Greece: Macro Monitor

2006 Outlook

Correction of excessive deficit feasible

- In 2006, the economic outlook remains favorable and we forecast above 3.0 percent real GDP growth on recovering investment activity.

- The results of our sensitivity analysis of budgetary projections suggest that even under relatively conservative assumptions about the macroeconomic environment, a correction of the excessive deficit is feasible this year.

- It is of paramount importance that authorities meet tax collection targets in order to attain the 3.0 percent of GDP budget deficit threshold, otherwise additional spending cuts will likely be required.

- The moderation of public wage growth and the government's increased emphasis on structural reforms leave scope for some easing in inflationary pressures this year.

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Summary

Real GDP growth in 2005 continued to significantly outpace the euro area average, rising by 3.7 percent from a year earlier. Private consumption remained the main engine of GDP growth last year, while net exports were a positive contribution mainly as a result of lower imports. Notwithstanding the above positive trends, the real growth of gross capital formation contracted by slightly over 1.0 percent in 2005, weighed down by significant cutbacks in public investment budget outlays and heightened business hesitancy to undertake new investments due to post-Olympic economic uncertainties.

In 2006, the economic outlook remains favorable and we forecast real GDP growth of around 3.4 percent with bouncing investments compensating for lower net exports and a likely moderation of household consumption due to slower wage growth. Main downside risks to our growth projections include a failure of investments to stage a healthy recovery following last year's slowdown and a worse-than-expected contribution from net exports due to eroding competitiveness and a less benign external environment as a result of higher oil prices and persistent global imbalances. Looking further ahead, the gradual waning of the special factors that supported economic growth in recent years, namely pro-cyclical fiscal policies and the sharp interest rate declines post-EU entry, create headwinds to the medium-term growth outlook but we continue to forecast 3.0 percent-plus annual GDP growth rates over the next two-three years, mainly as a result of strengthening investment activity.

Rallying oil prices and higher VAT and excise tax rates heightened underline cost-push pressures and boosted average year-on-year inflation to 3.5 percent in 2005, from 2.9 percent in the prior year. In 2006, the moderation of public wage growth and the government's increased emphasis on structural reforms leave scope for some easing in inflationary pressures and we now expect average consumer price inflation of around 3.2 percent this year. However, the inflation differential is likely to remain significant over our forecast horizon, with further adverse implications for competitiveness.

The 2006 budget targets a 2.6 percent-of-GDP general government deficit, aiming to correct the excessive deficit without causing ''substantial adverse effects on economic growth or social cohesion''. The results of our sensitivity analysis of budgetary projections presented in this report suggest that even under relatively conservative assumptions about the macroeconomic environment, a correction of the excessive deficit is feasible this year, contingent on the authorities´ ability to ensure ordinary revenue growth broadly in line with nominal GDP. If, however, tax collection disappoints, then it will be difficult to meet the 3.0%-of-GDP deficit threshold without additional spending cuts, a rather difficult endeavor as past experience has shown, not least because of the inherently inelastic nature of primary spending and the need to run a sizeable public investment budget to facilitate implementation of the CSFIII program.

The pace of reforms accelerated markedly in 2005, particularly in the form of new legislation on flexible working hours, overtime costs, the banking sector pension system, public-private partnerships, shopping hours and public enterprises. This year will in all likelihood see greater efforts, on the part of government, to secure effective implementation of the above reforms and tangible results. After the first half of the year, the reforms momentum may slow down in anticipation of this autumn's local and regional elections. Beyond that, the Government's strategy until the general election (due in spring 2008) remains an open question, e.g., whether it will choose to consolidate existing gains or, alternatively, concentrate on new areas, such as unemployment and the cost of living, both primary concerns of citizens.

Other issues that present challenges for the government this year include the low CSF-III absorption rate, privatizations (not least that of Olympic Airlines, though the main focus this year will be on the banking sector), the overhauling of public enterprises, and the question of working hours, triggered by recent developments in the banking sector.

Also in this issue:

We revisit the question of whether there is currently an overvaluation of Greek home prices. Our analysis suggests that rising housing prices in Greece are fully justified by economic fundamentals. Hence, the possibility of an overvaluation of housing prices in Greece is currently low thus limiting the risk of an abrupt correction in prices that could have negative consequences for overall economic activity. This conclusion is reinforced by the non-speculative nature of housing demand as documented by survey data from Greek households.

We also conduct a comparative analysis of the lending rates in Greece and the Eurozone. Based on this analysis we conclude that, over the period from 1998 to 2004, the Greek weighted average lending rate has declined significantly and currently stands 125bps above the EU-10 average. This spread in Greek-euro area lending rates can be attributed, at least partly, to higher deposit rates, higher credit loss reserves and higher operational costs.

We look at the recent trends and outlook of the world oil market and examine the economic implications of higher oil prices. In the case of Greece, we suggest that we may already be experiencing the first impact of higher energy costs through the price mechanisms, while we reiterate that domestic output growth rates could have been 0.3-0.5 percentage points higher if oil prices were not fluctuating around historically very high levels.

Finally, we review recent developments regarding the Community Support Framework for Greece and conclude that a significant acceleration in the signing of new projects and, in particular, the successful completion of projects already underway is required to avoid losses of EU structural funds

Key macroeconomic indicators

y/y grwoth	2003	2004	2005e	2006f
GDP (constant prices)	4.6	4.7	3.7	3.4
Final consumption	3.2	4.3	3.6	3.1
Total investment	13.7	5.7	-1.2	3.8
Domestic demand	5.5	4.7	2.3	3.2
Exports g&s	1.0	11.7	2.7	5.5
Imports g&s	5.2	9.3	-1.4	4.5
National CPI (average)	3.5	2.9	3.5	3.2
Budget balance (% GDP)	5.2	6.6	4.3	3.0
Public debt (% GDP)	108.8	109.3	107.9	105.0

Source: realisations, official estimates and EFG Eurobank forecasts

Part A

Economy and Macroeconomic Policies

- **Domestic economy**
- **Fiscal outlook**
- **Political overview and structural issues**

Domestic Economy: Performing well despite headwinds

- **The economic outlook remains favorable and we forecast real GDP growth of around 3.4 percent this year on the back of strengthening investment activity**

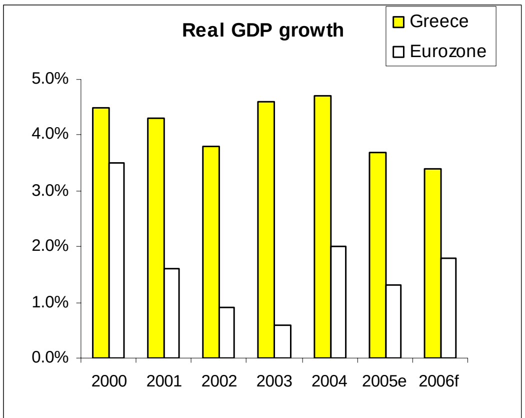
- **Main downside risks to our growth outlook include a failure of investments to stage a healthy recovery following last year's slowdown and a worse-than-expected contribution from net exports due to eroding competitiveness and a less benign external environment**

2005 growth surpassed expectations

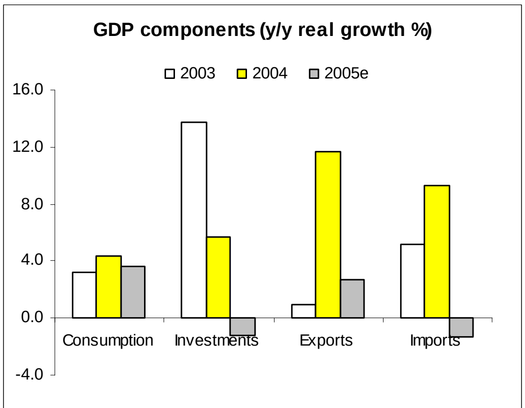
Real GDP grew by 3.7 percent y/y last year after rising by 4.7 percent y/y in 2004, with upbeat readings in key conjunctural indicators showing that the economy maintained a strong momentum through to early 2006. Private consumption remained the main engine of GDP growth last year, helped by the rapid expansion of consumer credit, continuing strong real wage growth and positive wealth effects from firmer equities and recovering housing prices. Also, net exports were a positive contribution, mainly as a result of lower imports. In contrast to the above positive trends, gross capital formation growth contracted by 1.2 percent y/y in 2005, weighed down by significant cutbacks in public-investment budget outlays and heightened business hesitancy to undertake new investments due to post-Olympic economic uncertainties.

Outlook remains positive in 2006

We forecast real GDP growth to remain strong this year (EFG 2006 forecast: +3.4 percent vs. the 3.8 percent official projection), with bouncing gross fixed capital formation growth compensating for declining net exports and a likely moderation in household spending due to slower wage growth. Main downside risks to our growth projections include a failure of investments to stage a healthy recovery following last year's slowdown, a worse-than-expected contribution from net exports due to eroding competitiveness and a less benign external environment as a result of higher oil prices and persistent global imbalances. The gradual waning of the special factors that supported economic growth in recent years, namely pro-cyclical fiscal policies and the sharp interest rate declines post-EU entry, could also induce downward risks to themedium-term growth outlook. Yet, we continue to forecast annual GDP growth of 3.0 percent or higher in the next two-three years, mainly as a result of strengthening investment activity.



Source: Ministry of National Economy, ECB, EFG Eurobank



Sources: NSSG, EFG Eurobank

Consumer spending remains resilient

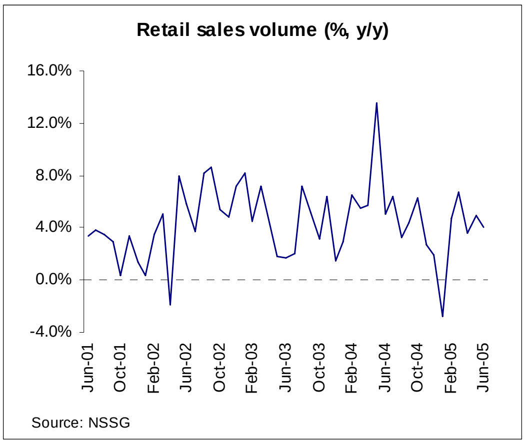
Although eroding disposable incomes due to higher oil prices and slower real wage growth risk a mild deceleration in consumer spending this year, recent conjunctural indicators show no significant abatement of consumer spending vigor. Following some transitory weakness in early 2005, retail sales (volume terms) have been on a recovering path lately, posting average year-on-year growth of 3.2 percent in January-November 2005 on the back of strong gains in the furniture, household equipment and food sectors. New private car registrations declined by 3.0 percent y/y last year, but this followed annual growth in excess of 15% in the 2004 Olympics year. Furthermore, although the consumer confidence index for Greece has moved sharply lower after reaching a 4-year high in April 2004, the index appears to have stabilized in recent months, and at -36 in December 2005 was not far off its historical average level.

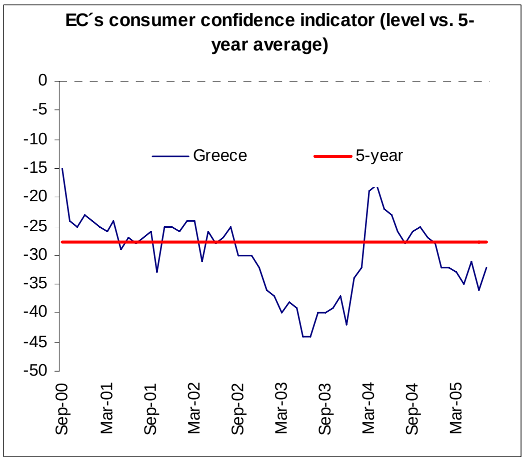
Fast credit growth continues

As we have noted above, the post-EMU credit boom has provided the engine of strong consumer spending in recent years. Meanwhile, these trends continued unabated last year with the year-on-year growth of household credit coming in at around 30 percent in January-November 2005. As we have noted in the past, the gradual elimination of pent-up demand and lower disposable incomes due to tighter fiscal policies might, at some point in the future, induce a drive by Greek households to restore over-extended balance sheets. Moreover, although total outstanding household credit as a percentage of GDP in Greece remains well below the EU average[1], its rapid rise in recent years could potentially increase macroeconomic and prudential risks in the case of sudden and unforeseen adverse events such as a sharp economic downturn or a significant rise in interest rates. These risks are particularly relevant given that the level of non-performing loans is already high for this stage of the business cycle. Although we deem such worries credible, we note that the BoG has already taken steps to address provisional concerns by raising specific provisions and capitalization levels, mandating risk-management and credit-rating systems in banks, and facilitating the compilation of comprehensive credit information on individual borrowers. Moreover, according to most relevant measures, the Greek banking sector currently seems to enjoy high solvency rations and it is also well capitalized.

Employment expectations improving

Total employment rose by 1.5 percent in the first half of last year, while the unemployment rate fell to 9.6 percent in 2Q 05, from 10.4 percent in the prior quarter. Notwithstanding the risk of a mild slowdown in the pace of job creation this year and the next as a result of a gradual cooling of domestic economic activity, expectations of consumers and business firms (with the exception of those in the manufacturing sector) concerning employment prospects have been on the rise in recent months. Overall, Greece's labor market performance remains weak in comparison with other EU countries, hindered by high long-term unemployment and low participation rates, especially among youth and women. To this end, further measures in addition to those taken recently (extension of shopping hours, more flexible overtime arrangements, etc) may be needed to address such long-standing structural deficiencies.





