investment losses during the crisis and to switch from the pre-crisis growth model driven by consumption expenditure, toward a growth model in which export penetration plays a key role.

Moreover, the low level of investment in Research and Development (R&D) over time poses obstacles to the increase of domestic productivity. Notwithstanding the increase in R&D investment over the past years (€ 2 billion in 2017, from € 1.6 billion in 2008), investment as percent of GDP remains low compared to other European countries (Greece:1.1%; EU-28: 2.1%, 2017). However, over the past years, the role played by local firms in increasing total R&D expenditure has improved markedly; R&D expenditure funded by the

GRAPH 3

Research and Development (as % of GDP): Greece vs. EU-28
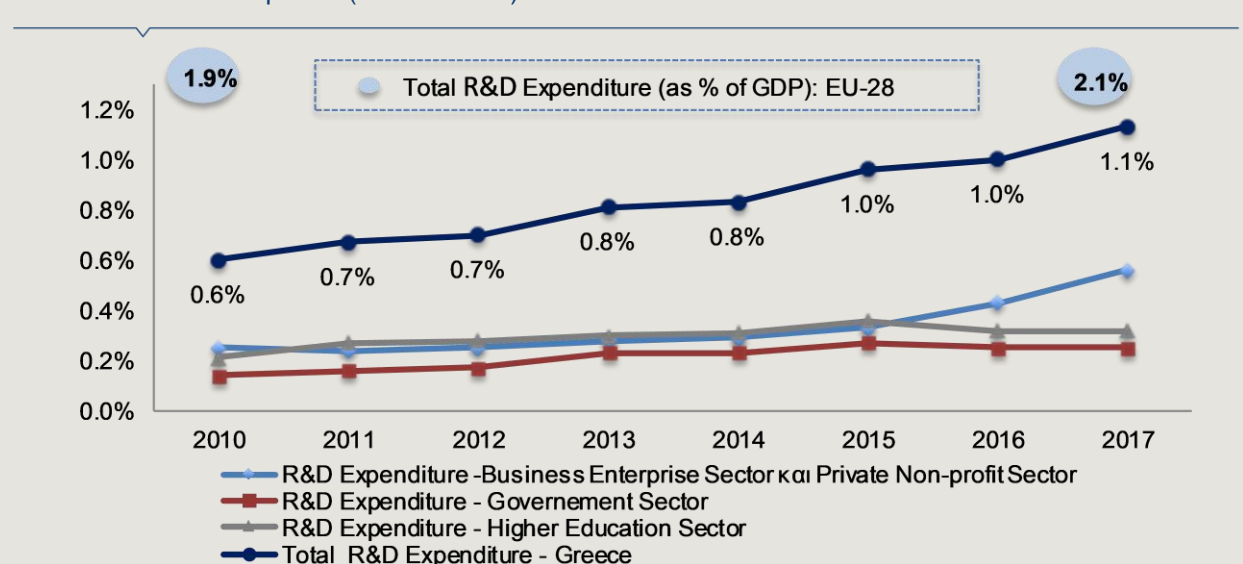
Source: Eurostat

business enterprise sector (0.4% of GDP) exceeded those funded by the higher education sector and the government sector in 2016, while it increased further in 2017 to reach 0.6% of GDP (Graph 3). Despite this increase, total R&D expenditure remain at a significantly lower level compared to the respective EU average.

In addition, according to the Small Business Act Fact Sheet (SBA, 2018), the share of Small and Medium-Sized Enterprises (SMEs) purchasing online is the lowest among EU countries; granted the proportion of SMEs selling online has marginally increased though remains low compared to other EU countries (10.7% vs. 17.2% of EU average). Against this background, a major challenge for an economy that aims to enhance research and technology infrastructure is the training of employees in these sectors. The share of SMEs providing ICT training to their employees is relatively low in Greece compared to the EU average (10.7% and 20.1% respectively), although the percentage of persons employed that have ICT specialist skills is relatively high (19.4%) compared to the EU average (17.8%).

