Greece: Macro Monitor

Quarterly Economic Review

Investment recovery supports GDP growth

- **We revise our 2006 real GDP growth forecast upward to 3.7% from 3.4%, as higher domestic demand growth overtakes the slack in net exports**

- **Strengthening residential construction activity, higher public investment spending and improved business sentiment point to a dynamic bounce in investments following their year-long slump in 2005**

- **Demand-side pressures, persistently high oil and raw material prices and above-inflation increases in private sector wages are likely to maintain upside price pressures, with annual inflation remaining above 3.0% both this year and the next**

- **Expenditure restraint and strong revenue growth over the first half of 2006 strengthen our belief that the authorities will succeed in reducing the 2006 general government budget deficit to no more than 3.0% of GDP**

Economic Research

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Summary

Economic growth surprised to the upside in the first quarter of this year, helped primarily by a dynamic bounce in investments following their year-long slump in 2005 amid significant cutbacks in public investment outlays. Strong world growth and upbeat domestic economic data point to continuing strong GDP readings in the quarters ahead. We now see real GDP growing by 3.7% this year with the slack created by a worsened net exports balance being taken up by higher domestic demand growth.

Risks to our upbeat growth projections include a worst-than-expected contribution from net exports due to the stronger euro and further competitiveness losses as a result of persisting inflation differentials vis-à-vis the main trading partners. High oil prices and persisting global imbalances also pose downside risks to our outlook.

Despite some risks of a mild slowdown in consumer spending in the coming months, given preliminary evidence of consumer borrowing fatigue and the negative impact of higher oil prices on disposable incomes, recent conjectural indicators and consumer attitude survey show no significant abatement of consumer vigor. Moreover, strengthening residential construction activity, higher public investment spending and improved business sentiment support our expectations of a healthy bounce in fixed capital formation growth this year.

CPI inflation has been edging lower in recent months despite elevated energy prices, higher public transport fares since February 2006 and adverse base effects from last year's VAT rate hike. However, demand-side pressures, persistently high oil and raw material prices and above-inflation increases in private sector wages are likely to maintain upside price pressures with the annual inflation remaining above 3.0% both this year and the next.

A tighter fiscal-monetary policy mix is likely to help contain inflationary pressures this year but broad-economy unit labor cost growth is expected to continue exceeding the corresponding eurozone average by a considerable margin. On a more positive note, recent structural reforms aiming to promote flexibility in the domestic product and labor markets and to apply corporate governance principles in public sector entities constitute important steps towards strengthening medium-term economic competitiveness.

On the fiscal side, expenditure restraint and strong revenue growth over the first half of 2006 strengthen our belief that authorities will succeed in reducing the general government budget deficit to no more than 3.0% of GDP this year. However, exit from the excessive deficit procedure may require further fiscal measures of a structural nature in the event of unforeseen adverse developments down the road.

Recent data regarding the pace of implementation of the 3rd Community Support Framework reveal worryingly low rates of program execution. Indeed, as the December 2008 deadline approaches, program completion rates are slowing instead of speeding up. As things stand at this point, the rate of program execution has to triple (i.e. to ca €620m per month) over the next 31 months in order to ensure the absorption of the full amount of funds available under the 3rd CFS.

The Government this year has focused mainly on implementing a number of economic reforms that were basically enacted last year. So far, the record has been mixed, but the Government has sought to maintain the momentum through a series of proposals in added areas, such as tertiary education and constitutional reform. The local and regional elections due in the autumn will also tend to attract increasing political attention in their own right,

and their results will add significant extra input into the political process in the months leading up to the next general election (in principle, in spring 2008).

Though the Government continues to stress its staunch reformist credentials, most of these reforms are still at the gestation stage (e.g., public-private partnerships, reform of public entreprises); it is therefore too early for their appraisal. Major hurdles, often of a legal nature, remain to be overcome in certain specific areas, including the attempted staffing changes at OTE telecoms and pension reform in the banking sector. In addition, the Government's declared agenda does not exhaust the full list of reforms needed, and must therefore be broadened to encompass a wider range of changes, such as that embraced by the Lisbon Agenda. Using the latter as a benchmark, there is evidence to suggest that Greece is not closing the gap appreciably with her more advanced EU partners. For this reason she will need to redouble her efforts in this domain.

Key macroeconomic indicators

Greece: key macro indicators

y/y grwoth	**2004**	**2005e**	**2006f**
GDP (constant prices)	4.7	3.7	3.7
Private Consumption	4.4	3.7	3.4
Public consumption	3.9	3.1	1.8
Total investment	5.7	-1.4	5.2
Domestic demand	4.7	2.3	3.6
Exports g&s	11.5	3.0	5.8
Imports g&s	9.8	-1.2	5.0
National CPI (average)	2.9	3.5	3.2
Budget balance (% GDP)	6.6	4.5	3.0
Public debt (% GDP)	108.5	107.5	105.0
Employment growth	2.9	1.4	1.4
Unemployment rate	11.0	10.4	9.8
Labour productivity growth	1.7	2.2	2.4

Source: realisations, official estimates and EFG Eurobank forecasts

Part A

Economy and Macroeconomic Policies

- **Political overview**
- **Domestic economy**
- **Fiscal outlook**
- **Structural issues**

Political and Economic Overview

As part of its economic reforms agenda, the Government this year has focused mainly on implementing a number of legislative initiatives that were enacted last year. So far, the record has been mixed (see below), but the Government has sought to maintain the momentum through a series of proposals in added areas, such as tertiary education and constitutional reform. In addition, the local and regional elections due in the autumn will also tend to attract increasing political attention in their own right, and their results will add significant extra input into the political process in the months leading up to the next general election (in principle, in spring 2008).

Economic growth is proceeding at a fairly satisfactory pace. At 4.1% in the 1st quarter of the year (y-o-y), it was almost twice as high as in the EU25 (2.2%). This has had the effect of softening the impact of the country's EU-mandated fiscal consolidation programme on the economy, as well as to afford the Government considerable vindication for opting for a gradualist approach to reforms. This may turn out to be a curse in disguise, however, for beyond the Government's own package of reforms lies the Lisbon Agenda. And here, where it really counts, Greece turns out to be the EU15's laggard, at least according to one international study.[1] Greece's ranking reflects lags in such areas as the information society, innovation, R&D and the business environment, even as public spending on education remains set in the 3.1%-3.5% range, one of the lowest in Europe. (The Government before the elections spoke of achieving 5%-of-GDP by the end of its 4-year term). These developments, in turn, may also help to partly explain the persistent nature of the country's unemployment, stuck at just under the 10% mark.

[1] According to a study conducted by the WEF (and reported in *To Vima*, 6.7.2006), Greece ranks last among the EU15 and 22nd among the EU25 (minus Cyprus) in achieving the Lisbon targets. Greece was awarded 4 out of 10, compared with 5.8 for first-placed Finland, for example.

Delays in the implementation of Lisbon-based reforms may be partly attributed to the Government's focus on fiscal consolidation, following its self-imposed fiscal audit in 2004. On this score, the Government declares itself confident that it will reduce the budget deficit as a percentage of GDP to below the 3%-Maastricht limit by the end of the year, in fact, to 2.6% (just as it brought it down to 4.5% in 2005 from 6.9% in 2004). The European Commission is less sanguine, and stands by its estimate of 3%-of-GDP for the current year. As for next year, the Commission reserves an opinion until it sees the 2007 draft budget, on which also hinges the abrogation of the current budgetary surveillance by Ecofin.

