Eurobank EFG Economic Research

Greece: Macro Monitor

A Quarterly Economic Review of the Greek Economy

2nd Quarter, May 2007

Economic trajectory remains favorable but imbalances grow

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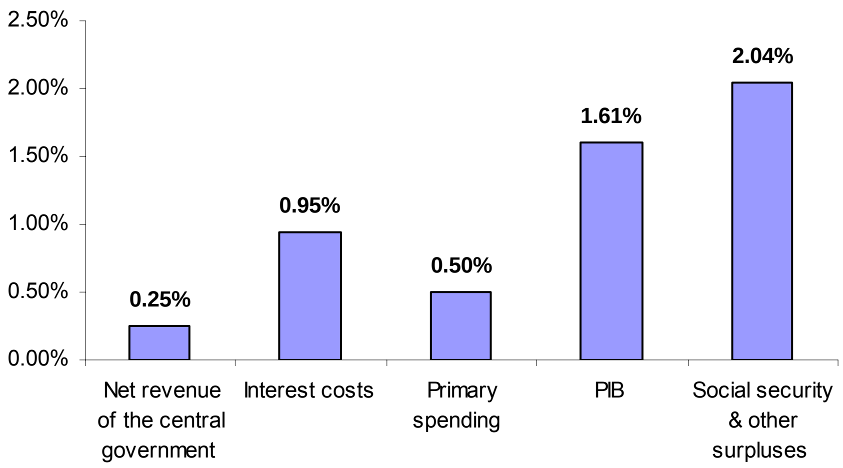
- The economy's outlook remains positive and we now see real GDP growth averaging 4.0% this year. The general government budget deficit is expected to remain at sub-3% of GDP levels, rendering an exit from the excessive deficit procedure (EDP) feasible as early as June 2007.

- Economic prospects for the coming 2-3 years are generally positive, but the sustainability of the present buoyant rates of economic growth in the medium-term will require a transformation of the existing model of economic development to one depending more on exports and business investment. This, in turn, will facilitate the correction of long-lasting imbalances, obvious consequences of which are the high level of inflation and a wide current account deficit

May 2007

Net contribution to the cumulative adjustment in the general government budget balance in the period 2004-2007 (% GDP)



Source: Eurobank EFG Research

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Political and Economic Overview

Caution, the name of the game until the next polls

As the Government considers its agenda and choice of tactics for the final stretch into the next general elections, all signs are that it will adhere to a very cautious policy programme in hopes of holding on to the privileged position on the political stage it has enjoyed, despite a number of setbacks, since March 2004. This position has certainly been aided all these years by the country's robust export- and investment-driven economic-growth performance (*though the manner of the distribution of its fruits across society is potentially an issue, one that the country's statistics have difficulty shedding light on, as evidenced, e.g., by the Government's extraordinary – upwards of 25% – recent revision of GDP*[1]).

Also to the Government's advantage is voters' visible disenchantment with the opposition parties. Nonetheless, for the remainder of its term the advantage of solid growth, and the confidence that normally comes with it, will not make the Government any less disinclined to pursue initiatives that could potentially stir controversy or otherwise exacerbate the kind of discontent already evident in the wake, *e.g.*, of the recent government-bond affair *(whereby undue transaction costs were reportedly sustained by several pension funds).* Unfortunately, the majority of measures required to effect deep structural changes and pull Greece out of the bottom rungs of the EU Lisbon Strategy league-tables fall under these categories. Ultimately, real structural change has proven a very challenging test for Greece, as amply illustrated by various international measures of Greece's overall competitiveness that show no tangible change in the country's ranking, a state of affairs effectively corroborated by the European Commission when it claimed recently that Greece "*is making limited progress in the implementation of its National Reform Programme*"[2].[3]

Despite vigorous pro-reforms rhetoric, Greece's relative international position broadly unchanged

Prime Minister Karamanlis continues to hold high the banner of reforms and change, claiming that the current four-year programme merely lays the groundwork for their continuation after the elections. The current programme has included, among others, a new, more streamlined, Development Law, tax reform *(though lower tax rates on firms and individuals have been offset by increases in indirect taxation)*, and the introduction of a successful, by most accounts, public-private partnership law[4]. Privatisations/part-privatisations over the 2004-2006 period raised €4,595m in proceeds, but out of ten operations, only two constituted full-blown privatisations, that of the National Bank of Greece in November 2004[5], and Emporiki Bank, sold

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[1] The date given for the approval by Eurostat of the revised figures is 9 July, after which negotiations will begin with a view to calculating Greece's increased contributions to the EU budget, with retroactive effect. For a discussion of the possible size of any extra contributions, see our *Greece, 2007 draft budget and GDP revisions*, 3 October 2006.

[2] Commission of the European Communities, Brussels, 12.12.2006, COM(2006) 816 final, Part II, *Implementing the Renewed Lisbon Strategy for Growth and Jobs, "A year of delivery" Assessment of the National Reform Programmes*, pp. 40-46.

[3] The highest-priority problem areas cited by the Commission are the pension system, the public administration, employment rates, unemployment and undeclared work, employment protection and labour mobility, and the quality and labour-market relevance of education and training. For a fuller discussion of Greece's progress in the implementation of Lisbon Agenda goals, see *Greek Bi-weekly*, 19 January 2007 and 13 March 2007.

[4] Projects worth €2.5bn have already been approved under Law 3389/2005.

[5] In 2006, a public capital-raising exercise to finance the acquisition of Turkey's Finansbank also reduced the relative share of the various pension funds through which in the past the

to Crédit Agricole in August 2006. In practice, the Government in the next few months will likely limit itself to reaping whatever public-relations advantage comes with the impending *(in June)* end to the EU's excessive-deficit procedure against Greece, and seek to mark at least a modicum of progress with the implementation aspects of a few of the key pieces of legislation, such as reform of public enterprises and education, on which it has to a large extent staked its reputation.

These two initiatives in particular ended up encountering great resistance among large groups of people, forcing the Government to partly water them down *(education)* or spruce them up with pecuniary trimmings of a precarious, as it turns out, nature (OTE)[6]. The Law on the Reform of Public Entreprises (3429/20.12.2005) in particular was supposed to introduce (i) modern rules of corporate governance, (ii) international accounting standards for these firms, (iii) the closer monitoring, by the competent ministries, of both their restructuring efforts and day-to-day activities, (iv) observance of the Government's incomes policy, and (v) an obligation on their management to elaborate business plans[7]. Many of these changes were designed for the long haul and so, in conjunction with various other factors such as lack of experience and systemic resistance, cannot be expected to bear fruit immediately. Having said that, haste will be of the essence considering that a year after the Law's passage, the country's 49 state entreprises are expected to see their deficits rise in total from approximately €1.3bn in 2006 to an estimated €1.48bn in 2007, *i.e.*, a 13.5%-increase. As for the new law on higher-education reform, the Government will have to face the university teachers trade union's (POSDEP) demand that the new law remain in limbo, for which they vow to go to court.[8]

Other, more sensitive, but unfinished, projects such as the privatisation of major ports, the privatisation of OTE or the disposal of Olympic Airlines are unlikely to be broached at all, probably joining pension reform in some reforms agenda in the not-too-immediate future in the next parliamentary term. Meanwhile, the Government was said to be opting, as a short-term alternative, for a 10%-placement of OTE shares or an outright share buyback by OTE, having been disappointed in its efforts to find a European strategic investor despite the offer of a 20%-stake, probably because of its insistence on sharing management with any potential partner[9]. After all, this would have constituted the country's first-ever privatisation of a major State-run utility. But lately both an eventual OTE placement and a similar placement by the Postal

government exercised major influence. All told, pension funds today account for almost 24% of National Bank's equity. By comparison, foreign institutional investors account for 50.5%.

6 Under Law 3371/2005 establishing the new banking-sector auxiliary fund ETAT, the Government was to transfer, for free, shares equivalent to 4% of OTE's equity in its possession to the TAP-OTE employees' fund (worth about €300-360m). This was meant to underwrite 20% of the cost of OTE's (generous) voluntary retirement programme – the Government's flagship reform in the public-entreprise sector. The scheme is under investigation from the European Commission, which is citing the possible presence of illegal state aid.

7 See, *Greece: Macro Monitor - 2006 Outlook*, February 2006, p.20.

8 A recent bone of contention has been the first ministerial decree issued on the basis of the new law, outlining the procedures to be followed in connection with the promotion of higher-education personnel. POSDEP claims that it infringes on universities' right to self-governance.

9 OTE' shareholders on 3 April 2007 approved changes to the company's charter that would allow the State to reduce its stake below a minimum 33 percent. It currently holds a 38.6%-stake. In December 2006, the Government passed legislation enabling it to reduce its stake to less than one-third. At the time, this was met with fierce union opposition as employees are against OTE's privatisation. With its new charter, which is modeled on the new legal framework for public entreprises adopted by the Government in December 2005, OTE will be able to hire and fire workers more easily. But, in view of the above, it is doubtful whether this in itself has made it more attractive in the eyes of potential buyers.

Savings Bank may be heading for a post-election rescheduling as a result of the unfavourable climate that has allegedly been created by all the talk about recourse to the ballot-box. (The Government targets privatisation revenues of €1.7bn for this year, of which €1bn could come from the OTE sale alone.)

As for Olympic Airlines, the Government insists it is still committed to finding a buyer. But because of the company's financial predicament none has been forthcoming to date. Therefore, the Government is trying to buy time by means of various maneuvers, the latest of which is a proposal to the European Commission to agree to a compromise which envisages somehow offsetting the €500m-plus in illegal state subsidies that the company must return to the state's coffers with the amounts adjudged by a Greek arbitration court (in December 2006) as owed the company by the Government following its move to the new Athens airport in March 2001. Meanwhile, there remains the problem of Olympic Airlines' (the successor to Olympic Airways since December 2003) continuing losses and ever-growing debt: according to OA's 2005 financial statement (released in December 2006), cumulative losses since December 2003 amount to €223m, while daily losses reportedly amount to €310,000, a situation that led the PM to declare back in September 2005, "Olympic Airlines cannot afford to operate along these lines any longer".

People broadly support Government in its management of economy, but fears about the future abound

This is not to say that reforms in general are rejected by citizens. What limited evidence exists from opinion polls suggests that people, *e.g.*, are fairly evenly split on the question of privatisations in general *(with a clear majority in favour of the privatisation of Olympic Airlines; not so as regards DEH and OTE).* They do acknowledge, by a very large margin, that the economic development of the country requires a strengthening of the private sector rather than the public sector[10]. But, by a small plurality, they also deem further reforms' prospects unfavourable due to the Government's alleged lack of a clear reforms policy framework[11]. In a similar vein, a plurality of voters do not think the recent higher-education law goes far enough[12]. But at the same time they also trust ND more than they do Pasok with the management of the economy[13], even as they express fears about the future (and especially unemployment) that far surpass the corresponding EU levels.[14]

Relations with the European Union, too, have had their ups and downs. Apart from its fiscal transgressions, which are now coming to a happy end, Greece must face up to its poor record in the adoption of Single Market rules: Greece combines a bad transposition deficit with a high number of infringement cases, putting the country, overall, from 12th place in the EU15 in 2004 to last position in the EU15 in July 2006 and in 24th position in the EU25[15]. In November 2006, Greece came

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10 See, *e.g.*, a poll by V-PRC on behalf of *Kathimerini*, 31.12.2006.

