Greece: Macro Monitor

A Quarterly Economic Review of the Greek Economy
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Strong economic growth supports fiscal consolidation

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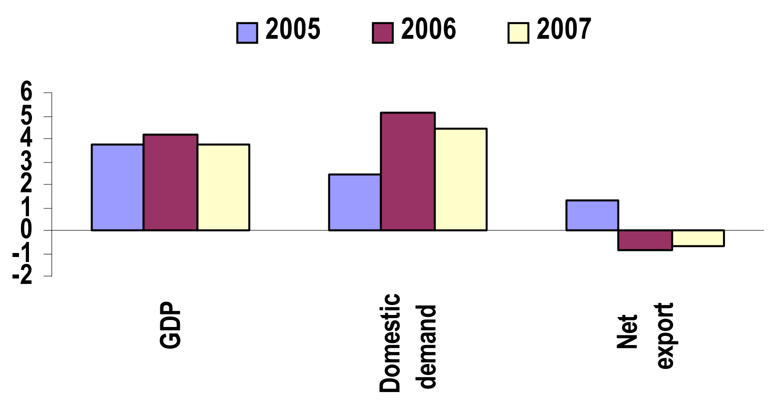
The most recent official data on the 2006 budget execution reveal that authorities are on track to meet their full-year deficit target of 2.6% of GDP. As a result, this year's budget outcome is likely to be in line with the Council's recommendation under Article 104(9) of the Maastricht Treaty and an exit from the excessive deficit procedure appears likely in 1H 07.

November 2006

Real GDP (%) and drivers



Eurobank EFG
Division of Economic Research & Forecasting

Summary

Greek GDP readings continue to surprise on the upside with the latest national account data recording a preliminary rise of 4.2% yoy over the first thee quarters of this year. This has been mainly the result of continuing strong private spending and a dynamic bounce in investments following stagnant growth in 2005. Exports of goods accelerated significantly in January-September 2006 but the overall external sector exerted a negative contribution as a result of higher imports.

These trends are likely to continue uninterrupted in the last quarter of this year and we now see full-year growth exceeding our previous forecast of 3.7% to reach 4.1% in 2006, with the slack created by a worsened net exports balance being more than counterbalanced by higher domestic demand growth. The latter's contribution is expected to rise to 5.1ppts this year from 2.4ppts in 2005. Net exports are expected to slash some 0.9ppts off real GDP growth in 2006 after exerting a positive contribution of around 1.3ppts last year.

Strong world growth and generally positive readings in an array of domestic economic activity indicators point to continuing strong GDP growth in the quarters ahead. Prospects for next year remain positive and we expect 2007 GDP to reach 3.7%. As for the likely composition of next year's gross domestic product, we expect a mild slowdown in consumer spending to be largely compensated for by higher government consumption and continuing strong gross fixed capital formation.

The positive differential in terms of ULCs (unit labour costs) vis-à-vis the main trading partners is likely to weigh on competitiveness and contain goods exports next year, but exports of services (mainly tourism) are likely to continue growing at a healthy pace. These, along with slower import growth due to moderating domestic demand, are likely to amount to a lower, though still negative, contribution from net exports in 2007. As a result, the current account deficit is expected to contract slightly in 2007 after widening to levels above 11%-of-GDP this year, but to remain at levels which, unless effectively addressed, will continue undermining the medium-term growth potential of the economy.

Downside risks to our upbeat GDP growth outlook for next year 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. Still high raw material and energy prices and persisting global imbalances also pose downside risks to our outlook.

Greek inflation has been edging lower in recent months with the year-on-year CPI averaging 3.3% in January-September 2006, compared with 3.5% in the same period a year earlier. 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 during 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 are seen as maintaining upside price pressures, with the average annual headline inflation expected to remain above 3.0% this year and the next.

Eurobank EFG expects average year-on-year CPI to drop to 3.3% in 2006, from 3.5% in 2005, with the corresponding core inflation index easing to 2.8%, from 3.2% last year. These developments, alongside annual productivity growth rates that are expected to remain broadly stable at around 2% over the forecast period, suggest limited room for any

significant abatement in ULCs growth in the foreseeable future, with the latter expected to continue exceeding the Eurozone average by a considerable margin next year.