Fiscal concerns may have had an undesirable knock-on effect on the Government's managing of the CSF-III, itself under risk of being cut back on account of delays in implementation. Out of an EU contribution of €22.7bn (2000-2006 + 2) Greece has yet to absorb €10.7bn, which in principle require, for their disbursement, matching funds from the Greek budget of the order of €5bn. Economy Minister George Alogoskoufis has reportedly agreed with the European Commission to reduce Greece's participation to about €2.0, leaving the EU's €10.7bn intact. This reduction in scale will purportedly make the whole entreprise more manageable. At the same time, of course, it will help the Government achieve its fiscal targets (at a cost to the country's longer-term growth potential that is difficult to estimate).

The Commission apparently has rejected a Greek demand for a one-year extension to the N+2 rule (under which the seven-year programming period is extended to nine, provided all contracts for any remaining projects are signed by the end of the seventh year). This would have given the Greek authorities the breathing space of one extra year until end-2009: by June 30th 2006, only 66.9% of the CSF as a whole had been contracted out (62.2% at end 2005). If by the end of the year the rest is not similarly contracted out, it will be lost (see page 22 for further discussion). The Greek side, for its part, is said to consider this as only the opening bid in a new round of negotiations involving the wider revision of CSF-III, probably to be concluded by end-October. Although the Government tends to blame the current state of affairs on its predecessors and their alleged slow start in launching the CSF-III, Pasok blame the present impasse on the current administration's alleged managerial ineptitude in conjunction with the public-investment cutbacks caused by the fiscal audit, which they claim was politically motivated.[2]

Although the Government appears to be consolidating its lead in the opinion polls at around the 2-3% mark, this advantage must be read in conjunction with a number of other indices, which actually tend to qualify any *prima facie* impressions: for example, those interviewees who think that the Government is not doing a good job, or who think that its performance is below expectations, regularly outnumber the other camp.[3] At the same time, however, main opposition Pasok has not been able to capitalise on ND's weaknesses, displaying "qualitative" shortcomings of its own.[4]

Citizens continue to view the future state of the economy with considerable apprehension, which on the face of it does not augur well for the Government in the longer term. According to the latest *Eurobarometer*[5], only 12% expect any improvement next year, while a full 57% expect the economy to deteriorate. The rest (31%) expect no change. As regards households' financial expectations, results are a little less bleak, with those expecting an improvement reaching 19% and a deterioration 28%. (53% expect no change.) Yet 56% of all those questioned declared themselves "fairly satisfied" with the life that they lead, with only 8% saying they were "not at all satisfied" – which compares rather favourably with the 11% of citizens who declared themselves "very satisfied". Those who described themselves as "not very satisfied" accounted for a quarter of the sample. Although the proportion of Greeks who feel that things will get worse in the next twelve months has decreased somewhat compared with the last two surveys (in spring and autumn 2005), Greek citizens continue to exhibit a large "dissatisfaction gap" in relation to the European averages, confirming the view that the Greeks, along with the Portuguese, are among the most pessimistic of European citizens, according to opinion polls of this kind.

[2] For an in-depth analysis of the fiscal audit of 2004, see our *Macro Monitor*, December 2004.
[3] See, *e.g.*, VPRC barometer, in *Kathimerini*, 11 May 2006, and MRB, in *To Vima*, 25 June 2006.
[4] For example, Pasok's biggest "deficits" emerge in the areas of "leadership", "effectiveness", "vision"/"optimism", "consistency", "coordination" and "decisiveness", even among its own supporters. See, *To Vima,* above.
[5] European Commission, *Spring Standard Eurobarometer*, July 2006.

Domestic Economy:
Investment recovery supports GDP growth

- **The economic outlook remains favorable and we forecast real GDP growth of around 3.7 percent this year on the back of strengthening investment activity**

- **Risks to our upbeat growth projections include a worst-than-expected contribution from net exports due to the stronger euro and further competitiveness losses as a result of persisting inflation differentials vis-à-vis the main trading partners. High oil prices and persisting global imbalances also pose downside risks to our outlook**

Q1 GDP above expectations, outlook remains positive

After recording above-consensus growth of 3.7% last year, Greece's real GDP has continued to surprise on the upside with the latest national account data recording a preliminary rise of 2.8/4.1% qoq/yoy in the first quarter of this year. This was mainly on the back of continuing strong domestic demand and, most importantly, a healthy bounce in investments following a year-long slump in 2005 as a result of significant cutbacks in public investment outlays.

Strong world growth and generally positive readings in an array of economic activity indicators confirm the aforementioned trends and point to continuing strong GDP readings in the quarters ahead. We now see full-year GDP growth exceeding our previous forecast to reach 3.7% in 2006 with the slack created by a worsened net exports balance being taken up by higher domestic demand growth (see table below).

Risks to our upbeat growth projections include a worse-than-expected contribution from net exports due to a stronger euro and further competitiveness losses as a result of persisting inflation differentials vis-à-vis the main trading partners. High oil prices and persisting global imbalances also pose downside risks to our outlook.

As a final note, the strong growth performance of the Greek economy in 2005 brought about further improvements in an array of real economic convergence indicators including the country's per-capita GDP, which in constant PPP terms (EU-15 = 100) rose further last year to 77.1% from 75.4% in 2004. This strong outcome was attained in spite of last year's sizeable fiscal adjustment and the waning/reversal of special factors that boosted growth in the prior year[6].

Investments rebounding after last year's plunge

The growth of residential construction permits in volume terms, a reliable indicator of future building activity, rose strongly towards the end of last year amid a rush of prospective homeowners to secure permits ahead of the introduction of VAT on new home purchases from January 1, 2006[7].

Though decelerating significantly from the extraordinary rates recorded in late-2005, the growth of permits remained positive in the first four months of this year (+5.7% y/y vs. 118% in Q4 05), and this, along with recovering public construction activity and improved business sentiment, support our expectations of a healthy bounce in fixed capital formation growth in 2006.

The latter contracted by 1.4% in real terms in 2005 as a result of sizeable cutbacks in public investment outlays and declining building-permit issuance in the prior two years. In addition to strengthening residential building activity, other factors supporting expectations of a considerable improvement in the outlook

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[6] Shipping revenues, which accounted for 2.3 percentage points of real GDP growth in 2004, decelerated significantly last year but remained a positive contributor to the tune of 0.2ppts of GDP. Also, strong Olympics-related extraordinary added some 0.4ppts to real GDP growth in 2004.

[7] Residential construction permits grew 118.5% y/y in Q4 from +20.2% y/y in Q3 and against average growth of -2.6% y/y in H1 05

for the domestic construction sector include recent strong gains in the index of construction business confidence and the continued double-digit growth of mortgage lending. Higher public construction is also likely to provide support given expectations of a considerable rise in public investment expenditure this year. On this latter point note that the outlays of the public investment program contracted by 21.1% y/y in nominal terms in 2005 but a 9.1% y/y rise in this expenditure category is budgeted for this year, not least because of the need to facilitate the proper absorption of structural EU funds under the 3rd CSF (2000-2006). According to the latest official figures, public investment outlays rose by 16.4% y/y in March 06, bringing their overall growth for the 1st quarter to -6.1% y/y from -56.6% y/y in the same period last year, and further strong gains are expected in the following months. According to one of our contacts at the Ministry of National Economy and Finance, public investment expenditure grew by 20% y/y in the April-May period, contributing around 0.8ppts to the Q2 GDP growth figure.

Business investments are also likely to grow faster this year after rising by 1.5% in real terms in 2005 given improved business confidence, better conditions in major trading-partner economies and positive developments in the domestic manufacturing, trade and retail sectors. Finally, note that the ratio of total investment expenditure-to-GDP in Greece has been on a rising path in recent years, supporting economic growth and helping to expand the productive capacity of the economy. This ratio rose to around 25.6% in 2004 from 23.6% in 2000 and, despite its marginal drop to ca 25% last year, remained well above the corresponding EU average (+20.8%).