11 The majority of those interviewed (51%) thought that the Government probably did not have a clear plan with regard to the reforms it wanted to promote, *vs*., 36% who thought it probably did. See another poll by V-PRC, again on behalf of *Kathimerini*, 11.2.2007.

12 Kappa Research, on behalf of *To Vima*, 1.4.2007. 43% of those interviewed said that the law did not go far enough, *vs*. 33.8% who thought the law went in the wrong direction.

13 Kappa Research, on behalf of *Ta Nea*, 10.2.2007.

14 The latest Eurobarometer indicates that as many as 55% of those interviewed thought that the country's economic situation would get worse in the next 12 months, *vs*. only 10% who thought it would become better. On a more optimistic note, 24% thought that their family's financial situation would improve in the next 12 months, *vs*. 22% who thought it would deteriorate. Greeks, together with Hungarians, are also the EU's champions when it comes to worrying about the employment situation in one's country, with 59% thinking that it would get worse in the next 12 months. See, Special EUROBAROMETER 273 "European Social Reality", Fieldwork November- December 2006, Publication February 2007.

15 Internal Market Scoreboard, No. 15, July 2006.

last in the EU25 in terms of the percentage of Directives for which measures of implementation had been notified to the Commission (97.87%, *vs*. an EU average of 99.06%). This has a direct impact on aspirations to enhance the country's competitiveness. On a different matter: the "main shareholder" issue also refuses to go away, after it was thought that certain changes to the law – essentially, an attempt by the Government to further tighten provisions aimed at curtailing the political influence of big media owners – had convinced the Commission to shelve the dossier.

On 21 March 2007 the European Commission announced that it was taking legal action against Greece for legislation potentially excluding certain companies from public procurement, in contravention of the relevant Community directives[16]. Finally, the country has had problems – as had been known for some time – absorbing the full complement of CSF-III funds allocated to it. This led to a deal between the Government and the Commission last November which provides for (i) the carrying over into CSF-IV of a list of "bridge" projects (presumably charged to CSF-IV), which otherwise would have to be scrapped for going over the deadline, thus safeguarding €1bn in EU funds, (ii) dispensation for Greece's share of the co-financing relating to 2006 (worth €1.7bn), in conjunction with a raising of the EU's share in co-financed projects *(said to mobilise another €1.2bn in EU funds, but at the cost of fewer projects)*, and (iii) certain reallocations of funds from lower-absorption to higher-absorption projects within the CSF-III *(said to "save" another €500m).*

To assess the amounts thus being "rescued", one must bear in mind that by the end of 2006, 90% of the CSF had been contracted out (NB: the official deadline was 31.12.2006), and just 53.2% of EU aid *(which totals €22.7 under CSF III)*, or €12.08bn, had either been disbursed or was pending (based on payment applications already submitted). In this light, the lack of matching funds *(a result of several years' cuts in the public investment budget)* also emerges as an important element, on a par with the well-known administrative delays, in explaining the problems encountered over the last few years by CSF III. The net effect – thanks also apparently to the acquiescence of the Commission to a tacit extension of the 31 December-deadline – is a reasonable level of EU fund absorption but with the savings on the Greek-budget side translating into a somewhat smaller number of works than originally planned.

A number of high-profile setbacks have taken their toll on Government leads in the opinion polls.

In the last few months, ND's leads in the opinion polls have fallen from a fairly steady 3%-3.5% to between one-third to two-thirds that. This is partly due to voter fatigue, wholly natural at this stage of a government's term. But it is also due to a string of negative-publicity affairs involving a number of government officials[17], culminating in the forced resignation of the Employment Minister on 28 April. These developments have ended damaging the Government's image as the standard-bearer of clean government and transparency and has complicated further on-going speculation regarding the timing of the next general election, whose date many theorised would be brought forward in an attempt by the Government to capitalise on the steady flow of favourable results produced by opinion polls. The situation is not made any clearer by ministers who claim in public that a long pre-electoral period is not good for the country, even as the PM insists that elections will be held "at the proper time". Mr Karamanlis will probably clear the air

[16] Article 51 of Directive 2004/17 and Article 44 of Directive 2004/18. For a fuller discussion, see *Greek Bi-weekly*, 26 March 2007.

[17] These include the abovementioned pension-fund "scandal", and the case of the Competition Commission official who allegedly attempted to bribe a dairy company, promising in return to exonerate it from accusations that it was part of a price-fixing cartel, for which it faced a massive fine.

on the occasion of the Thessaloniki International Trade Fair in early September *(barring a surprise announcement of elections in June)*, whereupon he will either cut his losses and announce early elections or, alternatively, let his government ride out its term until March 2008 on the reckoning that, in due course, voters will shift their attention to other matters.

Greece: key macro indicators			
y/y grwoth	**2005**	**2006e**	**2007f**
GDP (constant prices)	3.7	4.3	4.0
Private Consumption	*3.7*	*3.9*	*3.6*
Public consumption	*3.1*	*0.6*	*1.5*
Gross fixed capital formation	*-1.4*	*12.6*	*7.5*
Exports g&s	*2.9*	*6.2*	*6.0*
Imports g&s	*-1.2*	*9.8*	*6.5*
National CPI (average)	3.5	3.3	2.9
Budget balance (% GDP)*	5.5	2.6	2.4
Public debt (% GDP)*	107.5	104.6	100.9
Current account (% GDP)	8.2%	12.1%	11.5%
Employment growth	1.3	1.5	1.4
Unemployment rate	9.8	8.9	8.5
ULC growth	2.4	3.3	3.1
Labour productivity growth	1.9	2.4	2.5

Source: realisations, official estimates and EFG Eurobank forecasts

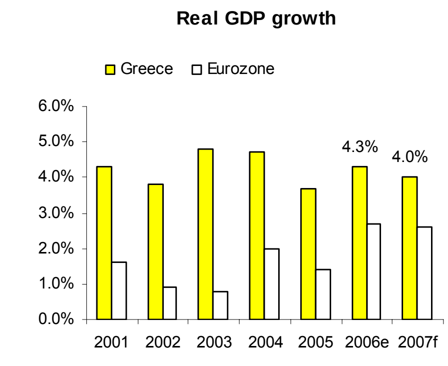
** Based on the unrevised GDP realised/projected data*

A review of recent macroeconomic developments & 2008 outlook

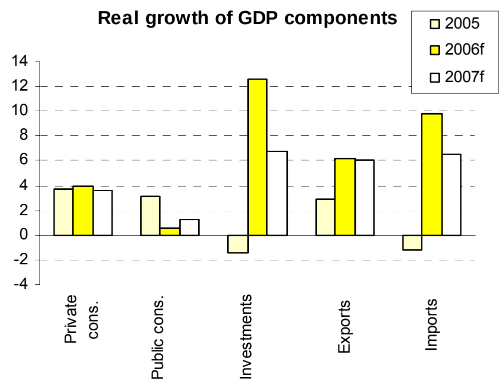
Above-trend growth in 2006

Greek real GDP growth rose by 4.3 percent y/y in 2006, a pace significantly faster relative to both official and market consensus forecasts. A dynamic bounce in gross fixed capital formation and buoyant private consumption were the main culprits of the economy's growth performance in 2006. In fact, the overall acceleration in economic activity was entirely due to domestic demand *(+6.1ppts contribution to real GDP growth vs. +2.1ppts in 2005)*, while net exports were again a negative contributor to growth to the tune of 2.0 percentage points. Another positive development was the 25.7% upward revision to Greece's nominal GDP numbers for the period 2000-06[18], which brought the 2006 GDP figure to around €250bn, from an earlier reported estimate of €195bn. As we have noted in our previous *Greek Macro Monitor (Nov. 2006 issue)*, the revision process started four years ago, with the new data purporting to better measure the valued-added of the services sector[19].

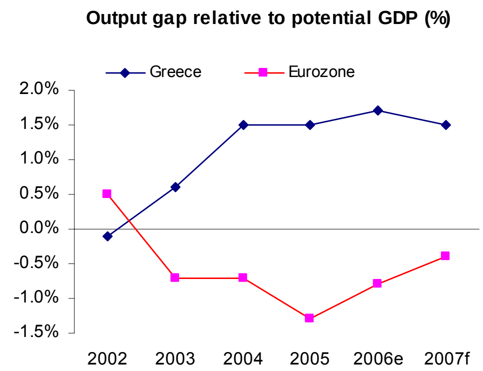
Gross fixed capital formation rose by 12.6% y/y in real terms in 2006, after recording a slight reduction a year earlier with strong gains reported in both private construction and capital expenditure components. The sharp rebound in investment activity boosted Greece's gross fixed capital formation-to-GDP ratio to 25.7% in 2006, from 23.7% in 2005 and an average Eurozone rate of around 21.5%. As we have noted in the past, the strong growth in Greece's investment spending in recent years has provided a powerful boost to potential output, with favorable



Source: Ministry of National Economy, EC, EFG Eurobank



Source: National accounts, EFG Eurobank



Source: EC

implications for the economy's medium-term growth performance. Upbeat readings in a stream of conjectural and forward-looking indicators of economic activity confirm the aforementioned trends and point to a continuation of strong GDP growth in the quarters ahead. Among them, the EC´s economic sentiment

18 The revision is still pending approval by Eurostat, but according Greece´s National Economy and Finance Minister George Alogoskoufis it is likely to be cleared by July 2007. It is not entirely clear yet whether Eurostat will approve the full 25.7ppts upward adjustment to GDP figures, but we suspect that at least a big portion of that will be endorsed.

19 The revised national accounts draw data from the latest population census (year 2001) and TAXIS, the electronic tax reporting system.

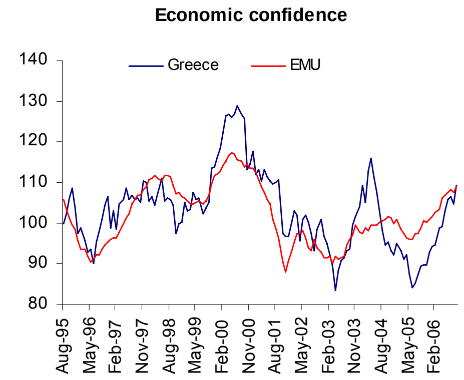
indicator for Greece has been on a rising trajectory throughout last year and in April 07 stood at its highest level in three years.

Strong economic trajectory continues

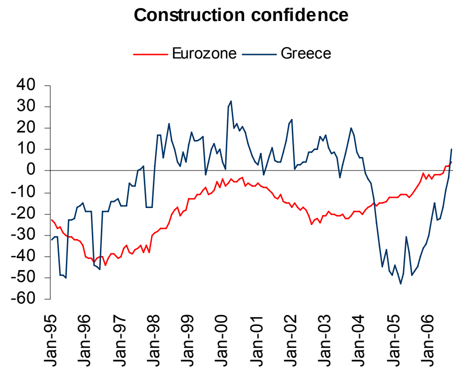
The economy outlook remains positive and we now see real GDP growth coming in at around 4.0% in 2007, a rate slightly higher than both our earlier forecast of 3.7% and the 3.9% official projection *(Hellenic Stability & Growth Programme 2006-2009)*. Domestic demand is again expected to be the engine of economic activity in 2007, but its growth pace is likely to decelerate somewhat relative to last year as a result of declining housing investment and a slight moderation in consumer spending. On the other hand, the external sector is likely to remain a drag on GDP growth. Consumer spending will continue to derive support from rising employment, strong gains in real incomes and the cumulative wealth effects from households' property and equity market holdings. Strong credit expansion *(though at growth rates relatively lower than in 2006)* will also continue to provide support, while public spending will likely remain subdued in line with the fiscal consolidation targets envisioned in the updated stability and growth program. With regard to investment activity, the annual growth of gross fixed capital formation is likely to decelerate somewhat in 2007, mainly on the back of declining housing activity relative to last year.

