Eurobank EFG Economic Research

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Greece: Macro Monitor

A Quarterly Review of the Greek Economy

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Effects of world economic slowdown increasingly evident

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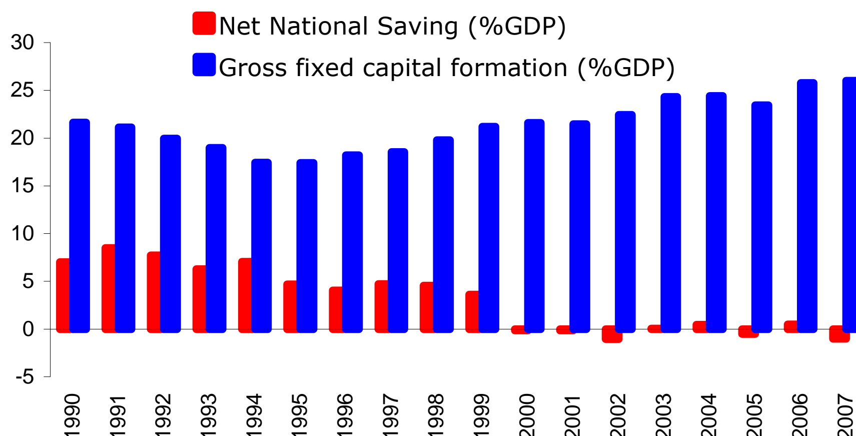
- **Domestic economic activity is expected to decelerate in both 2008 and 2009**, weighed down by tighter credit conditions and the dampening effects of higher oil and food prices on household disposable incomes. At the same time, tourism, shipping and exports continue to act as shock absorbers, significantly cushioning these effects. All told, we expect economic growth to come in at 3.3% this year, before decelerating further to around 3.0% in 2009.
- **We expect domestic inflation to remain elevated for the remainder of 2008**, fuelled by higher input costs, new administrative increases in the special consumption tax on fuels and accelerated wage growth. Though favorable base effects should facilitate some moderation in year-on-year inflation in the last quarter of the year, we expect annual CPI to come in at 4.5%, against our earlier forecast of 4.2%.
- Despite an expected improvement in budget revenue growth in H2, we see **upside risks to our *revised* 2.5%-of-GDP budget-deficit forecast for this year**, especially if efforts to crack down on tax evasion and reduce discretionary spending fail to yield the expected results.
- Our estimations suggest that, excluding the impact of oil prices and ship purchases, **the current deficit has to decline by 5.4 percentage points of GDP** (from the current level of approximately 14% of GDP) **in order to become sustainable in the medium-term**. This implies a required real depreciation of 25%, based on very lenient assumptions.
- **OTE and Deutsche Telekom reached a path-breaking agreement**, with OTE ceding day-to-day management control.

Graph: Rising external imbalance poses medium-term growth, prudential risks



Greece: key macro indicators *, **

y/y growth	2006	2007	2008f	2009f
GDP (constant prices)	4.3	4.0	3.3	3.0
Private Consumption	*4.2*	*3.2*	2.8	2.7
Public consumption	*-0.7*	*10.3*	4.0	4.0
Gross fixed capital formation	*12.9*	*4.6*	*4.5*	*4.7*
Domestic demand	*5.4*	*4.5*	*3.4*	*3.3*
Exports g&s	*5.1*	*5.9*	*5.0*	4.7
Imports g&s	*8.7*	*7.0*	*4.7*	4.9
National CPI (average)	3.3	2.9	4.5	4.1
Budget deficit (% GDP)	2.5	2.8	2.5	2.0
Public debt (% GDP)	95.3	94.5	93.0	92.0
C/A balance (% GDP)	11.1	14.1	-14.2	-14.5
Unemployment rate	9.3	8.3	8.3	8.0

Source: Realised (offical) data & EFG Eurobank forecasts

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Political and Economic Overview

The substantial fall in popularity of the two main parties, New Democracy and Pasok, was deemed by most political commentators to be one of the most important political developments of the earlier part of the year. In recent weeks, however, the trend has, if anything, been further strengthened following revelations in Germany that Siemens, the engineering and electronics giant, in what has been described in the international press as "probably the biggest corporate bribery crisis ever"[1], had purportedly paid bribes to government officials and political parties to win contracts in Greece and elsewhere. The allegations refer to both main parties and cover the period 1998-2005. Coming on the heels of a string of cases that have come under judicial investigation (the milk cartel, the structured-bonds/pension funds affair, the wire-tapping revelations), the Siemens affair, through the significant changes it has purportedly brought about in the way citizens perceive and feel about politics may – according to a small but growing school-of-thought – end up triggering a longer-lasting transformation in the structure and complexion of the country's political system.

Most opinion polls put the two main parties' collective strength in the wide range of 46%-58%, compared with 79.9% at the September 2007 general elections and 86% in March 2004. Under these circumstances, a hung parliament in the next elections has become a distinct possibility for the first time in decades. The privileged beneficiary of this new trend was Left-wing Syriza, which saw its share of "votes" in opinion polls shoot to over 18% in March 2008, compared with the modest 5% it garnered in September 2007. Four months later, Syriza has lost some, but not all, of its recent gains (its losses are estimated at between 3-6 percentage points from its March highs). Hence Pasok's systematic courting of Syriza, which, however, has not returned the compliment – quite the contrary.[2] (Pasok finally got the message, and in the beginning of June decided to make it its official policy to contest the next elections alone; nonetheless, the issue does not appear to have entirely died down, at least as far as Pasok is concerned.) Similarly, New Democracy insists that any scenarios (promulgated in the press) suggesting the possibility of a post-election alliance between ND and other parties (presumably, populists LAOS) are baseless and undermine the party's autonomous dynamic in the whole run-up to the next elections, whenever the latter take place.

While the two main parties hover in the low 30s to mid 20s, ND continues to hold on to its steady, 3pp+, leads over Pasok. This, despite the well-known problems arising from the Siemens affair, the wave of rising food and fuel prices, the sale of OTE (see below) and the latest disturbances in the universities[3]. On the "credit" side of the ledger, one has to include the better-than-expected growth in the first quarter of the year (3.6%) and the Government's handling of the Skopje affair at the NATO summit in Bucharest (2-4 April). Were these voting preferences to solidify over time, no major party would meet the minimum threshold demanded by the current system to allow a single party to form a 151-majority in Parliament, *i.e.*, 41.5% of the popular vote. Interestingly, unless one or other party succeeds in breaking out of the current mould, even the new electoral law adopted in January (set to apply in the elections after the next) will not save the day: the new legislation, designed to make it easier for winning parties to form working majorities in Parliament, also requires, according to the experts, that the winning party secure at least 39.5% of the vote. Insofar as, on present evidence, this has few chances of materialising, some of the country's more imaginative commentators have already begun to speak of the end of the post-dictatorship (1974), essentially two-party, era and the possible emergence of new political forces.

Constitutional reform comes to an unglamorous end

Another Government priority for the current term was constitutional reform. A first attempt was scuppered by the opposition parties acting as one in the previous parliament. The Government insisted, nonetheless, on a fresh attempt in its second term despite having been informed by Pasok that the main opposition party would abstain from the proceedings. In the event, the Government, on 27 May, managed to secure the required three-fifths majority on three of the articles it

[1] Financial Times, 25 June 2008.

[2] Alecos Alavanos, former chairman of Syriza and currently leader of the party's parliamentary group, went so far as to compare collaborating with Pasok ahead of the next general elections to a "descent into Hades" (27 May). Most commentators considered this to mark the end of the affair.

[3] These have not deterred the Government from continuing to look for legal loopholes in the Constitution that would allow charitable foundations or wealthy individuals to set up private universities. The Constitution bans private universities.

had sought to amend (out of 38) thanks to a sufficient number of "yes" votes from the smaller opposition parties (Pasok was absent from the session). The articles in question are article 57 (this overturns a ban on concurrent extra-parliamentary gainful employment for MPs), article 79 on amending budget items in mid-course, and article 101 providing special status to island and mountain regions. More important than what this revision achieved was what it did not achieve: because the revision process is now complete, another revision cannot take place before the parliament after the next (*i.e.*, at least five years from now). Thus, the more contentious articles, such as article 16 banning private universities and article 24 on the protection of wooded areas will remain in their current form, to the satisfaction, presumably, of most opposition MPs.

High-growth on a knife-edge?

On the economic front, the first quarter's 3.6%-growth rate was higher than the 3.4% pace that many analysts had been expecting. It was also significantly better than the Eurozone's 2.1% and the EU27's 2.3%.[4] The European Commission's Spring Economic Forecasts (published on 28 April) saw a slowing down of economic growth in Greece to 3.4% in 2008, from 4% in 2007. The Government's forecast – for now – is 3.5%, though Minister George Alogoskoufis has been reported as mentioning the figure of 3.4% as a possibility[5].

Slowing economic growth is a worldwide phenomenon: the World Bank on 10 June revised downward its global growth projections for 2008 to 2.7%, from 3.7% in 2007. For its part, the IMF, in its latest *World Economic Output Update* (July 2008), projects that world growth will decelerate to 3.0% in 2008 (from 4.8% in 2007 on a fourth-quarter-on-fourth quarter, Q4/Q4, basis), before picking up to 4.3% in 2009.

Interestingly, however, in Greece, the country's two most "international" sectors, *i.e.*, shipping and tourism, are only partly mirroring international trends, with, on balance, positive results so far. Bank of Greece data for **gross transport receipts** (mainly from merchant shipping, *i.e.*, the country's single biggest foreign-exchange earner) reveal for the period January-May 2008 an increase in receipts of 21.3% compared with the first five months of 2007.[6] This, in the face of a decline in worldwide rates of merchandise-trade volume growth (to an estimated 5.9% for the whole of 2008, from 6.4% in 2007 and 9.1% in 2006[7])[8]. As far as **tourism** is concerned, predictions by market participants for tourism receipts pointed to an appreciable decline for the year as a whole, perhaps of the order of 5-8%. If this turned out to be the case, it would indeed be worrying given that tourism internationally, including in the Mediterranean, seems to be defying the global trend toward less spending: according to the United Nations World Tourism Organisation, international tourist arrivals grew year-on-year by about 5% worldwide in the first four months of 2008, and by 4% in Southern and Mediterranean Europe[9]. However, the latest data produced by the Bank of Greece suggest that tourism revenues in the first five months of the year actually *grew* by 8.2%.[10] Furthermore – and this will come as no surprise to those who are close to the tourism industry – the slight increase in arrivals by air transport (2.8%) was overshadowed by the large increase in arrivals from the emerging markets of Eastern Europe and in particular Russia. Based on the (imperfect) data available, the increase in the share of such markets has more than offset, in terms of total revenues, the falling share of arrivals from other, more traditional, countries of origin, such as Britain. However, it is premature to say whether or not this is a lasting trend, given that Greece's high season starts in June. Lastly, the third pillar, **merchandise exports**, also fared relatively well in the first quarter of the year, rising to €4.56bn compared with €3.80bn

[4] See, Eurostat News Release, *Euroindicators*, 97/2008, 9 July 2008 (second estimates for the first quarter of 2008). Greece's Q1 growth rate was the highest in the EU15.

[5] *Kathimerini*, 4 July 2008

[6] See, Bank of Greece, *Balance of Payments: MAY 2008*, Press Release, 22 July 2008, http://www.bankofgreece.gr/en/announcements/text_release.asp?relid=1630.

[7] International Monetary Fund, *World Economic Outlook*, April 2008, Statistical Appendix, p. 256, http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/tables.pdf.

[8] By June 2008, the number of Greek-owned ships rose to 4,545, from 4,346 at the end of 2007 and 4,164 in 2006. Of these 4,545, 3,019 were vessels with a capacity of over 10,000 dwt (*i.e.*, 98.2% of the total capacity of the Greek-owned fleet). The latter represent a total capacity of 218.33m dwt, a 6.9% rise in capacity over the previous year for this class of vessel. See, *Kathimerini*, 11 July 2008, citing a study by Petrofin S.A., a Greek-based international financial-services company.

[9] See, http://www.unwto.org/facts/eng/pdf/barometer/UNWTO_Barom08_2_en_Excerpt.pdf.

[10] See, Bank of Greece, *Balance of Payments: MAY 2008*, Press Release, 22 July 2008, *op. cit.*

in the corresponding quarter of the previous year (a nominal 20% increase y-o-y).[11]

(The three main pillars of Greece's export activity are: (i) merchandise exports, (ii) shipping and (iii) tourism. In 2007, total gross receipts from exports of goods reached €17.45bn[12]; gross receipts from shipping reached approximately €16.94bn[13]; tourism brought in another estimated €11.4bn.[14])

Inflation, for its part, is seen by the Government as rising to 3.5% or more this year (*vs.* the Bank of Greece's 4%), from 3.1% last year. But this could yet prove overoptimistic: in April, inflation reached 4.4% and in May and June 4.9%, the highest level since 1998. The average for the year might be closer to 4.5%. (In the Eurozone in May it was 3.6%, the same as in Q1.) In addition to the worldwide rise in energy and commodity prices, Greece has to contend with its low-energy-efficiency economy, causing energy-price rises to have a greater impact on the price level than elsewhere. More worryingly still, core inflation (*i.e.*, inflation excluding petroleum and fresh-produce prices) came in at 4.0% in June, from 4.2% in May and 2.5% in May 2007. The persistence in the inflation gap with the rest of the Eurozone, and the phenomenon of Greece being the fifth worst-hit country as far as food prices are concerned[15,16], highlight once again the vulnerability of the Greek economy to any form of inflationary assault, whether of domestic or foreign origin. In the medium term, and on past trends, the gap between Greek and EU price-levels will tend to increasingly narrow as a result.[17]

One (fortunate) side-effect is that increasing numbers of commentators are beginning to assign greater responsibility than hitherto for this state of affairs to the distortions, structural rigidities and monopolistic practices evident in the Greek economy, which theoretically could pressure the Government into seeking more effective policy action in the areas of competition policy, opening up closed-shop professions and furthering market liberalisation. However, the impression among critics of the Government that the latter preferred to shift its responsibilities to others, *e.g.*, by blaming the external environment, rather than deal with the root causes at home, was not helped by the announcement, on 3 June, that PM Karamanlis had requested in a letter to the Commission President José Manuel Barroso that the issue of high prices as well as the possibility of European measures to support the poor figure on the European Council's agenda later in June. Having said that, the day before at the Ecofin Council in Brussels Minister Alogoskoufis had aligned himself with the "orthodox" school: he sided with the majority of his colleagues against the notion of cuts in fuel taxation and tampering with the price mechanism *via* changes in VAT, and in favour of boosting competition and combating profiteering, while targeting specific national relief measures at the lower-income strata – all three, essentially *domestic* affairs at this stage. The Government is planning in September to activate the National Fund for Social Cohesion, based on Law 3631/15.1.2008. It is also considering targeted income-support measures for the unemployed and those on low pensions, but their announcement should not be expected before the autumn whereupon the Government will have a clearer picture of developments in the world economy and of the state of budgetary execution (see below). All in all, the onus of adjustment would continue to be on national policies, thereby maintaining the pressure for

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[11] Bank of Greece, *Bulletin of Conjectural Indicators*, No. 112, May-June 2008, p. 137, http://www.bankofgreece.gr/publications/pdf/sdos200805-06.pdf. In 2007. Average gross exports per quarter were €4.35bn. This makes 2008 Q1's export performance look somewhat less impressive. But protracted industrial action since the beginning of January at the country's main port, Piraeus, has clipped this year's export (and import) figures.

[12] *Ibid.*

[13] *Ibid.*, p. 138.