Skill-Mismatches between Supply and Demand in the Labour market: Structural Unemployment after the Crisis

In 2018, the unemployment rate dropped further by 2.2 pps., averaging 19.3%, down from 21.5% in 2017. The decline in the unemployment rate is broadly related to the recovery in economic activity. This drop is mainly related to the cyclical component of unemployment, which varies in response to changes in the demand for goods and services depending on the phase of the business cycle. Thus, the rise in consumer spending and external demand contribute gradually to job creation. In parallel, structural unemployment, although at high levels over time in Greece, increased further during the crisis.

These developments are depicted in the Beveridge curve for the Greek labour market (Graph 4). The Beveridge curve illustrates the (expected) negative relationship between the job vacancy rate (defined as job vacancies over the sum of job vacancies and occupied posts), which is an indicator of labour demand by firms, and the unemployment rate. Movement along the curve is typically related to the cyclical fluctuations of the economy. For instance, a downward movement along the curve is related to an increase in unemployment and a decline in job vacancies. During recessions, there are usually fewer job vacancies and a higher unemployment rate, while during the expansion phase of the business cycle there are more job vacancies resulting in a fall in unemployment.

As shown in Graph 4, from the onset of the economic crisis in 2009 and up to 2013 Q2, there was a rise in the unemployment rate and a decline in the job vacancy rate. During 2013 Q3 to 2014 Q2, the small rise in the unemployment rate coincided with an increase in the job vacancy rate. This implies an outward shift of

GRAPH 4

Beveridge Curve, Greece, 2010Q4-2018Q4 (4-quarters average)
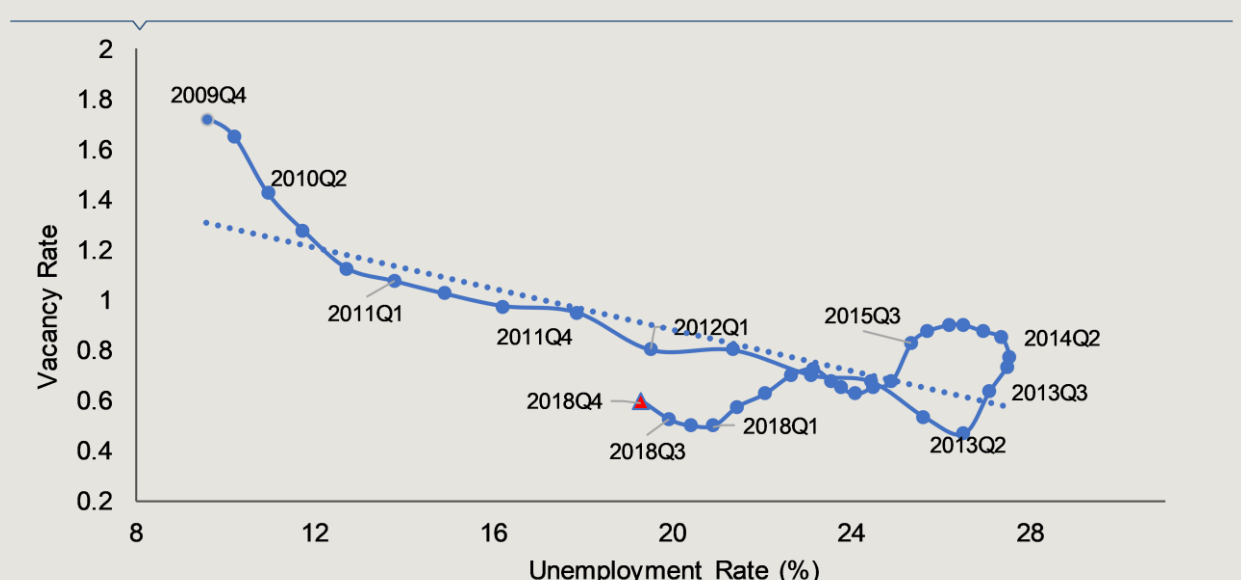
Source: Eurostat, Alpha Bank, Economic Research Division calculations

the curve suggesting the worsening mismatch between skill demand and supply in the labour market and is related to a rise in structural unemployment.