1 Consumption and mortgage loans to Greek households stand at 41% of Gross Disposable Income (GDI), compared to 83% in the eurozone, while interest payments correspond to 2.5% of GDI, compared to 4.5% in the eurozone. Regarding loans to businesses, total outstanding corporate credit to enterprises stands at 40% of GDP compared to 62% in the eurozone.

Investment seen recovering in 2006

Gross fixed capital formation contracted slightly in 2005 after recording annual average growth of 8.0% over the previous five years, but we look for a gradual recovery in investment activity this year as the government accelerates the absorption of EU structural funds and its new business-friendly initiatives start to yield tangible results. Our expectation for a brighter domestic investment environment ahead is further supported by the continuation of double-digit growth rates in mortgage lending, strengthening residential construction activity and recent improvements in key sentiment and business activity indicators.

Improving construction prospects...

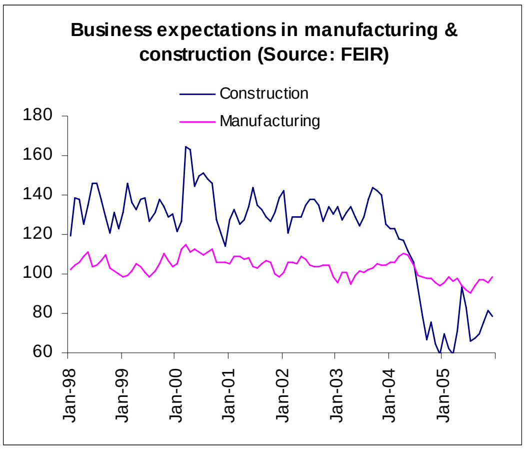
Building permits in volume terms rose by 11.9 percent y/y in the first eleven months of 2005 following a 4.1 percent y/y contraction in the same period a year earlier. Moreover, cement production grew by 2.4 percent y/y in January-November 2005 after declining by 2.0 percent y/y in the January-November 2004. Residential construction activity (as measured by the volume of permits) is estimated to have accelerated further towards the end of last year as prospective homeowners rushed to secure permits ahead of the introduction of VAT on new home purchases from January 1, 2006. Moreover, the average annual growth of domestic bank lending to households over the first 11 months of 2005 exceeded 26 percent after rising by around 25 percent in the prior year and, although a mild slowdown in mortgage credit seems likely in early 2006 (as a result of the introduction of new measures affecting real-estate transactions), growth prospects for the current year as a whole remain favorable.

...supported by new legislation on PPPs and improving EU flows absorption

All in all, activity in the domestic construction sector is expected to improve in the quarters and years ahead, deriving support from a likely acceleration in the implementation of CSFIII co-financed projects and the recent introduction of legislation aiming to promote projects in the form of Public-Private Partnerships (PPPs). Reflecting the above positive trends, the index of business expectations in construction has been on a gradual recovery path in recent months following earlier steep post-Olympic declines, while the price index of dwellings appears to have been on a rising trajectory lately following a mild deceleration in 2004. The growth prospects of business investments in equipment also appear favorable this year, supported by the continuation of strong domestic demand trends, healthy exports growth and improving business expectations in the industrial and service sectors.

Industrial developments uninspiring

Industrial production fell by 0.8 percent cumulatively in January-November 2005, weighed down by an equiproportional drop in manufacturing output and weaker production in the mining and quarrying sectors. Reflecting these uninspiring trends, the capacity utilization rate in industry retreated further and stood at 72.3 percent in December 2005 compared to 75.2 percent in the same month a year earlier. The poor performance of the manufacturing sector reflects among other factors weak production trends in the domestic textiles, footwear and clothing sectors, which have lately been facing increasing competition from imports from China and other low-cost countries. Improving growth prospects in some key eurozone economies where a significant portion of Greek exports is destined to may suggest room for a gradual recovery in domestic industrial output this year but deteriorating terms of trade due to persisting inflation differentials with the rest of the Eurozone and the continuing loss of competitiveness of traditional manufacturing sectors in Greece



leave limited room for optimism. Note, finally, that the Greek PMI manufacturing index fell below the 50 boom-or-bust threshold in January, the first such decline in nine months.

Current-account balance deteriorating

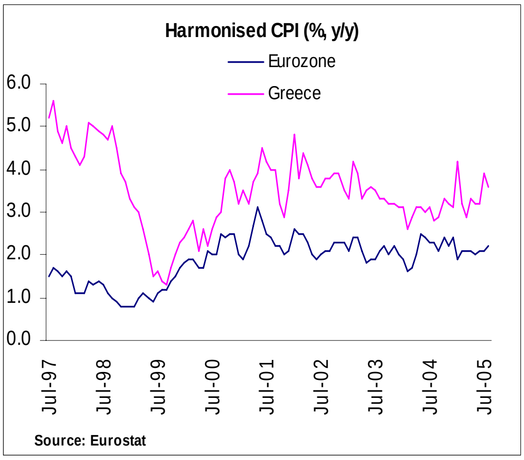
Following a considerable improvement in the current-account balance in 2004, the 33.8 percent y/y (€2.9bn) cumulative rise in the deficit in January-November 2005 was entirely the result of a wider trade gap due to a sharply higher oil bill and net payments in the ships balance (as opposed to net receipts recorded in the corresponding period of 2004). In fact, the trade balance excluding oil and ships actually improved by around 3.8 percent y/y in the first eleven months of last year as a result of higher exports and declining imports. Higher general government gross payments to the EU and in net interest, dividends and profits also contributed to the current account's deterioration in the first eleven months of 2005. On a more positive note, the services surplus widened during that period mainly on the back of higher net shipping receipts (despite the continuing fall in freight rates) and higher tourism revenues. Net receipts from transportation (mainly shipping) and travel services grew by 1.8% y/y and 6.9% y/y, respectively in January-November 2005. On the financial account side, strong inward portfolio investment to the tune of €7.5bn in January-November 2005 offered the main source of current-account deficit financing, while the FDI balance recorded a net outflow of €1.0bn, after recording a small net inflow during the same period a year earlier.

Olympics legacy boosts tourist sector

The Greek tourism sector appears to have finally begun to realize the benefits of the Olympics legacy. This has been helped by an intensified promotional effort by the Greek Tourism Development Ministry, which estimates a rise of over 10 percent y/y in 2005 tourist arrivals and forecasts the number of foreign tourists visiting the country rising to 20 million within ten years (from around 14 million last year). Further initiatives designed both to attract more tourists from the high-income brackets and to expand the tourist season beyond the summer vacations are currently under consideration by the government. Some of the steps proposed to help attain these aims include additional large-scale investments in the sector and the introduction of incentives for the retirement of ageing facilities.

Inflation likely to ease slightly in 2006,

Rallying oil prices and higher VAT and excise tax rates[2] heightened underline cost-push pressures and boosted average year-on-year inflation to 3.5 percent last year, from 2.9 percent in 2004. The CPI basket's heavyweights last year were housing and, to a lesser extent, the transport and clothing-footwear components[3]. These accounted for slightly more than 60 percent of the average annual rise in the overall index over that period. Presumably, higher heating (housing) and motor fuel (transportation) prices played a role in the above developments. On the other hand, communications was the component with the lowest contribution to both headline and core inflation rates, continuing a trend that has been in place since 2000 following the liberalization of the telecoms sector. Core CPI (i.e., national index excluding the volatile fresh produce and energy components) averaged 3.1 percent y/y in 2005, down from 3.3 percent y/y in the prior year, but risks are for a higher core inflation reading in 1H '06 due to more pronounced second-round effects from higher oil prices.



[2] Increase in oil price is estimated to have added around 1.2pps to average Greek inflation last year. Increase in VAT and other excise taxes is estimated to have added another 0.2pp or so.

[3] The total weight in the CPI basket is 34.6%.

An intensification of underlying inflationary pressures is also manifested by higher producer prices4, with recent price gains in domestically produced consumer goods pointing to increased efforts by local manufacturers to pass higher input costs to the final consumer. Meanwhile, imported prices in industry were up 10 percent cumulatively in January-November 2005, after rising by 5.9 percent over the same period a year earlier with the acceleration mainly due to higher energy costs. In 2006, the expected moderation of public wage growth and the government's increased emphasis on structural reforms leave scope for some reduction in the inflation differential with the rest of the Euro area. However, this differential is expected to remain significant over our forecast horizon, with further adverse implications for Greece's economic competitiveness. Eurobank EFG has a 3.2 percent y/y average CPI forecast for this year.

Inflation differential seen persisting…

Greece's high inflation rates, rapid unit labor cost growth and a positive output gap resulted in a significant appreciation of the real exchange rate in recent years, more than offsetting the beneficial impact of EMU membership. As a result, export growth has generally been sluggish and export market shares have declined by more than 15 percent cumulatively since 2000. On the inflation front, domestic consumer prices of goods and services excluding fuels and processed food have cumulatively been over 6 percent higher than the EU-12 average over the past 5 years. Last year, the Greek/Eurozone headline inflation differential (harmonized terms) averaged 1.3pp against 1.1pp in 2004 and 1.3pp in 2003.

…weighing on competitiveness

Cyclical influences and Greece's higher dependency on oil relative to other EU members[5] can explain a good deal of the persistent inflation differential. However, this can also be explained by other, more structural factors having to do with the degree of openness and competitiveness in key sectors of domestic economic activity. As we have noted before, the inflation differential features among the main causes of deteriorating economic competitiveness in recent years with various relevant indicators showing that domestically produced goods and services find it increasingly difficult to compete in both domestic and international markets. For example, the rather disappointing performance of the Greek manufacturing sector alongside strong domestic demand growth and rising imports point to increasing import substitution. Other relevant indices of Greek economic competitiveness, ranging from the sizeable current account deficit to the euro-real effective exchange rate weighted by Greece's trade shares, also continue to tell a worrying story. In this respect, prudent incomes policies, further fiscal tightening and structural reforms to promote flexibility in domestic product and labour markets are deemed imperative. Regarding the former, we note that the official announcement that public sector nominal wage increases will not exceed expected inflation in 2006 offers some scope for more favourable labour cost developments this year.

[4] PPI: +8.3% y/y cumulatively in November 2005 vs 4.3% y/yia year earlier.

[5] According to IEA data, Greece's total energy bill as % of GDP is the highest among (EU) members.

2006 fiscal outlook: Correction of excessive deficit feasible

- **The results of our sensitivity analysis of budgetary projections presented below suggest that even under relatively conservative assumptions a correction of the excessive deficit this year is feasible**
- **This is contingent on the authorities´ ability to ensure ordinary revenue growth broadly in line with nominal GDP**

Deficit drops in 2005, mainly due to non-recurring Olympics costs

Despite the underperformance of budget revenues last year, the government managed to reduce its 2005 fiscal deficit to an estimated 4.3 percent of GDP, from an upwardly revised 6.6% of GDP gap in 2004. As the table below illustrates, the key driver of this adjustment was a sharp reduction in the public investment budget's outlays (worth 1.4 % of GDP), mainly due to non-recurring expenditure on Olympic Games infrastructure. The remaining portion of the improvement was attained with the help of a higher surplus in the general government accounts (0.6 percent of GDP) and lower primary spending (0.36 percent of GDP). On the other hand, budget revenue underperformed initial targets, adding around 0.23 of GDP to the overall deficit figure, a rather disappointing development in view of the hikes in VAT and related measures taken last April to boost tax proceeds. Net ordinary budget revenue is estimated to have grown by 7.5 percent in 2005, undershooting an initial annual growth target of 11.4 percent (later revised to 6.7 percent). This underperformance was presumably due to widespread tax-evasion, which has also led to a significant decline in the budget revenue-to-GDP ratio over the past five years[6].

Targeting an end to the excessive deficit

The 2006 budget targets a 2.6 percent-of-GDP general government deficit this year, aiming to correct the excessive deficit without causing ''substantial adverse effects on economic growth or social cohesion''. The new budget has undergone a number of significant changes since the initial draft was unveiled by the government in early October after the European Commission signaled that it would like to see Greece reducing its deficit via measures which would be ''more structural rather than one-off'', effectively opposing the use of special revenue-generating measures. Consequently, the government lowered its target for one-off revenues in 2006 from €2.0bn (or 1.03% of GDP) - initially reported to come via the securitization of delinquent tax arrears - to €1.1bn (0.6% of GDP) now expected to be generated with the help of other special measures. The latter include higher dividends from three public sector companies, concession contract extensions and clearance of fines and licenses by the Telecom and Post Commission.

Contributors to 2006 fiscal adjustment

As the table below illustrates, a significant portion of this year's fiscal adjustment is projected to come via higher budget revenues, the main portion of which will be due to one-off measures worth 0.6pp of GDP.

TABLE 1: Contributions to total deficit reduction (% of GDP)

	2005 (e)	2006 (B)
Net ordinary revenue*	-0.23%	0.81%
Interest costs	0.26%	0.44%
Primary expenditure	0.36%	0.21%
Pubic Investment budget	1.40%	0.03%
Public utility surpluses & adjst.	0.55%	0.23%
Total contribution	**2.3%**	**1.7%**

source: 2006 budget & EFG Eurobank research
e: expected, B: 2006 budget
(*): tax revenues + one-off inflows - tax returns

These, together with lower interest costs, are expected to account for a whole percentage point of the 1.7pps-of-GDP total targeted deficit reduction in 2006. In addition to the above, the new budget also foresees: i. a 0.2pp-of-GDP reduction in primary expenditure relative to last year via higher restraint in public-sector wages and pensions, lower government consumption costs and slower growth of social-security and health outlays, and ii. a 0.2pp-of-GDP rise in the

6 Ordinary budget revenue as a %age of GDP has been in a constant decline over the last five years, dropping to an estimated 24.5% in 2005, from 28.1% in 2000.

surplus of the general government due to higher public utility dividends and lower defense costs. Finally, the targeted balance of the public investment program (PIB) in 2006 is projected to post a small improvement relative to last year, mainly as a result of higher EU structural fund inflows and the containment of public investment outlays at last year's level. This will contribute 0.1pps-of-GDP to this year's expected deficit reduction.