[14] Estimate by the Association of Greek Tourism Entreprises (SETE), July 2008. SETE's estimates are lower than the National Statistical Service's, which lump economic immigrants from neighbouring countries together with tourists.

[15] According to Eurostat, food prices in Greece in April were 7% higher than they were a year ago. The corresponding rise for the EU as a whole was 7.1%. For the Eurozone, it was 6.2% (Ireland, Denmark, the UK and Austria saw higher food-price rises than Greece). Overall inflation in Greece in April was 4.4% y-o-y, while it stood at 3.3% in the Eurozone. Eurostat, STAT/08/76 2 June 2008, http://europa.eu/rapid/pressReleasesAction.do?reference=STAT/08/76&type=HTML&aged=0&language=EN&guiLanguage=en.

[16] The Athens Chamber of Commerce and Industry conducted its own research at the end of May-beginning of June, conducting a broad survey of supermarket prices in Greece and four other European countries for the same products. For some products, Greek prices were the most expensive. But at the same time, for other products Greek prices were among the lowest. See, *Kathimerini*, 6 June 2008.

[17] Greece's Economic and Social Committee issued a report in July 2008 entitled *Monitoring Indices for the National Reforms Programme 2005-2008.* The report reproduces Eurostat data (p. 19) showing that in 2007 Greece's price level was at 84.6% of the EU15 level (84.9% in 2006). See, http://www.oke.gr/index-gr.htm.

domestic Greek reforms. In this context, the European Commission's latest Internal Market Scoreboard (9 July 2008)[18] does provide some (qualified) solace, without, however, leaving any room for complacency: Greece is one of ten Member States to have achieved their best result so far. More specifically, Greece achieved a transposition deficit of 1.4% for the first time ever. But this still places her in 22nd place in the EU27. Greece also faces 88 open infringement proceedings, which places her 4th from the bottom (ahead only of France, Spain and Italy).

(In the event, the European Council meeting on 20 June did support some EU-based measures: in relation to food prices, through the relaxation of a number of restrictive CAP-related measures; through an examination of restrictive regulation in the retail sector; and a closer monitoring of activities in the commodity-related financial markets, including speculative trade. However, national measures to alleviate the impact of higher food and oil-and-gas prices on the poorer sections of the population according to the European Council would have to be "short-term and targeted" to avoid "distorting price signals and causing broad-based second-round effects on wages and prices". At the same time, governments should avoid "distortionary fiscal and other policy interventions [which] prevent the necessary adjustment by economic agents."[19])

The European Commission does not foresee the level of **unemployment** this year falling from last year's 8.3%.[20] This would be consistent with the stable Q1 trends recorded in the Eurozone (7.1%). The Economy Ministry is more optimistic and says the figure will go down to 7.4% by year-end. The Commission does not deny that such an outcome is feasible, but not before the following year. With the slowdown gathering pace in the Eurozone economy, the issue of unemployment will increasingly be on the minds of policy-makers, alongside the question of inflation.

Another looming worry is Greece's growing **current account deficit**, which has doubled in the past ten years to reach 14% of GDP (sparking negative coverage in the international press, *cf.* an article in the *Financial Times* published on 7 May). Minister Alogoskoufis, without wanting to minimise the problem, argues that other indicators are faring better and that "the high current account deficit reflects, to a great extent, high private and public investment[-goods] inflows which reinforce the production and export potential of the economy".[21] Unfortunately, this is not the end of the story (see special section in this issue). In addition, other, broader, indicators with a more long-term impact are less encouraging. For example, the IMD's *World Competitiveness Yearbook 2008* ranks Greece a mere 42nd in the world, when only a year ago it was 36th. In a similar vein, the World Economic Forum's *Global Competitiveness Report 2007-2008* ranks Greece 65th, from 61st in 2006 and 51st in 2004 (out of 131 countries).

Another headache is Eurostat's questioning of the official **2007 fiscal results**, which had already seen the country's fiscal deficit rise to 2.8% of the (revised) GDP compared with an original target of 2.2%. (In 2006, the deficit was 2.6% of GDP.) The original 2007 target was overshot mainly because of extraordinary central-government outlays due to last year's summer forest fires, to greater-than-expected reimbursements to taxpayers, to unplanned expenditures related to last year's early elections, and to a slightly smaller-than-expected surplus registered by the social-security funds and local authorities. However, during an early-June visit to Athens to scrutinise government accounts, Eurostat officials were said to question, in addition, the manner in which €400m's-worth of Community funds (0.2% of GDP), €500m's-worth of interest-rate swaps (0.25% of GDP) and the alleged "surplus" of local authorities, social-security funds and hospitals (the so-called "white hole") had been recorded in the budget. (All told, the statistical discrepancies in question may be equivalent to about 0.6% of 2007 GDP; a final verdict will probably be made known in the autumn.) The country exited the Excessive Deficit Procedure in June 2007. Any new *ex post* transgression (if transgression there is) is unlikely to bring Greece under the EDP's provisions again, provided good progress is made on this year's fiscal targets. The **2008 budget** foresees a general-government deficit of 1.6% of GDP, which, in its ambitiousness, might provide sufficient leeway to

[18] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1122&type=HTML&aged=0&language=EN&guiLanguage=en
[19] Brussels European Council, 19/20 June 2008, Presidency Conclusions, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/101346.pdf.
[20] See, *Spring Economic Forecast 2008-2009*, 28 April 2008, http://ec.europa.eu/economy_finance/pdfs_files/2008/spring-forecasts/eu-member-states/el.pdf.

[21] Letter to the *Financial Times*, 9 May 2008.

prevent any upward revision of the 2007 data pushing the 2008 budget deficit back toward the 3%-of-GDP threshold through knock-on effects. However, more problematic than the side-effects of any 2007 upward revision may yet prove the actual achievement of the 2008 targets themselves. Already in the first five months of the year, tax revenues are said to be off course by €1.7bn. (First-half results for 2008 show revenues increasing by 5.7% *vs.* a target of 12.1%.) Various options are being considered (*e.g.*, enticing taxpayers who owe money to settle with the tax authorities on favourable terms – outstanding tax debts are said to be in the region of €15bn), though to date the Economy Minister has ruled out introducing any new taxes. Opposition Pasok considers that the accumulated effects of underestimating the deficit in the years 2007 and 2008 will lead to a year-end 2008 budget deficit of 3.5% of GDP.

Structural reforms and privatisations

Parliament on 31 March gave its overall approval to the **pensions-reform bill**, after months of crippling strikes and protests by unions and opposition parties. The main points of the reform are (i) the merging of scores of pension funds into just 13, (ii) the trimming of many special and supplementary pensions, and (iii) making early retirement more difficult, while offering people incentives to work longer. Most observers and analysts across the spectrum (SEV, GSEE, assorted technocrats) viewed the reforms as minor and insufficient.[22] Meanwhile, four professional groups, lawyers, notaries-public, engineers and journalists, two public- and a few private-sector trade unions have appealed to the Council of State to overturn the law as it applies to them. Another problem is the tight schedule foreseen by the law for the mergers to take place. The bulk will have to be finalised by the end of August, but the Federation of Social Fund Employees warns that this is not possible for a number of practical, administrative reasons.

In a landmark vote, Parliament on 19 June approved an agreement between the Greek State and Deutsche Telekom AG allowing the German company to take control of 25% of **OTE**'s share capital plus one share, exactly the same as that which the Greek State will end up with. (Prior to the agreement, the Greek State controlled 28%.) DT will also assume day-to-day management of the company. For its part, the Government claims that, under the terms of the agreement, the State secures a better deal than under alternative scenarios, such as holding a minority stake of up to 33%. In particular, by virtue of Article 9 of the law, it argues that it will have a right of veto over "all the important operational issues affecting OTE". A look at the actual text of the law indicates that this is indeed the case with regard to the basic character and constitution of the company and its wider mission, the approval of financial statements before they are submitted to the general meeting of shareholders, and to various institutional issues regarding the role of management. As far as labour relations and the company's pricing policy are concerned, these are covered by other parts of Greek legislation, and to this extent are not entirely within DT's exclusive decision-making power. However, with regard to such issues as voluntary early retirement schemes and the dismissal of redundant staff, the bill, despite providing for an extensive consultation process (Article 15), ultimately gives the final say to top management.

The two parties reached their original agreement on 14 May. Earlier, on 17 March, Deutsche Telekom bought Marfin International Group's almost-20% stake. By mid-July, DT had managed to build up another 2%-stake through purchases of shares in the open market, eventually reaching the 22%-mark. The new law ratifies the sale of the outstanding 3% by the Government, for €442m. (MIG decided to sell its shares after the Government introduced new legislation in January requiring Government approval for the acquisition, by private investors, of equity stakes of 20% or more in State-controlled utilities which possess or operate national infrastructure networks. This is being investigated by the European Commission for compatibility with free-capital-movement and competition rules within the Single Market.) By the end of 2011, the Greek State will have the option, but not the obligation, to sell to DT another 15%-stake.[23]

Though consistent with ND's pre-electoral 2004 programme, the deal sparked major controversy, involving as it does the first real sell-off of a leading public entreprise. Criticism came not only from the Pasok camp, but also from leading liberals such as former Minister Stephanos Manos. Manos argues that DT should have been forced to buy at least 35% of the company's equity before being handed over the management, while he has also rebuked the Government for depriving small investors of a chance

[22] For a more detailed discussion, see *Greece: Macro Monitor*, March 2008, pp. 5-7.

[23] http://www.parliament.gr/ergasies/nomosxedia/EisigisiEpitropon/599/K-OTE-EIS.pdf , p. 2.

to sell their shares at the higher price of €26 and €29 at which MIG and the Government, respectively, sold theirs (at the beginning of June, OTE shares were trading at around €18-€19 per share). In Pasok's view, the law stipulates that the Government and DT should have made a public offering for the remaining free float. The fact that the latter did not meant that small investors had been duped. Pasok is intent on taking the Government to court over the agreement on grounds of breach of faith: the DT-OTE agreement makes no reference to the need for the new OTE's investment plans to be vetted for compatibility with the national interest, contrary to Article 11 of Law 3631/2008 which the Government itself introduced in January; no serious attempt is made, according to Pasok, to assess the value of OTE's real-estate portfolio in Greece and abroad; the agreement raises serious issues relating to the country's national security; etc. The European Commission apparently is of the view that a public offering to minority shareholders ought to be made, but is awaiting the (Greek) Capital Market Commission's final decision before taking any action. The latter is known to be against such an offer.[24] The Government's public-relations case was not helped when Deutsche Telekom admitted (on 26 May) that it had surreptitiously tracked thousands of telephone calls to identify the source of leaks to the news media about the company's internal affairs.

With regard to the wider policy of privatisations, Minister Alogoskoufis has suggested that next in line are **EYDAP** and **EYDATh** (the Athens and Thessaloniki water-and-sewerage utilities), "though nothing specific was in the cards", according to the Minister. The model to be followed has similarities, but also differences, to that which applied in OTE's case. The Government is seen as gradually reducing its stake in both utilities to around 35%-40% (in EYDAP it currently controls 70% [the State 60% and the Agricultural Bank of Greece, ATE, 10%]; in EYDATh it controls over 70%). But although the Government will purportedly seek a strategic partner for both companies, in neither case apparently will the latter be handed the management or even co-management rights (Public Works Minister Souflias is said to oppose such an arrangement). This will make finding a partner all the more difficult. (It is recalled that previous attempts to privatise OTE had foundered on the Government's insistence to remain an active co-manager of the company.) France's Suez Environment, which currently possesses about 5% of EYDATh, has expressed a vivid interest in both companies.

As far as **DEH** is concerned, Minister Alogoskoufis has reiterated that New Democracy's 2004 election programme stipulated that the State's share would not fall below 51%, and the Government is sticking to this position.[25] The current turbulence in the capital markets has allegedly induced the Government to postpone any other major privatisations. This means that plans to list **Athens International Airport** and **DEPA** (natural gas) on the Athens Stock Exchange will have to wait until next year, as will another **Postal Savings Bank** flotation[26]. However, recent press reports citing Government officials suggest that the Government might be preparing for the sale of **ELTA** (Hellenic Post) shares before the end of the year, ahead of the deregulation of the postal-services market. According to the Communications Ministry's Secretary-General George Anastassopoulos, the Government is interested in finding a partner for ELTA in 2008 or, alternatively, list company shares on the ASE and then find a strategic investor (the OTE model). The postal-services market is set for full deregulation in the EU by 2011[27], and the Government apparently wants to test the waters before the market frees up. Meanwhile, ELTA faces competition only in its courier services, which are already liberalised, and a strategic partner for ELTA's courier services should, reportedly, be announced by September (a consortium of four firms is reportedly interested in acquiring a 51%-stake in "Tachymetafores A.E.", currently number three in the market with a 14%-market share). Also, talk of a 5%-10% placement of **ATE**

[24] Meanwhile, the Union of National Bank Employees authorised, on 21 July, one of its pension funds (the latter is in possession of 145,000 OTE shares) to bring a lawsuit against anyone responsible for the alleged non-observance of the public-offer provisions contained in Greek law. (This could include DT and the Capital Market Commission.)

[25] DEH is locked in a legal battle with the European Commission which insists that DEH should give up its monopsonistic hold over the country's lignite deposits.

[26] The Government's original plans foresaw a placement of about 20%, which would bring its stake to below 50%, from today's 65.1%. Meanwhile, the Postal Savings Bank announced losses of €37.7m in Q1 2008.

[27] The Third Postal Directive adopted on 20 February 2008 allows some Member States the possibility to postpone full market opening by a maximum of two more years. http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/323&format=HTML&aged=0&language=EN.
The Greek Minister of Transport and Communications Costas Hatzidakis has already said that Greece will make use of this provision. See, http://ec.europa.eu/internal_market/post/doc/conferences/speech_hatzidakis_en.pdf.

shares has faded away, leaving a restricted number of alternative potential targets to allow the Government to meet its goal of €1.6bn in privatisation receipts for 2008. (Its receipts so far are limited to the €442m raised by the OTE sale.) The most important alternatives are the **two main container terminals in the ports of Piraeus and Thessaloniki** (see below). Other choices that have been mentioned include the privatisation of the Mont Parnès Casino, the partial privatisation of some regional airports *via* the method of public-private partnerships and the sale-and-leaseback of government properties. The Government allegedly expects revenues of €800m from this source alone, though to date the only tenders that have been announced are the four proclaimed on 8 July by the Tourism Development Ministry for the leasing, for forty years, of marinas at Mytilene, in Lesbos, Mallia, in Crete, the city of Zakynthos, and Argostoli on Cephallonia.