Investment maintains its dynamism after rebounding strongly in 2006

Improved business confidence, rising profitability and buoyant residential investment were some of the key catalysts of last year's rebound in investment activity. Gross fixed capital formation growth added around 3.3ppts to overall real GDP growth in 2006, which compares with an average positive contribution of 1.8ppts in the period 2001-2006. Residential investment was one of the most dynamic components of domestic demand, recording annual growth of 32.3% after declining slightly in each of the prior two years. This was mainly the result of the huge spike in the issuance of building permits ahead of the imposition of VAT tax in newly-build homes and the upward adjustment in the so-called "objective values" of real estate, effective from January 2006. Buoyant mortgage lending and favorable financial conditions extended additional support.



Source: EC



Source: EC

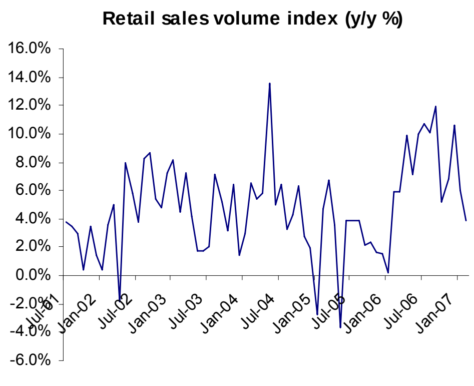
Elsewhere, business investment rose by 8.6% y/y in 2006, after growing by only 1.5% y/y in 2005, while public investment recorded growth of 7.6% y/y after a sharp contraction in the prior year. Prospects for investment remain positive this year though overall fixed capital formation growth is likely to decelerate relative to 2006. This will be mainly the result of weaker housing investment, as suggested by last year's 19.5% y/y decline in building permits.[20] On a more positive note, the growth of business investment spending is likely to remain strong this year, deriving support from buoyant demand and still ease financing conditions. A more friendly business environment following recent reforms is also likely to continue supporting business investment in the period ahead. On the latter point note that according to recent data, more than four thousand applications corresponding to ca €11.8bn of new investment in the manufacturing and tourism sectors have been submitted to the authorities between March 2005 and December 2006, aiming to reap the benefits of the new development law. Moreover, the Development Ministry has already approved proposals for a series of PPP partnerships, corresponding to some 2.5bn of new investments in construction, tourism infrastructure, as well as in the areas of education, health, and regional development.

EU funding to continue supporting economic activity in the period ahead

Increased EU co-financed spending will be an additional factor supporting domestic economic activity in the quarters/years ahead. Interestingly, only 58% of a total €32.4bn of *public funds (i.e., national plus EU funds)* available under CSFIII had been spent by the end of last year, meaning that the average pace of spending on eligible projects needs to more than double this year and the next, relative to the prior six-year period in order to avoid loss of available funds. Although the authorities′ ability to ensure full implementation of the CSFIII program by the end-2008 deadline remains a concern - on account of a less satisfactory than required track record and the risk of complacency ahead of the parliamentary elections, which are normally scheduled to take place in May 2008 - a certain degree of comfort is provided by: i. last year's significant acceleration in the flow of new CSFIII projects with a *signed contract (24.3% of public funds in 2006 vs. 14.1% in 2005 and a 13.1% average annual rate in the 2001-2005 period)* and ii. a recent improvement in the absorption rates of EU structural funds *(cumulative rate up to 53.2% in 2006, from 40.1% in the year earlier*). In addition to infrastructural spending provisioned under CSFIII, the NSRF program running between 2007 and 2013 provides for a further € 20.4bn of EU structural funds *(plus € 2bn for rural development and fisheries)*, an amount requiring a total €12.1bn of national co-funding for its adequate implementation. In view of the above, we estimate the total flow of public expenditure *(i.e., national and EU funds)* on CSFIII and NSRF projects to amount to over € 11.5bn *(or an amount higher than 5.5%-of-GDP)* per annum this year and the next, providing a powerful impetus to GDP growth.

Consumer spending remains vigorous

Consumer spending grew by a preliminary 3.9% y/y in 2006, contributing around 2.7ppts to overall GDP growth. Consumption continued to derive support from buoyant credit expansion, rising employment, strong gains in disposable incomes and increased social transfers to lower income groups.



Source: NSSG

Notably, higher oil prices over the first three quarters of 2006 did little to restrain consumer vigor. With regard to conjectural indicators of consumption activity, retail sales in volume terms grew 8.0% y/y in 2006 from 3.0% y/y in 2005, with strong gains recorded in most sectors of retail

[20] Permits constitute a reliable leading indicator of future residential building activity.

trade. Also, the total import bill for new and used cars rose by 16.2% y/y, while tax receipts from mobile telephony grew by 11.8% y/y. Furthermore, consumer lending remained buoyant, providing a powerful boost to private consumption. These developments were in synch with a surge in the retail business confidence index to 7-year highs in late 2006 and confirm last year's healthy rise in consumer spending. Looking ahead, a tighter monetary/fiscal policy mix and a relative moderation in wage growth are expected to outweigh positive developments in employment and direct income tax cuts, inducing a marginal slowdown in private consumption over the remainder of this year. Developments over first few months of 2007 have been reassuring with retail sales and new car registrations recording average growth of 4.9% y/y and 2.6% y/y, respectively in January-February (latest available data).

External sector to remain a drag on GDP growth this year

A significant re-acceleration in the growth of imports of goods and services rendered the overall external sector a negative contributor to GDP growth last year despite rising exports. These developments have been manifested in the significant widening of the country's current account deficit to levels slightly above 12%-of-GDP in 2006, from 8.1%-of-GDP in 2005. As we will analyze below, the deterioration in the balance of payments dynamics is up to a certain extent the result of worsening economic competitiveness, a trend that needs to be reversed in the period ahead so as to prevent the external imbalance from undermining the medium-term growth prospects of the economy. On a more positive note, Greek exports of goods *(+11% y/y on national accounts basis in 2006 vs+8.2% y/y in 2005)* grew at a pace significantly faster than global demand, boosting their share in total world exports. In the services sector, Greek exports posted small positive growth in 2006 after remaining broadly stagnant a year earlier. For the current year as a whole, an expected slowdown in the pace of goods exports is likely to be broadly offset by accelerating services exports, while imports are projected to keep pace with domestic demand. As a result, the external sector's overall contribution to GDP growth is likely to be less negative than in 2006.

Industrial output to rise again this year

Following two consecutive years of output declines, domestic industrial production showed some signs of life last year *(total output up 0.5% y/y)*, reflecting continuing increases in the production of energy and durable consumer goods as well as rising activity in the intermediate and capital goods sectors. Manufacturing output rose by 0.8% y/y in 2006 following a 0.8% decline in 2005, while over the first two months of the current year *(latest available data)* manufacturing production and overall industrial output recorded cumulative increases of 3.9% y/y and 3.2% y/y, respectively. Reflecting these positive developments, the index of business expectations in manufacturing has been on a rising path throughout last year, and in March 2007 stood at its highest level in about 4 years. Moreover, the index of secured production in industry rose to 4.8 months in 2006, from 4.5 months in 2005 and reached an average of 5.0 months in the first quarter of 2007. A similarly positive story is also told by the evolution of the PMI manufacturing index for Greece, which currently stands close to its highest levels in five years. Current production and new orders have been the main drivers of PMI performance, with employment also showing gradual improvement. The oil & coal and the food and beverages sectors have hade the greatest contributions to overall industrial production growth in recent quarters, while the apparel/clothing and textiles sectors continued to safer significant output declines *(total output down 41.6% cumulatively between 2000 and 2006)* as a result of intensified competition from imports from low cost producers.

Employment prospects improve but structural problems persist

Employment grew by 1.5% y/y in 2006, prompting a further decline in the unemployment rate to 8.9%, from 9.8% in 2005. The rise in total employment last year was mainly due to faster job creation in the services sector *(primarily, in public administration)*, with the concomitant decline in the average number of unemployed being mostly attributed to fewer layoffs relative to the same period a year earlier. Furthermore, recent survey data measuring hiring intentions across all branches of economic activity point to positive employment growth this year, though this maybe somewhat slower than in 2006 on account of unfavorable base effects. Notwithstanding these positive developments, however, unemployment among such vulnerable social groups as youngsters and women remains high, while employment gains in recent years have been rather moderate, especially taking into account the strong pace of GDP growth.

Overall, major labor market indicators in Greece generally continue to lag these in other EU-15 member countries. Among them, the domestic employment rate *(61% currently) continues to* lag the EU-15 average rate by as much as 5pts, while the duration of unemployment in Greece remains elevated by European standards. The above developments point to serious and persistent structural rigidities and require further measures to enhance flexibility in the domestic labor market. Among other things, such steps should aim to encourage part time employment, constant upgrading of labor skills, equal opportunities for employment and better integration of economic immigrants in the labor market.

Medium-term prospects remain positive but widening imbalances pose risks

Economic prospects for the coming 2-3 years are generally positive, with annual GDP growth rates expected at the 3.5-4.0% region. Variations in the future growth composition compared to last year's outcome are likely to be marginal, with economic activity remaining exclusively demand-driven. Domestic demand growth will likely decelerate gradually over the respective period as the current elevated rates of credit growth will inevitably cool down and the ratio of total outstanding credit to households *(i.e., %-of-GDP terms)* will level off. Business investment is expected to remain strong over the corresponding period, while growth in residential investments should slow down. Moreover, to the degree that the sizeable external imbalance will continue to be a reflection of buoyant consumer spending and housing investment (*and not investment activity intended to raise the economy's productive capacity)* the external sector will remain a drag on economic growth, hindering a more rapid decline in the external debt ratio and restraining the economy's debt servicing capacity. The above suggest that the sustainability of the current buoyant rates of economic growth will require a transformation of the existing model of economic development to one depending more on exports and business investment. This, in turn, will require a further strengthening of the economy's productive capacity and greater flexibility so as to produce value added products that will compete more successfully in international markets. This is particularly true as the current production base of the economy is not broad and flexible enough to allow a shift in the sources of production towards more export-oriented uses. Moreover, product and labor markets in Greece continue to suffer from serious rigidities, while the needed transformation of the productive base of the economy will require the correction of long-lasting imbalances, obvious consequences of which are the high levels of inflation and the current account balance.