Assessing the new budget

Greece's 2006 budget appears to be in line with the February 2005 EU Council's directive for an implementation of adjustment measures of a permanent nature leading to a correction in the fiscal deficit by at least 0.6 percentage points of GDP. In this regard, it is encouraging that the government has reduced considerably its target for one-off revenues this year after the European Commission expressed serious reservations on the appropriateness of such inflows for deficit-reduction purposes. The fact that the 2006 budget targets a fiscal gap well below the 3.0%-of-GDP excessive deficit threshold, thus allowing for a safety cushion in case some of its underlying assumptions prove overly optimistic, is also encouraging. Generally speaking, a more restrictive incomes policy relative to last year[7], the planned reductions in the government's consumption costs, slower growth in social security & health outlays and the targeted revenues from one-off measures could facilitate a material deficit reduction in 2006. In fact, we expect the authorities to generally manage to eliminate the excessive deficit this year (see the results of our budgetary sensitivity analysis below), contingent on a rigorous implementation of the 2006 budget. Yet, we flag for significant risks and challenges surrounding the targeted adjustment, some of which are highlighted below

Macro assumptions may prove optimistic

Greece's 2006 budget is framed on an upbeat macro assessment, envisioning a slight acceleration in real GDP growth to 3.8%, from 3.6% last year. This year's GDP growth forecast assumes a strong bounce in real gross fixed capital formation growth to +5.4%, following a (preliminary) decline of 1.2 percent in 2005, which is expected to more than compensate for the projected slowdown in public spending growth and a worsening contribution from net exports. Yet, risks to this year's GDP growth outcome lie to the downside in our view, given a more challenging external environment (persistent global economic imbalances, risks of a hard landing in the U.S. housing market, etc) and a more restrictive fiscal/monetary policy mix domestically. Also, given the sizeable reduction in the target for one-off revenues and the small downsizing of the public investment program this year, we feel that risks are for a somewhat less dynamic than officially-projected bounce in investments in 2006. Also, slower real wage growth and less favorable external developments point to some downside risks to the official projection for consumer spending growth this year. Finally, we note that last year's stronger-than-expected real GDP growth was to a significant degree due to the improved contribution of net exports, mainly as a result of negative year-on-year import growth over the first three quarters. However, the favorable base effects from the 2004 Olympics year are gradually fading and we see limited scope for any significant external-sector contribution to GDP growth this year.

Tax revenue key to deficit reduction

The relatively inelastic nature of the greatest portion of ordinary budget expenditure, further planned reductions in the corporate tax rate and the need to maintain a sizeable public investment budget in order to support GDP growth and facilitate a faster absorption of EU funds[8,9,10] mean that a main challenge

[7] Public-sector wages are set to grow by 3.0 percent in nominal terms this year, lower than last year's 3.2% and against an official forecast average inflation rate of also 3.2% in 2006.

[8] In 2005, around 70 percent of total primary expenditure represented public sector wage and pension payments as well as transfers to the social security and health system, while interest costs amounted to as much as 20 percent of total ordinary budget outlays.

[9] A further significant cutback in public investment could adversely affect economic growth and exaggerate recent problems evidenced in the absorption of EU structural funds as the biggest (and more elastic) portion of the public investment program is co-financed by the EU.

facing fiscal authorities this year is to meet the target for revenue growth. Ordinary budget revenue growth underperformed an initial full-year target of slightly over 11 percent last year mainly on the back of poor VAT receipts (estimated to have grown by just 1 percent in 2005) despite higher VAT and excise-tax rates since April 1, 2005. This has presumably been the result of extensive tax evasion among non-wage earners and small-, medium- and large-sized businesses. To this effect, a comprehensive effort is currently under way to increase tax revenues with the help of special audits and electronic cross-checking as well as a mandatory filing of periodic VAT returns. These measures already appear to be bearing fruit as indicated by the significant acceleration in tax revenue growth in late 2005 and the BoG´s cash data, which shows a constant improvement in the central government's borrowing requirement since last June.

Closer monitoring of primary expenditure needed

On the spending side, although we remain concerned about the authorities' poor track record in reining in budgetary spending (especially primary outlays)[11], we generally deem the 2006 budget expenditure targets attainable. Our conviction about the attainability of these targets is particularly strengthened by a higher restraint in the public sector's wage bill this year as well as the government's determination to implement tighter spending controls on public enterprises and hospitals, with a view to reducing need for subsidies and loan guaranties. Certainly, more structural measures will be needed down the road to promote medium-term sustainability of public accounts and to this end it is encouraging that last year the authorities consulted with two special technical IMF missions on tax administration and public expenditure management. The government has already formed two high-level task forces to follow up on the Fund's recommendations. Another positive development is that the government has recently raised the public profile of the issue of pension and health care reform, although no specific reform initiatives are expected in this term of office.

High debt places heavy burden on public finances

The 2006 budget targets a reduction in the general government debt-to-GDP (currently the highest in EU-12) to 104.8%, from 107.4% last year, with privatization revenues in excess of €1.6bn sought to facilitate that aim. As we have noted before, a swift return to fiscal discipline represents a key policy challenge for the Greek authorities in light of their obligation to comply with the EU Council's decisions, but also in view of the need for a timely reduction in the debt-to-GDP ratio. The necessity of that objective is indisputable given the heavy burden the current sizeable debt-servicing costs place on public finances. Indeed, annual interest payments currently stand at 5-6% of GDP, representing some 65% of the total wage and pension bill. If amortization costs are also taken into account, the total annual cost rises to around 17- 18% of GDP, an amount equivalent to slightly more than 80% of total primary expenditure.

EC sees Greek excessive deficit persisting through to 2007

According to its *Economic Forecasts Autumn 2005,* the Commission forecasts Greece's general government budget deficit coming in at 3.8% of GDP in 2006, from 4.7% of GDP in 2005[12]. This assessment is based on a less-favorable growth scenario than that envisioned in the Greek budget, as well as a ''more prudent assessment of direct tax revenues, based on past outcomes''. Note that the Commission's 3.8%-of-GDP deficit projection for 2006 does not account for extra receipts worth around 0.6% of GDP envisaged

[10] The government already announced that it would proceed with a further 3.0pps reduction in the corporate income tax rate to 29% this year and that it would start cutting personal income taxes beginning in 2007.

[11] Primary spending last year increased 6.3% against a budget target of 5.9%. Interest costs rose by 3.3%, overshooting an initial growth target of 2.8%.

[12] The Commission's 3.7%-of-GDP estimated budget deficit outcome for 2005 incorporates 0.8pps of GDP of one-off receipts from the securitization of tax arrears. However, the government subsequently scrapped its initial plans to proceed with such operations as a means of boosting 2005 and 2006 budget revenues.

in the Greek 2006 budget, but even including such revenues the expected outcome exceeds the 3.0%-of-GDP excessive deficit threshold[13]. The Commission also forecasts a 3.8%-of-GDP deficit in 2007, based on unchanged legislation. Given that the Greek economy is currently under close surveillance by the EU authorities over its excessive deficit[14], failure to reduce the 2006 fiscal gap to no more than 3.0% of GDP could potentially result in closer monitoring and even significant fines. The latter is particularly true given Greece's burgeoning debt-to-GDP ratio (currently, the highest among the EU-12 countries) and the revised stability and growth pact's increased emphasis on debt dynamics. On a more positive note, some recent press reports suggested that the Greek government could finally reach a compromise with the European authorities over an extension of the deadline for a correction of its excessive deficit by one year to end-2007. Such an eventuality, however, would probably be contingent on a positive political decision by the EU Council and, to this extent, we do not incorporate such a scenario into our forecasts[15]. A decision by EU authorities to request Greece to take additional (structural) measures beyond those included in the 2006 budget to reduce its deficit would admittedly represent a worst-case scenario. In fact, the government has already rejected firmly the idea of imposing new direct taxes, while further significant cut-backs in the public investment budget would seriously endanger the implementation of the 3rd CSF program, which has already experienced significant delays.

Greece's updated Stability Program

Last December, the Greek government submitted to the EU authorities the country's updated stability and growth program. For this year and the next two, the program's base-line scenario assumes a benign global environment and forecasts average real GDP growth of 3.9 percent along with average inflation of around 3.0 percent. Under these (rather optimistic) assumptions, the general government deficit is expected to decline further and reach 1.7 percent of GDP by 2008, with the budget's primary balance rising over the same period to 2.8 percent, from 0.9 percent in 2005. General government expenditure is projected to decline by 1.7 percent of GDP over the period 2006-08, with just 0.3pp of this decline due to lower interest costs. The remaining portion of the expected expenditure adjustment will come via a better allocation of resources within the general government and from further cut-backs of central government consumption outlays. On the receiving side, general government revenue as a percentage of GDP is expected to remain broadly flat at around 42 percent over the three-year period, after increasing by a whole percentage point last year. All in all, the fiscal consolidation effort over the forecast period will be aided by the intensification of efforts to fight tax evasion, a gradual increase of minimum excise tax rates on fuels to bring then in line with those in other EU countries, further cut-backs in public consumption outlays, savings from the wage bill and lower subsidies and transfers to state enterprises (DEKO). Measures already taken to accelerate the absorption of EU funds will also help to reduce deficits in the years ahead. Finally, an alternative scenario envisioning a less upbeat macro trajectory than that of the updated program's base-line (average annual real GDP growth of 3.4 percent instead of 3.9 percent), continues to forecast a sub-3% of GDP fiscal-deficit outcome this year and the next two as a likely slowdown in budget revenue growth is offset by corresponding cuts in specific expenditure items.

[13] According to the EC's Autumn 2005 Forecasts, temporary revenues worth 0.6% of GDP have not been taken into account because the Greek 2006 draft budget did not specify the underlying measures.

[14] In February 2005, the EU Council ordered Greece – in accordance with Article 104(9) of the Treaty - to end its excessive deficit situation at the latest by 2006 through ''(i) a rigorous implementation of the 2005 budget as approved by its Parliament and (ii) implementing in 2006 adjustment measures of a permanent nature leading to a correction in the deficit of at least 0.6 percentage point of GDP''.

[15] Following the latest Ecofin meeting (mid-January), Economic and Monetary Affairs Commissioner Almunia said whether Greece will be granted an extension will not be decided before March 2006, when EU finance ministers (Ecofin) will meet to consider the Commission´s report on the Greek budget. Separately, Greek FinMin Alogoskoufis said Greece has not yet asked for a one-year extension to the deadline for achieving the target but this would ''depend on developments''.

2006 Budget: main figures

In € mio	2004 real.	2005 (B)	2005 real.	2006 (B)
1. Ordinary Budget				
a. Gross ordinary revenue	42,055	46,310	44,758	47,650
a1. Tax returns	2,798	2,600	2,554	2,200
a2. Special (non-ordinary) revenue			0	1,100
a3. Net revenue (a-a1+a2)	39,257	43,710	42,204	46,550
b. Expenditute	45,490	47,577	48,051	50,190
b1. interest	9,464	9,800	9,774	9,600
b2. Primary expenditure (b-b1)	36,026	37,777	38,277	40,590
2. Ordinary budget balance (1a3-b)	-6,233	-3,867	-5,847	-3,640
				11.2%
3. Public Investment Budget				7.4%
a. Revenue	2,894	3,400	3,078	3,490
b. Expenditure	9,522	8,050	7,700	8,400
4. PIB balance (3a-3b)	-6,628	-4,650	-4,622	-4,910
5. Central government balance (2+4)	-12,861	-8,517	-10,469	-8,550
5a. Primary balance (5+1b1)	-3,397	1,283	-695	1,050
6. Public Utility Sector surplus & adjustment	1,756	3,510	2,887	3,540
6a. Public utility & other surpluses	5,836	4,260	4,390	4,990
6b. Transfers to social security	-1,916	-450	-450	-400
6c. Diffence expenditure	-1,792	-1,600	-1,400	-1,500
6d. Adjustments	-372	1,300	347	450
7. General government budget balance (5+6)	**-11,105**	**-5,007**	**-7,582**	**-5,010**

% of GDP	2004	2005 (B)	2005 (r)	2006 (B)
1. Ordinary Budget				
a. Revenue	25.2%	26.1%	24.9%	24.6%
a1. Tax returns	1.7%	1.5%	1.4%	1.1%
a2. Special (non-ordinary) revenue			0.0%	0.6%
a3. Net revenue (a-a1+a2)	23.5%	24.6%	23.4%	24.1%
b. Expenditute	27.2%	26.8%	26.7%	25.9%
b1. interest	5.7%	5.5%	5.4%	5.0%
b2. Primary expenditure (b-b1)	21.6%	21.3%	21.3%	21.0%
2. Ordinary budget balance (1a3-b)	-3.7%	-2.2%	-3.2%	-1.9%
3. Public Investment Budget				
a. Revenue	1.7%	1.9%	1.7%	1.8%
b. Expenditure	5.7%	4.5%	4.3%	4.3%
4. PIB balance (3a-3b)	-4.0%	-2.6%	-2.6%	-2.5%
5. Central government balance (2+4)	-7.7%	-4.8%	-5.8%	-4.4%
5a. Primary balance (5+1b1)	-2.0%	0.7%	-0.4%	0.5%
6. Public Utility Sector surplus & adjustment	1.1%	2.0%	1.6%	1.8%
6a. Public utility & other surpluses	3.5%	2.4%	2.4%	2.6%
6b. Transfers to social security	-1.1%	-0.3%	-0.2%	-0.2%
6c. Diffence expenditure	-1.1%	-0.9%	-0.8%	-0.8%
6d. Adjustments	-0.2%	0.7%	0.2%	0.2%
7. General government budget balance (5+6)	**-6.6%**	**-2.8%**	**-4.2%**	**-2.6%**

Focus: sensitivity analysis of budgetary projections

3.0%-of-GDP deficit target attainable in 2006

In the following table we present the results of a sensitivity analysis on the projections of the 2006 budget. The general conclusion of our simulation exercise is that, under relatively mild assumptions about economic growth and fiscal developments, Greece can correct its excessive deficit this year by attaining a budget gap of no more than 3.0% of GDP. In our simulation we examine the attainability of the 2006 budget targets under various scenarios regarding economic growth, revenue elasticity and ordinary expenditure performance.