An international tender for the privatisation of the two main container terminals in the ports of Piraeus and Thessaloniki was launched in mid-January. **OLP**, which is 74%-State owned, received two bids (from China's Cosco Pacific Ltd and Hong Kong's Hutchison Port Holdings), while **OLTh** three (from the two abovementioned companies and P&O Ports, a part of Dubai Port World, together with construction firm Aktor and Piraeus Bank). On 3 June, OLP announced that Cosco had made the better offer, worth €4.3bn (of which 79% was guaranteed) – touted by the Government as a world record – to operate the port's commercial docks for up to 35 years; Cosco also promised to invest a further €620m to expand the docks.[28] The huge offer immediately caused the Hong Kong bourse authorities to suspend trading in Cosco shares until the following day, whereupon Cosco submitted a stock filing clarifying that the amount it was offering was just €500m at today's prices. The amount of €4.3bn in actual fact corresponded to the overall 35-year lease, factoring in inflation. The firm added that if it won the tender, its business plan would be funded by €250m from borrowing and the rest from equity funds. On 12 June, the Piraeus Port Authority (OLP) named Cosco as the provisional winner of the bid.[29] Meanwhile, 2,000 port authorities' employees decided to extend their on-going overtime ban (begun on 5 January) into June and, then, July. In the six months of the year, OLP has seen a 75% fall in container traffic and a 5% fall in vehicle traffic, leading to revenue losses of the order of €10m. According to the Piraeus Chamber of Commerce, accumulated costs to Greek companies this year from such industrial action have reached €4bn, and many international companies have turned to other ports in the Mediterranean for their services. The OLP-Cosco deal is expected to stem the recent tendency which saw the gradual marginalisation of Piraeus. The country's biggest port fell from 57th in the world in 2004 to 64th in 2005 and 2006 in terms of container capacity.[30] As far as Thessaloniki is concerned, OLTh announced on 22 July in a stock-market filing that the provisional winners were Hutchison (in a joint bid with Greek pharmaceuticals firm Alapis), after submitting by far the highest bid. (The latter is in the region of €419m, plus new investments, additional income from rents and a proportion of future earnings, of which €2.175bn or 70% of the offer price will be guaranteed even if actual revenues fall short of expectations; this brings the total value of the offer to €3.1bn over a 30-year period). The winning preliminary bid will not be formally announced before the last week of July. The port's managers hope that a final agreement could be signed, then ratified by Parliament, before the end of the year so that the new contractors can be installed sometime early next year.

It is worth recalling that whether the Government under- or overshoots by a few hundred million euro this year's €1.6bn privatisation-revenue target will make no effective difference to another goal, *i.e.* the reduction of public debt: at the end of 2007, public debt stood at €216 *billion*.

Other news in brief

OTOE on 2 June decided to ramp up its protests following its failure to persuade the **banks** as a group to negotiate a new, two-year **collective wage agreement**. The tipping point came when the National Bank of Greece, which represents 23,57% of the sector's employees, refused to give its authorisation to the Hellenic Banking Federation to negotiate with OTOE on its behalf, opting for an agreement with its own employees instead. The banks that share NBG's view (namely, Alpha Bank, Eurobank, ProBank, FBB, HSBC, BNP Paribas, Citibank, American Express Bank of Cyprus) between them

[28] OLP officials claimed that Cosco's offer equaled about seven times the company's current capitalisation, five times its total profits and at least 15 times the container terminal's profits.

[29] Cosco will also invest €620m in upgrading Piers 1 and 2, it will pay an initial amount of €50m to OLP, a futher €591m in rent over the 35-year period, and a guaranteed amount of at least €2.7bn from future earnings.

[30] *Containerisation International Yearbook 2008*.

represent far more than the 30% that is required to pre-empt a common front. (According to Law 1876/1990, sectoral negotiations with the industry's trade union can begin only if banks representing 70% of total bank employees give their assent.)

Parliament on 9 June approved a bill embodying the **Government's incomes policy** (public-sector salaries and pensions) for 2008 (Law 3670/9.6.2008[31]). Salary increases (calculated on the basis of basic salaries) will be of the order of 2% starting on 1.1.2008 and another 2.5% on 1.10.2008, which amounts to 3.5% on average for 2008 – the same number as the latest official estimates for the inflation rate. According to trade-union leaders, the actual increase is less than 3% because the increases do not apply to a proportion of the income received by employees in the form of benefits. In **the private sector**, SEV and GSEE agreed at the end of March to nominal salary increases of 12.42% for two years (2008-2009). This was deemed generous under the circumstances, but necessary according to SEV's Dimitris Dimitrakopoulos to ensure peaceful labour relations. Minister Alogoskoufis expressed reservations, fearing another uptick in inflation.

Economy Minister George Alogoskoufis made it known on 27 February that he was in favour of substituting a **capital-gains tax** on income from short-term stock-market transactions for the current 0.15% tax. (The abolition of a 2.4% stamp duty on life-insurance contracts was also announced two days earlier.) New legislation should not be expected to come into effect before 2009.

After efforts lasting no less than eight years, the **Athens Stock Exchange** is purportedly preparing to open its doors to **shipping companies**.

The **electricity market** is set to see further real liberalisation following an announcement by Edison, the Italian power company, and Hellenic Petroleum, Greece's largest refiner, that they were planning a 50-50 joint venture to build a capacity of over 1,500 MW over the next five years. The investment, worth €1.5bn, will reportedly make them the second-biggest power operator in Greece, with about 12% of the market. Other European producers with a presence on the Greek market are Spain's Endesa and Italy's Enel, both in joint ventures with Greek companies.

In a separate development, **Greece and Turkey** signed a protocol on 2 July allowing Greece to import **electricity** of up to 200 MW in the summer months in 2008-2009, and Turkey to import an equivalent amount in the winter months. This is the second significant common project between the two countries in the energy field, following the inauguration in November of a joint natural-gas pipeline built to carry Azeri oil, to be extended to Italy by 2012.

Parliament ratified the **Lisbon Treaty** on 11 June with New Democracy and Pasok voting in favour, and the three smaller opposition parties voting against. At the same time, Pasok sided with the other opposition parties in demanding a referendum, but this was turned down by the Government majority. Pasok's stance drew a response from former Pasok prime minister Costas Simitis who wrote a letter to party chairman George Papandreou – a letter which he made public the following day – saying he disagreed with the referendum proposal on the grounds that this was not in keeping with standard practice and that a negative outcome could end up marginalising Greece in the EU (nor, we may add, was it in keeping with earlier decisions by EU leaders[32]). The tone of the letter and the fact that Mr Simitis went against declared party policy infuriated Mr Papandreou who asked Mr Simitis to remove himself from the party's parliamentary group. These events did little to restore the image of party unity inside Pasok, seven months after a bruising leadership contest. (A day later, Irish voters turned down the Treaty in a referendum, the only one to be held in the 27 Member States).

George Provopoulos was appointed **new Bank of Greece Governor** for a six-year term on 14 June, succeeding Nicholas Garganas. Until 22 May, Provopoulos was CEO and deputy board chairman at Piraeus Bank. He served as Deputy Governor of the central bank in 1990-1993.

Constantine Papadopoulos
Advisor on European Affairs

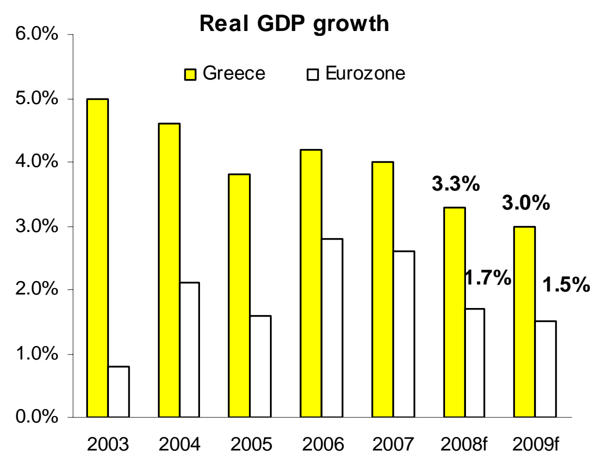
[31] http://www.parliament.gr/ergasies/nomodetails.asp?lawid=598

[32] Another problematic aspect underlying Pasok's stance is the political inconsistency and legal conundrum that would arise should the Government accept a referendum – in any case, after the Pasok-backed vote in Parliament which approved the Treaty – only to find that voters were against the Treaty.

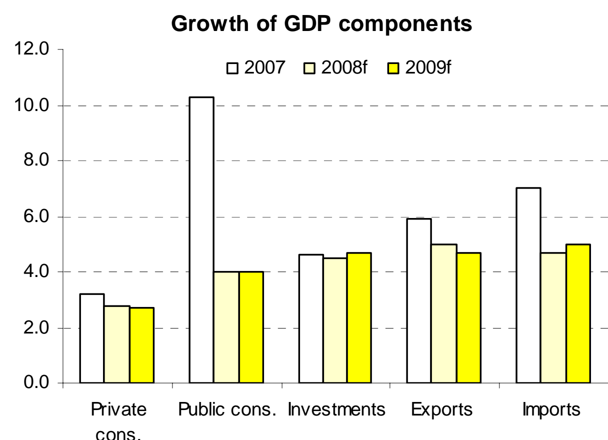
A review of recent macroeconomic developments and outlook

The Greek economy continued its strong performance last year, driven mainly by buoyant domestic demand. Real GDP growth reached 4.0% yoy, exceeding average growth in the euro area by a large margin. However, domestic economic activity decelerated in the second half of 2007, as the global financial crisis and a worsening external environment began to take its toll on the Greek economy. Domestic demand remained the main engine of economic activity, though its growth pace eased relative to 2006, reflecting the fading out of strong residential investment in recent years and a slowdown of private consumption towards more sustainable levels. Consumer spending remained supported by hefty real wage gains, double-digit credit expansion and a further rise in employment. Yet, its growth eased to 3.2% yoy, from 4.2% yoy in 2006, while public consumption accelerated due to the implementation of relief measures in the areas affected by the 2007 summer fires. Government spending was also boosted by unforeseen costs associated with the organization of the snap parliamentary elections last September. Despite lower domestic residential activity, business investment continued to perform strongly thanks to improving business profitability and favorable domestic financing conditions for the greater part of 2007. Elsewhere, investment in construction excluding housing posted double-digit growth, while public investment remained broadly flat after growing strongly in the prior year. All in all, domestic demand added slightly more than 5 percentage points to GDP growth last year, while the external sector remained a drag, though its contribution improved to -1.3 percentage points (ppts)-of-GDP, from -1.8 ppts-of-GDP in 2006. Exports of services accelerated significantly, mainly driven by the rebound in the shipping sector, though this was partially counterweighed by slower growth in goods exports. The latter lagged external demand, reflecting further competitiveness losses and the inadequacy of the production base to meet domestic consumption and investment needs.

Domestic economic activity is expected to decelerate in both 2008 and 2009, weighed down by tightening credit conditions and a significant deterioration in the global growth and inflation trajectory. We now forecast Greek real GDP growth to decelerate to 3.3% this year against our earlier growth projection of 3.5%[33]. This is expected amid a more pronounced softening of domestic demand, which will be less-than-fully compensated by the improved contribution from net exports. Main downside risks to our projections include a less favorable growth trajectory in major trading-partner economies and a bigger-than-expected deceleration in domestic consumption and investments, as a result of tighter lending conditions and the dampening effects of higher oil and food prices on household disposable incomes. These are likely to outweigh further real wage gains, lower income taxes and higher social benefits, while public consumption growth will need to decelerate following last year's spike in order to prevent a significant overshooting of the, *admittedly ambitious,* 2008 budget target.



Source: National statistics, EC, Eurobank EFG



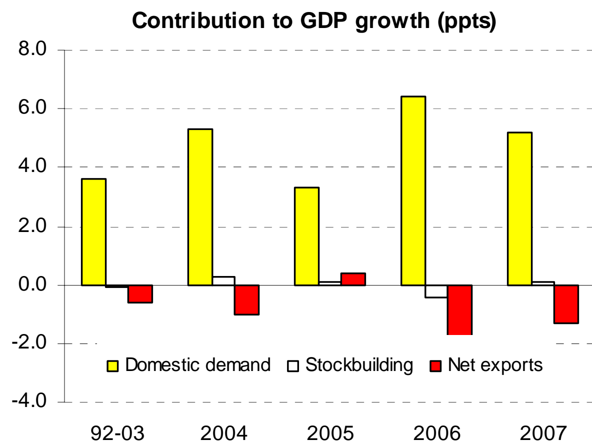
Source: National statistics, EC, Eurobank EFG

[33] See our Greek Macro Monitor, March 2008

On a more positive note, the Greek economy can continue to rely on such shock absorbers as its below-average reliance on exports, incoming structural funds and the strength of its service sectors, mainly shipping and tourism. We expect domestic demand to contribute slightly more than 4 percentage points to GDP growth this year, with the external sector's *(negative)* contribution recording a marginal improvement as a result of slower import growth. Meanwhile, the stronger euro and the persistent and widening ULC growth differential vis-à-vis main trade partners will erode competitiveness further and result in a relatively weak performance of exports of goods. On the other hand, exports of services are likely to remain strong, mainly thanks to the dynamic performance of the transportation sector. With regard to domestic demand developments, we expect residential investment growth to remain stagnant or decline further this year, while business investment will continue to perform strongly over our forecast horizon, assisted by healthy corporate balance sheets, recent tax cuts, EU structural funds and the expected implementation of projects aiming to reap the benefits of the new investment law and new regulatory framework for public-private partnerships[34].

According to the latest national accounts data, real GDP growth was 3.6% yoy in the first quarter of this year, same as in Q4 2007 but lower than the 4.4% yoy rate realized in Q1 2007. Investments contracted by 6.8% yoy, after declining by 4.7% yoy in the last quarter of 2007, while final consumption growth eased to 2.3% yoy after growing at an average annual rate of around 4.5% throughout last year. The overall external sector showed an improvement, but this was mainly the result of a sharp contraction of imports *(-7.8% yoy vs. +11.8% in Q1 2007)* rather than higher exports *(4.1% yoy vs. +7.9% in Q1 2007).*

From a medium-term perspective, economic prospects remain generally favorable though, given the severity and duration of the global credit crunch, we view the balance of risks as being skewed towards lower-than-previously-anticipated growth ahead. We now forecast annual GDP growth rates in the vicinity of 3.0% over the coming 2 years.



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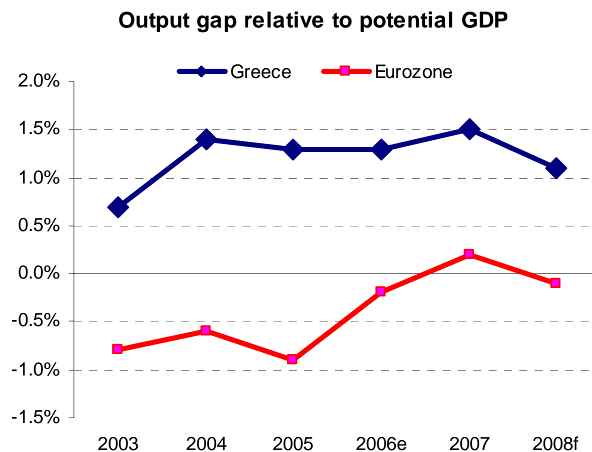

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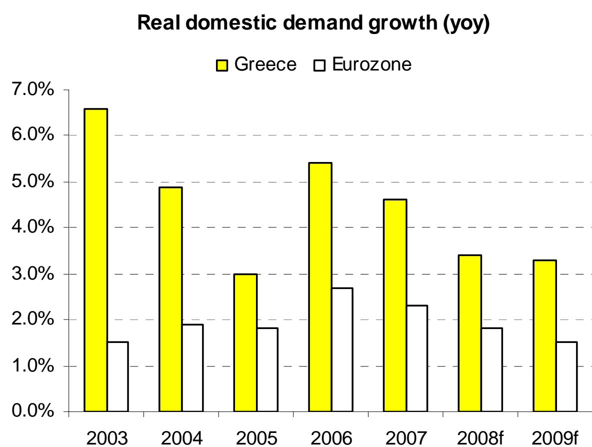


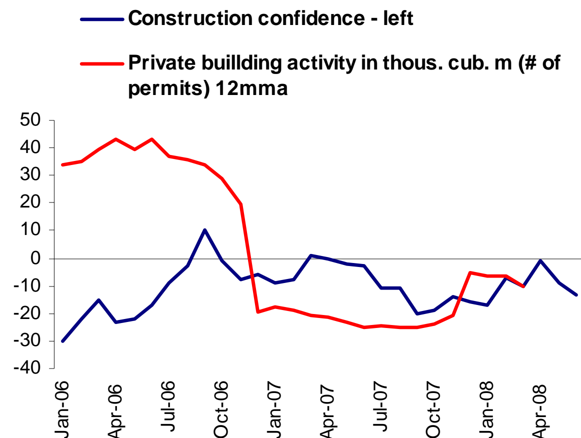
Source: National statistics, EC, Eurobank EFG

Variations in the composition of future growth compared to this year's outcome are likely to be marginal, with economic activity remaining exclusively

[34] According to recent data *(Feb 2008)*, more than four thousand applications corresponding to some €13.2bn of new investment in the manufacturing, energy, tourism and other sectors have been submitted to the authorities, aiming to reap the benefits of the new development law, of which investment plans corresponding to €8.8bn have already been approved. Moreover, the Development Ministry has already approved proposals for a series of PPP partnerships, corresponding to some €3.1bn of new investments in construction, tourism infrastructure, as well as in the areas of education, health, and regional development.

demand-driven[35]. Strong productivity gains thanks to heavy investment in infrastructure in recent years, a further expansion of the Greek shipping fleet and the implementation of several large-scale energy interconnection projects in the natural gas, electricity and oil sectors are likely to continue supporting domestic growth as well as the export orientation of the economy. On a less positive note, the external sector will remain a drag on economic growth, restraining the economy's debt-servicing capacity and posing risks to medium-term economic growth. Such risks may become particularly pronounced in the period ahead, given a more difficult external environment and the fading out of exceptional factors that supported growth in recent years, including the collapse of domestic interest rates post-EMU entry and the hosting of the 2004 Olympic Games.