External sector likely to be a drag on GDP growth this year despite rising exports

Last year the external sector was a positive contributor, accounting for roughly a full percentage point of real GDP growth. However, this was not due to strong exports but rather the result of negative import growth, among other reasons, due to unfavorable base effects related to the 2004 Olympic year. Exports of services were broadly stagnant in 2005, mainly as a result of lower shipping revenues, but those of goods posted real growth of over 8% following a small decline in 2004. This year, we forecast an acceleration of the overall growth of exports of goods and services which, however, will be more than outweighed by higher import growth as a result of strengthening domestic demand and abating (adverse) base effects from the strong surge in imports during the 2004 Olympics year. These forecasts are supported by the most recent customs statistics showing an 18% y/y average rise in merchandise export revenues in the first five months of the year along with an 11% y/y increase in the trade deficit as a result of higher imports (+13.7% y/y).

Higher tourist receipts are also likely to support export growth this year in view of Greece's improved status as a favorable international tourist destination and the significant upgrading in the infrastructure of the domestic hotel industry over the last few years. Tourist arrivals are estimated to have risen by round 9% in 2005, following a 2.5% decline in the prior year and strong growth is expected to continue this year. According to the most recent balance-of-payments data, travel receipts in the first four months of this year posted a slight decline (-0.7% y/y) relative to the same period a year earlier but this was due to a rather weak first quarter. Travel receipts recorded growth of 14.9% y/y in April and this strong performance is likely to continue during the summer period given high occupancy rates in domestic hotel facilities and anecdotal evidence of strong tourist arrivals in recent months.

Consumer spending strong, mild cooling down possible in H2

Although some preliminary evidence of consumer borrowing fatigue and the negative impact of higher oil prices on disposable incomes suggest risks of a mild deceleration in consumer spending later on this year, conjectural indicators and consumer attitude surveys show no significant abatement of consumer vigor yet. Following some transitory weakness in early 2006, retail sales in volume terms bounced strongly in recent months, posting average growth of 5.4% y/y in January-April 2006 (vs. +4.1% y/y in the same period of last year) on the back of strong gains in department stores, supermarkets and furniture, household equipment and food sectors[8]. New private car registrations declined by 3.0 percent y/y cumulatively in the first four months of this year following a 3.0% drop in 2005, but these losses followed annual growth in excess of 15% in 2004. Also, the business confidence index in retail trade has moved sharply higher in recent months, following a prolonged post-Olympics slump, driven by strong gains in its present situation and future expectations components. Separately, higher employment growth and a falling unemployment rate (9.7% in 1Q 06 vs. 10.4% in 1Q 05) are also expected to continue underpinning private consumption during the remainder of the current year with additional support provided by improving consumer sentiment. Tracking improving consumer confidence in the rest of the euro area, the consumer confidence indicator for Greece has been edging higher in recent months and at -31 in June it stood at its highest level since early 2005.

Somewhat counterintuitively, the Greek consumer confidence indicator has exhibited mostly diverging trends from other (generally upbeat) domestic indicators of consumer vigor such as retail and auto sales in recent years, but this phenomenon seems to have subsided lately with the most recent confidence data better reflecting current consumption developments. The above findings have also been documented in a household survey of 600 Greek households conducted recently by market research company ICAP. The survey showed a more-than-8% decline in the percentage of households expecting a deterioration in the state of their finances this year relative to the corresponding survey a year earlier, which depicted an ‘‘unprecedented’’ degree of pessimism about future developments. Despite this improvement, however, the percentage of households expecting an improvement in their finances this year remained relatively low (~9.6%) with inflation representing the most important factor influencing household expectations regarding their future financial well-being.

Fast credit growth continues, some signs of fatigue emerging

The post-EMU credit boom has provided the main driver of strong consumer spending in recent years and these trends continued unabated in 2005. The average annual growth of household credit reached 27.2 percent following growth of 28.5 percent in 20049.

As we noted in our previous Greek Macro Monitor, the gradual elimination of pent-up demand and lower disposable incomes due to tighter fiscal policies should, at some future point, induce a drive by Greek households to restore over-extended balance sheets. In fact, some preliminary evidence of household credit fatigue has been evident lately, as suggested by the gradual deceleration of consumer credit growth in recent months (+20.5% y/y in April 2006 vs. 22.3% y/y in December 2005 and levels above 33% y/y in H1 2005).

Nonetheless, continuing strong mortgage lending and accelerating credit growth to domestic enterprises have been providing an offset with the total outstanding balances of domestic MFI loans to domestic enterprises and households continuing to rise at double-digit rates in January-April 2006 period. This total reached €144.6bn or around 80% of GDP in April 2006, from ca 76% of GDP in December 2005 and 66% of GDP in January 2005. At the breakdown, mortgage lending growth reached record levels in January-April 2006 (annual rates in excess of 30% y/y) despite earlier expectations of a slowdown from the beginning of this year due to the imposition of VAT on new real estate transactions. Moreover, the growth of bank loans to domestic enterprises has been on a rising path recently after a mild slowdown over the past two years, supporting expectations of a higher amount of business investment this year.

[8] The Greek retail sales index excludes auto sales and accounts for roughly 70% of the private consumption component in the GDP report.

[9] These figures include securitized debt and non-tradable corporate bonds held by domestic banks which reached ca €3.25bn and €9.7bn, respectively in December 20006.

Although total outstanding household credit in Greece (in percentage-of-GDP terms) remains well below the corresponding EU average, its rapid rise in recent years could potentially raise macroeconomic/prudential risks in the case of sudden and unforeseen adverse events such as a sharp economic downturn or a significant rise in interest rates. These risks are particularly relevant given that the level of non-performing loans is already high for this stage of the business cycle. Although we deem such worries credible, we note that the BoG has already taken steps to address provisional concerns by raising specific provisions and capitalization levels, mandating risk-management and credit-rating systems in banks, and facilitating the compilation of comprehensive credit information on individual borrowers. Moreover, according to most relevant measures, the Greek banking sector currently seems to enjoy high solvency rations and it is also well capitalized.

Inflation eased in H1, upside risks ahead

Greek inflation has been edging lower in recent months with the year-on-year CPI averaging 3.2% in January-June 2006 against 3.3% in H1 05. In a similar vein, the CPI index - which excludes the volatile fresh produce and fuels component - eased to 2.6% y/y in January-June 2006 from 3.2% y/y in the same period a year earlier, despite second-round effects from oil, higher public transport fares since February 2006 and adverse base effects due to the 1ppt increase in VAT rates in April 2005. According to the latest CPI data (June 2006), the most significant contributors to the annual inflation rate were higher housing costs, food, tobacco and transport prices, which together accounted for more than half of the 3.2% year-on-year rise in headline inflation during that month. Communications was once again the CPI basket's sub-component with the greatest disinflationary contribution (adding less than 0.03ppts to the June figure), thanks to the intensified competition in the telecoms sector.

Looking ahead, the exhaustion of adverse base effects from last year's VAT hikes are likely to have a dampening impact on year-on-year CPI rates in the remainder of this year. However, demand-side pressures, persistently high oil and raw material prices and above-inflation increases in private sector wages this year and the next[10] are likely to maintain upside price pressures, with the average annual headline inflation remaining above 3.0% this year and the next (see table). These, alongside productivity growth rates that are expected to remain broadly stable over the forecast period, suggest limited room for any significant abatement in ULCs growth, with the latter continuing to exceed the Eurozone average by a considerable margin over the period under consideration.