Sensitivity Analysis of budgetary projections

	A Scenario (baseline)	B Scenario (best)	C Scenario (worst)
Assumptions			
Real GDP growth	3.4%	3.8%	3.0%
GDP deflator	3.3%	3.5%	3.2%
Ordinary budget expenditure	5.0% (4.8%)	5.0% (4.8%)	4.8%
PIB revenue	13.4%	13.4%	13.4%
PIB expenditure	9.1%	9.1%	9.1%
Analysis results: fiscal deficit as % of GDP	deficit	deficit	deficit
Revenue elasticity = 0.95	**3.0%**	*2.9%*	*3.1%*
Revenue elasticity =1.05	*2.9%*	*2.7%*	*2.9%*
Revenue elasticity = 0.75	*3.3%*	*3.2%*	*3.4%*

Source: EFG Eurobank research

Analysis description

Our baseline scenario assumes 3.4 percent real GDP growth this year, incorporating a somewhat less dynamic than officially projected recovery of investment activity. Our best-case scenario of 3.8 GDP growth coincides with the official baseline scenario (2006 Budget), envisioning a dynamic bounce in gross fixed capital formation growth this year along with accelerating exports and the continuation of strong consumer spending. The third (worst-case) scenario assumes economic growth of just 3.0 percent as a result of weaker than officially projected investment activity domestically and a drag on GDP growth from net exports due to a less benign external environment. Each one of these three scenarios is then examined under three different sub-scenarios regarding budgetary expenditure growth and the elasticity of net ordinary revenue with respect to nominal GDP growth. (Net ordinary revenues mainly comprise direct and indirect tax receipts and exclude tax returns. In 2006, this budgetary component also includes one-off receipts worth 0.6 percent of GDP, expected to be generated by special measures such as increased dividends from public companies and concession contract extensions)

The average elasticity of net ordinary budget revenue was just 0.5 or so in the period 2000-2004, presumably due to widespread tax evasion. However, intensified efforts by fiscal authorities to increase tax revenue in recent months appear to have already started to bear fruit with the corresponding elasticity rising to ca 0.97 last year, albeit from a weak base. In our exercise we examine the budget performance under three different assumptions of ordinary revenue elasticity (baseline: 0.95, best: 1.05, worst: 0.75), using our best judgment about tax collection performance this year. Note that the 2006 budget assumptions imply a 1.15 elasticity of net ordinary revenue (excluding any one-off measures), which is higher than our best-case assumption. On the expenditure side, we assume a small overshooting of the budget target for the growth of ordinary budget outlays (5.0% y/y vs. 4.8% y/y assumed in the budget) in both our baseline and best-case scenarios for GDP growth, except in the event of significant revenue underperformance (revenue elasticity of 0.75). In the latter case we assume, somewhat counter-cyclically, that the government exercises tougher spending restraint and meets the budget target for revenue growth. The same assumption also applies to our worst-case scenario for GDP growth this year (3.0% in real terms).

Results

As the table above illustrates, the authorities are likely to correct the excessive deficit this year under various scenarios for GDP growth and mild assumptions about budgetary expenditure, contingent on their ability to assure ordinary revenue growth broadly in line with nominal GDP. If, however, tax collection disappoints, then it will be difficult to meet the 3.0%-of-GDP deficit threshold without additional painful spending cuts, a rather difficult endeavor as past experience has shown, not least because of the inherently inelastic nature of primary spending and the need to run a sizeable public investment budget to facilitate implementation of the CSFIII program. Also, the analysis results do not change significantly if different scenarios regarding the performance of the public investment budget are taken into consideration. As a final note, we assume through this exercise that the EU authorities will not oppose the use of special revenue-generating measures worth 0.6 percent GDP that are incorporated in the 2006 budget. As we have noted above, the European Commission's *Autumn 2005 Forecasts* did not take into account these temporary revenue measures since they were not exactly specified in the Greek 2006 draft budget the Commission had at its disposal at the time. These measures were detailed in the final 2006 budget (see above) and, presumably, their use to help reduce deficits is still awaiting approval by the EU authorities. The Commission is expected to review Greece's updated stability and growth program in late February, while a decision on whether to approve the budgetary targets for this year will be reached by the Ecofin Council in mid-March. Under the excessive deficit procedure for Greece, the budget deficit must be reduced to no more than 3.0% percent of GDP by the end of this year through the implementation of "adjustment measures of permanent nature leading to a correction in the deficit of at least 0.6 percentage points of GDP''. Since the additional fiscal adjustment envisioned by the Greek 2006 budget above and beyond the assumed special revenue measures amounts to a still-sizeable 1.1 percentage points of GDP and given that the government has cut almost in half its target for one-off revenues this year relative to that envisioned in the initial draft budget, we feel that these one-off measures will finally receive EU approval. It should be emphasized, however, that in the absence of such special revenue measures the government would almost certainly need to take extra measures in order to eliminate the excessive deficit by the end of 2006. Such measures would probably range from additional cut-backs in public investment expenditures, further reductions in the government's consumption and operating costs and even additional excise tax hikes (cigarettes, alcoholic beverages and/or other items).

Political overview and structural issues

Political developments and policy priorities

The first half of 2006 will be crucial for the ND government as it will be the period during which it will need to produce both the results and the momentum required to carry it through to the next parliamentary election, in principle in spring 2008: the start, in early summer, of political campaigning for the local elections due in the autumn, and the pre-election mood that will prevail during the remaining 16-17 months before the end of the Government's 4-year term, will probably dull any governmental appetite for bold new initiatives. Hence the need for the Karamanlis government to convince critical sectors of the electorate in the next several months that it is capable of ultimately delivering on such promises as making inroads against unemployment and the perceived high cost of living, to name two concerns repeatedly cited by citizens, but where results so far are, on the whole, undistinguished. In recent months, ND's lead has been trimmed to 2-2.5 points[16], compared with highs of 6-7% achieved in the early days. Though talk of early elections has abated of late (originally meant to capitalise on earlier, more substantial leads), the long-rumoured, but also long in coming, cabinet reshuffle was delayed by revelations of a major wire-tapping/spying scandal targeting the PM, cabinet ministers, top figures in the armed forces, the police, *et al*.

In his New Year's address, the Prime Minister – besides reiterating his much-touted resolve to carry on the fight against "corruption" – stated that citizens this year could expect to see more reforms being implemented. Last year saw a spate of mostly low-impact changes being voted in by Parliament, ranging from more flexible hours and reductions in the cost of overtime, which proved quite straightforward in their implementation, to more complex ones, such as reform of the bank pensions system, new legislation on public-private partnerships, the extension of shopping hours and changes in the *modus operandi* of public entreprises (including the end of jobs for life for newly-hired staff), none of which is entirely complete, or fully implemented yet, for various reasons (see below). For the new year, bold talk of a "second wave of reforms" has mostly receded and now the onus seems to be on the effective implementation of last year's initiatives, along with the introduction of several other political and social reforms (see below).

Putting aside for the moment the Government's fiscal-policy objectives, the three priorities in this year's structural-reforms agenda are, according to Economy Minister George Alogoskoufis:

(i) more "privatisations", particularly in the banking sector, though only Emporiki may lose its State tutelage if the initiative proceeds according to plan, allegedly by March, and Crédit Agricole, Emporiki's strategic partner (with a 9%-stake) – and the Government's preferred candidate to acquire a controlling share – ups its stake and takes control of Emporiki's management.[17] (On 2 February, Mr Alogoskoufis said that no-one had a formal right of first refusal in relation to Emporiki's privatisation and that the selling-off process would be "open". But he added that, "informally", Crédit Agricole would be granted just such a right.) For their part, the Agricultural Bank (currently, 84.5%-owned by the State) and Postal Savings Bank/TT apparently will confine themselves to standard share flotations, with the former purportedly aiming to offload a substantial tranche (10%?) via the ASE (perhaps by April), and the latter seeking a first-time listing on the bourse via a 25%-30% share flotation purportedly before the summer. The Economy Minister is known generally to favour the entry of new, foreign banks into the Greek market (including as

[16] Many analysts consider this lead fragile indeed for – far from being based on a Pasok revival – it is regularly accompanied by an express lack of confidence by interviewees in *both* main parties.

[17] The State directly controls a 9.5%-stake. State-controlled pension funds may be induced to sell another 10-15%. In all, this could raise Crédit Agricole's stake to 30-35%, making it Emporiki's main shareholder.

strategic investors in such institutions as the Postal Savings Bank) as a means of sharpening competition, as opposed to further M&As among existing Greek banks, which, he believes, may well have the effect of dulling it.[18] The Government's "National Reform Programme for Growth and Jobs 2005-2008" of October 2005 also spoke of the "privatisation" of ports, a process which in 2006 may remain confined to setting up a number of PPP-type projects, leaving their listing on the ASE, alongside that of the country's smaller airports, for next year at the earliest;

(ii) the reform of taxation for individuals, to be implemented beginning in 2007, and involving mainly a reduction in tax rates within a three-year time horizon. This will include a fall in the rate, ultimately from 30% to 25%, for middle incomes of up to €50,000 per annum (currently, top-end incomes begin at €23,001); a reduction in the top rate from 40% to 35% (to apply to incomes of €50,001 or more, instead of the current €23,001+); an increase in the tax-free threshold from the current €11,000 to perhaps €12,000; and some relief on the burden on high-value properties; details to be announced in February. It is recalled that corporate-tax rates are also set to fall, by ten points, *i.e.*, from 35% to 25% over a three-year period, starting with income earned in 2005; and

(iii) implementation of the recently-adopted law on public entreprises (3429/20 Dec. 2005), touted by Mr Alogoskoufis as *"the country's biggest reform ever"*. The law introduces modern rules of corporate governance and international accounting standards for these firms, as well as closer monitoring, by the competent ministries, of both their restructuring efforts and day-to-day activities. Indeed, such firms are expected to adhere closely by the Government's overall economic-policy objectives, its incomes policy and even its views on such important business variables as prices. Importantly, the law compels loss-making firms to draw up new collective agreements with workers: this is expected, first and foremost, to lead to downward pressure on existing salaries. If no new collective agreements are forthcoming in these (loss-making) firms within four months of the law's entry into force (*i.e.*, by 27 April), the Government will have the right to legislate unilaterally, thus – controversially – circumventing the hitherto well-entrenched institution of arbitration.[19] Needless to say, this eventuality has trade unions up in arms. Be that as it may, the biggest challenge will be how to deliver deep cost cuts across-the-board, to which end the Government is threatening with the withdrawal of loan guarantees, stricter financial controls, and the capping of executives' high salaries (which may lead to salary cuts of up to 50% or more in some cases).

(It is worth adding at this point that OTE telecom's voluntary retirement scheme – which set in motion the whole series of changes in labour relations in the public sector, and, in particular, the abolition of jobs-for-life for newly-hired personnel in public entreprises – is reported in the press as having stalled: the first 700 early retirees allegedly have yet to be compensated by the utility's pension fund due to uncertainty attaching to the State's likely role as contributor. This, therefore, renders all the more portentous a decision by the European Commission on 8 February to launch a formal investigation into the Government's plans to underwrite 20% of the cost of OTE's voluntary retirement programme[20], citing its possible incompatibility with Single Market rules due to the possible presence of (illegal) state aid[21].

[18] The counter-argument, of course, is that the emergence of "national champions" would facilitate Greek banks' penetration of the markets of Central and Eastern Europe. This kind of outward foreign investment can be shown, at least in some instances, to have been restrained or stymied by the relatively small size, by European standards, of even the largest Greek banks.

[19] Loss-making public firms number 21, exactly half of all non-listed public entreprises. The latter, in 2005, toted up between them net losses of €959m, compared with total profits of €685m for the six publicly-quoted public entreprises. For some reason, the Ministry of the Economy excludes loss-making Olympic Airlines from the list.

[20] See Law 3371/30.6.2005.