Balance of payments dynamics

Current account balance deteriorates as trade deficit widens sharply

The considerable deterioration in the current account balance last year was mainly due to i. a further widening in the trade deficit, as a result of cyclical *(e.g., Greek vs. foreign partner growth differentials)* as well as structural *(e.g., loss of economic competitiveness)* influences and ii. certain special factors such as higher oil prices and strong imports of ships. We expect the current account deficit to remain at elevated levels in 2007 on account of: i. broadly steady *(or slightly lower)* oil prices relative to last year ii. a continued sizeable deficit in the ships balance iii. our projections *(national accounts basis)* regarding the growth of exports and imports this year

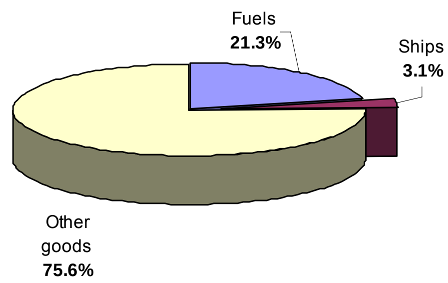
Exports performance improves…

The strong global growth trajectory of the last 2-3 years has boosted Greek exports excluding oil and ships, especially these of high value-added manufacturing goods, which have been enjoying a rising share in international export markets. This improved export performance has also been the result of a re-direction of Greek exports towards the neighboring Balkan countries as well as other rapidly growing emerging economies including the ex-Soviet Union countries and the Middle East. Notably, the shares of Greek exports of manufacturing goods characterized by high technological and specialized labor intensities have been risen strongly in recent years and they are now holding the second and fourth highest places, respectively with regard to their share in total Greek exports. Nonetheless, their shares lag considerably the corresponding Eurozone averages in absolute terms.

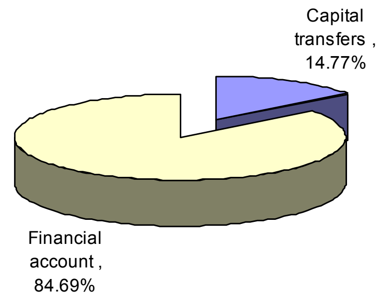
…but imports continue to exceed exports in both absolute and growth terms

Despite these positive developments, the total bill for imports continues to exceed *(in absolute terms)* that of exports by a large margin, while their growth rates remains strong, and at times higher than those of exports. As we have already suggested, this phenomenon can be explained by the high volume of imports of capital goods, but also by the inability of domestic production to meet rising consumption and investment needs. A multitude of structural, legal and taxation-related impediments to foreign direct investment constitutes another hurdle to the export orientation of the economy, rendering the financing of the current account deficit overly dependent on the export of services and current transfers.

Contributors to the cumulative widening in the trade deficit between 2003 and 2006
(~63%-of-GDP cumulative widening of the trade deficit over the 2003-2006 period)



Sources of financing of the current account deficit in the 2003-2006 period



A growing savings-investments imbalance

To be sure, the current account deficit deterioration reflects the inadequacy of domestic savings in financing increased domestic consumption and investment needs, but it is also a consequence of the country's eroding competitiveness, mainly as a result of higher inflation relative to major trading partner economies[21].With

[21] The level of domestic national savings stood at 15.9%-of-GDP at the end of last year vs. 15.1%-of-GDP at the end of 2005 and it was around 6pts lower than the corresponding Eurozone average. On a more intertemporal basis, Greece´s average savings rate declined to 15%-of-GDP in the 2001-2006 period from 16.9%-of-GDP in 1995-2000, with strong consumption spending and increased fiscal deficits being responsible for the decline.

regard to economic competitiveness, this has suffered considerable losses in recent years, as suggested by the 13% rise in the euro's real trade-weighted value *(against 28 major trading partners of Greece)* over the period 2000-2006. Moreover, Greece's relative ULCs growth *(in euro terms)* recorded cumulative increases of 34.7% in manufacturing and 15.2% for the whole economy over the past six years, a pace considerable faster than in the euro area.

Special contributors to current account deficit deterioration

Besides the above mentioned drivers of the deterioration in the balance of payments dynamics, some special factors also contributed to the sharp widening of the current account deficit. In 2006, some 29.5% of the deficit was due to net payments for the purchase of ships, around 23.5% due to the rise in the deficit of the oil balance and 15.7% due to the rise in net interest payments. Even without accounting for the net payments for fuels and ships however, Greece's current account deficit rose to 5.9%-of-GDP in 2006, from 4.0%-of-GDP in the prior year and an average deficit of 4.5%-of-GDP in the period 2001-2005 [22]. Regarding the oil balance, while the rise in its deficit over the last 2-3 years was to a large extent a consequence of sharply higher international fuel prices, the economy's high oil dependency has also played a part in the ensuing deterioration. Indeed, according to Eurostat's most recent data, Greece's gross domestic consumption of energy per unit of produced output in 2004 was the highest in the EU-15, while the ratio of net imports of crude oil and oil products to the domestic consumption of crude and products was the highest in the EU-25. The country's high oil dependency constitutes a medium-term policy challenge that needs to be addressed via the diversification of energy needs towards alternative, and potentially more cost efficient and environmentally friendly, sources.

Financing not a problem, but deficit persistence poses medium-term macro risks

Although Greece's Euro zone membership effectively secures the adequate financing the country's external deficit and debt, the wide current account gap poses a threat to the medium-term growth prospects of the economy. Indeed, given that around 75% of the country's current account deficit is financed by external borrowing, the servicing of the accumulated gross external debt absorbs considerable domestic resources with negative consequences for growth and employment.

Price and wage developments

Inflation eased in 2006 despite higher oil prices

Greek consumer inflation *(EU-harmonized terms)* eased to 3.3% y/y in 2006, from 3.5% y/y in the prior year, with the corresponding index which excludes the volatile non-processed food and energy components coming down to 2.9% y/y, from 3.2% y/y. The main drivers of disinflation last year were: i. the gradual abatement of base effects related to the rise in VAT rates and other indirect tax hikes in April 2005[23] ii. a significant deceleration in the growth of domestic fuel prices relative to the prior year and iii. the increased share of imports from low cost producers *(e.g., China)*of such broad goods categories as apparel-footwear, durable goods and household consumption goods. On a less positive note, demand-side pressures along with faster ULC growth and higher non-processed food prices prevented a more pronounced deceleration in consumer inflation. With regard to imported price pressures,

[22] On a more positive note, sizeable payments for the purchase of ships lay the ground for higher future revenues from transport services that could, in turn, facilitate the financing of the external deficit and the servicing of external debt.

[23] The VAT hike is estimated to have boosted year-on-year consumer inflation in December 2005 by 0.75pts, and the average 2005 CPI by 0.6pts. Note also that the average price of Brent in EUR-terms rose 18.6% in 2006 vs. 46.2% in 2005.

average imported inflation *(ex fuels)* recorded a significant acceleration last year, but remained lower than domestic inflation, thus contributing to the containment of the overall growth of the general level of prices. Finally, at the producer level, annual PPI inflation averaged 6.9% y/y in 2006 vs. 3.5% y/y in 2005 *(Jan 07: -0.5% y/y)*, with the rise in the corresponding index being mainly attributed to higher non-durable consumer goods prices.

CPI expected to move lower this year, but underlying price pressures intensifying

The outlook for domestic inflation appears to have improved recently, especially taking into account the subdued CPI readings over the first four months of 2007. According to the latest available data, national CPI eased to 2.5% y/y in April 07, from 2.6% in March 07 assisted by favorable base effects and lower fuel and vegetable prices. This brought the 12-month rolling inflation rate to 3.0% y/y from 3.2% y/y in December 06. We now forecast an average CPI rate of 2.9% y/y this year, compared to our earlier forecast of 3.0% y/y. Our new inflation projection is based on the following assumptions: i. the average annual domestic retail price of oil will remain broadly constant (*or decline slightly)* relative to 2006. ii. the rate of growth of raw material and base commodity prices *(excluding energy)* will ease slightly vs. the previous year iii. unit labor cost growth will decelerate somewhat this year, but will remain well above the corresponding euro zone average iv. the EUR´s trade-weighted value will record a further rise in 2007, contributing to the containment of imported inflationary pressures[24]. Despite our forecasts of lower headline inflation this year, underlying price pressures appear to have intensified recently as indicated by the most recent elevated core inflation readings *(+3.7% y/y in 1Q 07 vs. 3.4% y/y in 4Q 06 and 3.0% y/y in 4Q 05)*. Lagged effects from past hikes in oil prices appear to be one the factors that have contributed to the recent intensification of underlying price pressures, as also manifested in rising producer prices of consumer and intermediate goods. Looking ahead, we expect headline inflation to remain around current levels over the coming 2-3 moths, before edging higher on subsiding base effects and rising pipeline pressures.

Inflation differential vis-à-vis trading partners persists

On a relative basis, the differential between Greek core CPI and the corresponding Eurozone measure declined by 2 tenths of a percentage point to 1.1% last year, while that of headline inflation declined by 3 tenths of a percentage point to 1.4%. As we have noted in the past, the inflation differential is partially attributed to the ongoing process of convergence of the level of prices and incomes in Greece to the corresponding Euro zone averages *(Balassa-Samuelson effect)*. However, the stickiness of domestic core inflation to relatively elevated levels can be mainly explained by cyclical differences *(i.e., a positive output gap in Greece vs. a negative output gap in the euro area)* as well as Greece's faster growth of labor and other input costs. Inadequate competitiveness conditions in certain sectors of the economy *(mainly services)* also encourage rents-seeking behavior on the part of domestic firms, with adverse consequences for the general level of prices.

Wage developments continue fuelling inflationary pressures

Economy-wide ULC growth accelerated to 3.3% y/y in 2006 from 2.4% y/y in 2005 reflecting**:** i. higher wage costs and social security contributions *(up 5.8% y/y in 2006 vs. 3.9% y/y in 2005)* and ii. a slight acceleration in labor productivity to 2.4% in 2006 from 1.9% in 2005[25]. Looking

[24] The BoG forecasts a further rise of 0.8% in the EUR´s nominal value weighted by Greece´s major trading partners, while domestic until labor costs growth is projected to ease to 3.1% from 3.3% in 2006

[25] The relevant productivity measure in measured in GDP per wage-earner terms

ahead, domestic ULC growth is expected to decelerate slightly to 3.1% this year *(BoG forecast)* reflecting a somewhat slower rise in wage and social security costs per wage-earner and relative steady productivity growth relative to last year. In the Eurozone, ULC growth is expected to accelerate slightly this year, leading to a small decline in the Greek/Eurozone ULC growth differential.

Monetary aggregates and credit

Credit expansion decelerates but rate of growth remains elevated

The Greek component of Eurozone's M3 growth excluding currency in circulation accelerated significantly last year *(+10.6% y/y in 4Q 06 vs. 6.9% y/y in 4Q 05)*, a trend that persisted during the first two months of 2007. In addition to other influences, this acceleration was up to a certain extent the result of the flattening in the government bond yield curve, which stimulated a shift of funds from longer-maturity instruments *(such as fixed income mutual funds)* not included in the M3 definition to instruments included in M3 *(e.g., deposits with maturities of up to two years)*. The annual growth of total lending by domestic financial institutions accelerated in 2006, though the pace of credit expansion ebbed somewhat during the fourth month of last year *(+15.3% y/y vs. 14.0% y/y in the same period a year earlier)*. The main driver of last year's credit expansion was lending to domestic households and businesses, while the growth rate of lending to the general government turned negative in Q4 after recording small positive growth over the first three quarters. Specifically, last year experienced a considerable rise in business lending, while the growth of household borrowing was somewhat lower than in 2005. The increased issuance of corporate bonds by domestic firms explains a significant part of the acceleration in business lending, with the holdings of such instruments by domestic financial institutions in December 2006 accounting for ca 15% of total bank lending against 12% in the same month a year earlier. Over the first two months of this year *(latest available data)*, the growth of total credit to the economy decelerated, reaching 13% y/y in February.