The most recent official data on the 2006 budget execution reveal that authorities are on track to meet their full-year deficit target of 2.6% of GDP. As a result, this year's budget outcome is likely to be in line with the Council's recommendation under Article 104(9) of the Maastricht Treaty and an exit from the excessive deficit procedure appears likely in 1H 07.

Notwithstanding the sizeable reduction (i.e., by 4.8ppts-of-GDP) in the general government budget deficit in the 2005-06 period, significant fiscal imbalances remain, especially in view of the relative slow pace of reduction of the debt-to-GDP ratio and the fact that a significant portion of the recent fiscal adjustment has been attained via temporary measures.

Despite steps taken last year to track down widespread tax evasion, the problem persists as demonstrated by the rather disappointing growth of direct tax revenues (ex-VAT receipts) over the first nine months of 2006. Moreover, 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 will again be attained next year but further room exists for expenditure restraint and an intensification of government efforts to reduce tax evasion.

Also in this issue:

- ✓ **A special study on the impact of housing-related wealth effects on the overall economic activity in Greece.** We construct an econometric model of private consumption to show that a 10ppts increase in housing-related wealth raises private consumption and GDP growth by 1.82ppts and 1.22ppts, respectively. We also find that strong wealth effects from housing in Greece can be attributed to the large share of real estate in Greek households' total portfolio of assets (~ 81.5%) as well as the relatively low volatility of house prices. Wealth effects are stronger in semi-urban areas and the countryside where homeownership in higher.

- ✓ **An update on recent developments regarding structural EU funding to Greece.** We highlight that a set of measures proposed by the EC will facilitate the absorption of EU funds under the 3rd CSF but at the cost of simultaneously reducing the size of this CSF. We also cover the main aspects of the NSRF 2007-2013 (4th CSF).

Key macroeconomic indicators

y/y grwoth	**2005**	**2006e**	**2007f**
GDP (constant prices)	3.7	4.1	3.7
Private Consumption	*3.1*	*3.8*	*3.3*
Public consumption	*2.7*	*2.9*	*3.0*
Total investment	*0.0*	*8.1*	*6.0*
Domestic demand	*2.2*	*4.7*	*4.0*
Exports g&s	*3.7*	*4.6*	*4.2*
Imports g&s	*-2.1*	*6.4*	*5.2*
GDP in current prices (euro bn)	*181.1*	*195.3*	*209.1*
National CPI (average)	3.5	3.3	3.1
Budget balance (% GDP)	5.2	2.6	2.5
Public debt (% GDP)	107.5	105.0	101.0
Current account (% GDP)	7.7%	11.4%	10.7%
Employment growth	1.4	1.4	1.5
Unemployment rate	10.4	9.2	8.2
ULC growth (whole economy)	4.1	3.5	2.6
Labour productivity growth	2.3	2.3	2.3

Source: realisations, official estimates and EFG Eurobank forecasts

Political and Economic Overview

The last two months have been dominated by mostly non-economic issues such as the recent municipal and prefectural elections, the six-week-long school teachers' strike, allegations of corruption in the ranks of the Competition Commission (triggered by an investigation into possible price-fixing practices indulged in by a number of dairy companies), protests from thousands of public-sector contract workers demanding tenure (following pre-election promises to that effect by New Democracy) and, lately, talk of early elections (to be held supposedly in autumn next year after the anticipated closing, in spring, of the current excessive-deficit procedure following a series of improved economic and fiscal data). The PM immediately moved to quash such rumours, not entirely successfully, however.

In the recent local elections, both parties claimed successes, even as Pasok-backed candidates closed somewhat the gap at the level of prefectures. The main opposition party gained Piraeus, but ND held on to Athens and Thessaloniki. However, a worrying factor for both camps was the low turnout.[1] For its part, ND interpreted them as an endorsement of the Government's policies and as a message from voters to continue down the path of reforms. That said, recent opinion polls have reverted to form, indicating leads for ND of the order of 3%-plus.[2]

Halfway through its term, the Government can claim some economic successes, though the actual reforms programme lately seems to have run out of steam (see below). The most important success is the gradual return of the country's economic growth to rates approximating the high averages of the Pasok years (official predictions of 3.8% for 2006 will probably have to be revised upward to slightly over 4% before the end of the year) – close, but still not quite the 5%-plus rates promised by ND before the elections. Other bright spots are: the pick-up in private investment, in part thanks to the new incentives law (but at a fiscal cost that is not readily ascertainable); the first real big privatisation (Emporiki); a new legal framework for public-private partnerships, which has already set in motion a number of projects; and substantial progress in the area of fiscal rehabilitation – notwithstanding the fact that the recent massive upward revision of GDP (+25.7%) did not bring in a single euro in additional tax receipts, and ended up seriously muddying the country's statistical waters.