With regard to more high-frequency indicators of domestic economic activity, retail sales *(volume terms)* posted average year-on-year growth of 0.6% yoy in January-April 2008, after growing by 2.9% yoy over the same period in 2007, while registrations of new passenger cars rose by 2.6% in the first four months of the year after recording cumulative growth of 3.5% a year earlier. Extensive industrial action by trade unions ahead of the passage in parliament of a new law for reforming the social security system negatively affected retail sales early this year although sales bounced in April. However, the overall picture points to a gradual retrenchment of consumer spending as a result of higher food and oil prices. With regard to expectations of domestic consumers and retailers, the EC retail trade confidence indicator for Greece hit a two year-year low in June, reflecting worsened conditions in the domestic retail market, while the consumer confidence index dropped in July to its lowest point on record, tracking the nose-diving of relevant indicators of consumer vigor in the euro area. In the residential housing sector, the volume of building permits dropped by 21.7%yoy in January-March, hurt by rising costs of construction materials and a saturation of strong demand for housing in recent years. Activity in the residential housing market is likely to remain stagnant in the remainder of 2008, but a gradual improvement is expected in the next couple of years as the stock of issued, but not yet used, building permits remains high and fundamentals in the sector continue to be generally positive.



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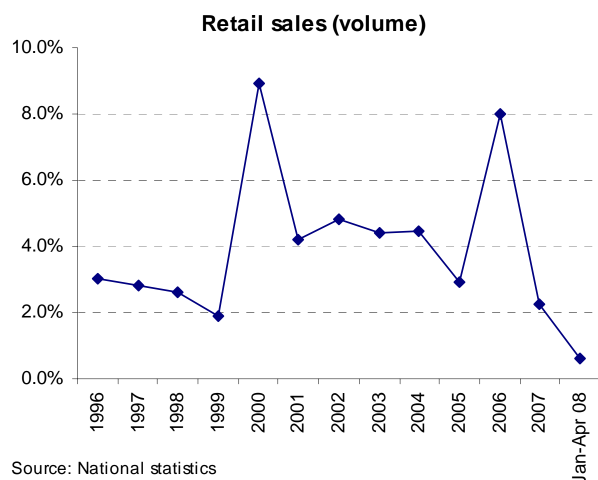
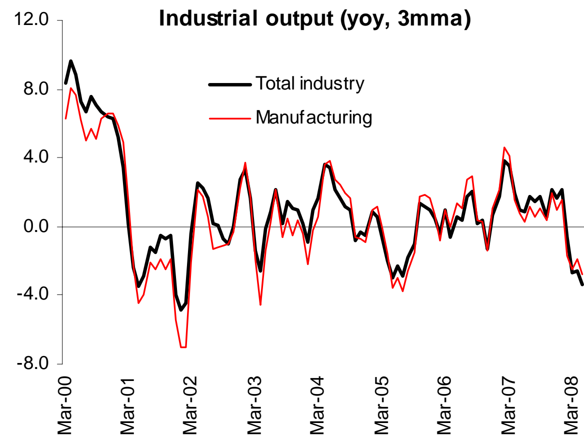


Source: National statistics

[35] "The 2007 Update of the Hellenic Stability and Growth Program 2007–2010" submitted to the European authorities last December projects annual real GDP growth at around 4 percent, but recently the government flagged for heightened external risks to the domestic environment, revising its annual growth forecast for this year and the next down to 3.6%, while the inflation forecast for 2008 was raised to 3.5 percent from 2.8 percent previously.

In the industrial sector, total output in the first five months of 2008 contracted by 2.4% over the same period a year earlier, hurt by weaker manufacturing and lower mining and power production. Manufacturing output fell 7.9% yoy in May, its steepest decline since December 2001, affected by soaring input costs, a two-week transport strike by truckers and a spoiled seed-oil scandal that effectively shut down manufacturing of by-products like margarine and other processed food. Reflecting these negative developments, the index of business expectations in manufacturing declined in June to a 2 ½-year low. On a more positive note, the purchasing managers´ index (PMI) for Greece signaled in June its 18th consecutive month of expansion in the domestic manufacturing sector, despite worsening external conditions and sharp rise in input costs. The Greek June PMI index has been on a rising path after hitting a multi-month low 51.4 in January, driven by healthy domestic demand conditions and strong exports to new fast-growing markets in the broader region. Barring a further unforeseen worsening of global economic and market conditions, activity in the Greek manufacturing sector is likely to improve gradually over the rest of the year, driven by a continuing improvement in the domestic textiles sector and positive trends in the food & beverages, chemicals and transportation equipment industries.

In the domestic labor market, the unemployment rate fell to 7.7% in April, from 9.0% in the prior month, assisted by a seasonal rise in labor demand by the tourist industry ahead of the summer peak season. Meanwhile, employment continued to grow at a healthy pace in the first four months of the year, with gains continuing to be concentrated in the private non-agricultural sector. Despite this improvement, employment in Greece continues to lag that in the EU-15, reflecting persisting structural rigidities in the domestic labor market as suggested by the high unemployment among youngsters and women as well as the low level of part-time employment.



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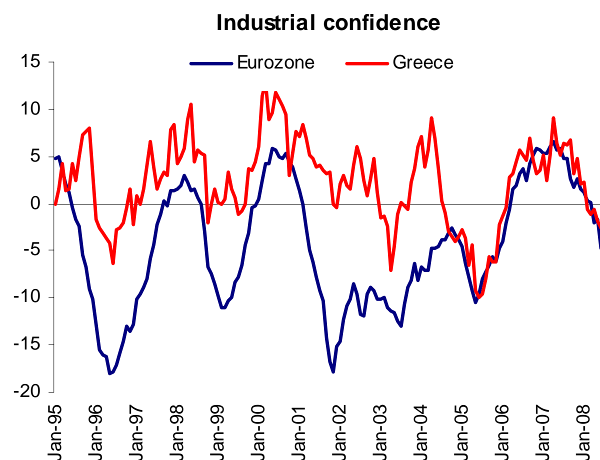

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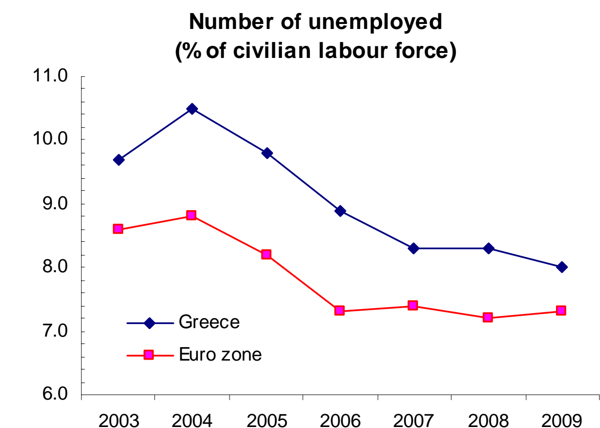
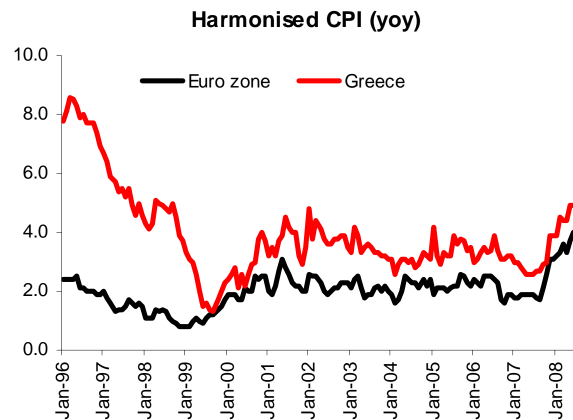


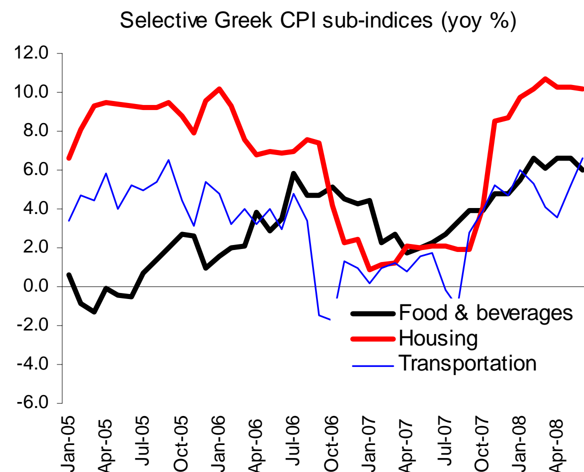
Source: EC

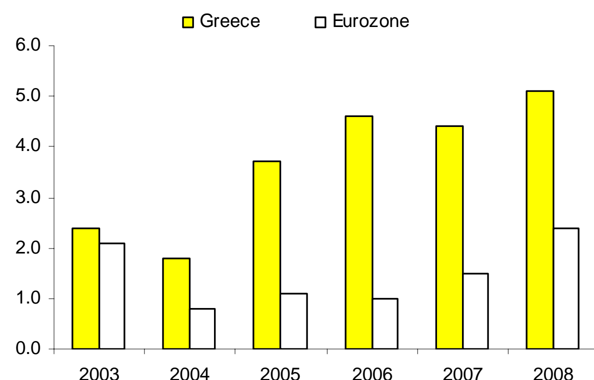
Greek core CPI accelerated to 3.2% in 2007, from 2.9% in the prior year, reflecting persisting demand-side pressures, higher input costs and rapid domestic wage growth[36]. Yet, the confluence of certain temporary factors, including lower domestic fuel and processed food prices relative to the same period a year earlier, allowed headline inflation to ease to 3.0% in 2007, from 3.3% a year earlier[37]. In line with these developments, the Greek inflation differential vis-à-vis the euro area declined to 0.9 percentage points *(ppts)* last year, from 1.1ppts in 2006, while the corresponding core CPI spread eased to 1.2ppts from 1.4ppts in 2006. Notwithstanding these positive developments, the sharp bounce in energy and food prices has caused an abrupt end to disinflation since September 2007. Headline CPI finished last year at 3.9% yoy and stood at 4.9% yoy in June 2008, its highest level in seven years. More worryingly, core CPI remains in an steep upward trajectory since the middle of last year, reflecting rising wage costs and growing second-round effects from past increases in domestic oil and food prices. Core CPI stood at 4.0% yoy in June 2008 vs. 4.2% yoy in the prior month and 2.5% yoy in the same period a year earlier.

We expect domestic inflation to remain elevated in the remainder of 2008, fuelled by strong year-on-year gains in oil and food prices, new administrative increases in the special consumption tax on fuels and accelerated wage growth. Though favorable base effects should facilitate some moderation in year-on-year CPI in the last quarter of 2008, we now expect the average annual reading to come in at 4.5% this year, against our earlier forecast of 4.2%. This compares with an annual CPI forecast of 4.0% yoy for 2008 presented in the latest BoG annual report. This was published back in April 2008, i.e., before the latest oil price rally past $140/bl. As such it probably understated the risk of higher crude prices lasting longer than previously expected.



Source: Eurostat





Source: EC, spring 2008 forecasts

Specifically, it based its 2008 CPI projection on a $100/bl average-price-of-oil-assumption for this year, which along with the relevant forecasts for the evolution of the EUR/USD rate, translates into an average rise in the €-price of oil by 23% yoy in 2008

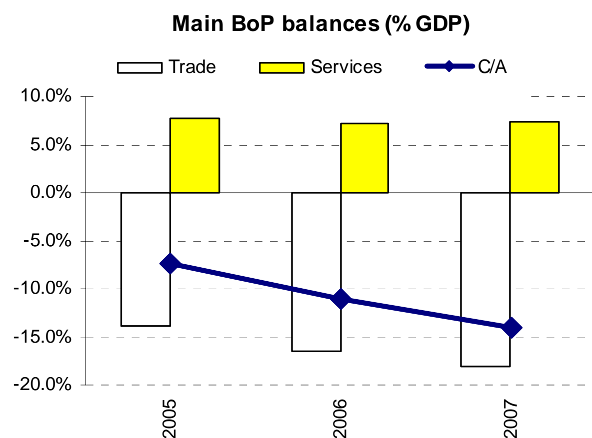
[36] Economy-wide unit labor costs accelerated further last year *(4.2% yoy vs. 3.5% yoy in 2006)*, with the rise being even more pronounced in the domestic business sector *(4.8% yoy vs. 4.1% yoy)*. Furthermore, according to the European Commission estimates *(Spring 2008 forecasts)*, Greece run a positive output gap of 1.3ppts in 2007, pointing to continuing inflation pressures from excess demand

[37] In average year-on-year terms, domestic energy and processed food prices rose by 2.1% and 3.7% in 2007, after respective increases of 9.4% and 5.2% in 2006. Furthermore, the retail price of fuels in the CPI basket grew in 2007 by 1.3% vs. 10.9% in 2006, while price inflation of other raw materials remained high but decelerated to +9.2% in 2007 from 24.8% in 2006. On a less positive note, higher inflation relative to a year earlier was recorded in the prices of non-processed food (2.2% yoy vs. 1.9% yoy), manufacturing goods excluding food & energy (2.2% yoy vs. 1.6% yoy) and services (3.7% yoy vs. 3.1% yoy).

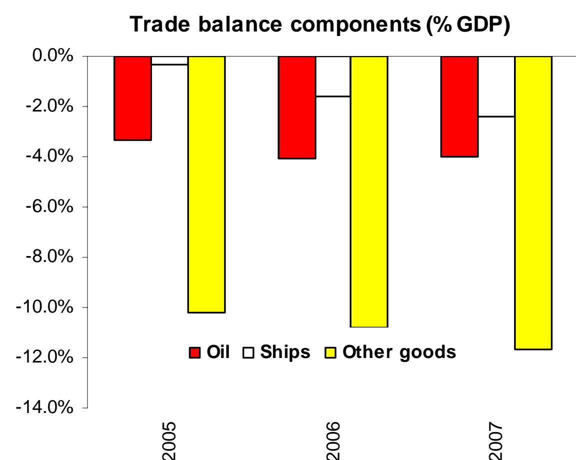
vs. a rise of just 0.2% yoy in 2007. With the rise in the average €-price of crude oil having been around 54% year-to-mid July, however, our analysis suggest upside risks to the official inflation projections.