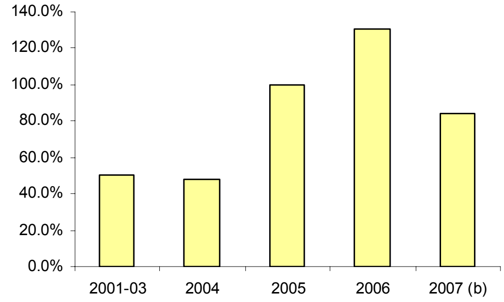
The gradual deceleration in the growth of household borrowing in recent quarters *(albeit from considerably elevated levels)* reflects declining rates of growth in both mortgages and consumer loans. In percentage-of-GDP terms, the total outstanding balance of loans to Greek household stood at 44.0% at the end of 2006 compared to 38.0% a year earlier, while excluding securitized loans the corresponding ratio stood at 41.1% in Greece vs. an average ratio of 54.3% in the euro area. 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 prudential 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 ratios and is also well capitalized. Finally, the profitability of domestic banks remained at satisfactory levels in 2006 for a fourth consecutive year, assisted by a positive domestic macroeconomic environment, still accomodative monetary conditions, rapid credit growth and the rising profitability of subsidiaries operating in neighboring counties.

Fiscal developments

Fiscal adjustment renders exit from EDP feasible in 2007

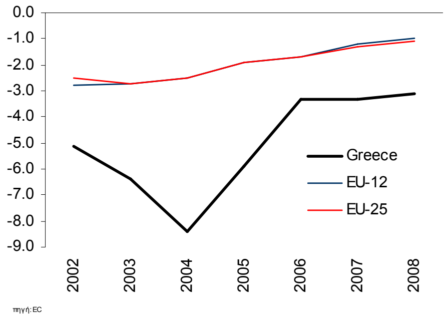
Last year witnessed further considerable fiscal adjustment, as suggested by the improvement in the country's cyclically-adjusted primary balance, which turned into a 1.8%-of-GDP surplus, from deficits of 0.7%-of-GDP and 2.8%-of-GDP in 2005 and 2004, respectively[26][27]. This positive development contributed to the decline in the general government budget deficit to 2.6%-of-GDP in 2006, from 5.5%-of-GDP in 2005, rendering feasible an exit from the excessive deficit procedure (EDP) as early as in June 2007. The reduction in the overall fiscal gap in 2006 was primarily the result of a lower central government deficit, which was, in turn, due to strong revenue growth and the containment of primary expenditures within budget limits. More precisely, primary budget receipts grew by 8.8% y/y in 2006, supported by a series of revenue-boosting measures taken over the last 2 years[28] as well as the generation of special *(direct and indirect)* tax revenues worth 0.6%-of-GDP[29].

Ordinary budget revenue elasticity relative to nominal GDP



Source: Eurobank EFG

Cyclically adjusted general government budget balance (% GDP)



Indirect tax revenues grew by 10.8% y/y in 2006 on the back of strong VAT receipts as well as tax receipts from real estate and equity market transactions. On a less positive note, direct tax receipts grew by only 1.8% last year, with the rather poor performance of this main revenue category being the result of a further reduction *(by 2.5pts)* in the main corporate tax rate to 25% as well as the fading effects of the steps taken in 2004 to settle a large number of outstanding tax liabilities to the state. On the spending side, last year's primary expenditure growth was limited to only 2.6%, while interest rate costs were reduced by 1.9% y/y. A lower deficit in the public investment balance *(PIB)* and a higher-than-projected overall surplus of social security funds and other entities also contributed to the reduction of the 2006 budget deficit. In 2007, the deficit is expected to decline to 2.4% of GDP, assisted by one-off revenues worth around 0.5%-of-GDP and a further decline in the total expenditure-to-GDP ratio on the back of lower interest costs, government consumption and investment expenditure.

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26 The non-cyclically adjusted primary balance yielded a 2.0%-of-GDP surplus in 2006, after recording a deficit of 0.6%-of-GDP in the prior year.

27 Greece´s updated stability and growth program for the period 2006-2009 foresees a gradual decline in the general government budget deficit to 1.2%-of-GDP by 2009, from 2.6%-of-GDP in 2006, which implies a 0.9pts-of-GDP adjustment in primary balance to a surplus of 2.9%-of-GDP at the end of the reference period.

28 E.g., a 1ppt hike in VAT rates in March 2005 as well as increases in special consumption taxes on fuels, cigarettes and mobile telephony.

29 Last year´s one-off revenues of 0.6%-of-GDP were due to payments and deferred payments by banks in exchange of the assumption by social security of pension commitments.

These forecasts are based on the old GDP series and not on the "revised" GDP data reported by the Greek authorities in the EDP notification tables in April 2007[30]. Should the Eurostat confirms in full the proposed upward revision in GDP figures, the denominator effect of a higher GDP would tend to reduce the overall deficit. However, the concomitant revision to gross national income would lead to a permanent increase of Greece's contribution to the EU budget, as well as a one-off payment of arrears on such contribution that would accrue to the 2007 balance. According to the European Commission's estimates *(spring 2007 forecasts)*, these would result in a deficit close to, but below, 3% of GDP.

Dynamics improving but debt ratio remains worryingly high

The significant fiscal consolidation implemented last year contributed to a sizeable reduction in the public debt-to-GDP ratio to 104.6%, from 107.5% in 2005. With a pace of debt reduction similar to that implemented in 2006, and assuming adherence to the fiscal targets envisioned in the updated stability and growth program *(2006-2009)*, the BoG projects a gradual decline in the debt ratio to levels around 68%-of-GDP by 2015. This constitutes a particularly encouraging prospect, especially taking into account the expected explosion in social security-related costs after 2010 *(please also see our Greek Macro Monitor report Nov. 2006)*. However, a certain degree of caution is warranted in fully relying on such projections, considering that Greece has failed to attain a faster pace of debt reduction in recent years despite the confluence of exceptionally favorable conditions, including strong GDP growth rates, the sharp decline in domestic interest rates post-EMU and the attainment of sizeable primary surpluses over that period[31].

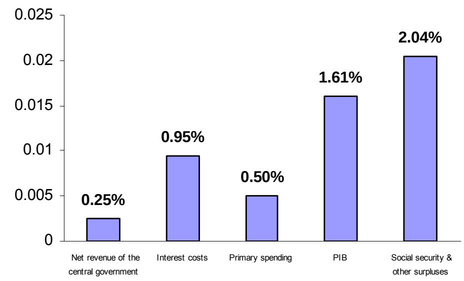
[30] The revision would imply a 25.7ppts upward adjustment in the level of nominal GDP.

[31] The pace of reduction in the Greek debt ratio amounted to 1%-of-GDP annually over the last 10 years.

Medium-term fiscal challenges remain

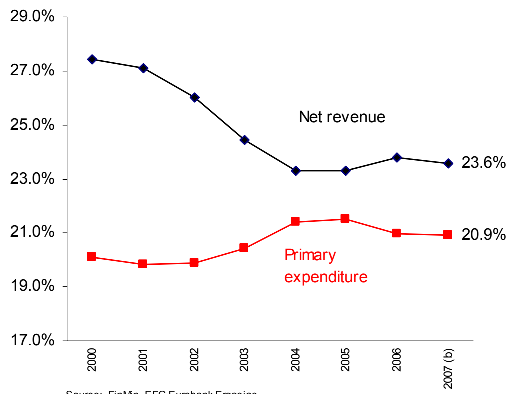
Despite the sizeable reduction (i.e. by 4.8ppts) in the general government budget deficit in 2005-06, significant fiscal imbalances remain especially in view of the stickiness of the debt-to-GDP ratio at levels above 100%-of-GDP and the fact that a significant portion of that reduction has been implemented via temporary measures *(see also analysis below)*.

Net contribution to the cumulative adjustment in the general government budget balance in the period 2004-2007 (% GDP)



Source: Eurobank EFG Research

Ordinal budget components (% GDP)



Source: FinMin, EFG Eurobank Ergasias

Moreover, despite measures taken last year to track down widespread tax evasion, the problem persists, as demonstrated by the moderate growth of direct tax revenues excluding VAT receipts *(up by around 1.0% in 2006)*. On this latter point, note that the main contributors to last year's acceleration in ordinary revenue growth were higher non-tax revenues as well as VAT and indirect tax receipts. The latter were assisted by the 1ppts rise in VAT rates in April 2005 and a more recent package of special revenue-generating measures, including significant increases to cigarette, gasoline and mobile phone taxes. Finally, the need for a continuation of efforts to attain a more sustainable fiscal position is also manifested in the cyclically-adjusted deficit, which remains persistently higher than the 3.0%-of-GDP stability threshold. On tax evasion, we note that the level of budget revenues from income & property taxes and social security contributions in Greece *(%-of-GDP terms)* is currently lower than the corresponding Eurozone averages *(12.1% vs. 14.4% for contribution and 9.3% vs. 11.7% for taxes)*, although most euro area member countries currently enjoy similar *(or even lower)* direct tax and contribution rates. As we have noted in the past, additional fiscal consolidation ahead will require more efforts to contain primary expenditure, broaden the tax base, track down tax evasion and reduce inefficiencies in an oversized public sector. The need to reduce further the total tax burden on the private sector further complicates the picture, since there is currently limited scope for a rise in corporate and personal income tax rates without adverse consequences for domestic growth and competitiveness.

Domestic Market Developments

GGBs tracks core market developments, spreads tighten on fiscal prospects

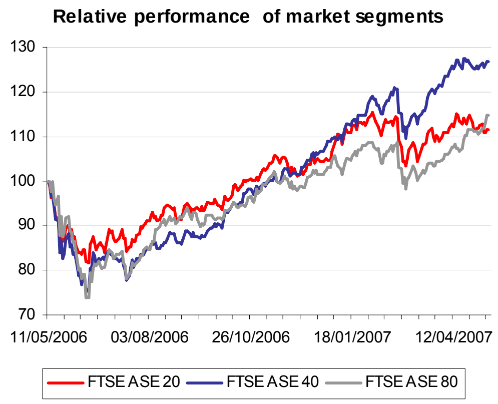
The Greek government bond (GGB) market tracked closely developments in the corresponding core euro zone markets throughout 2006 and year-to-date, with the GGBs yield curve undergoing a bearish flattening shift as a result of additional ECB rate hikes and higher longer-term yields amid rising medium-term risks to price stability. The 10-year GGB/Bund yield spread closed last year at ca 27bps, higher by ca 6bps from its levels at the end of 2005. The 10-year GGB/Bund yield spread stood at 23bp at the time of writing compared to levels around 27bp at the end of last year. We expect a further decline in the 10-year spread to levels below 20bps later in 2007 as a result of favorable fiscal developments and positive rating action by major rating agencies.

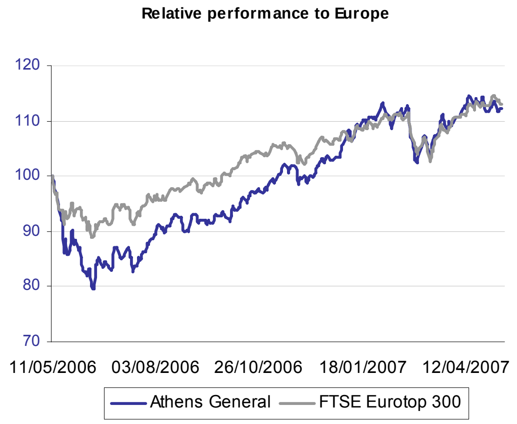
Positive stock market developments in 2006

2006 was another good year for the domestic stock market with the general ASE index rising by 19.9% y/y amid strong investor interest *(mainly by foreign investors)*, which saw the market's average daily turnaround rising by 64% relative to the prior year. Ample global liquidity conditions, positive domestic *(and international)* macro developments, the strong profitability of listed of companies, M&A activity and the appeal of Greek market as a proxy for the *converge play* in neighboring markets were some of the main drivers of the stock exchange's bullish performance last year.