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[1] Abstentions in municipal polls amounted to 35.4%, while they soared to 43.3% in prefectural elections.

[2] The results of an opinion poll by MRB published on 16 November show New Democracy with a 3.1-point lead, or 36.6%, vs. 33.5% for Pasok. They are followed by KKE (7%), Coalition of the Left/Synaspismos (4.1%), and LAOS (3.6%). PM Karamanlis leads by 18 points Pasok Chairman Papandreou as the person "most suited to lead the country". Nonetheless, 60.6% of those polled said that the Government will "probably" or "certainly" not carry out its pre-election promises.

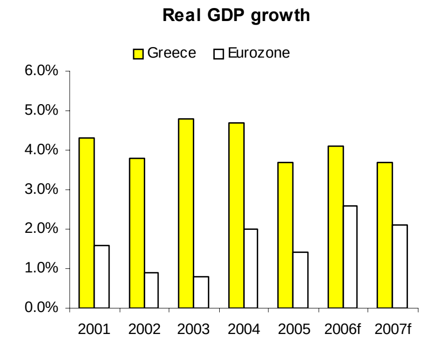
A review of recent macroeconomic developments & 2007 outlook

Stronger than expected growth in 2006

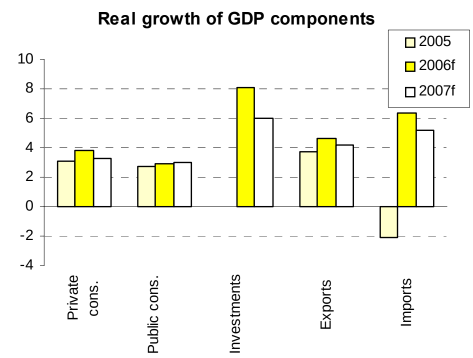
After recording above-consensus growth of 3.7% in 2005, Greece's real GDP has continued to surprise on the upside with the latest national account data recording a preliminary rise of 4.2% yoy over the first thee quarters of this year. This was mainly on the back of higher domestic demand growth relative to the same period a year earlier as a result of continuing strong private spending and a dynamic bounce in investments following stagnant growth in 2005. The growth of goods exports accelerated significantly in January-September 06 but the overall external sector exerted a negative contribution as a result of higher imports. These trends are likely to continue uninterrupted in the last quarter of this year and we now see full-year growth exceeding our previous forecast of 3.7% to reach 4.1% in 2006, with the slack created by a worsened net exports balance being more than counterbalanced by higher domestic demand. The latter's contribution is expected to rise to 5.1ppts this year from 2.4ppts in 2005, while net exports are expected to slash some 0.9ppts off real GDP growth in 2006 after adding up around 1.3ppts to overall growth in 2005.

Outlook remains positive for next year

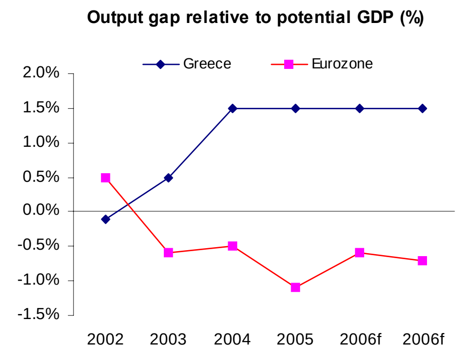
Strong world growth and generally positive readings in an array of domestic economic activity indicators point to continuing strong GDP readings in the quarters ahead. Prospects for next year remain positive and we expect 2007 GDP to reach 3.7%. As for the likely composition of next year's gross domestic product, we expect a mild slowdown in consumer spending to be largely compensated for by higher government consumption and continuing strong gross fixed capital formation. Regarding the latter, we expect the abating effects of this year's tax reform on housing to have a slightly lower positive impact on construction than in 2006, but investment in equipments is projected to continue growing at a healthy pace,