Current-account balance widening

In January-April 2006, Greece's current account deficit widened by €3.7bn over the same period a year earlier, reaching €10.2bn or ca 5.3% of this year's forecast GDP. This deterioration was mainly the result of a rise in the trade deficit (both in the overall balance and the balance which excludes oil and ships) and, to a lesser extent, an increase in the income account deficit and a drop in the services surplus. Around half of the overall rise in the trade gap over the first four months of this year was due to a higher net oil import bill with a significant part of the remaining increase being accounted for by net payments for the purchase of ships. On a more positive note, revenues from exports of goods (excluding oil and ships) grew strongly in the first four months of 2006, rising by 16.9% compared with the same period a year earlier, but this was more than outweighed by a 14.3% y/y increase in the corresponding import bill.

[10] A new 2-year collective agreement for minimum wages in the private sector was signed on 12 April 2006, envisioning cumulative wage rises of 5.8% and 5.1% in 2006 and 2007, respectively. For this year, the collective agreement provisions for a 2.9% rise in minimum wages and salaries effective 1.1.2006, with the second installment – another 2.9% – coming on 1.9.2006. A further 5.1% increase will apply on 1.5.2007 (based on the levels obtaining on 31.8.2006). On 1 May 2007 the minimum wage will be €29.39 and the minimum salary €657.89. Note that the 2006 budget provisions for wage increases of 3% and 4% in 2006 and 2007, respectively, applying in principle to the loss-making public enterprises and the civil service.

Elsewhere, the widening in the income account deficit in January-April 2006 was the result of higher net payments for interest, dividends and profits given the continuing rise in non-residents' holdings of domestic government bonds, while the increase in the overall surplus of the transfers balance over the same period was exclusively attributed to higher current transfers to non-governmental sectors. On the financial account side, strong inflows of non-residents' funds into Greek government bonds and, primarily, to domestic deposit and repo instruments provided the main source of current-account deficit financing, while the FDI balance recorded a net inflow of €374mn in January-April 2006 period, compared with a net inflow of €155mn in the corresponding period of last year.

As an overall assessment of balance-of-payments developments in Greece over the last 2 years, we note that the single most important driver of the deterioration in the current account balance over that period[11] was a sharply higher bill for oil imports as a result of rallying international oil prices. Net payments in the ships balance (as opposed to net receipts recorded in 2004), increased government gross transfers to the EU as well as higher payments on interest, dividends and profits also contributed to this deterioration.

On a more positive note, the services surplus increased considerably over the last two years, helped by higher tourist receipts and revenues from shipping (despite the significant fall in freight rates since mid-2004). The surplus in the services balance recorded a 14.4% y/y decline in the first four months of this year, but this was mainly due to higher resident payments for transport as well as other services. We expect an improvement in the services balance over the remainder of this year as a result of higher revenues from tourism and shipping services.

[11] The current account deficit widened from 4.8% of GDP in 2004 to 6.7% of GDP in 2005 and a further deterioration to levels above 7.0% of GDP is expected this year.

Inflation differential vis-à-vis trading partners continues weighing on competitiveness

In line with the recent worsening in the country's balance-of-payment dynamics, the Greek real effective exchange rate (CPI-deflated) appreciated further in recent quarters with cumulative gains in the corresponding index amounting to around 2 percentage points since the beginning of 2004. This appreciation reflects an accumulation of competitiveness losses in the Greek economy as a result of persisting inflation differentials vis-à-vis the main trading partners. On a more positive note, recent structural reforms aiming to promote flexibility in the domestic product and labor markets and to apply corporate governance principles in public sector entities[12] constitute important steps towards strengthening medium-term economic competitiveness.

From a shorter-term perspective, a tighter fiscal-monetary policy mix is likely to help contain inflationary pressures this year and the next but broad-economy unit labor cost growth is expected to continue exceeding the corresponding Eurozone average by a considerable margin, not least because of above-inflation domestic wage increases in the private sector over the same period. On the latter point note that private-sector negotiations earlier this year between the General Confederation of Greek Labour (GSEE) and the Employers' association settled on an agreement for a (higher than previously expected) nationwide increase in the minimum wage of 6.2% in 2006 and 5.4% in 2007. An earlier proposal by employers to exclude high-unemployment regions from the obligation to apply the agreed nationwide minimum wage increase was rejected by labor union representatives during the negotiations and was not retained in the final agreement.

[12] Among other measures these included legislation aiming to promote more elastic working hour arrangements, lower overtime pay, extended opening hours in retail outlets and banks and the abolition of lifetime employment for newly hired employees in public-sector enterprises.

Domestic manufacturing sector's outlook improving

Generally positive news from the domestic manufacturing sector recently, with output growth accelerating by an average 0.4% y/y in the first five months of 2006 compared with a 3.5% y/y contraction in the same period a year earlier. The poor performance of the Greek manufacturing sector last year reflected, among other factors, weak production in the domestic textiles, footwear and clothing sectors, which have been facing increasing competition from imports from China and other low-cost producers. On a brighter note, improving growth prospects in key Eurozone economies, where a significant portion of Greek exports is directed at, have helped to improve conditions in the domestic manufacturing sector in recent months with further outlook gains expected during the remainder of this year, as also indicated by the recent strong reading in the Greek PMI and manufacturing business confidence indices. Nonetheless, deteriorating terms of trade due to persisting inflation differentials with the rest of the Eurozone and the continuing loss of competitiveness of traditional domestic manufacturing sectors leave little room for complacency, particularly in the absence of further intense efforts to enhance competitiveness and innovation in industry.

Successful budget execution supports forecasts for a sub-3.0% of GDP deficit in 2006

In our previous Macro Monitor (February 2006), we presented a sensitivity analysis of budgetary projections which showed that, even under relatively mild assumptions about economic growth, Greece would succeed to correct its excessive deficit this year by attaining a general government balance of no more that 3.0% of GDP. This optimistic assessment was based on the premise that the authorities would stick to their budgeted expenditure targets and that tax revenue growth would not fall much short of that of nominal GDP. On this latter point, we emphasized then that the average elasticity of net ordinary budget revenue[13] with respect to nominal GDP growth in the period 2000-2005 was no much higher than 50%, presumably as a result of widespread tax evasion, and that a sustained correction of this discrepancy would be a major step towards attaining structural fiscal consolidation. A comprehensive effort by the authorities to boost tax collection via, among other means, special audits, electronic cross-checking, mandatory filing of periodic VAT returns and the creation of a special tax squad apparently contributed to this aim as suggested by the sharp rebound in tax revenue growth since last August. The significant improvement in tax collection led to an overshooting of last year's budget revenue target by a considerable margin and continued strong revenue growth over the first half of 2006 raises optimism that authorities will succeed to reduce the overall deficit to 3.0% of GDP or lower this year.

More specifically, the most recent official data recorded a cumulative deficit of around €3.6bn in the central government balance in January-May 2006, down 41.2% y/y from the same period a year earlier and against a full-year target of €8.6bn. On the spending side, primary expenditure grew by 4.1% y/y in the first five month of 2006 compared with a full-year growth target of 6% y/y while total ordinary budget outlays declined by 2.1% y/y over that period, mainly due to lower interest costs. On the other hand, net ordinary budget revenue (which excludes tax reimbursements to tax-payers and incorporates non-ordinary revenue worth ca 0.2% of GDP) grew by 10.5% y/y in 2006, slightly exceeding a 10.3% target for the full year.

[13] Net ordinary budget revenue mainly comprises direct and indirect tax receipts and excludes tax returns.