[21] The Greek side claims that the Government extends this aid in its capacity as "shareholder", not as "the State", with a view to alleviating extra costs that only it in the sector allegedly faces due to the quasi-civil-servant status of its employees. The European Commission is less sure as no other "shareholder" is set to take any analogous steps.

The Government had promised to cede a 4%-stake[22] – today worth about €370m, but last summer closer to €300m – in favour of the company's auxiliary fund TAP-OTE in support of OTE's early-retirement programme. In so doing, it intended to contribute to the estimated €1.0-1.5bn price tag[23] attached to a scheme that aimed at the reduction of the work force by a third, for which over 5,500 employees have already qualified in principle. If the Commission disallows the aid, OTE will have to fund the early-retirement programme by itself, with whatever consequences that will entail for its already negative, since 2004, financial results; alternatively, it will have to revise the (overly generous) terms of the deal or, even, find a way to "compensate" its competitors in some as yet unspecified manner.)

Other proposed legislation for 2006 includes: (a) a rule to allow mayors and prefects to be elected in local and regional elections by a 42%-majority, thus obviating the need for a second round of elections; (b) redesigning the country's development regions into five new districts, purportedly to better reflect the requirements of the forthcoming, €20.1bn 4th CSF (2007-2013); (c) new rules on industrial concentration in the media and on multiple ownerships in media entreprises; (d) a new framework, proposed by the Finance Ministry, regulating land use in coastal areas (which is said to provide for much easier terms regarding seaside building, and for the legalisation, in return for cash, of many illegal constructions in such areas, for obvious revenue-raising reasons); and (e) new terms, laid down by the Ministry of Public Works and the Environment, for the issuing of building permits and for the operation of the ill-fated Land Registry, as well as a national land-use plan to be unveiled in the spring. The latter's importance lies in the fact that it may help encourage more investment, *e.g.*, in the tourist industry or in the renewable-energy sector, which are currently often held up on account of various types of dispute among various stakeholders over the appropriate land use. Last but not least, the PM announced in early January that the Government intended to set in motion a process to revise the Constitution. Any proposals will be voted in by the Parliament to emerge from the next elections, which are due in 2008. The last review was in 2001.[24]

Much unfinished business remains from last year's reforms

Resolution of banks' pension-fund problems – critically exposed last year by the introduction of IAS – remains in limbo as the Government has yet to table the presidential decree implementing Law 3371 of 30.6.2005 which provided for the setting up of a new, sector-wide, auxiliary fund to replace a number of individual banks' funds. Emporiki Bank, which faced the severest problem, managed to avert negative financial results, based on IFRS, but only because it secured a decision by shareholders in August to join – in principle – the new auxiliary fund, ETAT. In so doing, Emporiki adopted the new law's stipulations regarding the transition from a system of guaranteed benefits to one of fixed contributions in respect of auxiliary funds (for employees hired post-1993), thus scaling down substantially, at a stroke, its nominal pension liabilities under IFRS. In reality, ETAT has yet to be established. For their part, Emporiki's employees are vehemently opposed to joining it and will undoubtedly

Furthermore, these extra charges, according to the Commission, might have been offset by special benefits deriving from OTE's former monopoly position, in particular with regard to its fixed telecom network. Clearly, there is room for negotiation.

[22] The Greek State directly controls a 36%-stake, while indirectly it controls another 3% through Hellenic Exchangeable Finance S.C.A.

[23] The original figure implied last year by the Government was €1.5bn. The European Commission now speaks of a total bill of €1bn.

[24] Among the provisions under review are provisions pertaining to: (i) the possible establishment of non-governmental, not-for-profit universities, (ii) the establishment of a Constitutional Court, (iii) the partial lifting of the ban on alternative employment for MPs, (iv) new controls on public contracts and the introduction of personal responsibility for civil servants entrusted with managing public funds, (v) an adjustment to the articles on the "basic shareholder", which caused the well-known dispute with the European Commission last year, (vi) the funding of political parties, (vii) a curtailing of the right of tribunals to overturn governmental decisions when this entails severe budgetary implications, and (viii) some curtailing of the permanent-tenure régime in the civil service through the possibility to hire in the public sector on the basis of indefinite contracts. Finally, there are no plans to change the rules governing the relationship between the State and the Church.

seek recourse in the courts. (The courts rejected as groundless an earlier appeal by Emporiki staff seeking an injunction, on the argument that ETAT had yet to be formally established.) OTOE itself considers the law unconstitutional. The legal uncertainties surrounding the decision to close down funds that are private-law entities, in order to replace them with a single (auxiliary) fund that will be a public-law entity without the consent of the insured, are a major cause behind the observed delay in government action, as well as behind the wait-and-see attitude of Alpha Bank, National Bank, Attica Bank and ATEBank. (Piraeus Bank was the first, on 26.1.2006, to apply to insure its employees with ETAT according to the provisions of Law 3371/2005.) Of course, this delay may have a knock-on effect on plans to privatise Emporiki, supposedly by March, unless prior real progress is made on the pensions front. That said, Emporiki Bank, pursuant to on-going plans to restructure itself for privatisation and to meet pension liabilities, in December successfully raised €397m in fresh equity.

For its part, the new **Public-Private Partnership Law**, adopted by Parliament in mid-September (Law 3389/13.9.2005), though potentially crucial in at least partly counteracting the adverse effects of drastic cuts in the public-investment budget for 2005-2006, should not be expected to yield concrete results for several months, if not years. Though the appropriate administrative structures now seem to be in place, at least at the level of central government, the experience of other countries suggests that PPPs will only prove themselves successful after a fairly long period of trial-and-error. In this sense, there are hopeful signs insofar as the Government is already, reportedly, pushing forward four sets of deals, including the construction of a large number of school buildings[25], three new hospitals, the modernisation of a number of ports and the relocation of various government services.[26]

There is renewed talk over **shopping hours**, including **banks' opening hours**, despite the fact that last August's law providing for their prolongation in the retail sector produced to date hardly a ripple in established patterns, employment and sales. (Perhaps more important in setting off changes to current customs in the longer run will be the arrival of the new shopping malls, discount chains and giant department stores which will be more sympathetic to the newly-extended hours.) In November, Development Minister Sioufas said that his Ministry was not studying any additional measures in this area, but a month later he proposed the optional opening of shops for seven Sundays a year[27]. In this, he may have been emboldened by statements, made earlier in December, by Alpha Bank chairman Yiannis Costopoulos to the effect that the retail banking industry faced major obstacles in its efforts to adapt to today's more-competitive environment, one of which was insufficient opening hours (the other being excess personnel). Together with Eurobank's "exchange" bureau in "The Mall" in Maroussi, open beyond bank branches' usual hours, and statements from George Alogoskoufis that it was logical that banks should follow the opening hours of shops, including on Sundays, should this apply to retailers, the stage was set for a new heated debate on banks' opening hours. Bank workers' union OTOE denounced attempts to extend working hours, conceding, however, that the existing system could be changed if there were agreement in the framework of a

[25] The first phase involves 27 new schools in Attica, including construction and maintenance, with a budget of €150m. (According to the Chairman of the School Buildings Organisation/OSK, an estimated 480 schools will be required in Attica alone.) The second phase reportedly will involve 25 schools in Thessaloniki and Macedonia, while a third phase eventually will involve a similar number of schools in the rest of the country. OSK's Chairman has said that building the schools needed in Attica would take 12-15 years under the standard, State-operated system, whereas thanks to the PPP method it will only take 7-8 years.

[26] Judging from this list, it would appear that private operators would be acting more as subcontractors than as entrepreneurs/concessionaires. To this extent, the additional capital they can be expected to put up (or, alternatively, the savings they can be expected to generate to the public sector's advantage), compared with pre-PPP, standard public contract practice, will be less than in the case of concession-type, big-project PPPs. This will be important in assessing their value from a fiscal point of view. In addition, the body of independent public-policy evidence assessing value-for-money for PPPs, based on the experience of other, advanced, countries, unfortunately is still slim.

[27] The Development Ministry intends to launch a dialogue with interested parties "soon".

collective pact with employers. (Such an agreement may have been seen at the time as partly depending on the outcome of wage negotiations, with OTOE demanding 10% pay increases.) But a side agreement between Eurobank's largest union and management extending opening hours until 9 p.m. on weekdays and inaugurating Saturday opening at two branches (at "The Mall" in Maroussi and "Cosmos" in Thessaloniki) angered OTOE which denounced such "unilateral" initiatives and vowed to fight them in the courts. OTOE then promptly expelled Eurobank's union from its ranks. In a surprise move on 30 January, however, the country's banks riposted by announcing their refusal to conduct talks with OTOE on a collective wage agreement, citing changing market conditions that made negotiations with their own unions much more appropriate[28]. The Government refrained from openly taking sides, citing its incompetence in the matter. It remains to be seen whether this move will usher in a new, more "flexible", era in labour relations overall.

Privatisation policy this year, as mentioned above, focuses almost exclusively on the banking sector. The State expects revenues of €1.65bn for 2006 (compared with a realised €2.1bn in 2005). However, this figure depends also on developments in such areas as **Olympic Airlines**. The Government now says it is prepared to dispose of majority ownership by October (two months ago, it was April, *i.e.*, before the onset of the tourist season) – but still there are no reports of any takers. Also, the **"Eleftherios Venizelos" airport** should be heading for the ASE this year for its first share flotation[29].

Real estate, including the leasing of Olympics venues and various tourist assets, is another potential area of activity, but the Economy Ministry has refrained from making any new announcements, beyond what is already known regarding a number of tenders presently under way. It is now estimated that by the summer a number of Olympic venues will have found private-sector operators interested in leasing them[30]. But, apparently, not all installations are equally attractive to the private sector, and this is a problem in light of maintenance costs[31]. As for ETA (Tourist Development Corporation), it has not produced any results in the last two years.[32] In addition, the Government promised in January that it would present new legislation on the sale and lease-back of State assets. This is presented to the public as a modern financial instrument that will afford the Government more flexibility in making the most of State-owned real-estate assets, even as it generates revenues, *e.g.*, to help upgrade such government-run operations as hospitals (though, according to one view, EU regulations compel governments to use such revenues to write down the public debt); but unless it is accompanied by a broad-based programme of relocation of government departments to cheaper premises (nothing of the sort has been announced), a sale and lease-back programme may ultimately prove not much more than a short-term revenue-raising exercise. Accordingly, Mr Alogoskoufis is reported as saying that he did not expect its use to make much of a dent on public debt figures.

Lastly, long-standing plans to privatise the gas utility DEPA are no longer making headlines, and no initiatives are expected before some time next year (earlier plans referred to a strategic partnership via the divestment of a 35%-stake). Likewise, there are no further plans for share flotations in OTE telecoms (following last September's 10%-placement) or PPC/DEH (51%-State-owned)

[28] The banks argue that the move is legal since the Hellenic Bank Association is not considered an employers' body, thus relieving it from the obligation to conduct collective wage negotiations. It can sign such agreements provided it has the consent of 70% of its members. But it now appears to have the unanimous backing of all members *not* to.

[29] The Sunday *To Vima* (29.1.2006) reports that the Finance Ministry is looking to prolong Hochtief's concession from 25 to 30 years in exchange for an extra €300m in revenues and lower user rates.

[30] Press reports refer, among others, to the International Broadcasting Centre, the closed badminton arena in Goudi, the Hagios Cosmas marina and sailing centre, and the Hellenikon complex, which includes the canoe-kayak slalom course.

[31] This category is said to comprise the weightlifting arena in Nikaia and two football stadia, in Volos and Patras.

[32] There are plans, reportedly, to sell off the Afandos golf course in Rhodes, the Corfu casino, the marinas at the Peace and Friendship Stadium in Phaleron and in Alimos, though nothing specific has been announced yet.

Other news in brief

Talks are under way for the new two-year **national collective agreement on wages** between SEV (Federation of Greek Industries) and GSEE (General Confederation of Greek Workers). According to reports, the two sides are edging close toward an agreement. Earlier, labour unions had threatened with strike action, unless employers withdrew proposals for a differentiated minimum wage by region and sector, intended to address serious viability problems faced by many firms located especially in northern Greece and/or in the textiles sector in particular. GSEE subsequently struck a more conciliatory tone, citing the need to confront the problem of high unemployment in these areas. But SEV upped the ante again, when, in the context of a meeting of the National Employment Council, it renewed a long-standing demand for an increase in the ceiling of permissible mass lay-offs in firms (currently, 2% per annum) and a reduction in non-wage labour costs. In the government sector, nominal salary increases will be around 3.0% (*vs.* an estimated inflation rate of 3.2%).

The Government proclaims itself pleased with the results produced by its **Investment Incentives Law** (L. 3299/14.12.2004), with applications to date having reached 1,256 and nominally worth €2.5bn. Of these, 601 investment projects had been approved by 3.2.2006, worth €959m and potentially creating 3,376 jobs. That said, the Government is already reportedly working on a new incentives law, one that will reflect the specific requirements of the next, 4th, CSF (2007-2013).

A source of considerable anxiety for the Government is the **CSF-III absorption rate**, which remains low. In January this year, it stood at 42% – compared with 55% for the EU15. This means that in the three remaining years 2006-2008 (*i.e.*, until the end of the programming period, including the customary two-year extension) the Government will have to absorb as much as €16bn, whereas during the previous six years (2000-2005) the authorities managed to absorb approximately only €10bn. The Government insists that it will not lose a single euro. Many outside observers are not so sure, though, having said that, a number of EU-related legal and implementing issues that dogged the authorities last year have now been settled with the Commission[33], thus in theory paving the way for higher rates of absorption than in the recent past.