Greek equity market review & outlook 2007 (*Contributed by Mina Lagounari, EFG Eurobank Securities Research*)

The ASE General index is gaining 8.7% year-to-date, making Greece one of the best performing developed markets in 2007. Mid and small caps are significantly outperforming their larger peers, with gains of 18.1% and 11.4% for the FTSE ASE 40 and 80 indices against 6.2% for the FTSE ASE 20. Average daily volume is up 28% year to date, to €439m from €343m in FY2006. Strong foreign buying interest continues, with net inflows from international institutional investors standing at €3.4bn in the Jan-April period, against €4.3bn for the whole 2006. All categories of domestic investors remain net sellers. M&A activity continues (food and beverage sector, banks, cement, construction, electricity) but deals are so far relatively of small scale. Banks have concluded the presentation of their business plans, all giving a bullish outlook both in Greece and abroad. There has been no privatisation activity so far in the year, but according to recent statements from the Finance Minister both this year's major cases of OTE and Post Savings should go ahead as scheduled (until June-July). We remain positive on ASE's prospects. We expect the market to end another year on positive ground, on the back of a supportive international environment and strong domestic drivers. The outlook for equities remains positive internationally with benchmark indices trading near their year highs. Corporate results are coming in better than expected in both the US and Europe while M&A activity continues to boost interest. Macros are an occasional source of concern, particularly in the US, though not alarming. On the domestic front, the reporting season of Q1 2007 results has already started and evidence so far is particularly encouraging, though as always skewed at the beginning of the season due to the tendency of strong results being announced sooner rather than later. The increasing exposure of ASE-listed firms to neighbouring countries with high growth profiles keeps contributing to group results. We believe that Q1 should come on the whole supportive of our double-digit EPS growth scenario for 2007, which calls for 22% increase in the weighted average EPS growth for our universe. Valuation-wise, the Greek market continues to sustain a premium compared to its developed peers, but we believe that the valuation gap is not a threat, as long as the ASE keeps offering superior earnings growth. Net foreign inflows continue unabated, which is one of the capital supportive drivers in the ASE's fifth consecutive year rebound. As long as there is high available liquidity and interest rates remain fair, flows should keep benefiting equities. Adding to these, potential privatisations as well as a continuation of M&A activity following domestic and international trends can assist towards a positive year-end scenario. Our year end target price for the ASE General index is 4,900, 3% higher than current levels but we reiterate our view that the market might overshoot by either momentum, market moving M&As or a combination of both. As major risks to our scenario we identify the possibility of a hard landing macro scenario (US), a sudden increase in investor risk aversion, particularly for emerging markets and failure of domestic firms to deliver on EPS growth expectations. We can also not exclude the chance of more pullbacks and subsequent rebounds, as market volatility has increased in H1 2007 to date.





2007 budget: an assessment

On November 14 2006, the government submitted to parliament its final draft for the 2007 budget. The new budget forecasts a deficit-to-GDP ratio which is below the 3.0% excessive deficit threshold for the second year in a row. Specifically, the general government budget deficit is projected to post a further decline this year and to come in at 2.4% of GDP, from 2.6% of GDP in 2006. The 2004 and 2005 deficit-ratios were revised upward to 7.4% and 5.1%, from the previously reported outcomes of 6.9% and 4.5%, respectively. The 2007 budget is framed on the projection of an upbeat macroeconomic environment characterized by a continuation of strong GDP growth and falling inflation. Real GDP growth is projected to grow by 3.8%, while average inflation is seen easing to 3.0% this year from 3.2% in 2006. The main figures of the draft budget (both in millions of euros and as a percentage of GDP) are presented in the following table and a brief assessment follows:

2007 draft budget	*In € mio*			% GDP		
	2006 (b)	**2006 (e)**	**2007 (b)**	**2006 (b)**	**2006 (e)**	**2007(b)**
1. Ordinary Budget						
a. Gross ordinary revenue	47,650	47,730	51,370	24.4%	24.5%	24.6%
a1. Tax reinbursements	2,200	2,200	2,200	1.1%	1.1%	1.1%
a2. Special revenue	1,100	770		0.6%	0.4%	0.0%
a3. Net revenue (a-a1+a2)	46,550	46,300	49,170	23.9%	23.8%	23.6%
b. Expenditure	50,190	50,313	53,360	25.8%	25.8%	25.6%
b1. interest	9,600	9,530	9,750	4.9%	4.9%	4.7%
b2. Primary expenditure (b-b1)	40,590	40,783	43,610	20.8%	20.9%	20.9%
2. Ordinary budget balance (1a3-b)	-3,640	-4,013	-4,190	-1.9%	-2.1%	-2.0%
3. Public Investment Budget						
a. Revenue	3,490	3,550	3,890	1.8%	1.8%	1.9%
b. Expenditure	8,400	8,100	8,750	4.3%	4.2%	4.2%
4. PIB balance (3a-3b)	-4,910	-4,550	-4,860	-2.5%	-2.3%	-2.3%
5. Central government balance (2+4)	-8,550	-8,563	-9,050	-4.4%	-4.4%	-4.3%
5a. Primary balance (5+1b1)	1,050	967	700	0.5%	0.5%	0.3%
6. Public sector surplus & adjustment	3,540	3,409	3,948	1.8%	1.7%	1.9%
6a. Public utility & other surpluses	4,990	4,138	4,383	2.6%	2.1%	2.1%
6b. Transfers to social security	-400	-423	-415	-0.2%	-0.2%	-0.2%
6c. Diffence expenditure	-1,500	-1,500	-1,700	-0.8%	-0.8%	-0.8%
6d. Adjustments	450	1,194	1,680	0.2%	0.6%	0.8%
7. General govnt balance (5+6)	-5,010	-5,154	-5,102	-2.6%	-2.6%	-2.4%
Nominal GDP (EUR bn)	194,902	194,902	208,740			

Source: 2007 draft budget, EFG Eurobank Research

As the above table shows, the overall drop in the general government budget gap this year is projected to come from a small decline in the central government deficit (i.e., to 4.3% of GDP, from 4.4% in 2005) and a 0.2ppts-of-GDP rise in national account adjustments. The overall surplus of social security funds and public utilities is again expected to remain significant (2.1% of GDP), providing an important source of financing to the central government. Net ordinary budget revenue as a percentage of GDP is expected to decline by 0.2ppts to 23.6%. Total tax revenues are forecast to grow slightly faster than nominal GDP in 2007, mainly on the back of higher indirect tax receipts. The latter will account for ca 70% of the projected rise in overall tax revenues. Total tax revenue is expected to increase to 23% of GDP in 2007, from 22.9% of GDP last year, while the ratio of indirect to direct taxes will rise to 1.47 from 1.42. On the spending side, the annual growth of primary outlays is expected to fall short of that of nominal GDP and, along with a further significant drop in interest costs, is projected to lead to a decline in ordinary budget expenditure to 25.6% of GDP in 2007 from 25.8% of GDP in 2006. This reduction will be facilitated by slower projected growth in the total public wage bill (~ 25% of total primary expenditure) relative to 2006 as well as significant cutbacks in government consumption outlays. It should be noted, however, that this latter expenditure category has been notoriously difficult to contain in the past and unless a more serious effort is undertaken to suppress government consumption and operating outlays, an overshooting of next year's primary expenditure target remains a risk. As an overall assessment of the projected fiscal consolidation progress over the period 2004-07, we note that more than two-thirds of the cumulative reduction in the central government budget deficit over that period comes from the expenditure side (i.e., 2.9ppts of the 3.4ppts-of-GDP drop in the deficit). Moreover, around half of the projected expenditure decrease (i.e., 1.5ppts of GDP) is due to the post-Olympic cutbacks in public investment outlays, while an additional 1.0ppts-of-GDP adjustment is attained via lower interest costs. In that sense, the thrust of overall fiscal adjustment attained so far can be characterized as anything but dramatic. As such, significant room remains for further cutbacks in such expenditure categories as government consumption outlays, while a major challenge for the authorities in the years ahead will be to maintain a satisfactory pace of revenue growth in the face of further expected reductions in corporate and personal income tax rates. Overall, we believe that a sub-3.0% budget deficit outcome is attainable this year but we see further room for expenditure restraint and an intensification of government efforts to crack down on tax evasion.

Structural funding for Greece: The critical two years ahead

- **2006 witnessed a significant acceleration in the pace of implementation of the 3rd Community Support Framework (CSF III)**
- **Public expenditure on CSF III projects needs to accelerate further this year and the next so as to avoid loss of available EU funds**
- **The overlapping of CSF III and the National Strategic Reference Framework over the 2007 – 2008 period creates a further challenge in efficiently absorbing EU funding**
- **The proposed management system for NSRF is more centralized and weakens the powers of local/regional authorities.**

I. 2007 – 2008: a critical period for the evolution of EU funding

The 2007-2008 period is critical for the evolution of EU structural funding for Greece. Over this period, both the 3rd Community Support Framework and the National Strategic Reference Framework (CSF IV) will be in operation. This overlap puts an extra burden on public authorities to promptly deliver projects eligible for EU funding. These two years are particularly critical for the 3rd CSF as its implementation lags behind schedule. In order to prevent losses of available funds, public *(i.e., EU + national)* expenditure on CSF III projects would need to accelerate to approximately €567m per month in 2007-2008, from €375m per month in 2006. NSRF projects do not have the same deadlines as those under CSF III, yet if their implementation is delayed, it could be very difficult to gain momentum thereafter. The following table gives an indication of the required public expenditure on CSF and NSRF projects in 2007 and 2008.

Indicative flow of public expenditure on CSF III & NSRF projects necessary to avoid loss of funds (in €bn)			
	2006 (3rd CSF only)	2007	2008
Annual	4.5	11.7	11.6
Monthly expenditure	0.375	CSF III: 0.567 NSRF: 0.410 ----------- 0.977	CSF III: 0.567 NSRF: 0.402 ----------- 0.969
Source: Eurobank EFG research			

As the table above illustrates, monthly public expenditure on EU co-financed projects will need to reach €977m in 2007 from €375m in 2006, itself a record year for public spending since the beginning of the 3rd CSF in 2001.

II. Pace of execution of CSF III program remains inefficient

In November 2006, the need to accelerate the execution of CSF III was pressing and a request by the Greek government to extend the program´s 2008 deadline by one year was rejected by EU authorities. Around that time, the Greek government adopted a new set of measures with the approval of the European Commission in order to facilitate the future absorption of EU funds *(see our Quarterly Economic Review of November 2006).* One of those measures was the increase in the co-financing levels for 2006 projects, with a higher percentage of project costs now being financed by EU funds than that planned initially. The downside is that there have also been certain cut backs in the available national funding for CFS III. Overall, the above measures resulted in a 5.24% reduction in total available funding *(national plus EU funds)* under CSFIII, which now stands at €32.4bn. Despite the above mentioned measures, pressure to accelerate the execution of the 3rd CSF remains strong. The most recent official data for public spending on 3rd CSF projects show a significant, though yet insufficient, acceleration in execution rates in 2005 and 2006. By the end of 2006, €18.8bn out of €32.4bn *(i.e., 58%)* of the program's available public funds had been spent. Moreover, the higher execution rates recorded in 2005 and 2006 were to a certain extent the result of transferring already completed projects from the purely nationally funded part of the Public Investment Budget to the EU co-financed part.