Recent fiscal developments & European Commission projections

Greece's general government budget deficit amounted to 4.5% of GDP last year compared with a deficit of 2.8% of GDP envisioned in the 2005 budget and the 3.7%-of-GDP figure in the previous (March 2005) update of the Stability and Growth Programme of Greece[1]. This significant divergence from the initial targets can be put down mainly to the sizeable statistical revisions to Greece's fiscal accounts carried out since the EDP notification of September 2004 and, to a lesser extent, a reimbursement fine of EU funds equivalent to 0.25% of GDP that was recorded as an expenditure item in last year's accounts. In 2006, Greece targets a fiscal deficit of 2.6% of GDP with lower government consumption outlays, slower growth in social security and health outlays and targeted revenues from one-off measures worth 0.6% of GDP[1] accounting for the bulk of the projected adjustment (see table below). For this year, the European Commission forecasts a 3.0%-of -GDP deficit outcome. The difference with the Greek target is mainly due to more conservative projections for real GDP growth as well as for tax revenues and government consumption outlays. The Commission's forecast incorporates fully a recent permanent increase in the oil consumption tax and a temporary rise in domestic corporate withholding taxes (amounting to 0.1% of GDP and 0.25% of GDP, respectively) but only half of the special revenue-generating measures are included in the Greek 2006 budget, as their accounting treatment requires further clarification. In line with the above, the Commission expects an improvement of 0.8% of GDP in the cyclically-adjusted budget balance this year, while, assuming unchanged policies, the deficit projection for 2007 would be around 3.5% of GDP with no accompanying improvement in the structural balance relative to this year. These projections also include a further reduction in the general government debt-to-GDP ratio to 105% in 2006 and about 102% in 2007, from an estimated 107.5% last year with the existence of considerable stock-flow adjustments continuing to hinder a faster reduction of the debt ratio, which remains among the highest in the euro area. Such discrepancies between cash and accrual accounting contributed around 2.1ppts to the debt-to-GDP ratio in 2005 and they are expected to amount to 1.6% of GDP this year.

2006 budget: contributors to fiscal adjustment

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

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

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

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

These, together with lower interest costs, are expected to account for a whole percentage point of the 1.7pps-of-GDP total deficit reduction envisioned in the 2006 budget. In addition to the above, this year's budget also foresees: (i) a 0.2pp-of-GDP reduction in primary expenditure relative to last year via higher restraint in public-sector wages and pensions, lower government consumption costs and slower growth of social-security and health outlays, and (ii) a 0.2pp-of-GDP rise in the surplus of the general government due to higher public utility dividends and lower defense costs. Finally, the targeted balance of the public investment program (PIB) in 2006 is projected to post a small improvement relative to last year, mainly as a result of higher EU structural fund inflows and the containment of public investment outlays at last year's level. This will contribute 0.1pps-of-GDP to this year's expected deficit reduction.

Structural issues

The structural reforms agenda: Broadly speaking, the Government's economic-reforms agenda comprises the following objectives and initiatives:

- Reductions in tax rates.[14]

- The new Development Law 3299 in 2004 on regional-investment incentives, and plans to replace this with a new law in January 2007 to reflect the CSF-IV's (2007-2013) new requirements. (A new draft law will be unveiled in September.) According to the latest data, since the 2004 law was enacted 2,200 projects have been submitted to the authorities representing investments worth €4.9bn. Of these, 1,300 have so far been approved, worth €2.3bn. The Development Ministry does not release figures on the budgetary cost of the accompanying incentives and subsidies. According to reports, the new legislation will be even more generous than the previous one, offering subsidies of between 30% and 60%, which to varying degrees will apply to all regions of the country.[15]

- Public-private partnerships (the first project involving the building of new schools in Attica has been approved, and others are in the pipeline).

- Simplifying administrative procedures pertaining to the operations and establishment of companies. In addition to passing Law 3325/2005 last year, which aimed at simplifying procedures for the issuing of operating licenses for manufacturing firms, the Development Ministry presented a draft bill on 13 July that will bring important changes to corporate law, in line with EU guidelines. The draft bill, which will replace a law dating from 1920, introduces provisions enhancing the rights of minority shareholders, further simplifies administrative procedures for the setting up and day-to-day running of companies (*e.g.*, it simplifies provisions pertaining to the revision of corporations' charters), and modernises the framework underlying decision procedures at board-of-director and general-meeting levels. More legislation will have to be introduced later to deal with EU directives relating to accounting law and mergers and acquisitions.

- Opening up the energy market (currently, the least open in the EU).

- Drawing up a National Land-use Plan, comprising also regional sub-plans (still pending).[16]

- Further privatisations/part-privatisations: following two recent share flotations (Agricultural Bank of Greece and Postal Savings Bank, both institutions still firmly within State control), the biggest item on the agenda is the privatisation of Emporiki Bank, the country's fourth largest by assets. Crédit Agricole, which already controls 9% of Emporiki, launched a friendly takeover bid in early June, putting up a €3.1bn cash offer to buy 100% of Emporiki's share capital, at €23.50 a share.[17] On 19 June, the Bank of Cyprus submitted a rival bid valued at €3.78bn; but this was a cash-and-stock offer (3.25 of its shares plus €6 in cash, for each Emporiki share). Minister George Alogoskoufis told Parliament on 28 June that the Government would accept cash or a cash equivalent (for its 11% stake[18]) but did not want to take risks based on other companies' stock fluctuations. The

[14] See *Greek Economics BiWeekly*, 9 June 2006.
[15] Clearly, from an economic viewpoint the higher the subsidy the more difficult it is to assess the investment's true profitability and social worth.

[16] On this score, the Development Minister three times in the last two years has announced specific plans, including the immediate adoption of local land-use plans with a view to unblocking a number of large-scale investments that had been on ice for the last ten years.
[17] Emporiki's share closed at €26,78 on 13 July.
[18] The State controls 11% through DEKA, the State portfolio agency; 5.5% is controlled by State employment organisation OAED; 4.5% is controlled by farmers' State-controlled pension fund OGA; and 2.5% is controlled by the State-sponsored Social Security Foundation IKA.

next day, the Capital Markets Commission approved Crédit Agricole's tender offer prospectus and said that any counteroffers must be submitted by 25 July. A week later (5 July), it approved BoC's tender offer prospectus. The two current public offers run until 7 August (which may be extended until the end of August if other potential buyers come forward with competitive bids).

- Reform of public entreprises (DEKOs): Law 3429/20.12.2005 – touted by Minister George Alogoskoufis as *"the country's biggest reform ever"* – introduces modern rules of corporate governance and international accounting standards for these firms, as well as closer monitoring of their restructuring efforts and day-to-day activities. It also abolishes the practice of conferring permanent employment status on newly-hired employees, introducing in its place private-sector type contracts. More controversially, the law compels *loss*-making, unlisted firms to draw up new collective agreements with workers with a view essentially to containing their wage bills. A 27 April deadline was largely missed, but by 31 May the Government could claim that 48 out of the 53 public entreprises that come under the new law's scope had signed two-year wage agreements with staff consistent with Government guidelines (basically, 3% pay rises for next year and 4% for the year after), while the remaining five were on the verge of doing so. In contrast, GSEE proclaimed that, at most DEKOs, collective wage pacts had been reached which exceeded the limits of incomes policy, "*thus making the law a dead letter*".[19] (Under the provisions of the new law, public entreprises that failed to come to an agreement on pay rises in line with Government guidelines would have to accept the unilateral decisions handed down by the Government, a controversial clause in its own right insofar as it ran counter to the well-established practice of arbitration. According to GSEE, the new wage agreements made this clause irrelevant.) The end-of-April deadline was tacitly extended as regards two other obligations facing State firms under the new law, *viz.*, a requirement to submit (i) new business plans (to 31 July), and (ii) new personnel/labour regulations (enshrining, among other things, the end of permanent jobs for new personnel) and new rules of operation including on corporate governance (to the end of August). The accumulated debts of DEKOs are estimated at €13bn.[20]