Source: Ministry of National Economy, EC, EFG Eurobank



Source: National accounts, EFG Eurobank

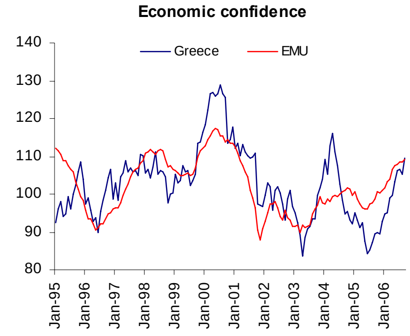


Source: EC

deriving support from a more friendly business environment following recent reforms and a dynamic global growth trajectory. The positive differential in terms of ULCs vis-à-vis the main trading partners is likely to weigh on competitiveness and contain goods exports next year but exports of services (mainly tourist services) are likely to continue growing at a healthy pace. These, along with slower import growth due to moderating domestic demand and the wearing-off of positive base effects from the contraction of the real growth of imports last year, are likely to amount to a lower, albeit negative, contribution from net exports in 2007. As a result, the current account deficit is expected to contract slightly in 2007 after widening by around 4ppts-of-GDP this year but to remain at levels which, unless effectively addressed, will continue undermining the medium-term growth potential of the economy. As for the risks to our upbeat GDP growth outlook for next year, these 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. Still high raw material and energy prices and persisting global imbalances also pose downside risks to our outlook.

Investments rebounding after last year's plunge

Gross fixed capital formation growth has bounced strongly this year (+6.5% in January-September 06 vs. -2.8% in the same period a year earlier), assisted by accelerating business as well as public investment spending. The growth of housing investment is estimated to have returned into positive territory in 2006, following a mild contraction over the previous two years. Though decelerating significantly from the extraordinary rates recorded in late-2005, the growth of residential construction permits in volume terms, a reliable indicator of future building activity, remained positive in the first eight months of this year (+7.0/y vs. +118% in Q4 05), and this, along with recovering public construction activity and improved business sentiment, support our expectations for a continuing recovery of gross fixed capital formation growth in the quarters ahead. In addition to strengthening residential building activity, other factors supporting expectations for a considerable improvement in the outlook for the domestic construction sector



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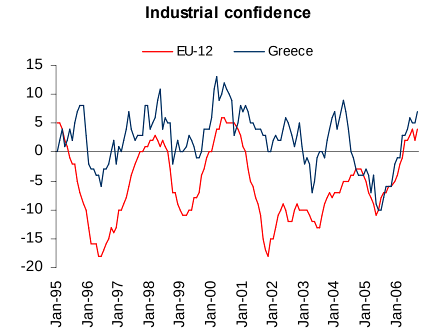

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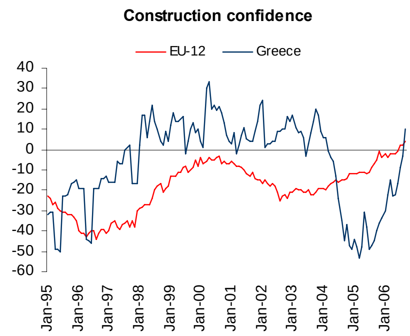


Source: EC

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. The outlays for public investment contracted by 21.1% y/y in nominal terms in 2005 but a 7.7% y/y rise in this expenditure category is projected for this year (2007 draft budget), not least because of the need to facilitate the proper absorption of EU structural funds. Business investment is also growing 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. Importantly, 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, remains well above the corresponding EU average (+20.8%).

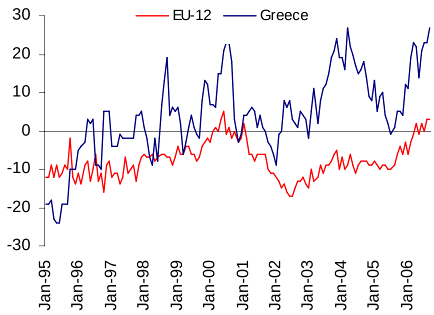
External sector likely to be a drag on GDP growth this year despite rising exports