The flow of public expenditure on CSF III projects (% of total CSF III public funds)						
	2001	2002	2003	2004	2005	2006
Annual Rates	5.3	7.1	9.8	9.3	12.6	13.9
Cumulative Rates		12.4	22.2	31.5	44.1	58

As the table above illustrates, an additional €13.6bn of public *(EU + national)* funds needs to be spent by December 2008 in order to meet the deadline for the full execution of the CSF III program.

The flow of monthly public expenditure on CSF III projects (million euros per month)						
2001	2002	2003	2004	2005	2006	Jan. 2007 – Dec. 2008
142	**192**	**266**	**250**	**342**	**375**	**567**

The latter point implies that public expenditure on 3rd CSF projects would need to accelerate to approximately €567m per month between January 2007 and December 2008 from €375m per month in 2006 *(i.e., a staggering increase of ca 51%)*, so as to prevent loss of available funds. Out of the 25 operational programs *(13 of which are regional)*, the ones facing the largest execution problems are the Railways, Environment and Health programs as well as the Western Greece, Crete and the North & South Aegean regional programs.

III. New Contracts in CSF III

As we have already pointed out in previous issues of our Greek Macro Monitor,[32] the timely signing of contracts for new projects is 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. An initial December 2006 deadline set by the European Commission for the signing of new contracts reflected the need for a prompt completion of this stage. The Greek government "succeeded" in negotiating the abolition of this deadline without of course reducing the risk that delayed signing of contracts implies a lower probability of proper completion. By March 15, 2007 *(latest available data)*, 92.8% of the 3rd CSF had reached and/or passed the first stage of a signed contract with €30.1bn out of a total available amount of €32.4bn of public funds having been contracted out. As the table below demonstrates, there was a significant acceleration in the flow of new projects with a signed contract over the last two years.

32 See our November 2006 and July 2006 issues.

The flow of new CSF III projects with a signed contract (% of total CSF III public funds)							
	2001	2002	2003	2004	2005	2006	1/1/2007 – 15/3/2007
Annual Rates	13.3	13.7	13	11.6	14.1	24.3	2.8
Cumulative Rates		27	40	51.6	65.7	90	92.8

IV. Absorption Rates

At the end of 2006, 53.2% of total EU funds had been cashed out, or €12.1bn 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
Annual Rates	9.2	5.8	6.1	9.6	9.4	13.1
Cumulative Rates		15.0	21.1	30.7	40.1	53.2

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

V. NSRF 2007 – 2013

On March 30, 2007 Greece became the second EU member state after Malta, to conclude negotiations with the European Commission on the National Strategic Reference Framework 2007 – 2013 *(NSRF or CSF IV as it is sometimes called)*[33]. The NSRF was sent to the EC for approval on January 26, 2007. The broad priorities contained in the NSRF are laid out in 13 Operational Programmes *(8 sectoral and 5 regional)*. Moreover, a draft law for the management, control and application of NSRF was issued by the Ministry of Economy on April 20. The management and control system of NSRF resembles the system that was set up for managing the funds of the 3rd CSF, though it is far more centralised than the latter. Under the new system, the Ministry of National Economy gains even more execution powers than the already extensive powers it held under the previous framework. At the other hand, the powers of the local/regional authorities are weakened. The latter seems to be the aftermath of serious delays observed in the absorption of funds allocated in the regions *(either through sectoral or regional programmes)* during the implementation of CSF III. On their part, local authorities claim that they were never sufficiently supported by the central government. According to the government, 80% of the NSRF funds will be allocated to the regions. Total available public funds under the NSRF 2007 – 2013 amount to €36.5bn of which €20.4bn will come from structural funds *(European Regional Development Fund: €12.5bn, European Social Fund: €4.2bn and Cohesion Fund: €3.7bn)*, €4bn will be for rural development and from the Fisheries Instrument and €12.1bn are national funds. Following the approval of all the Operational Programmes, a downpayment of 2% or approximately €400m will be made by the EU in order to get the programmes started. The following table provides an indicative flow of EU funds as shown in the NSRF plan approved by the EC.

Indicative flow of EU funds (€bn)							
	2007	2008	2009	2010	2011	2012	2013
Annual	3.1	3	3	2.9	2.8	2.8	2.8
Cumulative		6.1	9.1	12	14.8	17.6	20.4
Source: Greek Ministry of Finance							

33 See our Greek Macro Monitor November 2006 report for more details.

The Greek Tourism Industry: *Strong performance but limited room for complacency*

- **Recent data indicate that Greek tourism is performing well as the international publicity the country had enjoyed during the 2004 Olympics and increased private and public spending on advertising campaigns has translated into positive momentum and strong revenue growth in the industry over the last three years.**

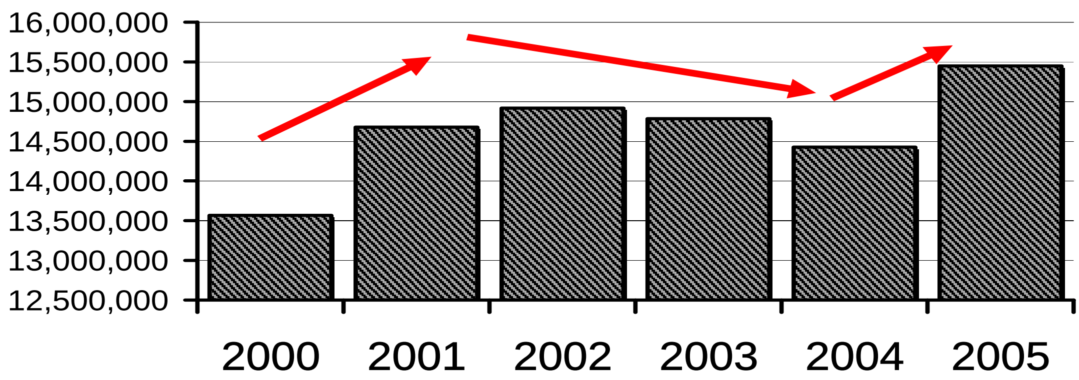
- **The industry though needs to stay on alert providing quality services at competitive prices, as competition in the broader region is expected to become stronger in the years to come.**

The progress so far

Activity in the Greek tourism industry has picked up pace over the last 2-3 years. According to the latest data provided by Eurostat, Greece's travel receipts in 2005 amounted to €11.037 billion. This corresponds roughly to 4.8% of the revised Greek GDP figure for 2005 *(or 6.1% of the old GDP number)* and represents a 4.7% increase relative to 2004. Developments in the Greek tourism sector have not always been so positive, however, as past data indicate. While the very beginning of the decade was marked by a strong increase in both tourist arrivals and spending *(Diagrams 1 & 2)* the positive trend was reversed in the 2001-2004 period. One could attribute this rather disappointing performance to rising security concerns caused by the resurgence of terrorism after 9/11th and the ensuing "war on terror". However, the period 2005-2006 saw a strong rebound in tourist arrivals with corresponding annual growth rates in excess of 7.0% y/y.

Diagram 1

Tourist arrivals



In terms of travel receipts, the 2004 Olympics year appears to have marked a trend reversal as well. While arrivals were still down by 3.5%yoy that year, tourist expenditure picked up to €10.74bn, 6% up from the previous year. Moreover, over the last 2 years, foreign tourists have been spending more time *(on aggregate)* in Greece (Diagram 3) with the most recent Eurostat data placing Greece in the 7th position among EU25 countries in terms of nights spent by foreigners.

Diagram 2
Travel receipts
(mil. €, 2005 prices)

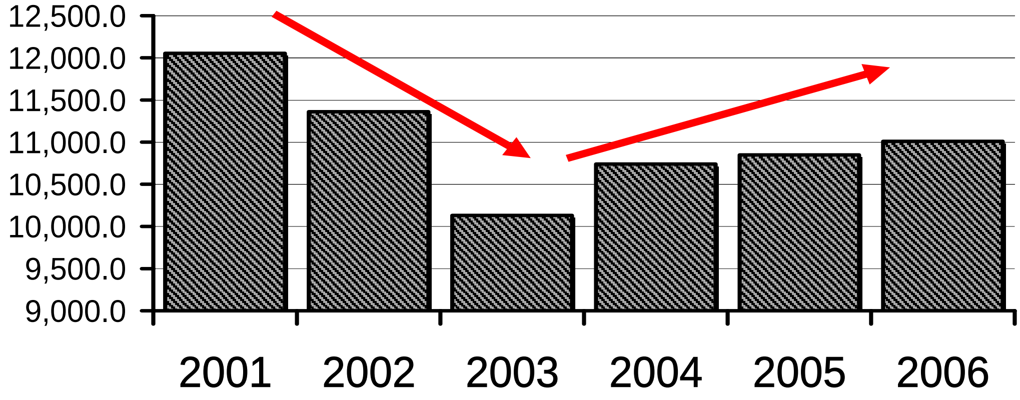
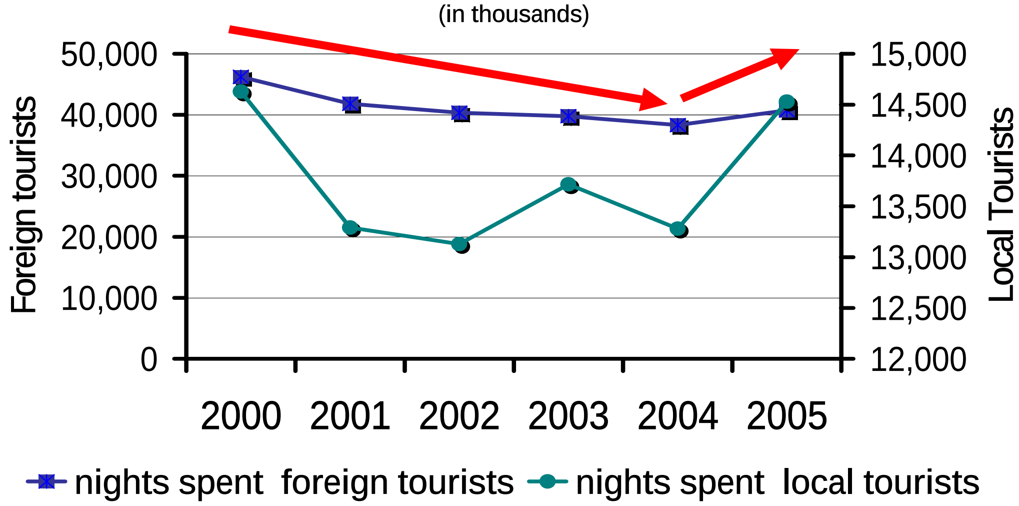