The most important outstanding issues

Bank pensions: the Government received a major setback to its plans to solve the banking pension-fund problem – critically exposed last year by the introduction of IAS, and particularly affecting some State-controlled banks such as Emporiki – on 12 July when the Council of State (the country's highest administrative court) put forward the opinion that the draft presidential decree to implement Law 3371/2005 (setting up ETAT, an industry-wide auxiliary fund meant to replace a number of individual banks' funds) as well as the Law itself breached certain constitutional provisions regarding the rights of citizens to form unions and associations (Article 12 of the Constitution), and the rights of workers in the context of free collective labour agreements (Article 22). Essentially, the CoS disapproved of the enforced manner

[19] The issue of what exact pay rises were agreed appears, therefore, to be a matter of some dispute. There are reports in the press that some State-controlled companies may have indeed been flouting the rules, thus corroborating GSEE's views. For example, it was reported that railway workers secured pay rises of over 10% for the two years, despite the fact that OSE (Hellenic Rail) is one of the country's biggest, if not the biggest (together with Olympic Airlines), loss-making companies. See *Kathimerini*, 12.5.2006. Workers at Hellenic Petroleum will also get a slightly better salary increase this year, 4% *vs.* 3.4% last year, according to Chairman Christodoulou himself (see the press, 1 June 2006).

[20] Out of 43 DEKOs, 19 generated losses in 2005. The biggest loss-maker was railways operator OSE, with losses before tax of €598m in 2005. All other DEKO losses put together, in 2005, amounted to €531.44m. Source: *Hellastat*, reprinted in *Kathimerini*, 12.7.2006.

in which pension rights were taken away from funds established by collective agreement. Following this development, it is unclear what lies in store for Emporiki Bank and plans for its privatisation.

- **OTE**: the country's main telecom services supplier (and former State monopoly) was to spearhead reforms in the State-entreprise sector, thanks to plans to abolish permanent jobs for newly-hired staff and to bring in new blood on more flexible terms with the help of a far-reaching voluntary-retirement scheme. But on 8 February, the European Commission launched a formal investigation into the Government's plans to underwrite 20% of the cost of OTE's voluntary retirement programme, citing the possible presence of illegal state aid and hence its potential incompatibility with Single Market rules. This is currently blocking any progress at the country's biggest utility.

- **Olympic Airlines**: The Government has failed so far to find any buyers, after more than half a decade of trying. Further clouding the company's outlook is the European Commission's announcement, on 26 April, that it was taking Greece to court for failing to recover about €540m in state aid from OA. The Government said that it would defend its position in court while trying to come up with yet another rescue plan. Meanwhile it said that OA would keep flying. Compounding matters, the European Commission is expected to take Greece to court for a second time in connection with Greece's failure to comply with an earlier ECJ decision calling on the Government to retrieve from OA €161m in illegal subsidies extended to OA during the period 1998-2002. The deadline expired on 4 June, and so the Commission is said to be considering going to court again, which could land Greece with fines of the order of €20,000 per day.

Part B

Special Focus Topics

- **Community Support Framework 2000-2006: Time is running out for Greece**
- **The effects of higher oil price volatility on economic sentiment in Greece**

Community Support Framework 2000 –2006: Time is running out for Greece

- **As the December 2008 deadline approaches, program completion rates are slowing instead of speeding up. Notwithstanding a temporary acceleration last year, mainly as a result of the inclusion of already completed national projects in the 3rd CSF program, the 2006 figures reveal worryingly low rates of program execution.**

- **Over the past 5½ years, the average monthly public expenditure on EU co-financed projects was €229m. This implies that the rate of execution has to almost triple over the next 31 months (to ca €620m per month) in order to facilitate absorption of the full amount of funds available under the 3rd CFS program.**

In previous issues of our Greek Macro Monitor we emphasised the need for a significant acceleration in the execution of the 3rd CSF in order to avoid losses of available EU funds. The most recent official data prepared for the 9th Monitoring Committee of the program confirmed those earlier concerns. The temporary acceleration of program execution recorded in 2005 proved to be mainly the result of transferring already-completed projects from the purely nationally-funded part of the Public Investment Budget to the EU co-financed part. Moreover, the data for the first 5 months of 2006 point to a deceleration rather than an acceleration of the program's completion rates. Specifically, by 1 June 2006 only €14.9bn or 43.6% of the program's available public (national plus EU) funds had been spent, leaving an additional €19.3bn to be spent over the next 31 months if the total amount available is to be absorbed before the December 2008 deadline (Tables 1 & 2).

Table 1: The Percentage of Public Expenditure on CSF III projects
(% of total CSF III public funds)

	2001	2002	2003	2004	2005	Jan. – May 2006
Annual Percentages	5.0	6.7	9.3	8.8	12	1.8
Cumulative Percentages		11.7	21.0	29.8	41.8	43.6

Table 2: The Monthly Flow of Public Expenditure on CSF III projects
(monthly averages in million euros)

2001	2002	2003	2004	2005	Jan. – May 2006	Jun. 2006 – Dec. 2008
142	**192**	**266**	**250**	**342**	**120**	**623**

Source: Ministry of Economy, Report for the 9th Monitoring Committee CSF 2000 – 2006

The above figures illustrate the evolution of the 3rd CSF since 2001. The first two years of the implementation of the program witnessed low rates of public expenditure on co-financed projects, but this was to be expected in view of the time required by the authorities to adjust to the new, stricter and more complicated rules of the 3rd CSF. In 2003, expenditure began to accelerate, but then it stalled again in 2004. The new government that was elected in 2004 needed an acquaintance period with the program, which implied further delays. By 2005 the need to accelerate expenditure had become urgent. Execution rates did go up during that year, though not significantly enough to assure full execution of the program before the December 2008 deadline. Nevertheless, it turned out that even that small acceleration was attained via transferring to the CSF program projects which were previously completed under the national component of the public investment budget. Moreover, it is rather doubtful that such a practice will continue to be employed successfully in the future. The national component of the Public Investment Budget was cut drastically in 2005 and 2006 in order to meet the budget requirements of the Stability and Growth Pact, thus reducing the number of purely national funded projects in the pipeline and leaving little room for future manoeuvre.

A brief review of the 25 current operational programs under the 3rd CSF (12 sectoral plus 13 regional) shows that sectoral programs currently facing serious execution delays include the Railways and the Information Society programs. Of the regional programs, the ones facing execution problems include Peloponnese, Epirus, the Ionian Islands and the North Aegean.

Table 4: The Flow of The Flow of Public Expenditure per Operational Program
(million €)

	Sectoral Programs	Total Public Funds	Total Public Expenditure 2001 – 5/2006	Realized average monthly expenditure rate	Public Funds available	Required average monthly expenditure rate
1	Highways, Ports, Urban Development	6,769	3,118	**47.97**	3,651	**117.77**
2	Competitiveness	3,217	1,427	**21.95**	1,790	**57.74**
3	Education & Initial Vocational Training	2,729	1,349	**20.75**	1,380	**44.52**
4	Railways, Airports, Public Transport	2,588	1,003	**15.43**	1,585	**51.13**
5	Information Society	2,278	856	**13.17**	1,422	**45.87**
6	Employment & Vocational Training	2,188	1,115	**17.15**	1,073	**34.61**
7	Rural Development	2,136	927	**14.26**	1,209	**39.00**
8	Culture	685	297	**4.57**	388	**12.52**
9	Environment	551	183	**2.82**	368	**11.87**
10	Health & Welfare	513	226	**3.48**	287	**9.26**
11	Fisheries	344	150	**2.31**	194	**6.26**
12	Technical Assistance	118	33	**0.51**	85	**2.74**
	TOTAL (Sectoral)	**24,115**	**10,685**	**164.38**	**13,430**	**433.23**
	Regional Programs					
13	Attica	1,574	894	**13.75**	680	**21.94**
14	Central Macedonia	1,282	534	**8.22**	748	**24.13**