The concurrent increases in these two rates indicate that the labour market is not affected by the phase of the business cycle i.e. the cyclical effect is reduced and thus, as is the effect of economic recession.

Since 2010, the labour market in Greece has been characterized by an increase in the natural level of unemployment, which is a measure of structural unemployment. However, it is worth mentioning that since 2013, when cyclical unemployment embarked on a downward trend leading to a decline in the total unemployment rate, long-term unemployment and structural unemployment remained rigid. Thus, the mismatch between labour demand and supply is reflected, *inter alia*, to the high long-term unemployment rate.

The long duration of unemployment weakens human capital and downgrades skills, creating difficulties in finding jobs. Thus, long-term unemployment usually discourages people to search for a job, while being out of the labour market can make them less competitive, slowing down the fall of structural unemployment.

Graph 5 depicts the cross-country correlation between the job vacancy rate and the unemployment rate for selected EU countries in 2018. In Czechia, Germany, Belgium and the Netherlands low unemployment is associated with a high job vacancy rate. In contrast, Greece and Spain exhibit a high unemployment rate and a low job vacancy rate. Countries situated above the curve are more likely to have higher mismatches between labour demand and labour supply, though they have the same unemployment rate.

In Greece, the mismatch observed between job vacancies and the number of people seeking for a job is mainly due to:

•   the transformation of the productive model of the country during the economic recession, reflected in the strengthening or the weakening of the activity of certain sectors,

•   the technological developments during the past decade,

•   the soaring outflow of highly-qualified people abroad ('brain drain').

GRAPH 5	Correlation between Vacancy Rates and Unemployment Rates across EU countries
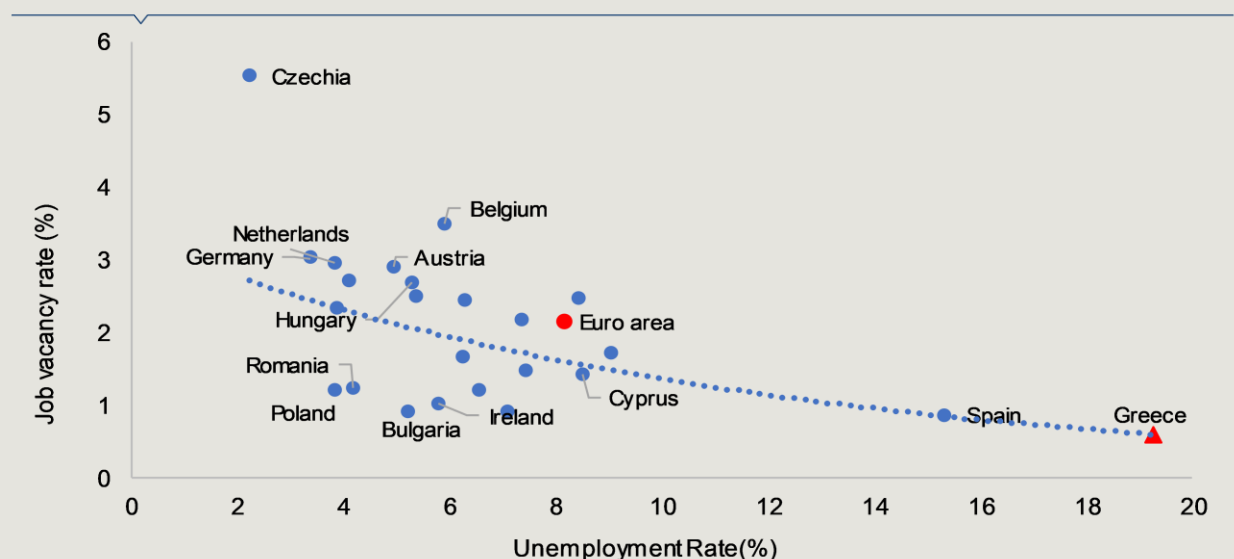
Source: Eurostat, Alpha Bank Economic Research Division calculations