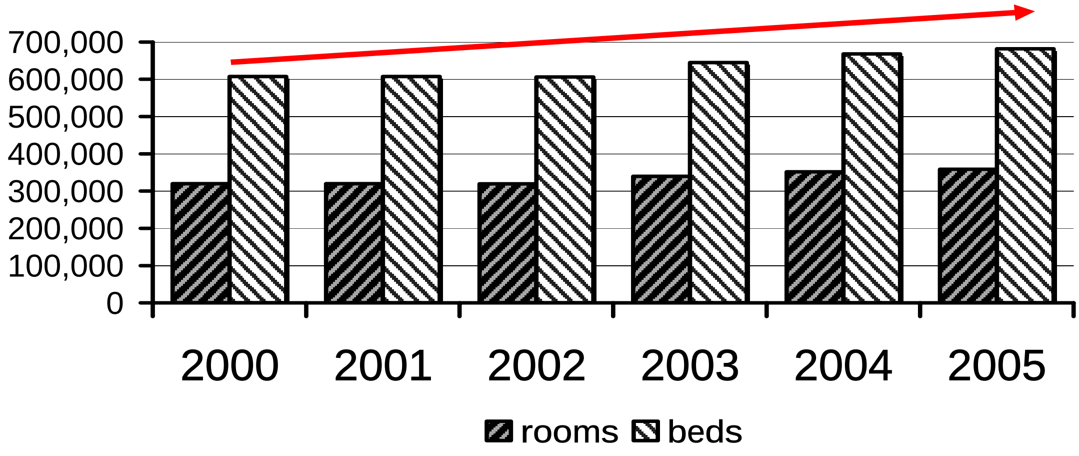
Diagram 3
Nights Spent
(in thousands)



Despite the increased volatility in arrivals and spending, the Greek tourism industry has also been increasing its capacity (in terms of beds & establishments) in recent years. With the exception of 2002, room, bed and establishment numbers have been on a constant rise. The largest capacity increase was witnessed in 2003, before the Athens Olympics. Since then, rates have been dropping steadily, though remaining in positive territory. In 2005, total beds were up to 682 thousands, with the relative growth rates dropping to 2.1% from 3.6% in the prior year. In 2005, establishments amounted to 9,036 units, growing by 1.5% y/y, from 2.4% y/y in 2004. In general, capacity (measured in beds) has increased by 12.2% since 2000 and establishments by 8.3% (measured in units). However, capacity growth is showing clear signs of deceleration.

Diagram 4

Capacity



In terms of visitors, Greece is enjoying a better diversified portfolio than many other European countries. However, a large percentage of tourist inflows come from a relative small number of EU countries. This could have positive and negative repercussions. While tourism in Greece may not be affected by the euro´s recent appreciation against the dollar, demand for tourism services in the euro area may be eventually filled by other countries that can offer cheaper services. According to the latest Eurostat data *(year 2005)*, 23% of foreign tourist nights spent in Greece were by German tourists, 19% by British and 7% by Italian. About 67% of tourist arrivals in 2005 were from the EU25 while arrivals from the US corresponded to less than 2% of total arrivals *(these numbers exclude cruises which correspond to an 8% of total annual arrivals for 2005).* While almost 50% of arrivals correspond to British, German and Italian tourists and roughly 7 out of 10 foreign tourists are from the EU, a couple of issues related to Greece's international tourist portfolio need to be addressed:

1) First, with regard to arrivals in Greek hotels and similar establishments data are rather mixed *(Eurostat, Diagram 5).* The number of tourist arrivals from Germany appears to have been dropping steadily since 2000 and today is only marginally higher than the corresponding British figure despite being almost double that in the beginning of the decade. Aggregate arrivals from Germany, Britain and Italy, Greece's major European partners, are now down around 11% from 2000 levels *(arrivals from Germany are down by 29%, from Italy up by a satisfactory 20% and from the UK are higher by just 1.38%).*
2) Net occupancy rates are high during the peak *(i.e., May-September)* season. In both Greece and Cyprus they usually stand between 70% and 90% while other countries in the area exhibit far lower rates (between 40% and 50%, Diagram 6).

Diagram 5

International Arrivals - Major Partners

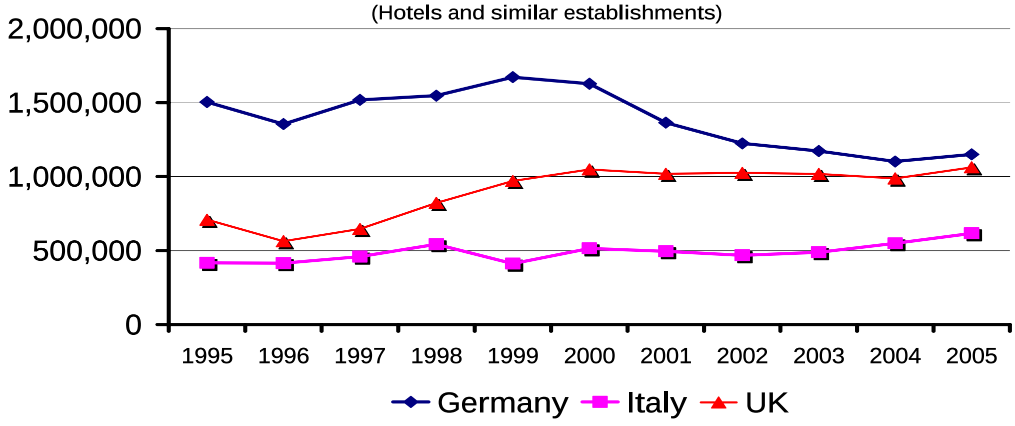
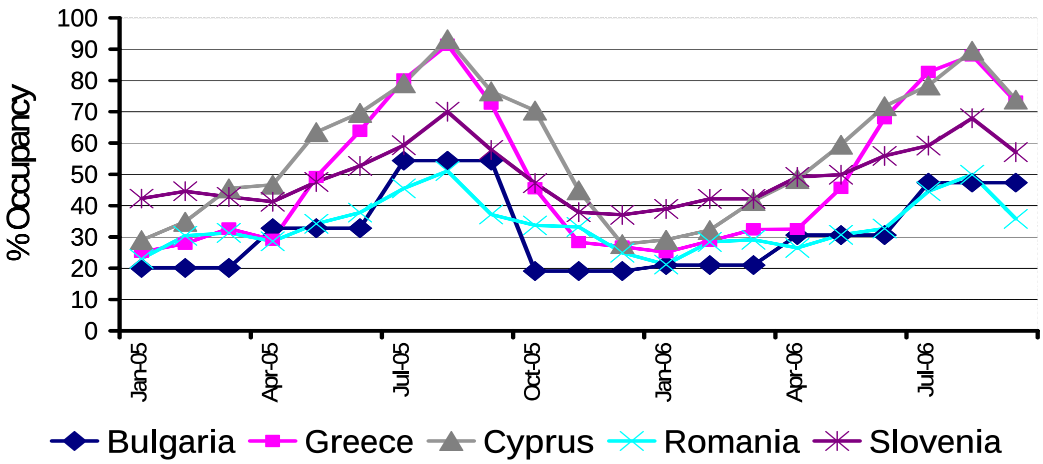


Diagram 6

Net Occupancy Rates

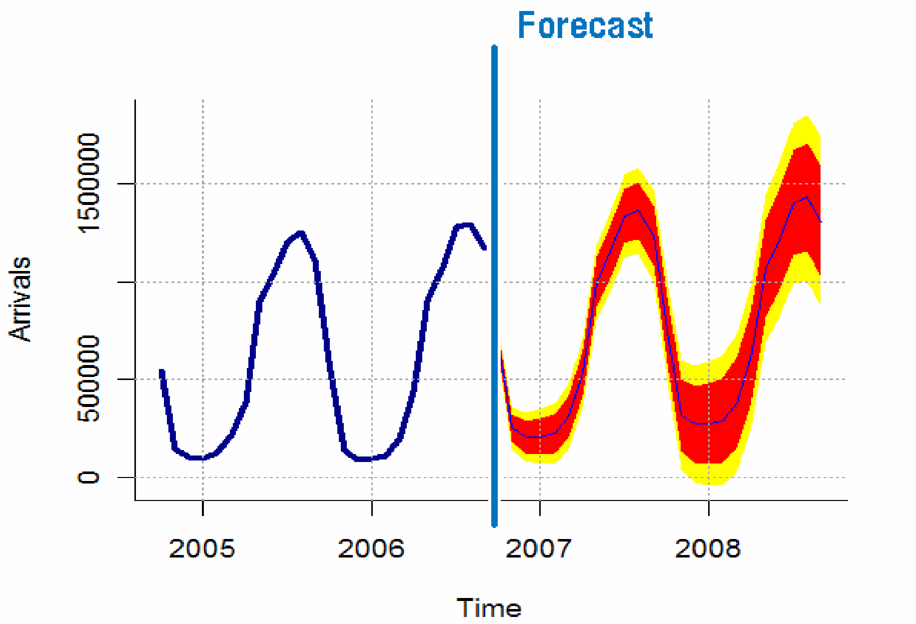


This implies that there is still spare capacity in countries like Romania, Slovenia, Bulgaria and Croatia during the peak season. These countries could eventually attract an increasing chunk of tourism from Greece's major EU partners, as they become increasingly capable in offering a competitive service-product mix in relative low prices. Indeed, recent data suggest that each one of these countries attracts an increasing number of visitors from Germany, UK and Italy. For example, Eurostat data show that last year Bulgarian hotels serviced 20% more visitors from Italy than in 2005 and Slovenian ones about 12% more. British visitors to Bulgarian and Slovenian hotels have also been increasing dramatically as well. Between 2002 and 2005, there has been an annual increase of roughly 50% in British visitors to Bulgarian hotel resorts. For Slovenia, the average rate is lower, but at 17.5% currently it still represents a very strong rate of annual increase. Croatia is also being increasingly discovered by British tourists: Croatian hotels serviced 28% more tourists in 2005 than in 2004. German visitors data are more volatile and do not indicate a clear pattern of an increase in the influx of tourists from this country to other Balkan countries.

This implies that the portion of German tourists Greece has been systematically losing since 2000, may be channeled elsewhere.

Despite the increasing number of visitors to other Balkan countries, the outlook for the Greek tourism industry is anything but bleak, as Greece remains the dominant tourist destination in the region. According to our forecasts, we should see a stable increase of hotel visitors in both this year and the next. While we can not exclude geopolitical factors that may affect tourism patterns in the area, our post sample point forecasts suggest that we should expect a **5.6%** of hotel visitors increase in 2007 and a **5.2%** increase in 2008. The fan chart in Diagram 7, displays the projected increase in visitors for these years highlighting the significant seasonal character of tourism in Greece. These forecasts are slightly above international estimates.

Diagram 7
Forecast of arrivals to hotels and similar establishments for Greece
(Dark (red) and light (yellow) areas indicate 80% and 95% confidence interval bands respectively.)



Source: Eurobank EFG Research

Conclusions

Despite the increased volatility in arrivals and travel receipts since the beginning of the decade, the Greek tourism industry is exhibiting new strength and momentum. The outlook for the next two years is very positive. However, there is a strong drive in neighboring Balkan countries to claim an increasingly larger percentage of visitors from sources that provide traditionally a large and stable supply of tourists to Greek destinations. Given the proximity of these potential competitors to countries such as

Germany or Italy (and their increasing accessibility), we should expect stronger competition in the coming years. Moreover, the slight discrepancy between tourist arrivals and receipts growth rates may be an indication that Greece is recently attracting more tourists that spend less. Continuous efforts to boost the quality of services in the sector paired with the strengthening of advertising campaigns are needed to ensure that Greece maintains its competitiveness and enlarges its share of international tourism.