The new agreement on the EU's "financial perspectives" for 2007-2013 struck by the European Council in Brussels on 15-16/12/2005 provides for €20.1bn in Community funding to Greece as part of the **4th Community Support Framework** (2007-13). Considering that the prevailing mood among net-contributor Member States was strongly in favour of a diminution in EU spending as a proportion of EU GDP; that the EU25 had to accommodate the needs of 100m more European citizens with below-average incomes; and that 2 years ago talk in Greece was of a financial package of the likely order of (only) €15bn-19bn (compared with 2000-2006's €26bn), it becomes clear why the Government hailed the deal as a success for Greece. Among the "pluses" is a provision granting a one-year extension to the maximum time available for the country to absorb the funds (*i.e.*, the N+2 rule becomes

[33] Since coming into office, the Government reformed the legal and regulatory framework for public works, largely in cooperation with the European Commission. Law 3263/2004 abolished the so-called "mathematical formula" and brought the institutional framework for the commissioning of public works in line with EU legislation and the European Court's case law. The institutional framework for public works was further revised by means of Law 3316/2005, which aimed to improve the quality in public-works studies in harmony with EU legislation, including the recent Directive 2004/18/EC. It also set strict conditions for making alterations to the study in the course of construction and codified the entire institutional framework for the commissioning of studies and other related issues in a single piece of legislation. Another important step towards improving the terms of competition was the codification of the national legislation and case law on public works, which was to be completed by the end of 2005. The aim is to make it simpler and easier to use for all parties involved in the provision of public works in Greece. Last but not least, the "main shareholder" law was thoroughly revised (see below).

N+3), and a provision that the national contribution to jointly-financed projects (*i.e.*, all CSF projects) can fall from the current minimum 30% to 15% for continental Greece and from the current 50% to 20% for the islands.

Parliament, in December, voted in Law 3427/2005 on the **imposition of VAT on new construction** and on a **capital-gains tax on properties** bought and sold. In conjunction with a revaluation of "objective" values (used for taxation purposes), the first since 2001, announced for the New Year (the immediate increase was an average 30%, but they will rise again annually over the next three years), this led to intensified activity and a marked appreciation of property prices especially toward the end of 2005. To the extent that this was speculation-driven, the real-estate market will probably be flatter this year. Nonetheless, Government revenues from property taxes in 2006 are expected, at least by some analysts, to double from last year, despite some sweeteners offered by the new law (*e.g.*, tax-free thresholds for first-time buyers).

The European Commission on 21 December 2005 finally shelved the **"main shareholder/media/tender" law** dossier, which involved Law 3310/2005 adopted on 20 January 2005 and suspended on 2 June by Parliament following the European Commission's position that the law was incompatible with Single Market rules by reason of the excessive restrictions it placed on media owners' right to also bid for public contracts. The Commission's latest decision followed the adoption, by Athens, of Law 3414/2.11.2005, which essentially took the teeth out of the previous version of the law, while maintaining a semblance of correspondence with the relevant primary clause in the Constitution. It is too early to tell whether or not the revised Constitution (see above) will amend Article 14(9), which was at the root of the Government's travails last year and its ultimate *volte face* over what was a central pillar of the Government's "anti-corruption" drive.

The President of **DEH** (the public power corporation) Ioannis Palaiokrassas (a former ND Economy Minister) resigned on 1 December 2005, after making allegations of involvement, by officials, in corrupt practices at DEH and failing to substantiate them by a deadline given him by Development Minister Sioufas.

On Thursday, 19 January 2006, the **ASE composite share-price index** closed at 3,968.05 points, which was the highest closing level since September 2000 (it closed at 4,118.28 on 8.2.2006, a 65-month high). The recent rally twice prompted cautionary words to investors from Minister Alogoskoufis, who reminded them of the excesses of 1999, only this time it is mainly foreign investors who are sustaining the bull market: in January 2006, foreign investors accounted for 40,83% of total shares traded on the ASE, compared with 36.09% in January 2005.

Last but not least, Economy Minister George Alogoskoufis, in a departure from "standard" practice, admitted (30.1.2006) that Greece's **pension system** was in the nature of a "*time bomb*" and that it "*must be defused in time*". However, he repeated the Government's position that any new legislation would be introduced during the next parliament, not now. For at least the next 26 months, he merely pledged to "*intensify*" the current "*dialogue*" so as to arrive eventually at a consensual outcome, based on "*mild*" and "*targeted*" adjustments rather than wholesale change, such as to preclude any abrupt shocks to the economy. (The Economic and Social Committee has been charged with organising the dialogue, and of commissioning a study whose conclusions all parties will be able to agree with – or, at least, with the numbers that will come out, as Mr Alogoskoufis recently explained. However, he also admitted that there were certain difficulties in actually launching the dialogue, while at the same time social partners also sought parallel, bilateral contacts with the Government.)

These statements by Mr Alogoskoufis did not prevent a (repeat) warning, five days later, from Economic and Monetary Affairs Commissioner Joaquin Almunia to the effect that Greece must not delay social-security reforms, given its very high public debt and the fiscal impact due to the country's ageing population and the dangers these posed to the sustainability of Greek public finances.

Mr Alogoskoufis' recent fears might have been heightened by an OECD report cited by him, which allegedly claims that expenditures on pensions in Greece will rise from 12.5% of GDP today to almost 25% of GDP by 2050 (compared with, say, EU15 runner-up Spain's 17.3%). On a more positive note, Mr Alogoskoufis said that the Government was prepared to study more closely the possibility of widening the tax relief and incentives offered to individuals who want to make use of private pension schemes as a supplement to their state pensions.

Part B

Special Focus Topics

- **Do the Greek real estate market and the economic business cycle move in tandem?**
- **Are Differences in Lending Rates between Greece and the EU justified?**
- **Oil prices and economic implications**
- **Community Support Framework for Greece: Recent developments and outlook**

Do the Greek real estate market and the economic business cycle move in tandem?

- **There is a bidirectional causal relationship between economic activity and the real estate market.**
- **Real estate markets and economic activity are not currently aligned in some major industrial countries that experienced a substantial rise in housing prices over the period 1995-2005.**
- **Greek housing prices currently appear to be in line with underlying fundamentals, limiting the risk of an abrupt price correction that could negatively affect overall economic activity.**

In a recent research piece by Moody's[34] it is argued that rapid credit expansion in Greece has created the conditions for an incipient real estate bubble. According to Moody's, low real interest rates, attributed to low nominal interest rates in the run-up to EMU membership and Greek inflation above the EMU average, induced higher demand for mortgage loans that fueled housing demand. In turn, rising housing demand in Greece has inflated housing prices.

A housing bubble has two features, namely prices rise above level consistent with underlying fundamentals and people keep buying a house due to expectations that housing prices will continue to rise. Thus, the question Moody's poses is whether housing prices in Greece are aligned to fundamentals summarized by economic activity?

Economic activity positively affects housing prices through households' wealth. Buoyant economic activity has a favorable impact on households' real disposable income that, in turn, raises demand for housing. It is estimated that a €100 increase in households' real disposable income in the US will raise real housing prices by €320.[35] In the UK a similar increase in real disposable income will raise housing prices by €251, while in Spain by €278.

Housing prices affect economic activity as well since a house is not just a shelter but also an investment that can generate income and finance household consumption. The way to do this is by means of the mortgage equity withdrawal facilities that many banks in the United States, the UK, Spain and elsewhere offer. The stereotypical withdrawer is someone who re-mortgages or takes out an additional secured loan to finance consumer spending. Mortgage equity withdrawal depends on the price evolution of the collateral i.e. the house. If housing prices go up, the value of the house and consequently the equity from the house that can be extracted will move upwards. In that context housing prices affect economic activity. The Federal Reserve System has estimated[36] that the house equity extraction net of commissions on homes sold, capital gains taxes paid on home sales and other fees stood at 7% of disposable income in 2004. In contrast, net extraction was 1.5% of disposable income in 1991.

This bidirectional relationship between the housing market and economic activity is reinforced by the impact of housing prices on construction activity and residential investment. A bullish housing market will boost prices and increase the profits that house constructors and developers realize. In order to increase their profits, the latter will invest more in residential fixed capital reinforcing overall economic activity. The bidirectional relationship between economy and real estate markets suggests that activity

[34] Moody's (2006), "Greece", Moody's Investor Service – Global Credit Research.
[35] OECD (2005), "Recent house price developments: the role of fundamentals", Economic Outlook, 78, pp. 193-234.
[36] Greenspan, A. and J. Kennedy (2005), "Estimates of home mortgage originations, repayments, and debt on one-to-four-family residences", Federal Reserve Board, Finance and Economics Discussion Series, 2005-41.

in the real estate market should move in tandem with the overall economy. Absence of co-movement will cast doubts over the sustainability of the rise in housing prices, implying a potential overvaluation not aligned to the fundamental factors determining housing prices.

In order to measure the degree of alignment between the business cycle and activity in real estate market, we compare an economy's output gap with the deviation of private residential fixed capital formation from its corresponding period average. Output gap is defined as the ratio of actual-to-potential GDP computed by OECD and reported in its *Economic Outlook.* Potential output is the level of output that would prevail should all wages and prices were flexible and the economy adjusted to balance supply and demand in all markets. A positive output gap indicates that the economy operates above full employment, risking to jeopardize price stability. By contrast, a negative output gap signals that the economy operates below its capacity at an employment level below full utilization. All in all, the output gap approximates the face of the business cycle that the economy experiences.

In order to approximate the phase of the real estate market, we estimate the percentage deviation of private residential fixed capital formation from its period average. According to the European Commission and OECD[37], private residential fixed capital formation consists of acquisitions less disposals of dwellings during a given period plus certain additions to the value of the existing stock of dwellings. Residential investment is a significant component of the gross fixed capital formation of the total economy that is used in the construction of GDP. In Greece, residential fixed capital formation stood at 5% of GDP in 2004.

The housing market has lately become a popular discussion topic among academics, market analysts, economists and households. The profound interest is reinforced by the cumulative increase of housing prices in current prices that has surpassed in some countries 100 % year on year. Specifically, in Spain it was up 105.6 % over the period 1995-2005.

In Chart 1 we present the corresponding graph for the US. The cumulative increase of housing prices in the US over 1995-2005 is 65 % in nominal terms. We observe that after 2001, the strong positive correlation between the business cycle and the real estate market observed before has collapsed. It appears that the real estate market has expanded over and above the business cycle in the US. Thus, rising housing prices in the US may not be justified by the business cycle, pointing to the possible presence of a housing bubble.

Indeed, research by investment banks[38] suggest that the US housing market is roughly 15% overvalued, with numbers ranging from 0% in Huston to 50% in Los Angeles. However, research by the Federal Reserve presented at an international conference on real estate organized by Eurobank EFG reaches a different conclusion. Specifically, when adjusted for housing quality, housing prices move in parallel to rents in the US implying that there is no housing bubble at a national level.[39] However, a housing bubble cannot be excluded at a state level.

Chart 1.
Real Estate Market and the Business Cycle: US

Source: Ecowin, Eurobank EFG Research

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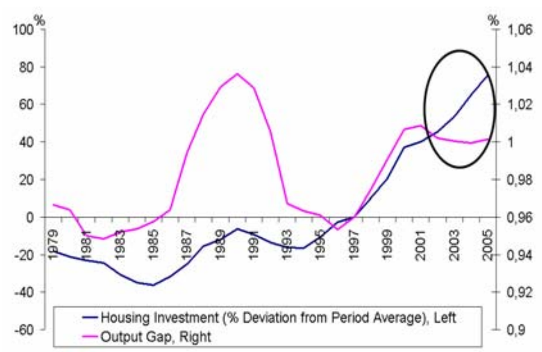
[37] http://forum.europa.eu.int/irc/dsis/nfaccount/info/data/esa95/en/een00137.htm

[38] Hatzius, Jan (2006), "Housing holds the key to Fed policy", Goldman Sachs, Global Economic Paper 137.

[39] Davradakis, M. and G. Hardouvelis (2006), "Is the real estate market overvalued? International trends and investment opportunities", Eurobank Research – Economy and the Markets, February 6.

The real estate market in Spain has also surpassed the business cycle in spite of the slowdown the economy experienced over the period 2000-2001 (Chart 2). This finding suggests that there is potential overvaluation in the Spanish housing market.

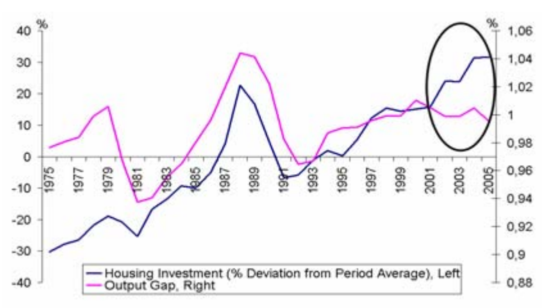
Chart 2.
Real Estate Market and the Business Cycle: Spain



Source: Ecowin, Eurobank EFG Research

Again, this is the conclusion by recent research at the Bank of Spain presented at the international real estate conference organized by Eurobank EFG. It was argued at the conference that housing prices in Spain are overvalued by 24-32%. This overvaluation is considered to be a correction to the housing prices over the historic low levels observed in the 80's. A misalignment between the housing market and the business cycle also appears to be present in the UK (Chart 3). UK has experienced a cumulative increase of 97.7% in nominal housing prices over the period 1995-2005, with the resulting misalignment pointing to the possible existence of a housing bubble.