The first three quarters of this year have witnessed a significant acceleration in the growth of goods exports which, however, was more than outweighed by higher import growth as a result of strengthening domestic demand and favorable base effects from the contraction in the real growth of imports last year. Specifically, the most recent customs statistics showed an 19.7% y/y rise in merchandise export revenues in the first eight months of the year along with an 11% y/y increase in the trade deficit as a result of higher imports (+13.8% y/y). In the services sector, tourist arrivals are expected to grow by around 10% in 2006, after rising by 9% in 2005 and strong growth is expected to continue next 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. According to the most recent balance-of-payments data, travel receipts (2005 prices) posted cumulative growth of 5.2% y/y in January-July 2006, despite a rather weak first quarter. Travel receipts recorded growth of 12.3% y/y in July and this strong performance is likely to have continued during the third quarter of the year 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 2007

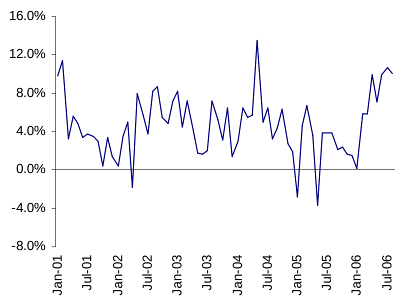
Private consumption continues to grow strongly, supported by rising disposable incomes, rapidly expanding consumer credit, above-inflation nominal wage growth and rising employment. Meanwhile, the positive wealth effects from the housing market that accrued to Greek households over the last few years continue to underpin consumer spending[3].

Retail trade confidence



Source: EC

Retail sales volume index (%)



Source: NSSG

[3] House prices rose by approximately 30% in real terms in 2001-05, following a similar increase in the previous 5-year period.

Although some preliminary evidence of consumer borrowing fatigue suggest risks of a mild deceleration in private consumption growth next year, conjectural indicators and consumer attitude surveys show no significant abatement of consumer vigour yet. Following some transitory weakness in early 2006, retail sales in volume terms bounced strongly in recent months, posting average growth 6.1% y/y in January-August 2006 on the back of strong gains in department stores, supermarkets and furniture, household equipment and food sectors[4]. New private car registrations grew by 0.7% y/y cumulatively in the first ten months of this year following a 4.1% y/y drop in 2005 and 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 falling unemployment rates (8.8% in 2Q 06 vs. 9.7% in 1Q 06 and 10.4% in 1Q 05) are 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 -30 in October stood near its highest level since early 2005. Somewhat counter-intuitively, however, the Greek confidence indicator continues to exhibit mostly diverging trends from other upbeat domestic indicators of consumer vigour such as retail and auto sales. This phenomenon has subsided lately, however, with the most recent confidence data better reflecting current consumption developments (see also our previous Greek Macro Monitor, *July 2006*).

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 uninterrupted during the first seven months of 2006 with the average annual growth of household credit averaging 30.6% following growth of 29.6% over the same period a year ago[5]. As we have noted in our previous Greek Macro Monitor (July 2006), 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, albeit from very strong levels (+24.7% y/y in July 2006 vs. 28.7% 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. This total reached ca €150bn or around 80% of GDP in July 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-July 2006 (annual rates in excess of 32% 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 higher business investment this year. Although total outstanding household credit in Greece (in percentage-of-GDP terms) remains well

[4] The Greek retail sales index excludes auto and gas sales and accounts for roughly 70% of GDP´s private consumption component.

[5] These figures include securitized debt and non-tradable corporate bonds held by domestic banks.

below the corresponding EU average[6], 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 ratios and is also well capitalized.

Current-account balance widening

In January-August 06, Greece's current account deficit widened by ca 86% over the same period a year earlier, with the overall deficit heading to levels above 11% of GDP in 2006. This deterioration was mainly the result of a higher trade gap and, to a lesser extent, an increase in the income account deficit and a drop in the services surplus. Over one half of the overall rise in the trade gap over the first eight months of this year was due to a higher net oil import bill and net payments for the purchase of ships. Revenues from exports of goods excluding oil and ships grew strongly in the eight months of 2006, rising by 12.2% compared with the same period a year earlier, but this was more than outweighed by an 11.1% y/y increase in the corresponding import bill. Elsewhere, the widening in the income account deficit in January-August 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 €810mn in the January-August 2006 period, compared with a net inflow of just €52mn in the corresponding period of last year.