Higher inflation in Greece relative to main trading-partners in recent years has been driven by cyclical and EU-convergence factors. It has also been a reflection of inadequate competitiveness in key domestic goods and services markets. This, in turn, has implied an accumulation of significant competitiveness losses to the Greek economy, as indicated by the sizeable appreciation of the EUR´s real weighted exchange rate against the currencies of 28 main trading-partners of Greece over the period 2000-2007[38]. With regard to wage developments, the Bank of Greece estimates broad-economy ULC growth accelerating to 4.9% yoy this year from 4.2% yoy in 2007 as a result of higher wage growth and broadly constant productivity gains. This should compare with expected ULC growth of 1.8% in the euro area vs. 1.4% last year *(EC spring 2008 forecasts)*. Note that a 2-year collective wage agreement reached by employers and trade unions earlier this year provisions for annual increases of 6.2% and 5.7% in minimum private-sector wages this year and the next *(compared with rises of 6.2% and 5.4% in 2006 and 2007, provided for by the previous 2-year wage agreement)*. In the public sector, the 2008 budget forecasts a rise in the central government´s total wage bill by 8.9% yoy in 2008 compared to a 5.9% yoy rise in 2007[39]. Public-sector wage costs this year will be inflated by special transfers to civil servants in the judicial branch, higher wages for military personnel as well as special benefits to teachers and public hospital personnel.

Greece's current account (c/a) deficit widened further last year, reaching €32.26bn or 14.1% of revised GDP, compared to 11.1%-of-GDP in 2006 and an average annual rate of 7.4%-of-GDP in the 2001-2005 period[40]. This was on the back of a higher deficit in the trade balance excluding net oil imports, higher net payments for the purchase of ships and a rise in the deficit of the balance of incomes. A lower surplus in the balance of current transfers due to higher payments to the European Union - as a result of a 9.7 percent upward revision to the 2001 GDP level - also weighed. With respect to the trade balance excluding oil and ships, export receipts grew by 4.7% from a year earlier, but this lagged behind the growth in the corresponding import bill, which rose by 12% yoy. Elsewhere, the services surplus expanded by around 9% relative to 2006, mainly reflecting higher revenues from merchant shipping *(+18.3% yoy)*, while *net* travel receipts remained broadly unchanged from a year earlier. On the other hand, the income account deficit widened by 27.5% yoy as a result of higher net interest, dividend and profit payments associated with a further rise in non-residents´ holdings of pubic debt. From the financing side, the balance of direct investment posted an outflow of €2.5bn, while a net inflow of €17.44bn was recorded under portfolio investment due to continued strong purchases of Greek government bonds and Treasury bills *(€25.7bn)* as well as shares of domestic firms *(€8.1bn)* by foreign investors.



Source: BoG, Eurobank EFG



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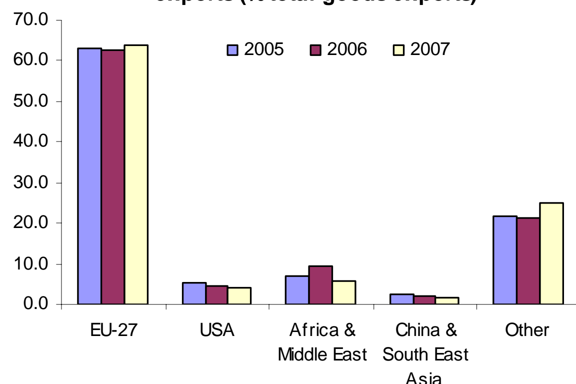
[38] This appreciation has been around 15% in terms of relative CPI rates; the appreciation has been 20% and 41% economy-wide and in the manufacturing sector, respectively in terms of ULC growth differentials.
[39] Including pensions, the corresponding rise is expected to be 8.9% yoy this year vs. 6.9% yoy in 2007.
[40] On a more positive note, the combined balance of the current account deficit and capital transfers surplus was 12.2%-of-GDP last year compared to 9.6%-of-GDP in 2006.

BoG settlement data for the first four months of 2008 indicate some tentative improvement in the pace of deterioration in the current account deficit. The latter rose by 5.7% yoy in January-April, compared with a deterioration of 18%yoy recorded in the same period a year earlier, as a further widening in the trade deficit was partly outweighed by higher surpluses in the balances of services, incomes and current transfers. More specifically, the trade deficit widened by around 16% yoy in the first four months of this year, mainly due to a sharp rise in the oil-imports bill. Excluding fuels and ships, the trade balance deteriorated by 6.4% yoy as, in value terms, imports continued to exceed exports by a factor of around 3. Elsewhere, the balance of services recorded a significant improvement from a year earlier thanks to higher revenues for shipping, while a rise of EU structural funds to the general government boosted current transfers.

All in all, a relative stabilization in the c/a-to-GDP ratio is likely this year, due to lower import growth and a decrease in the ships deficit *(-273% yoy in January-April).* However, we maintain that a more sustainable improvement in the years ahead requires a radical shift in the overall balance-of-payments dynamics. Enhanced fiscal consolidation and supply-side reforms to boost productivity and raise competition in domestic product and labor markets are the more obvious avenues via which such a shift can occur in the years ahead if an eventual economic hard-landing is to be avoided.

Despite higher inflation relative to euro area trading partners, Greek exports growth has been strong in recent years, thanks to a shift to higher value-added goods and services and a reorientation of exports from mature industrialized countries towards fast-growing neighboring emerging markets. This has facilitated the stabilization of Greece's share in world non-oil trade, following sharp declines in the latter part of the last decade. According to IMF Staff Report 2007, the share of Greek exports to emerging markets has increased from 30 percent in 1995 to around 50 percent in 2006, with exports to emerging economies accounting for nearly half of the export growth in 2005–06.[41] On the other hand, Greece's market share in the EU15 market has continued to decline, although it appears to have stabilized in other industrialized countries. Furthermore, the composition of Greek exports has been gradually shifting away from low-tech and labor-incentive exports (their share dropping to 40% in 2006 from 60% in 1995), towards medium-to-high-tech and resource-intensive exports[42]. Additionally, the demand of tourist services in important traditional markets e.g., Germany, France and Scandinavian countries remains strong, while the last decade has witnessed strong tourist inflows from new important markets, including Russia, China and CEE.

Source: BoG, Eurobank EFG



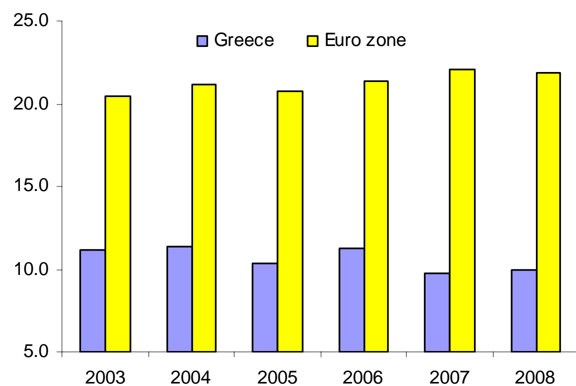
Source: BoG, Eurobank EFG

[41] Greek exports to Albania, Bulgaria, FYROM, Romania, Russia and Turkey as a percentage of total exports grew from around 12 percent in 1995 to over 20 percent in 2006.

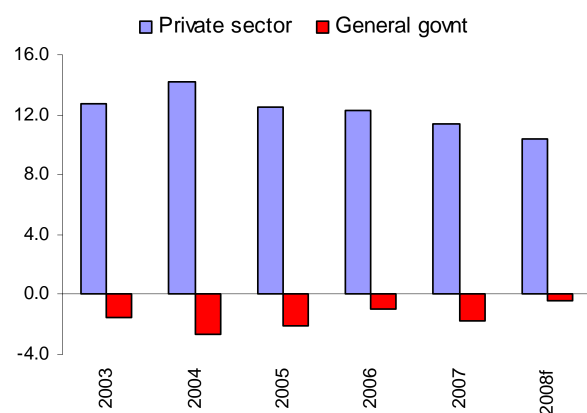
[42] The share of Greek low-tech and labor-intensive exports as a percentage of total exports has dropped from 60% in 1995 to 40% in 2006, with medium- to-high-tech and resource-intensive exports now accounting for around 60% of total exports.

Despite the satisfactory performance of exports, buoyant domestic demand and eroding international competitiveness has led to higher import growth and a sharp widening in the c/a gap in recent years.[43] From a more inter-temporal perspective, this has been the outcome of a rapid growth in domestic investment and relatively stable national saving, which have boosted Greece's savings-investments imbalance from around 10.5%-of-GDP in 2001 to over 15%-of-GDP presently. Several special influences have also played a role in the widening of the overall deficit, including, the appreciation of the euro´s trade-weighted value and elevated world oil and food prices. With respect to domestic investment, this has been outpacing the EU averages in both growth and level-to-GDP terms since 2001, assisted by enhanced macroeconomic and financial stability as well as the collapse of domestic interest rates post EMU entry. On the other hand, domestic saving rates have been lagging behind the corresponding EU average, reflecting higher public-sector deficits and a rising private-sector propensity towards consumption. In fact, the household sector has accounted for most of the increase in the saving-investment gap since 2001, owing to declining household savings and a strong pick-up in housing demand. On a more positive note, the domestic corporate sector has been in a surplus saving-investment position in recent years, reflecting the strong profitability in the shipping and banking sectors.

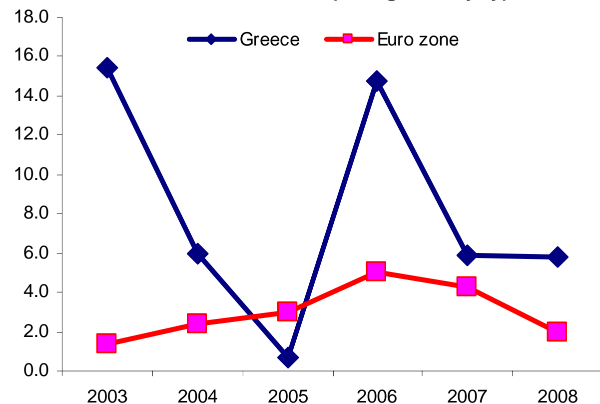
Although Euro zone membership effectively secures the adequate financing of the country's external deficit and debt, the wide current account gap poses a threat to the medium-term growth prospects of the economy. Given that now more than 70% of the current account deficit is financed by external borrowing, the servicing of the accumulated gross external debt absorbs considerable domestic resources. Rising indebtedness also raises the susceptibility of domestic households to sudden, unanticipated shifts in market sentiment that could instigate higher borrowing costs.



Source: EC



Source: EC



Source: EC

[43] Competitiveness, as measured by Greece's real effective exchange rate, has deteriorated by well over 10 percent since EMU accession in 2001, whether this is measured in terms or relative inflation rates or unit labor costs. This appreciation has been more pronounced vis-à-vis emerging markets.

In 2007, the general government budget deficit amounted to 2.8%-of-GDP, compared to a 2.2%-of-GDP target and the prior year's 2.6%-of-GDP outcome. This was mainly due to a higher-than-anticipated central government deficit. On the other hand, the overall surplus in the balance of social security funds, local governments and other entities rose by 0.1ppts-of-GDP from the prior year to 1.4%-of-GDP, but was lower than the budget target by 0.3ppts-of-GDP. The 2007 central government deficit was inflated by several extraordinary items including i. special transfers to the EU budget as a result of a sizeable upward revision to the county's GDP level ii. the reconstruction and rehabilitation costs incurred as a result of the summer 2007 fires iii. the costs of carrying out the snap national elections in September 2007 and iv. the settlement of outstanding liabilities between the state and the national carrier, Olympic Airlines.

Ordinary budget receipts rose by 6.3% last year, primarily assisted by higher indirect tax receipts. VAT revenues rose 9.8% in 2007, boosted by increased efforts by authorities to crack down on tax evasion, higher special consumption taxes on cigarettes and fuels as well as higher revenues from property transactions.[44] With regard to other broad categories of tax revenues, direct tax receipts grew by 5.0%, while non tax revenues declined by 13.7%. Revenues from personal income taxes grew by 9.5%, supported by higher nominal taxable incomes and employment. Personal income tax revenues accounted for ca 51.2%of total direct tax revenues in 2007 compared to 39.6% in 2000. Corporate tax revenues rose 5% in 2007 despite a further 3 percentage points cut in the effective tax rate.

From the expenditure side, ordinary budget outlays rose 11.2% in 2007. This included €2.4bn of extraordinary expenditure items, without which the corresponding year-on-year growth would have been 6.6% compared to the 5.8% budget target. Primary expenditure excluding extraordinary outlays grew by 7.6% vs. a 3.5% rise in 2006, while interest expenditure rose 2.1%. With regard to the public investment budget (PIB), investment expenditure grew by 7.6% yoy last year, while revenues increased by 29.1% as a result of a rise in the portion of co-financed projects aimed as to avoid loss of available EU funds. As a result the PIB deficit declined to 1.7% in 2007, from 2.1% in 2006 and 2.4% in 2005.

The 2008 budget targets a decline in the general government deficit to 1.6%-of-GDP from 2.8%-of-GDP in 2007, in line with the government´s aim to attain a balanced budget position by 2010[45]. The planned fiscal improvement is projected to result mainly from a 1ppts-of-GDP rise in budgetary revenue. A higher surplus in the overall balance of social security funds is also expected to contribute to the planned reduction in the general government deficit. The central government deficit is expected to decline to 3.4%-of-GDP this year, from 4.6%-of-GDP in 2007.

2008 Budget Plan	€mn		% GDP	
	2007	2008	2007	2008
1. Ordinary Budget				
a. Gross ordinary revenue	51,800	58,070	22.6%	23.7%
a1. Tax reinbursements	2,450	2,550	1.1%	1.0%
a2. Special revenue			0.0%	0.0%
a3. Net revenue (a-a1+a2)	49,350	55,520	21.5%	22.6%
b. Expenditure	55,017	59,058	24.0%	24.1%
b1. interest	9,750	10,500	4.3%	4.3%
b2. Primary expenditure (b-b1)	45,267	48,558	19.7%	19.8%
2. Ordinary budget balance (1a3-b)	-5,667	-3,538	-2.5%	-1.4%
3. Public Investment Budget				
a. Revenue	4,980	4,532	2.2%	1.8%
b. Expenditure	8,700	9,300	3.8%	3.8%
4. PIB balance (3a-3b)	-3,720	-4,768	-1.6%	-1.9%
5. Central government balance (2+4)	-9,387	-8,306	-4.1%	-3.4%
6. Public sector surplus & adjustment	4,315	4,280		
7. General govnt balance (5+6)	-6,182	-4,026	-2.8%	-1.6%

Ordinary budget revenue is projected to rise by 13.1% yoy, against an official forecast of 7.2% yoy for the growth of nominal GDP *(likely to prove optimistic, in our view)*. This strong performance is expected despite lower corporate tax rates and the planned reduction in marginal tax rates on personal income over the period 2008-09.[46] More reassuringly, budget revenues will likely be assisted by: i. the implementation of a unified tax framework on real estate transactions *(expected to generate some €550mn of additional budget revenues this year)* ii. the equalization of a special consumption tax on heating oil with that on motor fuels *(projected to bring €1.17bn of extra revenue to state coffers)* and iii. the

[44] The special consumption tax on liquid fuels was raised by 5.8% in July 2006 and again by the same amount in January 2007.