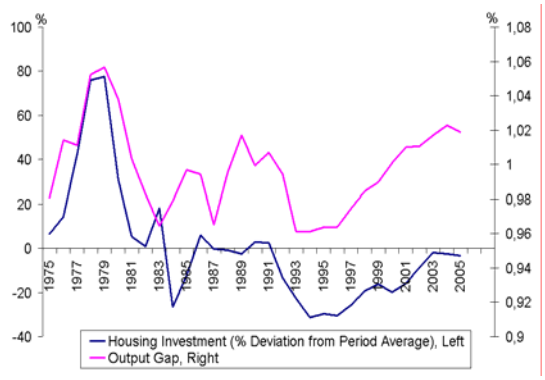
Chart 3.
Real Estate Market and the Business Cycle: UK



Source: Ecowin, Eurobank EFG Research

A report by International Monetary Fund (IMF) [40] suggests that there is a 60% overvaluation of housing prices in the UK, justifying our argument for overvaluation.

Chart 4.
Real Estate Market and the Business Cycle: Greece



Source: Ecowin, Eurobank EFG Research

In the case of Greece, no misalignment appears to be currently present between the housing market and economic fundamentals. In Chart 4 we observe that over the examined period, the real estate market in Greece has been broadly aligned to the business cycle following the peaks and slow-downs of economic activity. Indeed, the observed co-movement between the business cycle and the real estate market indicates that the recent strong increase in housing prices appears to be fully justified by the overall economic activity. Thus, rising housing prices in Greece are not speculative in nature and, therefore, not likely to generate an overvaluation or a bubble.

The non-speculative nature of the Greek housing prices is further confirmed by the responses of Greek households to a national survey organized by the Division of Economic Research and Forecasting of Eurobank EFG over the period 1/12/2005-09/01/2006. According to the survey's results, nine out of ten households who believe that housing prices will rise in the near future do not plan to sell their home. In other words, the elasticity of supply to changes of expected prices is very low. This explains the rising trend of housing prices in periods of high housing demand and the absence of abrupt

[40] Hunt, B. and M. Badia (2005), "United Kingdom: Selected issues", IMF Country Report, No. 05/81.

corrections in prices in the event of cooling demand for homes. According to the same survey, 78 % of the respondents who bought a house consider that buying a house is a secure investment. This feature of the Greek housing market implies that Greek households do not buy their residence for speculative purposes.

In conclusion our analysis suggests that rising housing prices in Greece are fully justified by economic fundamentals. Hence, the possibility of an overvaluation of housing prices in Greece is currently low thus limiting the risk of an abrupt correction in prices that could have negative consequences for overall economic activity. This conclusion is reinforced by the non-speculative nature of housing demand as documented by survey data from Greek households.

Are Differences in Lending Rates between Greece and the EU justified?

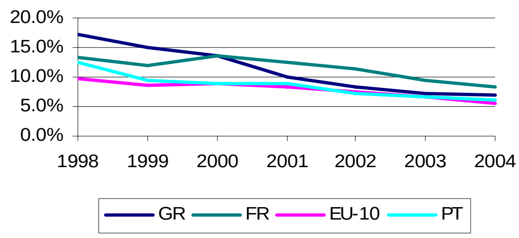
- **Greek lending rates have declined rapidly in recent years as a result of Greece's Eurozone entry and intensifying competition among local banks**
- **Greek weighted average lending rate currently some 125 bps above the euro area equivalent weighted average**
- **This margin can be explained, at least partly, by higher deposit rates, higher credit loss reserves and higher operational costs**

A current hotly debated issue is ...
the degree to which Greek lending rates have converged to the EU average in recent years and the factors that have prevented the complete elimination of the lending margin Greek enterprises and households pay over their European counterparts. Our approach is to develop a rudimentary pricing model to: i. define the underlying factors that determine the level of lending rates and ii. examine the degree to which differences in national lending rates can be attributed to differences in the significance of these underlying factors across the EU banking systems.

Lending Rates in Greece and the EU
A direct comparison between lending rates across several EU jurisdictions is by definition problematic, especially for the period before the harmonization of the lending categories in 2003. These difficulties arise because lending rates often refer to loans with different characteristics, different maturities and different levels of collateralization, such as different degrees of loan-to-value ratios. Furthermore, they can represent lending rates on new loans, or they can be averages of outstanding loans.

In order to circumvent such difficulties, we constructed a weighted average lending rate as the ratio of interest revenue from loans granted to enterprises and households to total loans outstanding. We have estimated this proxy for the lending rate for 10 out of the 12 euro area countries (we have excluded Luxemburg and Belgium because we were unable to find all relevant data). In Figure 1, we report the 3 countries with the highest weighted average lending rates and the EU-10 average. As we can see in this Figure, at the beginning of our sampling period Greek lending rates were significantly higher compared to the EU-10 average. However, since then they have declined sharply - especially after Greece's entry in the EMU - and by the end of 2004, they stood at 125 basis points above the EU-10 average.

Figure 1: Weighted Average Lending Rate (Enterprises and Households)



Determinants of the level of lending rates
As discussed in the introduction, we employ an implicit pricing model in order to define the underlying driving factors that determine the level of lending rates. According to this rudimentary model, the level of lending rates is determined by:

A) *The cost of funding*. The main source of funding for the banking sector is funds provided by depositors. A secondary source is the funds raised by credit institutions in the interbank markets. Hence, the lending rates charged by banks should, at a minimum, cover their costs of funding.

B) *Remuneration for expected losses*. An unavoidable risk of the banking business is the possibility that the borrower will fail to repay his loan as promised. The expected level of credit losses can be estimated by banking institutions based on their historical experience and it is reflected in their reserves and provisions for such losses. These reserves and provisions constitute an additional cost for the banks which is reflected in their lending rates.

C) *Remuneration for unexpected losses*. In addition to credit reserves, banks are also required to hold equity capital that can help them retain their solvency even when they realize unexpected losses, over and above those they have already provisioned for. The amount of equity capital held by a bank will depend on the riskiness of the bank's assets and its target level of credit rating. The return that the shareholders require for their investment and more generally the weighted average cost of capital (which also includes the cost of subordinated debt issued by the bank) will be also reflected as an additional spread in the bank's lending rates.

D) *Operating Expenses*. A factor that can not be omitted from any model of cost determination is that of operating expenses. We have used the ratio of operating expenses to amount of loans outstanding to assess the cost structure of the EU-10 banking systems.

E) *Market Structure*. On top of the purely technical factors that determine the pricing of loans, it is possible that the whole structure of the banking system (more or less concentrated) may also have an impact on the level of lending rates. The degree of concentration can be measured by the Herfindahl index, which gives us a metric of the size of each bank relative to the total size of the banking sector.

Assessment

In figures 2 , 3 and 4, we report the historical evolution of the deposit rates, provisions-to-loans ratios and the operating expenses-to-loans ratios (we do not report the figures for the other two factors, i.e. cost of equity and concentration ratio simply because the Greek data do not differ significantly from the EU-10 average). Based on these figures, we can conclude that all these three pricing factors are significantly higher for Greek banks, compared to the EU-10 average. The deposit rates are on average 50 bps higher than in the rest of the EU, the provisions-to-loans ratio of the Greek banks is the highest in EU-10, and the operational expenses-to-loans ratio, although it has declined steadily over time, is still the second highest amongst the countries we examined.

Figure 2: Deposit Rates with Horizon < 1 year

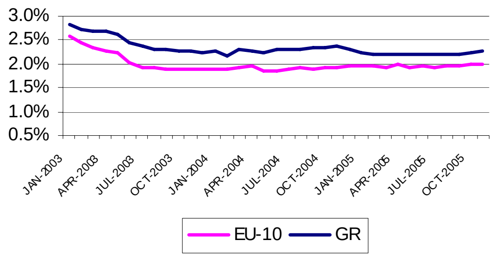


Figure 3: Provisions to Loans

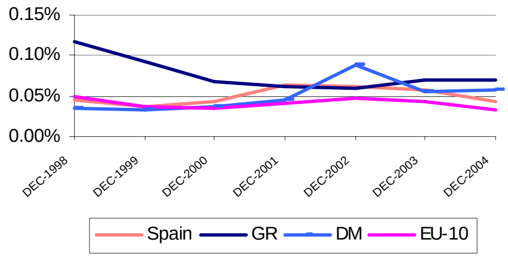
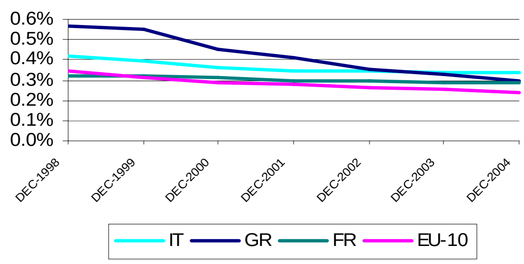


Figure 4: Operating Expenses to Loans



Summarizing ...

Focusing only on the differences between lending rates in Greece and the EU, without attempting to relate these differences to the underlying pricing factors, provides an incomplete framework for analysis. Although the framework presented in this section may be too simplified to provide a conclusive answer as to whether the 125 bps of lending margin that the Greek banks enjoy over the EU-10 average is fully justified by the underlying pricing factors, the fact that three out of the five factors are significantly higher than the EU-10 average can offer at least a partial explanation for this margin.

Oil prices and economic implications

- **Risks to oil prices and volatility remain to the upside in the near-term**
- **Investments in the oil production industry are crucial, if we are to see a significant drop in crude oil prices within the next decade**
- **Still, economies appear to be resilient against oil price inflation, while central banks adopt a tougher monetary stance**
- **Greece needs to decrease its oil intensity substantially**

We expect world oil demand to continue growing quite strongly in 2006. India's and China's demand is growing faster than last year and is expected to average 7 million barrels per day, 6% higher than in 2005. Risks to oil prices and their volatility remain to the upside in our view, as limited spare capacity, colder-than-normal weather conditions in the northern hemisphere and geopolitical uncertainties continue to impact market dynamics. Yet, it is still early to assess the full effect of higher energy costs on the EU, and the Greek economy in particular.

Short-term dynamics

Although some experts believe that the market may be currently oversupplied, the fact remains that there is very little spare capacity, and this has been recently plagued by seasonal and political factors. Last December, OPEC´s oil production was close to 26-year highs (almost 30 million barrels per day). This accounted for 40% of the world's oil supply. So far though, oil producing countries appear to be unable to cope with what seems to be a serious supply shock resulting from 30 years of underinvestment in production capacity. Moreover, the recent outbreaks of cold weather and disputes over Iran's nuclear program have created further instability in an already volatile market. Iran is the 2nd largest producer in OPEC (after Saudi Arabia), pumping 3.91 million barrels per day.

Any output reduction by Iran could cause serious supply and price stability problems worldwide. Experts estimate that oil prices could be pushed to as high as $100pbl, if Iran were to retaliate in case of any UN-imposed sanctions. Overall, around $5 may have been added so far to the barrel price of oil, due to the uncertainty caused by Iran's nuclear program. OPEC members' next meeting is scheduled for March 8. Traditionally, OPEC cuts production in the second quarter, as worldwide demand falls. However, if prices continue to be elevated, geopolitical concerns combined with limited spare production capacity may induce OPEC to keep producing at its current levels. This may be the case even if stockpiles were to increase further in the meantime. Hence, we anticipate that in the next few months, crude prices will remain close to their current levels, exhibiting significant spikes and volatility, stimulated by short-term supply uncertainty.

Long-term outlook

The currently elevated prices heighten the potential for increased investment in the oil industry. This is much needed for improving spare production (investing into exploration and development of new fields) and refinement capacity, so as to meet increased demand for crude and distilled products. Moreover, higher oil prices may also encourage the production of crude that has been expensive to extract so far, as well as investments into alternative energy sources. These developments along with further technological progress and the response of demand to the current price signals may possibly lead to a retreat of average oil prices over the next 5-10 years. Under such conditions, prices could retract to lower equilibrium levels within the $40-$50 band as consumers diversify their energy portfolio (using more energy efficient products and capital) and oil producers increase supply (achieved at lower costs due to technological advances). Still, price volatility and geopolitical uncertainty will continue to be a factor causing significant short-term price fluctuations and increased speculative investor activity in the oil and energy markets.

Economic effects of higher energy prices

Higher energy costs can have direct effects on economic activity. So far we know that they can depress consumption (especially of durable goods), cause delays in business investment or even induce costly resource and labor reallocation. They often affect an economy by creating negative expectations on future economic activity in both producers and consumers. Higher energy prices also imply higher production and distribution costs and can lead to cancellation or significant alteration of investment plans. Some sectors such as agriculture and transportation (or even tourism) can be affected more adversely than others.

Overall, dearer oil can cause a drop in GDP growth, with the impact depending on an economy's oil intensity, the ability of producers to pass the higher energy costs on to final consumers and the share of consumers´ income spent on energy consumption. Higher oil prices may also have significant inflationary effects, both direct and second-round ones. Yet, the world economy has so far demonstrated surprising resilience to the recent rallies in energy costs. According to the IMF's World Economic Outlook (Sept. 2005), inflation in developed countries (excluding USA) is projected to decelerate to 2.0% in 2006 from 2.3% in 2005. Moreover, developing countries' inflation should be on average down to 4.5% from 5.0% in 2005. According to the same source, real GDP growth rates are expected to continue rising steadily (though not spectacularly) this year, with the Euro area output expected to rise by 1.8% in 2006, from an estimated 1.2% last year.