15	Eastern Macedonia – Thrace	1,031	421	**6.48**	610	**19.68**
16	Thessaly	782	309	**4.75**	473	**15.26**
17	Crete	731	306	**4.71**	425	**13.71**
18	Western Greece	722	293	**4.51**	429	**13.84**
19	Central Greece	720	303	**4.66**	417	**13.45**
20	Epirus	659	236	**3.63**	423	**13.65**
21	Peloponnese	631	225	**3.46**	406	**13.10**
22	South Aegean	547	198	**3.05**	349	**11.26**
23	Western Macedonia	545	208	**3.20**	337	**10.87**
24	North Aegean	512	178	**2.74**	334	**10.77**
25	Ionian Islands	359	115	**1.77**	244	**7.87**
	TOTAL (Regional)	**10,094**	**4,221**	**64.94**	**5,873**	**189.45**
	TOTAL	**34,209**	**14,906**	**229.32**	**19,303**	**622.68**

In an effort to reduce potential losses of funds, the government plans to restructure the operational programs in order to relocate funds from programs lagging behind to ones that have recently gained pace. A similar type of restructuring took place in December 2005. According to Commissioner Almunia, the Commission and the Greek Government are considering measures of a technical nature to help reduce the risk of losses of EU funds. According to recent press articles, such measures could include, following France's example, the formation of special organizations to which EU funds can be allocated. These organizations will subsequently use these funds to complete the delayed projects later than ordinarily allowed.

So far we discussed the progress in the execution phase of CSF projects. We remind our readers that there are three consecutive phases in the implementation of a CSF project, namely, the signing of the contract, the execution of the project and, finally, the partial reimbursement of expenditures from EU funds. We will now say a few words about recent developments related to the first and third phases of the execution of the 3rd CSF.

New Contracts for CSF projects

By the end of June 2006, 68% of the 3rd CSF had reached and/or passed the first stage of a signed contract. Recall that the deadline to reach 100% signed contracts was December 2006. As we have argued in previous Macro Monitors, this deadline has been tacitly abandoned, reducing the probability of losing EU funds at the signed contracts phase. Nevertheless, the timely signing of contracts is still vital for the proper execution of projects. If contracts are delayed at the signing stage, the probability that they will not be completed by the December 2008 deadline naturally increases.

Table 4 shows a slight acceleration in the signing of contracts in 2005. As discussed earlier, part of this acceleration is attributed to the transferring of already completed projects to the 3rd CSF.

Table 4: The Flow of New CSF III Projects with a Signed Contract (% of total CSF III public funds)						
	2001	2002	2003	2004	2005	Jan. – June 2006
Annual Rates	12.6	13.0	12.5	10.8	13.3	5.8
Cumulative Rates		25.6	38.1	48.9	62.2	68

Absorption of EU funds

At the end of May 2006, 47% of total EU funds were cashed out, or €10.7bn out of a total available amount of €22.7bn. This percentage is higher than the earlier-discussed corresponding figure of public funds already spent. The difference is because the two sets of figures are not readily comparable. First, the EU fund absorption percentages reflect the pool of EU funds only, not public (EU plus national) funds. Second, the absorption figures are boosted by an EU pre-payment in 2001, the first year of the 3rd CSF programme, which was equivalent to 7% of the total amount of funds available. This pre-payment was disbursed at the very beginning to help the country begin the process and does not reflect the number of completed projects.

The Absorption Rates of EU 3rd CSF Funds (% of EU funds)						
	2001	2002	2003	2004	2005	Jan. – May 2006
Annual Rates	9.2	5.8	6.1	9.6	9.4	6.8
Cumulative Rates		15.0	21.1	30.7	40.1	47.0

The effects of higher oil price volatility on economic sentiment in Greece*

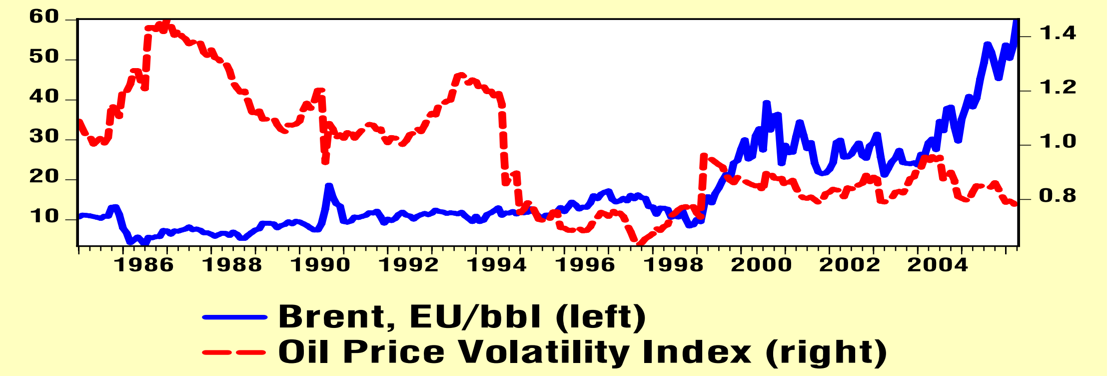
- **Oil price volatility affects consumer and producer expectations in Greece.**
- **Greek consumer spending may cool down considerably if oil prices continue to surge.**

High oil prices and, especially, increased oil-price volatility, introduce a strong element of uncertainty in the decision-making of producers and consumers. Uncertainty deters consumers from increasing their spending on expensive items and durable goods, while it may also cause significant reductions in their savings levels. On the other hand, producers may irreversibly postpone investment decisions as oil and energy prices surge. This can lead to a loss of competitiveness, while higher oil prices can also diminish profit margins. The reduction in consumption, savings, investment, productivity and competitiveness can lead to a significant slowing down in economic activity. In this note we present the main results of our recent econometric study on the effect of higher oil prices and their volatility on consumer and producer confidence in Greece.

1. Oil Price volatility and economic sentiment

Our estimates suggest that Greek producer and consumer expectations are linked negatively to higher oil price volatility. While dearer oil has so far had a benign effect on these expectations, oil-price uncertainty seems to have a much stronger impact. As oil-price volatility increases, producers expect future demand for their products to drop and their selling prices to increase, while consumers expect their savings to decline and spending on expensive goods to drop. Producer and consumer expectations are measured via the business and consumer surveys conducted by the European Commission.[21] The data are available as monthly time series from 1985 onwards. As a measure of oil price volatility (Figure 1) we construct a coefficient of variation of absolute spot oil price percentage returns[22], estimated within a (rolling) window of 48 months. This index allows for asymmetric effects of oil price fluctuations on economic variables, while also capturing the effects of extreme oil price fluctuations. The coefficient of variation, being a relative measure of price dispersion, enables the comparison of (oil price) volatility across different time periods. The higher (lower) the index, the higher (lower) is oil price volatility compared to the past.