[45] The authorities expected fiscal consolidation in 2009–10 to be implemented though higher budget revenues, with savings from a more rigorous expenditure management being mainly directed toward further reinforcing the social welfare system.

[46] The main corporate tax rate was reduced by 10ppts over the period 2005-2007 and now stands at 25%. With respect to personal income tax, the two middle marginal tax rates of 29 percent and 39 percent will be reduced by 2 percentage points annually in 2008–09 to 25 percent and 35 percent, respectively.

establishment of a National Committee for tackling tax evasion. On the expenditure side, a new legislation governing fiscal audits and controls is established to ensure that public spending remains within budget targets[47]. Yet, current expenditure is projected to grow by 8.7%, faster than nominal GDP. In our view, the targeted growth for current revenue is an ambitious one by historical standards, and, importantly, the target needs to be achieved in an environment of lower corporate and personal income tax rates as well as rising downside risks to economic growth.

The implementation of the central government budget in the first five months of 2008 shows a rise of just 3.5% yoy in net current revenue, compared with a budgeted increase of 13.0% yoy for the full year. Tax rebates surged by 33.8% yoy in January-May 2008, while for the year as a whole they are budgeted to decline by -2.8%. The government expects budget receipts to improve in the second half of the year, when the new unified tax framework on real estate transactions and the equalization of a special consumption tax rates on heating oil and motor fuels will start to bring additional revenues to state coffers. On the spending side, current expenditure grew by 8.4% year-to-May against a full-year budget projection for an 8.1% yoy rise, reflecting a 12.1% yoy increase in primary outlays and a 3.9% yoy decline in interest rate expenditure. In more detail, central government wage and pension expenditure rose by 9.3% yoy in January-May. Social-security and heath care costs grew by 18% yoy, while operational and other outlays rose by 16.3% yoy. In the public investment budget, revenues declined by 13% yoy, while expenditure rose by 31.4% yoy compared to the first five months of last year. The year-to-May central government deficit reached €6.78bn, up 54.3% over the same period a year earlier and against a budgeted decline of 11.8% for the year as a whole. Taking into account the rather poor performance on budget execution in the first five months of the year and a weaker-than-projected GDP growth dynamics we view the 1.6%-of-GDP deficit target as extremely difficult to attain without a genuine intensification of efforts to reduce tax avoidance and cut back on discretionary spending in the second half of the year.

[47] A General Directorate for Fiscal Audits is established along with internal audit units within Ministries, local authorities and public entities with a budget exceeding €3mn. The Directorate is expected to propose corrective measures whenever necessary to keep total spending in line with the Budget.

Following the GDP revision implemented last year, the public debt-to-GDP ratio stood at 94.5%-of-GDP at the end of 2007, down 0.8ppts from the prior year 2006. The decline in the debt ratio was mainly due the rise in primary surplus to 1.4% from 1.2% in 2006. The 2008 budget targets a further reduction in the debt-to-GDP ratio to 91%. It should be noted, however, that a range of drivers that favored a decline in the debt ration in recent years, including low borrowing costs and strong GDP dynamics, have weakened recently as a result of the credit crunch and receding world growth dynamics. Furthermore, despite the government´s efforts to streamline public expenditure, certain entities and enterprises in the broader public sector continue to operate, while generating losses and accumulating arrears or defaulting on government-guaranteed debt.

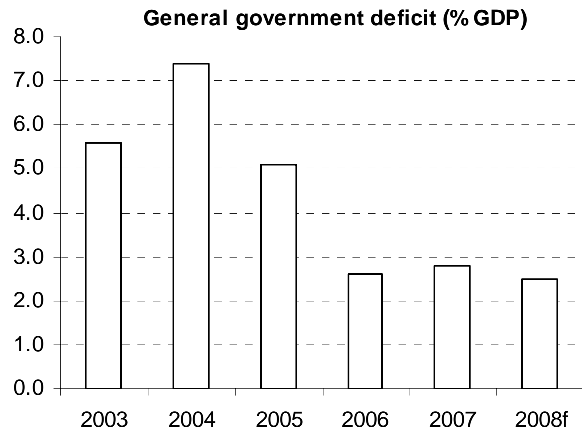
The last four years witnessed an unprecedented improvement in fiscal accounts, as suggested by the sharp reduction in the country's cyclically-adjusted fiscal deficit and the generation of a cyclically-adjusted primary surplus for the first time in four years in 2007[48]. These positive developments contributed to a sizeable decline in the general government budget deficit to below 3.0%-of-GDP since 2006, from levels near 8.0%-of-GDP in 2004, permitting the country's exit from the Excessive Deficit Procedure in June 2007. Despite this impressive performance significant fiscal imbalances remain. This is especially true in view of the high public debt level and the prospect of higher social-security and pension costs in the year ahead[49].

With regard to budgetary receipts, a series of revenue-boosting initiatives over the last five years have yielded measurable results. These included measures aiming to simplify the tax system and broaden the tax base as well as hikes in VAT and other indirect tax rates. Yet widespread tax evasion, especially among to self-employed as well as in the domestic property and retail fuels markets, have continued to restrain fiscal consolidation. As a result, budget revenues from income and property taxes and social-security contributions as percentage of GDP remain lower than in the Euro zone, though most euro

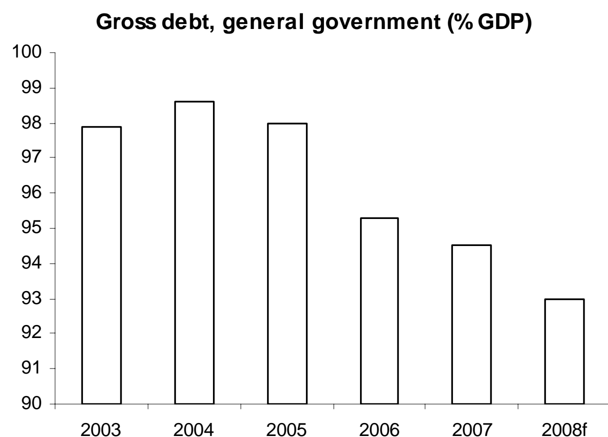
[48] Greece´s cyclically-adjusted fiscal deficit declined to 3.4%-of-GDP in 2007, from 7.9%-of-GDP in 2004, while the corresponding primary balance turned into a surplus of 0.5%-of-GDP last year, from a deficit of 2.9%-of-GDP in 2004.
[49] According to the latest estimates *(2002 stability programme update)* pension spending would rise by some 10¼ percent of GDP by 2050.

area countries enjoy similar or even lower direct tax and contribution rates. Overall, maintaining a strong pace of revenue growth will be a challenge in the years ahead, especially taking into account the reductions in the corporate and personal income tax rates. In this respect, we can not readily think of other potential measures to sustain a high growth of budgetary revenue in the year ahead, besides further indirect tax hikes and additional steps to broaden the tax base and rein in tax evasion.

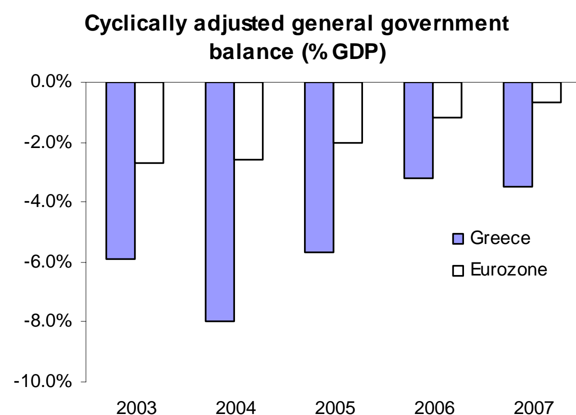
On the spending side, central government operating and other outlays *(currently ca 20% of current expenditure),* which constitute the most discretionary part of primary spending, have been consistently overshooting budget targets in recent years. Naturally, we see room for significant cutbacks in this major spending category as a means of attaining a more sustainable fiscal position in the medium-term. There is also room for containing the growth in the government´s total wage bill *(projected to rise by ca 9.0% this year*) via more prudent hiring policies and, more generally, by measures aiming to attain a leaner and more efficient public sector. To this end, a restructuring of the domestic health sector is currently underway aiming to consolidate the number of regional authorities, upgrade management of public hospitals, improve pricing and costing mechanisms, and introduce better controls on procurement. Furthermore, a pilot initiative in program based budgeting has been launched for one line ministry in 2008, as a precursor to eventually integrating this approach fully into budget preparation and execution. On a less encouraging note, a recent reform aiming to increase efficiency and accountability in public enterprises has up to this point yielded limited results, contributing little to the improvement of enterprise performance over the past two years.



Source: Realizations & Euorbank EFG forecasts



Source: Realizations & Eurobank EFG forecasts



Source: Eurostat

Credit growth to the domestic private sector continued its strong growth in 2007. The total stock of monetary financial institutions (MFI) loans to domestic households and businesses reached 41%-of-GDP in December *(45.5%-of-GDP inclusive of securitized loans)*, bringing the corresponding differential from the euro zone average to 13.3ppts-of-GDP from 16.5ppts at the end of 2006. Last year saw a significant rise in private-sector loans in foreign currency (*mainly mortgage loans denominated in Swiss francs),* with their annual growth standing at 74.5% in Q4 '07 compared with 17% yoy in Q4 '06. As a result, the share of fx-denominated private-sector credit rose to 7.6% of total loans in December '07 from 5.2% in the same month a year earlier. On balance, this has increased domestic households' susceptibility to sizeable exchange rate movements, but the share of fx-denominated loans as a percentage of total loans in Greece remains fairly low relative to other countries in the broader region experiencing fast credit growth. Moreover, on average 73% of new mortgage loans issued last year had fixed interest rates vs. 57% in the euro area and 37% in 2006, providing households with some level of insurance against unanticipated spikes in benchmark rates due to the global credit crunch.

The annual growth of MFI loans to the domestic private and public sectors remained strong in January-May 2008, despite the continuing decline of lending to the general government. *(The latter has been recording negative growth since Q4 06, mainly because of declining MFI holdings of government securities).* Private-sector credit continued to grow strongly, recording average year-on-year growth of 22.1% year-to-May, following growth of 19.7% over the same period a year earlier. The growth of MFI credits to domestic businesses *(loans, corporate bonds and securitizations)* was 24.5% yoy in May, up from 22.7% yoy in December and 15.4% yoy in May 2007, maintaining its rising trend since mid-2005. On the other hand, the growth of credit to households continued its gradual deceleration that started in 2007, though remaining in double-digit territory *(19.3% yoy in May '08 vs. 24.4% in May '07).* This slowdown has occurred on the back of slower decelerating economic activity in the first months of 2008 as well as a small increase in interest charges, though from historically low levels. Mortgage credit growth stood at 17.8% yoy in May, compare to 21.4% yoy in December, while consumer loans grew by 21.5% yoy, from 22.4% yoy in December.

With regard to monetary developments, the Greek component of the Eurozone's M3 growth excluding currency in circulation accelerated further in the first five months of 2008 *(up 17.2% y/y in May),* a development that can be partly attributed to the flattening of the government bond yield curve, which stimulated a shift of funds from longer-maturity instruments not included in the M3 definition *(such as fixed income mutual funds)* to instruments included in M3 *(e.g., deposits with maturities of up to two years).*

The Greek Tourism Industry: A good start in 2008 but questions remain about the future

"To hope for the best and prepare for the worst, is a trite but a good maxim."

J. Jay, Correspondence (1893)

- **Initial data for 2008 Q1 suggest a somewhat brighter-than-expected picture, with international tourism showing small signs of fatigue despite the worldwide economic downturn. However:**
- **It is reasonable to anticipate lower tourist inflows from such important markets as the U.S. and the UK this year. The economic slowdown, inflation and the credit crisis in those countries put pressure on disposable incomes.**
- **Our "*Worst Case Scenario*" for Greece suggests that if the worldwide economic slowdown continues well into the end of 2008, we *could* see a reduction in U.S. and UK arrivals to Greek hotels and similar establishments by 6% and 10%, respectively, by the end of Sep. 2008.**
- **The strong inflow of tourists from new markets such as Eastern Europe and Russia will partly or wholly alleviate the negative effects of any reduction in tourist arrivals from the U.S. and the UK.**

Tough times ahead?

It has been a difficult time for many U.S. and European households, struggling with declining housing prices and increasing energy and food costs. Moreover, the recent inflation spikes have led to sizeable pressure on disposable incomes across the globe, affecting consumption and economic growth. As fears of a longer-than-expected global slowdown have not gone away, the Greek tourism industry could be faced with some serious repercussions this summer. In this section, we investigate the likely impact of the current worldwide economic crisis to outside the Euro-zone demand. Namely, following the theme we outlined in the previous issue of the Macro Monitor, we examine trends in tourist arrivals from the U.S. and the UK. Tourist inflows from these countries are in heightened risk of a substantial slowdown due to the higher euro, the high prices of oil and costs of transport, as well as the impressive downturn in consumer confidence. As disposable income is contracting worldwide, *inter alia* due to higher energy, commodity and food prices, a textbook approach analysis would suggest a relatively high impact of the ongoing financial crisis on consumption in general and on discretionary spending in particular (such as on large-ticket goods and services, especially tourism which is considered a luxury good).

The global story so far

According to the latest barometer by the UNWTO (June 2008), world tourism "got off to a surprisingly sound start" in the first four months of 2008, with growth continuing at only a slightly lower pace than in the "remarkable year" 2007. Between January and April 2008, international tourist arrivals grew at, roughly, 5% compared with the same period in the previous year. Among all regions, Europe (not including the South and the Mediterranean) exhibited the slowest growth (2.3%). The Middle East enjoyed the highest growth (12.5%), maintaining the same momentum as the year before. The U.S. also did very well, no doubt supported by the lower dollar. These numbers are indicative of the resilience of world tourism in the face of the ongoing financial crisis and the ensuing economic concerns felt especially in the U.S. and quite a few European countries. However, they also reflect a tendency among tourists to avoid the expensive European destinations, due to the higher euro and increased prices.

The U.S. and the UK markets

The U.S. and UK accounted for 17% of the visitors Greece received in 2007. The UK is now the biggest market for Greece, overtaking Germany over the last decade. Between 2007 and 2006, total arrivals from the U.S. grew by 6.13%, actually outpacing UK arrivals' growth which remained flat (0.1%).

The U.S. market

According to the U.S. Office of Travel and Tourism Industries (U.S. Dept. of Commerce), there is evidence of flat growth rates of U.S. tourist arrivals to Europe as a whole. In the period Jan-Mar 2008, Europe received 2.4m U.S. tourists, i.e., 0.2% less than during the same period in 2007. Nonetheless, 5% more U.S. citizens traveled abroad than in 2007. Middle East and Africa have enjoyed a dramatic growth in U.S. tourist arrivals (53.2% and 47.9% respectively, year-to-date) amounting to 237,000 visitors. The above numbers indicate that the strong euro, combined with the economic downturn in the

U.S. and the ongoing credit crisis, has discouraged a portion of U.S. travelers, who have opted for cheaper non-European destinations (possibly providing better value for money under the circumstances). Europe attracted 39% of all U.S. travelers in 2007 (31.2m).