While the world economy has so far been resilient to higher oil prices, there are indications that forces may be building up that can lead to higher inflationary pressures ahead. For instance, in the euro area, recent steep increases in producer prices[41] may induce producers to pass on higher oil prices to the end-user, as pressures increase on profit margins due to higher energy prices and uncertainty in the oil markets.

Greece needs to reduce oil intensity

The energy intensity of the Greek economy is still high both in absolute as well as relative terms. Indeed, Greece's current energy intensity is higher than that in other developed counties such as France, Spain, Italy, Japan and the UK and well above the Euro-zone average. Greece was also among the 4 countries with the highest increase in industrial producer prices last year (average annual Greek PPI vs. EU average). Yet, this is not likely to spark an inflationary spiral ahead, though the next few quarters' data will be crucial for our understanding of the impact of dearer oil on the Greek economy. It is of concern however, that energy data indicate that as although the country struggles to transform itself into a service economy, it consumes more energy. As Diagram 1 shows, all Greek sectors except industry (i.e., transports, agriculture, household and services), are steadily increasing their quota of energy consumption, as the economy grows.

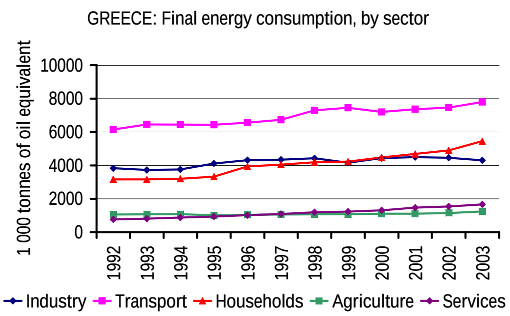


Diagram 1 (source: Eurostat)

Moreover, although energy intensity is declining (i.e., energy efficiency is improved) in industry and the economy as a whole (Diagram 2), the fact remains that almost all sectors of economic activity, spend more energy in absolute terms.

[41] Specifically, in both the euro-zone and EU25, Eurostat reported recently that industrial producer prices in December were up by 0.2% from the previous month. Excluding the energy sector, the increase was 0.1% in both the euro-zone and EU25 while prices in the energy sector rose by 0.4% and 0.6% respectively. On a yearly basis, industrial producer prices rose on average by 4.1% in the euro-zone and 5.2% in the EU25.

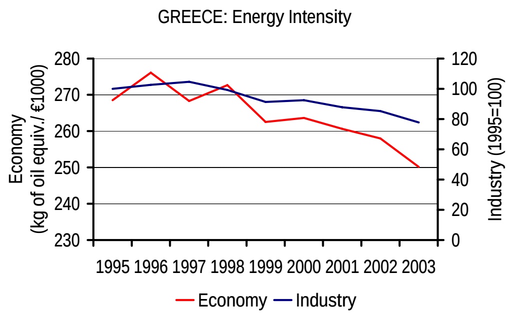


Diagram 2 (source: Eurostat)

The fact also that industrial producers prices have risen faster in Greece relative to other countries in the EU, coupled with the fact that the industrial sector (3rd largest energy consuming sector, see Diagram 3) is the "most efficient" sector energy-wise, should raise serious concerns to policy-makers and individuals as well. If the above behavior in the industrial sector is attributed to diminishing profit margins due to oil and energy price increases, how should then other less energy efficient sectors react?

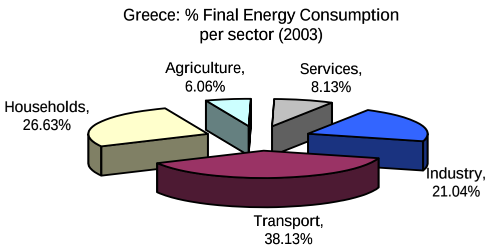


Diagram 3 (source: Eurostat)

To enhance our point, in Diagram 4 we display the 12 month moving averages of the core PPI (excluding construction and energy, left scale), the core CPI (harmonized) and the Goods' CPI growth rates (both on the right scale).

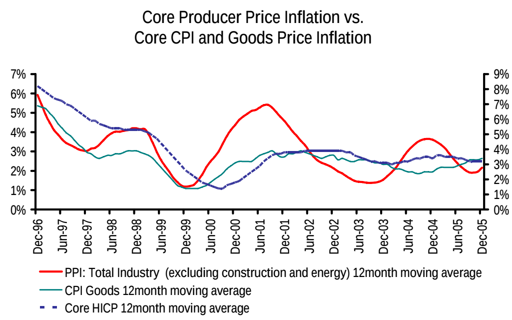


Diagram 4 (source: Eurostat)

Diagram 4 shows that core HICP and the Goods' CPI tend to follow output price inflation as this is expressed by the average PPI growth rate. The latter is followed by the Goods' CPI with an approximate lag of 12 months. As there is a recent upturn in the PPI (expected to last due to higher production costs), the relationship depicted in the diagram suggests that we may see some increase in core goods price inflation in 2006. This pick up in prices could be realized after the first half of this year, if oil and energy prices remain at high levels.

Summarizing, recent price data point out that we may be experiencing the first impact of higher energy costs through the price mechanisms. The full extent to which oil price inflation will trigger a significant increase in domestic prices is still not easy to determine, as the worldwide instability in oil markets creates further uncertainties. We maintain our earlier point, made past autumn, that output growth rates in Greece could have been 0.3-0.5 percentage points higher if oil prices were not fluctuating around historically very high levels.

Community Support Framework for Greece:
Recent developments and outlook

- **The allocated EU funds to Greece under the CSF IV programme amount to €20.1bn or ca 1.4% annually of the forecasted average nominal GDP for the period 2007-2013. This is higher than the initially expected amount, but lower (by approximately one percentage point of GDP per annum) than the allocated funds under CSF III.**

- **To avoid losses of EU CSF III funds, a significant acceleration in the signing of new projects and, in particular, the successful completion of projects already underway is required. Indeed, a total of €22.1bn has to be spent in co-financed projects over the next 3 years, compared to the €12.1bn spent in the first 5 years of the CSF III.**

- **In 2006, the CSF III EU co-financed part of the Greek Public Investment Budget (PIB) is the highest ever in absolute terms, thus generating most of the risks facing the proper execution of the 2006 PIB.**

CSF IV

Last December, the European Council reached an agreement on the EU budget for the period 2007 – 2013. The total amount of EU CSF funds allocated to Greece reached €20.1bn, which is higher than earlier official estimates. Yet, this amount is smaller (both in absolute terms and as a percent of GDP) than the corresponding allocation to Greece under the 3rd CSF, as two Greek regions, Attica and South Aegean, now have GDP levels above the 75% of EU's GDP cut-off line, while competition for such funds has increased as a result of the EU enlargement. Eurobank calculations show that the promised annual inflows under CSF IV amount to ca 1.4% of the forecasted average nominal GDP for the period 2007 – 2013, whereas the corresponding number under CSF III was 2.5% of the average nominal GDP of the 7-year period 2000-2006[42].

Besides the larger than initially expected allocation of funds under the new programme, another positive development for Greece is the relaxation of the n+2 rule, which caused many problems in the implementation of the 3rd CSF. This is to become an n+3 rule for the first 3 years of the new programme, meaning that once a project is contracted it will have to be completed before the end of the third – not the second – calendar year after the year it was signed. The increase in the percentage of EU co-financing of new projects also constitutes a welcome development as it implies less pressure on public finances, plus it can help with the timely completion of the projects, which will not be as much dependent on the availability of national funding. Under the 4th CSF, EU financing now covers up to 85% of the total cost of a new project compared to 75% in the 3rd CSF. In the cases of Attica and the South Aegean, these percentages can reach 85% from 50% under the 3rd CSF.

CSF III and Public Investment in 2006

In the 2006 central government budget, €8.4bn are allocated to the PIB out of a total projected expenditure of €58.6bn. There are two features of this year's PIB worth mentioning. First, the PIB amounts to 4.3% of GDP, the smallest such share since 1996. Second, the share of the EU co-financed component has gone up substantially, which puts pressure on the authorities to successfully develop projects that qualify for EU funding.

[42] Here we assume that nominal Greek GDP will grow by 7% per year and inflation will average 3.2% over 2007-2013.

More specifically, the EU co-financed part of the PIB was raised to €6.1bn, the highest absolute figure ever. At the other end, the national component of this year's PIB was reduced to €2.3bn from €2.55bn last year, following an already substantial reduction in 2005, thus reaching the lowest level (in absolute terms) since the year 2000.
The increased emphasis on the co-financed component is the result of necessity. Indeed, a significant acceleration in the absorption of EU funds is now needed over the next 3 years in order to avoid any losses of EU funds under the 3rd CSF. As we have already noted, a further €22.1bn has to be spent compared to €12.1bn that was spent in the first 5 years of the programme.

Our earlier analysis shows that most risks surrounding the proper execution of the 2006 PIB concern the progress of CSF III co-financed projects. In order to gain a deeper understanding of such risks, we remind our readers of the three major phases in the implementation of a CSF project:

- The first stage spans the period up to the signing of a contract by the counterparties involved.
- The second stage, the so-called expenditure stage, spans the period during which national public funds are disbursed as payments for the on-going execution of a project.
- The third phase ends when the EU goes ahead and credits the Greek government with its share of the cost, contingent, of course, on the co-funded projects' compliance with the relevant EU regulations.

New Contracts for CSF projects – an extension has been granted by the EU

By the end of January 2006, some 63% of the 3rd CSF program had reached and/or passed the first stage of a signed contract. According to the European Commission's initial regulation, this would leave a gap of 37% to be closed in only 11 months in order to meet the end-2006 deadline for reaching a level of 100% in signed contracts. Recently, the Greek authorities announced that the EU has granted an extension, allowing the signing of contracts in 2007 and 2008, which effectively abolishes the deadline altogether. Yet, there is little room for complacency, since, no matter when a contract is signed, the end date for completing the actual project and requesting the funds from the EU remains the end of 2008. Indeed, further significant delays in signing new projects would deprive those projects from the required time for completion.

The Flow of New CSF III Projects with a Signed Contract
(% of total CSF III public funds)

	2001	2002	2003	2004	2005
Annual Rates	12.6	13.0	12.5	10.8	13.3

In 2005 the flow of signed contracts accelerated significantly. This development reflects an improvement in the implementation process of the CSF as well as the maturing of many projects that experienced significant delays in the prior years. It also seems to be the result of transferring contracted projects from the purely nationally funded part of the PIB to the EU co-financed part. In the next three years, such a practice may not deliver analogous results and, hence, it is of paramount importance to speed up the whole contracting process.

Public Expenditure on CSF projects

The latest data - provided by the 8th Monitoring Committee of the 3rd CSF - show a substantial acceleration in public expenditure on CFS III projects. By November 15, 2005, €12.1bn out of a total amount of €34.3bn or 35.3% of the program had been spent.[43] The final deadline for reaching 100% of expenditure is December 2008, hence almost two thirds of the needed public funds has to be disbursed in the remaining 38 months.

The Flow of Public Expenditure on CSF III projects (% of total CSF III public funds)				
	Jan. – Oct. 2002	Jan. – Oct. 2003	Jan. – Oct. 2004	Jan. – Oct. 2005
Annual Rates	9.9	8.3	7.6	9.2

Here risks are similar to those noted earlier regarding the flow of newly signed contracts. Part of the acceleration observed in 2005 is due to the transferring of projects from the purely national component to the co-financed component of PIB and it is doubtful that such a practice can continue to deliver results in the future. Also, looking at the implementation of last year´s PIB, public investment spending in 2005 amounted to €7.5bn, which is significantly lower than the budgeted €8.05bn and reflects difficulties in the completion of the required EU co-financed projects. Looking forward, the growth of public investment outlays has to more than double and reach almost 20% of total public funds[44] annually in order to meet the deadline of December 2008. The increase in the EU co-financed part of the PIB we discussed earlier is thus justified.

Absorption rates of EU funds

Turning to the last stage of a CSF project, according to the Ministry of the Economy, at the end of 2005, 42% of total EU funds were cashed out, or €9.5bn out of €22.7bn. It is important to note that these figures are not readily comparable to the expenditure figures discussed earlier[45].

The Absorption Rates of EU 3rd CSF Funds (% of EU funds)					
	2001	2002	2003	2004	22/11/2005
Annual Rates	9.2	5.8	6.1	9.6	11.3
Cumulative Rates		15.0	21.1	30.7	42.0

The above data suggest that absorption of EU funds accelerated in 2004 and 2005. This is good news, but one should be cautious not to over interpret the figures. The inflow of EU funds in a given period is not necessarily an indicator of how well the process is being managed at that particular period. The absorption of all the allocated EU funds depends on the prompt signing of new contracts and the timely completion of the projects.

[43] This portion is by definition smaller than the percentage of projects with a signed contract discussed earlier.
[44] Public funds is defined as the total sum of EU and national funds required for the full implementation of the CSF programme.
[45] First, the percentages now reflect the pool of EU funds only, not public funds. Second, the absorption figures are boosted by an original EU pre-payment in 2001, the first year of the 3rd CSF programme, which was equivalent to 7% of the total amount of EU funds. This pre-payment was disbursed at the very beginning to help the country begin the process and does not reflect the value of completed projects.