Macroeconomic Environment	ANNUAL			MONTHLY		
	2016	**2017**	**2018**	**Jan.**	**2019** **Feb**	**Mar**
AGGREGATE DEMAND						
GDP at current prices (€ billion), sa	176.5	180.2	184.7			
(annual % change)	-0.4	2.1	2.5			
GDP at constant prices 2010 (€ billion), sa	184.4	187.2	190.8			
(annual % change)	-0.2	1.5	1.9			
Components (annual % change, at constant prices)						
Private Consumption	0.0	0.9	1.1			
Public Consumption	-0.7	-0.4	-2.5			
Gross Fixed Capital Formation	4.7	9.1	-12.2			
Exports of Goods and Services	-1.8	6.8	8.7			
Imports of Goods and Services	0.3	7.1	4.2			
LABOUR MARKET (annual % change)						
Nominal Unit Labour Costs [1]	-1.0	1.1	1.1			
REER Unit Labour Costs [2]	-1.2	1.5	1.3			
Unemployment Rate (%), sa	23.5	21.5	19.3	18.5		
PRICES (average annual % change)						
National CPI	-0.8	1.1	0.6	0.4	0.6	0.9
National core CPI [3]	-0.4	0.0	0.0	0.3	0.2	0.4
HICP (Harmonised Index)	0.0	1.1	0.8	0.5	0.8	1.0
GDP Deflator, SA	-0.2	0.6	0.5			
PUBLIC FINANCES						
General Government Primary Balance (€ billion, cumulative) [4]	6.4	6.9	8.1	0.7	0.8	1.4
G.G. Primary Balance (% of GDP) [4]	3.6	3.9	4.4			
General Government consolidated Gross Debt (€ billion)	315.0	317.5	334.6			
G.G. Gross Debt (% of GDP)	178.5	176.2	181.1			
EXTERNAL BALANCE & COMPETITIVENESS INDICATORS						
Current Account Balance (€ billion)	-3.1	-3.2	-5.3	-1.2	-1.0	
Current Account Balance (% of GDP)	-1.7	-1.8	-2.9			
Greece: Real Effective Exchange Rate Index,2010=100 (annual % change) [5]	0.7	1.3	1.7	-0.8	-1.1	-1.1
Greece: Nominal Effective Exhange Rate Index,2010=100 (annual % change) [5]	1.6	2.5	3.9	1.6	1.0	0.8

Sources: Hellenic Statistical Authority, Eurostat, BoG

[1] Nominal Unit Labour Cost based on hours worked

[2] Compared to 37 trading partners.

[3] Excluding food and non-alcoholic beverages,alcoholic beverages and tobacco and energy prices.

[4] Annual data defined here as General Government balance (according to ESA 2010) minus interest expenditure of General Government entities to other sectors. The effect of support to financial institutions is included in this measure of the primary balance. The measure of the primary balance presented here differs from the definition of primary balance used under the Economic Adjustment Program for Greece.

[5] The REER index is CPI-based. Both REER and NEER include the 37 main trading partners of Greece. A positive sign denotes loss of competitiveness of Greece's trade partners.

ALPHA BANK ECONOMIC RESEARCH AND ANALYSIS

11, Sophocleous Street

GR 105 59 Athens

T +30 210 517 8963, F +30 210 348 7873

Email: AlphaBankEconomicResearch@alpha.gr

Web site: http://www.alpha.gr