Greece attracts about 2% of U.S. leisure travelers worldwide. In 2007, Greece enjoyed a 17% increase in U.S. visitors, according to the U.S. Dept. of Commerce's surveys, the second highest rate of growth among 35 countries (ranking Greece in 20th position as an international destination from the U.S.'s point of view). First in arrivals' annual growth rates was Vietnam with a 21% increase of visits, which placed Vietnam 31st in terms of volume-of-arrivals. The Philippines came 3rd with a 15% increase, placing it 27th in volume terms. This improvement in Greece's standing as a tourism destination for U.S. travelers is appreciated even better when seen against the background of a 4% increase of U.S. citizens traveling overseas as a whole in 2007. The best YoY increase was in 2004, year of the Olympic Games, when arrivals from the U.S. increased by 49%. As we can see in Diagram 1, there has been significant variation in tourist inflows from the U.S. since 2001. Annual growth rates have been positive since 2004. However, for the 2001-2003 period, the double whammy of the U.S. recession of 2001 and the Sept. 11th terrorist attacks took its toll on U.S. visitors to Greece. Between 2000 and 2003, U.S. arrivals dropped 36%, which translates – roughly – to a 12% annual negative growth-arrivals rate. According to the June 18th report by the U.S. Bureau of Economic Analysis, real tourism spending in the U.S. declined 3.7% in 2008 Q1, taking its strongest dip since 2002. Could this be a precursor of 2008 peak season's trends, assuming U.S. has entered a recession in 2008?

The UK market

According to UK's Civil Aviation Authority, 3 million British citizens visit Greece every year. According to the UK's Office for National Statistics, so far this year (Feb-May 2008 results) UK residents' visits abroad decreased by 1% (totaling 17.7 million visits). Visits to Europe also dropped by 1% (YoY) and total expenditure abroad was squeezed by 1% to 9.1bn UKP. Visits to the U.S. have roughly remained the same as last year, contrary to higher expectations due to the cheaper dollar. In some parts of the world, UK arrivals have increased by as much as 5%, in defiance of the overall trend. These data, as in the U.S. case, indicate an early tendency of UK tourists to spend (on aggregate) less and, especially, to avoid European destinations that have become dearer and, hence, less attractive.

UK and U.S. tourist profiles in brief

U.S. tourists have on average an annual income of $109,000 and one-in-two pays his/her holidays through a credit card, spending about $1,332 ($78 per day). One-in-three book through an agent or the Internet, 86% do not use pre-paid packages, while 48% choose to pre-book their lodgings. Roughly one-in-two leisure travelers (58%) spend 9 days of holidays at hotels. 91% are adult-only parties, between 43 (females) and 46 (males) years of age. According to an older piece of research by VISA UK (2002), 50% of UK tourists usually book their holidays 2-6 months ahead while about half of the remainder (27%) book just a few weeks before they travel, or, at the last minute. About 2 out-of-5 pay by credit card (paying back in full the balance at the next invoice) while a further 1-out-of-5 pay off the outstanding balance gradually through installments. Both the U.S. and UK tourist profiles suggest that these consumers are fairly susceptible to the high cost of credit that the current financial crisis is inflicting upon their domestic economies.

The trends in the region

Seeking for leading indicators, we use neighboring countries' foreign tourist inflows in order to discern any trends and tendencies for the wider Mediterranean region which could also affect Greece. Table 1 contains tourist arrivals' growth rates for 2007 and 2008 for countries in the (East mostly) Mediterranean basin: Malta, Morocco, Romania, Bulgaria, Croatia, Turkey and Cyprus. In 2007, all of these countries experienced solid growth in tourist arrivals (with the exception of Cyprus). The most spectacular performance was that of Romania with almost 28% growth, followed by Turkey (17.8%). Moreover, Turkey, Romania, Morocco and Malta have enjoyed a surge in UK and U.S. tourist inflows, while Cyprus also has benefited from increased numbers of visitors from the U.S. (18.4%). Out of all the countries, Bulgaria has exhibited a strong downturn in UK tourists numbers (-15.3%) and a slow growth of visitors from the U.S. (2.3%). UK visits to Croatia growth rates were flat, though the country has seen 17.5% more U.S. tourists. Overall, the region (who are Greece's competitors) has shown very healthy performance in 2007. The Jan.-May period of 2008 has also shown signs of a good start for many of those countries (even though it is not peak season for tourism in the region, which implies that these numbers should be

treated with caution). So far, Malta and Romania have enjoyed a healthy increase in UK visits (first two columns of Table 1). U.S. visits to Romania and Morocco are on the increase while in Croatia and Malta they are dropping (Malta is suffering from a drastic decrease of 12% less U.S. tourists). Out of all the countries, Romania appears to be a solid performer.

The data on Cyprus are rather mixed. Performance of the tourism industry has not been spectacular in 2008 Q1 though this is not the peak season. A very strong increase in international tourist arrivals was posted in June 2008 (8.8%). On top of this, a strong increase of UK tourists was recorded (7.7%), greatly offsetting a drop of arrivals from Germany by 2.8% (roughly, 50% of the foreign visitors to the island are British). Overall, the Jan.–Jun. 2008 period was characterized by an increase of 2.7% in tourist inflows compared with the same period of the previous year. However, visitors from the U.S. dropped by 10% YoY in June, with an overall drop of 7% for the Jan.-Jun. 2008 period from the previous year. The Jan.-May tourist receipts were down by 5.7%. Per tourist spending was down by 6% YoY in May 2008, with UK tourists spending 12.8% less per capita, while U.S. tourists spent 27.5% more. From one angle, the strong increase in UK visitors to Cyprus could be interpreted optimistically from Greece's point of view for 2008, although it must be borne in mind that the individual performances of the respective tourism industries in the region appear to have decoupled from one another in recent years (some countries vastly outperform others or exhibit inverse trends).

The Greek case so far

As far as the Greek Tourism Industry is concerned, the messages from both the industry's entrepreneurs and government officials are still mixed. The daily press has reported that the Minister of Tourism Aris Spiliotopoulos has tried to downplay hoteliers' fears of a significant drop in tourist arrivals for the Jan-June 2008 period.[50] According to the Minister, quoting available data, arrivals are still growing positively (3%), despite concerns posed by UK tourist inflows. The Bank of Greece reported on July 22nd that travel receipts increased from last year by a hefty 8% (Jan-May period), while May enjoyed an increase of roughly 13% compared with May 2007. On the other hand, hoteliers are reporting a significant downturn in arrivals from Greece's main markets, and, rightfully, worry about a strong drop in the industry's turnover figures for 2008.

One must also bear in mind that the growth in travel receipts was almost flat between 2007 and 2006, according to the Bank of Greece (-0.3% decrease). Expenditure-by-trip of foreigners dropped by 1.48% to 472 euros in the same time-span, while the number of overnight stays remained the same (6.8).

The "worst case" scenario for hotel arrivals?

John Jay's quote suggests the prudent planner should prepare for the worst. It is true that so far, statistical readings do not point towards a dramatic slowdown in tourist arrivals. However, it is unsafe to extrapolate from non-peak season trends. About 60%-80% of tourism revenues are collected during the June-Sept. period in the region. Revenue levels are susceptible to random geopolitical factors and strong, sudden shifts in demand and travel patterns. The June-July official statistics could provide a clearer view but these are published with a significant lag.

In order to "be prepared", we provide a worst-case-scenario, extrapolating from tourist arrivals statistics available for Greece.[51] Our econometric model forecasts UK and U.S. arrivals on the basis of previous arrivals' histories, taking into account the exchange rate between the euro, the sterling and the dollar, incorporating consumer confidence information and including an intervention variable to indicate periods of recessions. We assume that the EUR/UKP and EUR/USD exchange rates will fluctuate around the 0.78 and 1.49 levels respectively until the end of 2008, while consumer confidence will continue to drop dramatically. We also hypothesize that a U.S. recession started around March 2008 and that it will continue until the end of the year. Under this bleak scenario we provide forecasts for U.S. and UK tourist arrivals to hotels and similar establishments in Greece.

Our econometric approach (see Table 2) suggests that if the worldwide economic downturn continues, UK and U.S. arrivals' growth rates will suffer considerably. By end of Sept. 2008, there could be a contraction in the

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[50] "KERDOS" newspaper, 15/07/2008, pg. 9. & http://walking-greece.ana-mpa.gr/articleview2.php?id=7855

[51] Detailed monthly tourist arrivals data to hotels and similar establishments are available through Eurostat only until the end of 2006. Hence, we had to forecast both 2007 and 2008 arrivals and, thus, our 2008 estimations are characterized by higher standard errors. Our forecasts should be treated with caution. However, they are indicative of a trend that is in tandem with the frictions and restrictions posed on the international tourism market by the worldwide economic crisis.

number of UK and U.S. visitors by 10% and 6% respectively, from the 2007 levels (year to date). The negative impact of lower tourist inflows from the UK and the U.S. could be even worse, provided that visitors from these countries decide to spend less. May 2008 data from Cyprus suggest that UK tourists' per capita spending decreased by 13% from the previous year, though U.S. visitors have spent 27% more. It remains to be seen whether this trend will define Greece's peak season spending by foreign tourists.

Conclusions

According to analysis of early 2008 data, tourism trends appear to be strong in the region. There are some indications that outside Eurozone travelers may prefer non-euro destinations this summer, due to the strong currency and increased prices. Moreover, our worst-case-scenario suggests a strong slowdown of tourist arrivals from the U.S. and UK markets. The Greek Tourism Industry is facing, lately, strong competition from nearby destinations which may benefit from lower prices and lower exchange rates, while offering a not-too-dissimilar tourist experience.

There is no strong indication yet that foreign tourist inflows to Greece will be dramatically lower in 2008. On the positive side, Eastern European visitors have been increasing geometrically in the last few years, counterbalancing a possible reduction of arrivals from markets such as the UK and the U.S.

However, if there is a severe drop in the demand for Greece's tourism services – an outcome which may be more relevant in the case of the UK and U.S. markets than in others, for the reasons outlined above – special caution should be taken to cushion the industry's downturn. Special consideration and forward planning should also focus on the possibility of the industry facing further negative figures in 2009, as the worldwide economic downturn possibly extends beyond 2008, causing a prolongation of the current restrained consumption trends and weak consumer confidence.

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Senior Economist

Diagram 1:

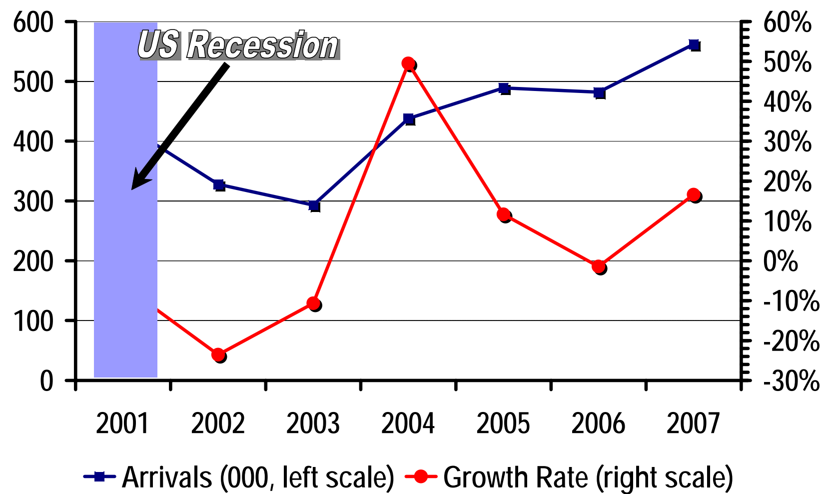

Table 1:

Tourist Arrivals

(% growth rates)

	May 2008 vs. May 2007	Jan-May 2008 vs. Jan.-May 2007	2007 vs 2006
Malta			
UK	15.2	3.4	11.8
US	-40.2	-11.8	20.3
Total	20.5	16.5	10.6
Morocco			
UK	-12.2	-14.5	27.4
US	9.1	8.2	13.9
Total	13.4	6.4	12.9
Romania			
UK	7.5	20	31.1
US	17.7	11.5	9.8
Total	26.6	35.1	27.9
Bulgaria			
UK	NA	NA	-15.3
US	NA	NA	2.3
Total	NA	NA	3
Croatia			
UK	-3.8	-5.2	-0.74
US	-3.8	-2.5	17.5
Total	16.4	6.9	7.5
Turkey			
UK	NA	NA	14.1
US	NA	NA	20.8
Total	NA	NA	17.8
Cyprus			
UK	-10.1	-3.6	-5.7
US	6.7	-5.2	18.4
Total	-0.55	0.14	0.63

Sources: National Statistics Office, Malta - Royame Du Maroc, Administration Du Tourisme - Observatoire Du Tourisme - Daily Camera - National Institute Of Statistics, Romania - National Statistical Institute, Republic Of Bulgaria - Central Bureau Of Statistics, Republic Of Croatia - Turkish Statistical Institute Prime Ministry, Republic Of Turkey - Statistical Service Of The Republic Of Cyprus

Table 2:
A "worst case scenario"
Estimated Tourist Arrivals Growth Rates

	UK		*US*	
	Year on Year	*Year to Date*	*Year on Year*	*Year to Date*
June	**-8.1%**	-19.0%	**-5.9%**	-1.0%
July	**-5.9%**	-13.9%	**-5.7%**	-5.0%
August	**-7.1%**	-11.3%	**-6.2%**	-9.3%
Sept	**-6.9%**	**-10.2%**	**-6.2%**	**-6.0%**

Source: Eurobank Research

EU structural funding for Greece:

Near the end of the line, the European Commission comes to the rescue

- **80.6% of available public funds (*i.e. EU + national*) under CSF III had been spent until June 15th 2008, with only 6 ½ months remaining until the end of the program.**
- **An extension granted by the European Commission moved the deadline by a full year for a number of projects worth a total of €1.96bn (1/3 of unspent public funds), easing the pressure for 4 (out of 13) Regional Programs and 10 (out of 12) Sectoral Programs.**
- **This will also prove helpful in curbing expenditures under the Public Investment Budget, traditionally used as a buffer to absorb pressures on the fiscal front.**

I. CSF III developments in 2008

2008 is officially the final year of the CSF III program. Only 5 months are left in order to utilize available EU structural funds to co-finance critical projects in infrastructure and human capital investment. As we have already discussed in previous issues of our Macro Monitor, various structural problems plaguing the public administration system have caused serious delays in the execution of the program. The delivery of public projects eligible for EU funding has been problematic from the beginning, despite numerous efforts to boost public spending. These efforts included restructurings of the program and the transferring of already-completed projects under the purely nationally-funded part of the Public Investment Program (PIB) to the co-financed part. A final and last minute restructuring is actually taking place right now in an effort to allocate funds to projects still capable of absorbing funds.

Throughout 2001-2007, the execution of the 3rd CSF program in Greece proceeded at a slower pace than required to secure a smooth absorption of EU funds. The latest available data, presented in the following two tables, show that public expenditure on CSF III projects accelerated significantly in 2007. The data for the first half of 2008 show a slowdown, but we should be careful in interpreting these results since public spending is not distributed normally during a fiscal year. Still, the high pace achieved in 2007 was lower than required to cover the lost ground *(see also previous issues of our Marco Monitor report).*

The flow of monthly public expenditure on CSF III projects
(million euros per month on average)

2001	2002	2003	2004	2005	2006	2007	1/1 – 15/6/2008
142	**192**	**266**	**250**	**342**	**375**	**465**	**292**

The flow of public expenditure on CSF III projects
(% of total CSF III public funds)

	2001	2002	2003	2004	2005	2006	2007	15/6/2008
Annual Rates	5.3	7.1	9.8	9.3	12.6	13.9	17.2	5.4
Cumulative Rates		12.4	22.2	31.5	44.1	58	75.2	80.6

Until the middle of June 2008, 80.6% of the total €34.2bn of public (*i.e. EU + national*) funds was spent under CSF III, in comparison with 58% at the end of 2006. The Ministry of Economy and Finance said recently that so far no EU funds have been lost thanks to the application of the n+2 rule[1].