An assessment of recent balance-of-payments developments

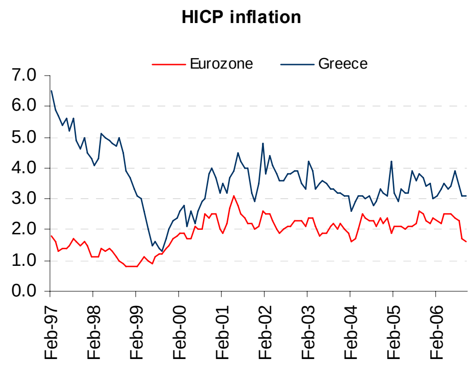
Greek exports of goods and services to neighbouring emerging economies have been growing at a strong pace and the share of high-technology goods exports as a percentage of total goods exports has been on a rising path in recent years. Nonetheless, the inability of domestic production to fulfil rising demand for high added-value imports, cumulative competitiveness losses due to the persisting inflation differential vis-à-vis the main trading partners and cyclical influences have manifested themselves via a significant deterioration in the current account balance. The current account gap averaged ca 7.3%-of-GDP in 2001-2005 and a further significant widening to 11.4%-of-GDP is expected this year (Eurobank EFG forecast). Looking at the current account deficit as a savings-investments imbalance, it surmises that the widening in the c/a deficit in recent years has been driven mainly by strong investment spending (both as percentage-of-GDP and in annual growth terms) and declining saving levels as a result of lax fiscal policies and strong household consumption patterns. On a more positive note, following entry into the euro area, Greece has been able to finance its c/a deficits at much more favourable terms than was previously the case. Nonetheless, the persistence of high external-sector deficits risks undermining the economy's medium-term growth prospects, especially

[6] i.e., 38.3%-of-GDP in August 2006 (or 41.2%-of-GDP if securitized consumer loans are include in the total figure) vs. 53.4%-of-GDP in the euro area. The Greek ratio has increased quite rapidly in recent years from levels around 13.7%-of-GDP at the end of 2000.

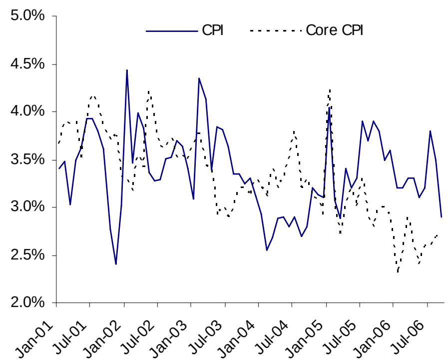
if these deficits continue to be primarily driven by strong private consumption and housing investment trends.

Year-to-September inflation edges down, upside risks persist

Greek inflation has been edging lower in recent months with the year-on-year CPI averaging 3.3% in January-September 2006, compared to 3.5% in the same period a year earlier. According to the latest CPI data, the most significant contributors to the rise in the annual inflation rate over the first nine months of this year were higher housing costs, food, tobacco and transport prices, with communications being the CPI basket's sub-component with the greatest disinflationary contribution. In EU-harmonized terms, the inflation differential vis-à-vis the EU-15 eased to 1.0ppts in the first eight months of this year, from 1.3ppts over the same period a year earlier, while the corresponding core inflation spread dropped to 1.3%, from 1.7% in 2005 and against an average rate of 1.3% in 2001-05. At the core inflation level, a reduction in the positive Greek inflation differential for manufacturing goods and services in January-September 2006 was counterbalanced, albeit partially, by a further rise in the differential of processed-food inflation. These generally positive developments occurred despite second-round effects from oil price rises, a positive and significant ULC growth differential with the rest of the EU-15 and adverse base effects earlier this year due to the 1ppt increase in VAT rates in April 2005. Despite higher commodity and oil prices, imported inflation remains relatively contained, helped by a stronger euro and increased imports of textile, apparel, household appliances and consumer durables from low-cost Asian producers. At the producer price level, average imported goods inflation in industry eased to 6.2% y/y in January-August 06 from 8.9% in the same period a year earlier, with the corresponding index ex-oil rising by just 2.4% y/y over the that period. 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 are seen maintaining upside price pressures, with the average annual headline inflation remaining above 3.0% this year and the next. Eurobank EFG expects average year-on-year CPI to drop to 3.3% in 2006, from 3.5% in 2005 with the corresponding core-inflation index (i.e., headline inflation excluding the volatile non-processed food and vegetables component) easing to 2.8%, from 3.2% last year. These developments, alongside annual productivity growth rates that are expected to remain broadly stable at around 2% over the forecast period, suggest limited room for any significant abatement in ULCs growth in the foreseeable future, with the latter expected to continue exceeding the Eurozone average by a considerable margin next year.