Figure 1



Source: Bloomberg LP & Eurobank Research

Figure 1 shows that while oil prices have increased dramatically over the last 5 years, oil price volatility as measured by our volatility index has not risen as much. It has receded from its high levels of the turbulent 1985-1994 period and it is now only slightly higher than the period spanning the years 1995-1998. This may partially explain the resilience (so far) of modern economies to the recent oil price surges. While oil price volatility remains lower in our days, it

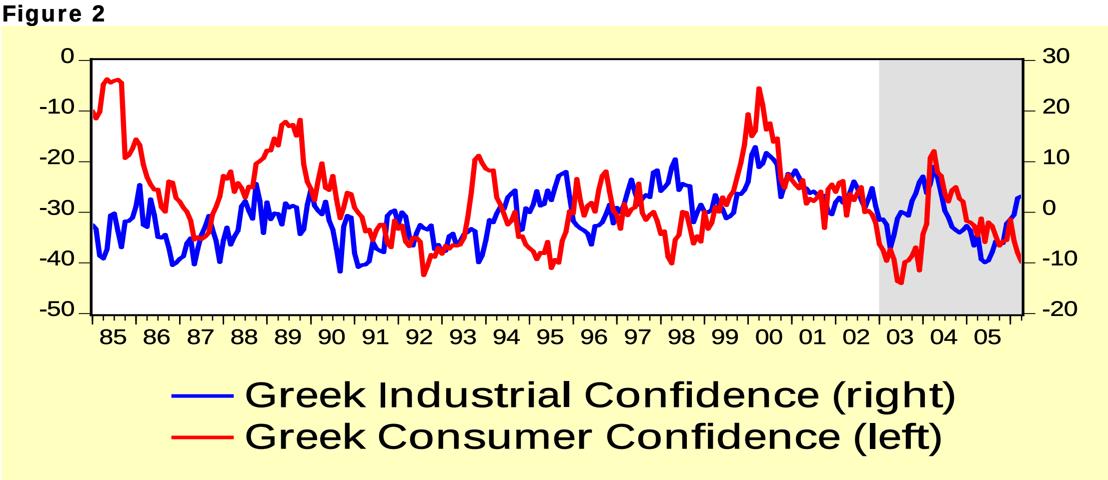
*: This section is partially based on analysis that appeared in our monthly research bulletin “Eurobank Research: Economy & markets”, No. 4, 28/04/2006 (ISSN: 1790-6881), which is published in Greek.

[21] Data, methodology and reports are available from the European Commission’s web site: http://ec.europa.eu/economy_finance/indicators_en.htm

still has an inverse effect on consumer and producer sentiment indicators.

Figure 2 shows that the Consumer Confidence Indicator generally leads the cycles of the Industrial Confidence in Greece, although this relationship appears to have been reversed in the last 3 years (shaded area). Greek consumers currently do not appear to be sharing the confidence of industrial producers. This could be an early indication of a future turning point in the Industrial Confidence indicator as well. Such a reversal in the Industrial Confidence cycle could be caused by increasing oil prices and price volatility.

Figure 2



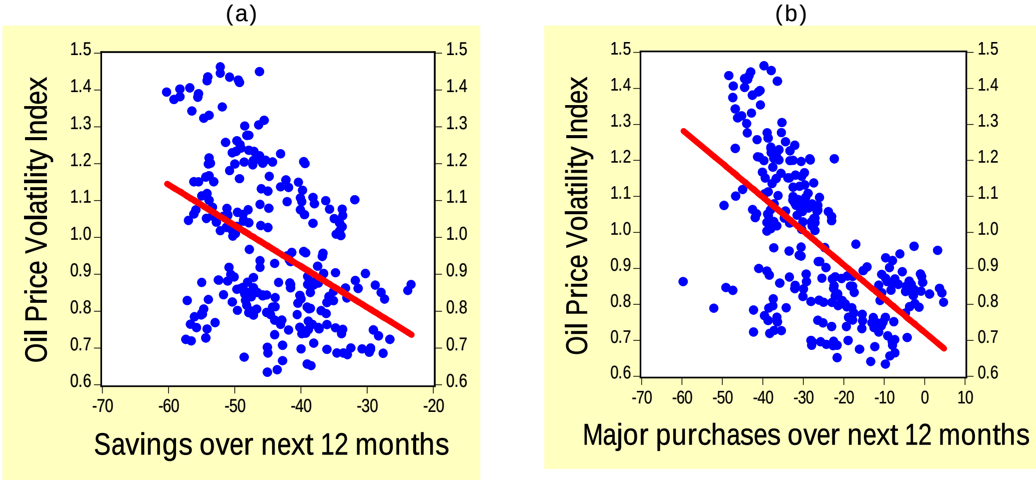
Source: European Commission

Figure 3 shows that the oil-price volatility index is negatively correlated with expectations in Greece.

Figure 3

Consumer Survey

(a) (b)



(continued next page)

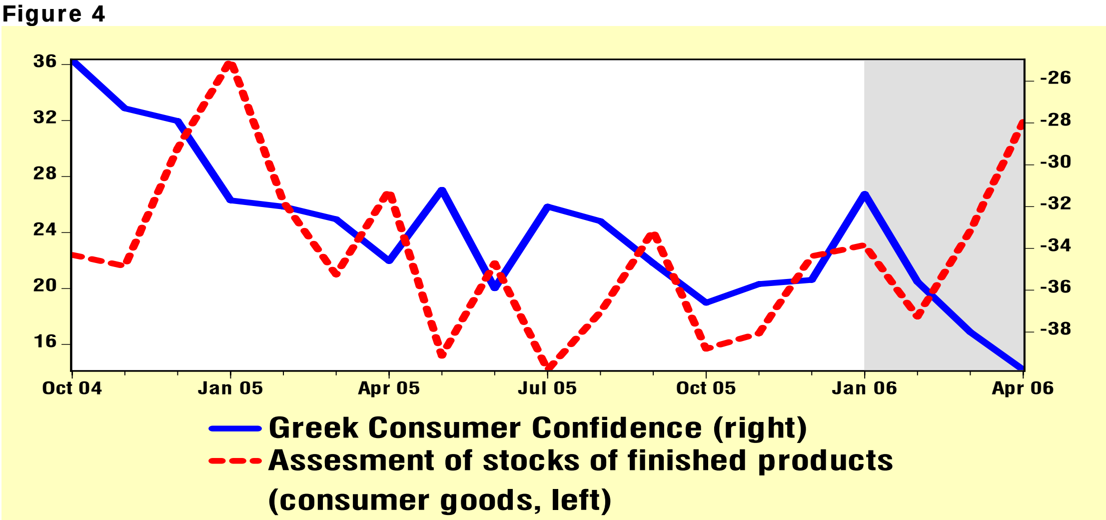
[22] Prices are for Dated Brent, the benchmark for 65% of the world's crude oil.

Figure 3 (continued from previous page)

Source: Eurobank Research

Figures 3(a) and (b) show that consumers expect reductions in major purchases ("big-ticket" durables) as oil price volatility increases. They also expect to save less, as increased uncertainty and higher prices of oil and other goods and services may induce them to spend more in order to maintain their life standards. The response of (industrial) producers is consistent with the consumers' intentions. In Figures 3(c) to (f) we see that as oil price volatility increases, producers experience a drop in both their orders and production activity. At the same time, they expect that in the quarter their product selling prices will increase, while their production output levels will recede even more.

Figure 4



Source: European Commission

Figure 4 shows that, already, consumer confidence has taken a significant dip in 2006, while more producers assess that consumer product inventories are on the rise. This may be an early indication of a demand slowdown due to higher costs and more expensive credit.

2. Epilogue

Elevated oil prices and rising volatility in energy markets create a "double-whammy" effect of increasing uncertainty about the future paths of inflation and production costs. Recent surveys and statistics indicate that while higher oil prices may be feeding into end user costs, creating inflationary expectations and suppressing demand in the short term, supply has also been showing signs of stress. The extent to which these developments may signal a turning point in the growth rates of the Greek economy remains to be seen. Nonetheless, continuing oil price surges and increased volatility have a negative effect on producer and consumer expectations, a very disquieting situation that may elicit some unwelcome developments in the months to come.