II. Extension eases pressures

Yet as the tables above imply, the monthly rate of public expenditure must reach €967m in the second half of 2008 in order to exhaust all available EU funds and avoid any losses. This represents a more than 100%-acceleration compared with the realised average monthly expenditure in 2007. Loss of funds seemed unavoidable until an EU decision on 30/6/2008 to grant an extension until the end of 2009 on a number of programs. This extension moves the deadline for the spending of €1.96bn of public funds (approximately 1/3 of unspent public funds) a full year ahead, providing a lifeline to the whole program.

The extension was the result of the tragic events of August 2007[1] which allowed the Greek government to invoke an EU regulation that provides for deadline extensions in the case of natural disasters. This regulation provided the necessary backdrop and legitimized the request for the badly-needed extension. In autumn 2007 the Greek Government requested a one-year extension for all sectoral programs and for four regional programs *(i.e. Attica, Western Greece, Peloponnese and Central Greece)*. An extension was granted initially only to the four aforementioned regional programs[1] and the Greek government was asked to provide further evidence and information on particular projects in the sectoral programs, which could be eligible for an extension. The request concerned €2.08bn of public funds, and finally the Commission approved the extension in the spending of €1.96bn. From the sectoral programs only two – Education and Culture – were not granted any extension and with public spending reaching 83% and 72% respectively by June 15th 2008, this means trouble for both programs.

The extension eases implementation pressures. Yet, the average monthly rate of public expenditure needs to accelerate approximately to €665m (from the €967m required before the extension) in the second half of 2008, when all 25 programs will be in operation, in order to avoid any loss of available funds. There is less pressure for those programs granted an extension, with the required monthly rate being only €419.8m. In 2009[1] the required monthly rate will fall to €161.8m. The following table shows the situation as of 15/6/2008 for the programs granted an extension and how helpful the extension will be for their implementation.

III. PIB Public Investments Program 2008

The Public Investments Budget (PIB) for 2008, which was presented in December 2007, reflected the need to accelerate the execution of the 3rd and the beginning of the 4th CSF programs. PIB expenditure was projected to reach €9.3bn (€8.7bn in 2007) in 2008. The purely nationally-funded part of the PIB was reduced for a fourth consecutive year to €2.6bn, as part of the effort to curb government spending and achieve the targeted reduction in the general-government budget deficit. However, the EU co-financed part of the PIB increased to €6.7bn, remaining on a rising trajectory since 2002.

This amount as we have already noticed in our last issue of Macro Monitor is lower than is necessary to absorb all the available EU funds until the end of 2008. We can only assume that the Government, in autumn 2007, had already taken into account the end-of-2009 extension of the deadline on public spending on co-financed projects. Even so, a reduction by €2bn in necessary public spending is a welcome relief to the government budget, which is still under enormous fiscal pressure. It is worth recalling that CSF projects are financed by national funds and only after their completion are EU funds released. The data for the execution of the budget for the first four months of 2008 point to a serious revenue shortfall and, in conjunction with a weaker-than-anticipated economic growth rate, put the budget-deficit target for 2008 in doubt. The PIB has been used many times in the past as a buffer in order to reduce the deficit. PIB expenditures are systematically overestimated in the budget[1] as they are the easiest to reduce when the need arises. As for the 4th CSF, it should also be noted that, so far, only administrative decisions and legislation necessary for the setting up of the public-administration structures are ready while the actual implementation has not yet started.

[1] Wildfires in the summer of 2007 devastated central and southern Greece, causing unprecedented loss of life and property.
[2] See March's 2008 issue of Macro Monitor.
[3] For convenience we assume that all public funds granted an extension will be spent in 2009.

IV. EU funds absorption rates

Until the middle of May 2008, 81.6% of total EU funds had been cashed out, or €18.5bn out of a total available amount of €22.7bn.

The absorption rates of CSF III funds
(% of EU funds)

	2001*	2002	2003	2004	2005	2006	2007	12/5/2008
Annual Rates	9.2	5.8	6.1	9.6	9.4	13.2	19.1	9.2
Cumulative Rates		15.0	21.1	30.7	40.1	53.3	72.4	81.6

* The 2001 figure is boosted by the 7% down payment.

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[3] Expenditure not meeting the appropriate conditions of funding must be excluded from the co-financing part of the EU budget. This exclusion is called a "**financial correction**". The purpose of financial corrections is to restore a situation where 100% of the expenditure declared for co-financing from the Structural Funds is in line with the applicable national and Community rules and regulations.

High Current Account Deficit: the Most Important Problem facing the Greek Economy in the Medium-Term[52]

Greece's current account deficit has assumed explosive proportions, reaching a historic high of 14.1% of GDP in 2007 (€32.26b). In the medium-term, this level is not sustainable, in our view. The competitiveness problem that is reflected in this figure represents one the most important structural dilemmas facing the economy, as it threatens to undermine its long-term growth potential[53]. Furthermore, the financing of the current-account deficit causes a rapid accumulation of external debt, which is now well above 80% of GDP, by far the highest in the EU-13. In effect, the country is spending its future capital now in order to finance a consumption rate which surpasses that of domestic production. The public at large does not seem to fully realize the commanding need to address the problem or the consequences of failing to do so. Participation in EMU appears to have contributed to the lack of full awareness of the problem, as it has removed both concerns about the financing of external debt, and the warning bells of devaluations. However, the loss of autonomy in the exercise of the monetary and exchange-rate policies renders the correction of the divergence more cumbersome, to the extent that instead of adjusting one price, i.e., the exchange rate, a myriad of prices of goods, services and factors of production will now need to be adjusted, so as to prevent a further significant loss of competitiveness. The crucial question is how to minimize the cost of adjustment and not whether there will be a cost.

Analyses which foresee a moderation of external deficit on the basis of economic conjuncture appear to be too reassuring. True, part of the deterioration is due to purchases of ships by Greek ship-owners *(17% of the current account balance or 2.4% of GDP in 2007),* and to the steady increase in the price of oil since 2000 *(14% of the deficit or 1.98% of GDP in 2007).* But, the trade balance, excluding fuel and ships, has also been on a steadily deteriorating trajectory since 2000. More worryingly, the price of oil appears to have surged above $100/bbl on a more permanent basis, while no help can be expected from the incomes balance either. The latter has traditionally counterbalanced trade deficits, but it is now in a deficit itself *(€9,077b or 28.1% of the current account deficit in 2007*) due to the increase in the portion of public debt and equity of Greek companies held by foreign investors[54]*.* The transfers balance is also deteriorating due to the reduction in net transfers from the EU *(due to the GDP revision but also from more permanent reductions in Cohesion fund inflows)* as well as the increase in remittances of foreigner workers living in Greece.

The current account deficit is caused by a combination of various structural imbalances and in this sense is not a transient phenomenon. Looking at the problem from a more inter-temporal perspective, the deterioration in Greece's BoP dynamics reflects a growing decoupling between national saving and investment. Total investment in Greece currently stands at around 28% of GDP, compared to 22% in the Euro area as a whole, with ca 7% corresponding to real estate. On the other hand, net private saving has turned negative *(-4.1% of GDP in 2006),* primarily due to the expansion of households' debt. T*he corporate sector, banks and maritime businesses in particular, continues to increase its saving, but public saving remains steadily negative.* This phenomenon is related to the deterioration in price competitiveness. Its beginnings can be traced to 1994 and the accumulation of real appreciation of the drachma incurred by the "hard drachma policy" *(15-28%, according to estimation methodology)*, which was not fully reversed by the March 1998 devaluation of 12.3% against the ECU. This is evident in the fact that the current account deficit was already above 7% of GDP when Greece joined EMU in January 2001. Disinflation was achieved in the period leading to Eurozone entry, but in the absence of much-needed structural reforms this proved insufficient. As a consequence, Greece continues to run a positive inflation differential of one percentage point or more vis-à-vis the Euro area. Since devaluation is no longer an option, inflation differences are accumulated, resulting in a significant real appreciation. The latter has been eroding the price competitiveness of Greek exports in recent years, despite the steady rise in productivity. Our estimations suggest that, excluding the impact of oil prices and ship purchases, the current deficit has to decline by 5.4 percentage points

[52] *Dr Tassos Anastasatos*, Senior Economist, Economic Research & Forecast Division. This piece draws on the article "The Deterioration of the Greek Balance of Payments: Causes, Consequences and Adjustment Scenaria" by the author, published in Vol. III, issue 6, of the Economy & Markets Bulletin of Eurobank EFG Research.

[53] Trend real GDP growth is estimated at around 3.0%.

[54] According to a recent estimate, foreign-investor holdings now account for more than 50% of total market capitalization of the Athens stock exchange (ASE).

of GDP in order to become sustainable, i.e. to prevent further increases in the external debt. With an estimated elasticity of BoP with respect to GDP of 0.21%, this implies a required real depreciation of 25%, based on very lenient assumptions.[55] This is tantamount to a return of the real exchange rate to its 2001 level, when the country adopted the common currency. The problem is exacerbated by the persistent nominal appreciation of the euro.

Part of the surge in prices has to be attributed to real convergence *(2.5 percentage points of GDP contribution to the current account deficit).* The increase in *per capita* incomes carries along a higher price level and, consequently, real appreciation *(Balassa-Samuelson hypothesis).* However, the greatest part of Greece's widening deficit is the product of above-potential GDP growth over the last decade or so *(4.2% average real growth since 2001, compared to a potential growth rate of approximately 3%).*[56] This overheating increases the price level, since rising demand cannot be matched by lagging domestic supply. Participation in EMU fostered expectations of higher future growth *(higher returns on investment)* and higher expected future *per capita* income. As a result, individuals invest more, but they also transfer resources to the present *(that is, they borrow)* in order to achieve an inter-temporal smoothing of consumption towards a new higher level. Given that a part of consumption concerns imports, this puts a further strain on the current account deficit.

In 2007, private consumption in Greece was equal to 70.6% of GDP, compared to a 56.3%-of-GDP average in the Eurozone. This means that Greeks are consuming as if their income were 25% higher from its current level.[57] Since Greece grows by 2% yoy faster in real terms (4.2% against a euro-area average of 2.1% since 2001), real convergence can be achieved in approximately 6 years *(Greek per capita GDP is today equal to 89.7% of the Eurozone average).* Consequently, along with a return of investment at more sustainable levels *(around 22% of GDP),* private consumption will need to fall by about 14 percentage points of GDP, so as to become sustainable. This implies a *required* real rate of consumption growth below 1.5% yoy over the next 7-8 years.

How can this be achieved? To begin with, the increase in consumption is enabled but also enlarged by the rapid growth of private lending *(94% of GDP in 2007, compared to 30% before the liberalization of the Greek financial system).* In turn, this is due to the decline of domestic interest rates brought about by EMU participation and the resulting stabilization of inflation and fall in risk premia. Although Greece΄s credit-to-GDP ratio stills lies below the euro-area average, credit growth is likely to decelerate in the coming years, as domestic households move to restore their balance sheets and interest rates rise further to preempt rising inflation risks.

However, this may not be enough. In order to improve the price competitiveness of Greek exports *(i.e, real depreciation),* the inflation rate in principle has to be reduced below the Eurozone average. Further, rationalizing aggregate demand, *i.e. eliminating overheating,* dictates restraints on nominal incomes growth at a rate that falls short of the sum of the inflation rate and productivity growth (6-7%). If not via an increase in productivity (which is already above Euro zone average), this needs to be achieved via a significant cut in real wages growth for the coming 6-8 years, or a combination of the two factors.

The size of required real depreciation can be substantially reduced if policymakers and businesses successfully implement strategies supporting energetic export promotion, sectoral restructuring and reorientation towards new target-markets. Regarding the latter, the increasing dynamism of Greek enterprises in their expansion to "new Europe" (30% of Greek exports in 2007 compared to 16% in 1995), and especially to the Balkans, is a positive sign. Since these markets grow at a faster pace and are expected to experience milder repercussions from the current financial crisis, demand for Greek products and services in those markets helps to counterbalance the loss of market shares in the Eurozone. A coordinated effort to turn domestic demand away from imports and towards domestic products can also help, but the extent to which this is feasible remains questionable.

[55] For example, if real oil prices remain constantly above the pre-2007 levels, the required depreciation will be significantly higher.

[56] Empirically, the main determinants of the BoP deterioration are real appreciation, the level of wages, credit expansion, the oil price, and, secondarily consumption expenditure and aggregate demand. In contrast, wage rigidities, fiscal deficits (which have been falling in recent years) and factors related to economic convergence (Balassa – Samuelson effect) do not seem to have a significant impact.

[57] Noting that the propensity to consume is higher in low levels of personal income; however, given real convergence, Greek figures should approach EA ones.

Another key prerequisite for a sustainable improvement in BoP dynamics is the improvement in the non-price competitiveness of the Greek economy. That is, *quality* enhancements of existing exported goods and a reorientation towards goods and services with characteristics of *higher quality and technological superiority* (innovation, cutting-edge technology, quality of production, establishment of high-end brand names). This would allow competing at prices higher than those of lower-cost producers without loss of market share. Although progress has been made in recent years with respect to the technological content and quality – and therefore value – of exported products and services, the "quality wager" has yet to be won by the Greek economy: only 10% of Greek exports are classified as high-tech products. If all aforementioned strategies fail, the required adjustment will eventually be accompanied by a prolonged period of slower economic activity, painful and lasting wage restraint, an increase in unemployment and, possibly, labor emigration. Although this scenario is not the most probable one, the size of required real depreciation, as well as the scope of required structural reforms, are sufficient to raise credible concerns.

Foreign Direct Investment would help to alleviate the problem only in the medium term and only to the extent that the in-coming investment can help increase the export orientation of the Greek economy. FDI should qualitatively upgrade the productive base of the economy, promote technology and organizational spill-overs to domestic businesses, increase productivity of the economy as a whole, reinvigorate competition (price reductions) and create job opportunities for skilled labor. At present, FDI is limited in volume and scope (mainly acquisitions), generally affects low-and-medium technology activities, and mainly concerns the retail sector and servicing of the domestic market. Potentially, this can aggravate the problem, if the initial capital inflow is eventually offset by profit repatriation and a possible displacement of domestic export-oriented businesses.

The exporting performance of the Greek economy is further undermined by its structural weaknesses. As an indication, Greece ranked 65th in World Bank's 2007 Total Competitiveness Index. Significant improvement is urgently needed in aspects such as the creation of a business -friendly economic environment, quality of infrastructure, education & training, and public administration.

To wit, economic policy faces an important challenge. Coordinated efforts are needed towards lucidly defined qualitative and quantitative goals at the macroeconomic and sectoral levels:

1. The narrowing/elimination of inflation differentials over the Eurozone average, by fighting oligopolistic conditions in markets and rigidities that prohibit market clearing.
2. A shift of domestic production towards high value-added products and services.
3. The realignment of domestic-demand management so as to prevent boom-and-bust cycles and reduce the propensity to import.
4. Reforms towards a less energy-intensive model of economic development.
5. Incomes increases at a rate lower than the sum of inflation and productivity growth.
6. Incentives to productive domestically-based investment and policies to attract exports-oriented FDI.

The crowning of structural reforms is the turn towards innovation and knowledge. This requires higher spending on R&D, the development of innovative organizational structures, effective regulation and a solid public administration. These require a radical shift in the culture of domestic economic agents and policy makers. Within a unified and increasingly competitive European and international environment, this is not a wishful alternative but a matter of survival.