Source: Eurostat



Source: NSSG

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

In line with the worsening in the country's balance-of-payment dynamics in recent years, Greek harmonized inflation has exceeded Eurozone inflation by an average 1.3 percentage points over the last five years, while the corresponding until labor cost differential has been as high as 2.1 percentage points over that period[7]. Meanwhile, the ensuing appreciation in the Greek real effective exchange rate (e.g., by ca 14% and 34% in CPI- and ULC-based terms, respectively, between 2000-06) reflects an accumulation of competitiveness losses to 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 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 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.

[7] Greece's broad-economy ULCs growth differential with the rest of the EU-15 is estimated to have reached around 2.6ppts this year, bringing the corresponding average for the 2002-06 period to 2.1ppts (EU Commission's Autumn 2007 forecasts). Specifically, Greek ULC growth in the broad economy is expected to rise by 3.5% in 2006, following growth of 4.1% in 2005, mainly reflecting strong growth of gross nominal salaries (+6.1% in 2006). On the other hand, average ULC growth in the euro area, is projected to rise by only 0.9% this year from 1.3% in 2005

Successful budget execution supports forecasts for a low budget deficit in 2006

The most recent official data on the 2006 budget execution reveal that authorities are generally on track to meet their full-year general government deficit target of 2.6% of GDP. Specifically, net ordinary revenue grew by 9.1% y/y in January-September against a full-year target of 9.7%, while primary spending rose by 5.2% over the same period, compared with a 5.7% y/y target for the year as a whole. On the public investment budget (PIB), revenues grew by 43.3% y/y and outlays by 10.4% y/y in January-September, with the cumulative central government deficit declining by 27.1% relative to the same period a year earlier and against a budgeted decline of 24.3% y/y in 2006. As a result of these positive developments, this year's budget outcome is likely to be in line with the Council recommendation under Article 104(9) of the Maastricht Treaty and an exit from the excessive deficit procedure appears likely in 1H 07. 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). 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 (ex-VAT receipts) over the first nine months of 2006 (up by only 1.0%). On this latter point, note that the main contributors to higher ordinary revenue over the first three quarters of this year were higher non-tax revenues as well as VAT and indirect tax receipts. The latter were assisted by last year's 1ppts rise in VAT rates and a 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 (5.5% of GDP in 2001-05), which remains persistently higher than the 3.0%-of-GDP stability threshold. Also, the cyclically-adjusted primary surplus of the general government has averaged no more than 0.2%-of-GDP over the corresponding period.

2007 budget: an assessment

On November 14, 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 next 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%, same as in the current year, while average inflation is seen easing to 3.0% next year from 3.2% in 2006. These forecasts are on the optimistic end of market expectations, but they do not seem entirely unrealistic given the strong growth performance of the Greek economy post-Olympics. Our central forecast is for 3.7% real GDP growth next year. The main figures of the draft budget (both in millions of euros and as a percentage of GDP) are presented in the following two tables and a brief assessment follows:

2007 draft budget	*In € mio*			% GDP		
1. Ordinary Budget	**2006 (b)**	**2006 (e)**	**2007 (b)**	**2006 (b)**	**2006 (e)**	**2007(b)**
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 next 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%, weighed down by special receipts worth 0.4ppts-of-GDP this year that are not expected to be repeated in 2007.

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 next year. Total tax revenue is expected to increase to 23% of GDP in 2007, from 22.9% of GDP this 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 this year 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 is projected to come 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) will be due to the post-Olympic cutbacks in public investment outlays with an additional 1.0ppts-of-GDP adjustment to be 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 rates1. Overall, we believe that a sub-3.0% budget deficit outcome is attainable next year but we see further room for expenditure restraint and an intensification of government efforts to crack down on tax evasion.

GDP revisions

In early October, the Greek government announced a 25.7-percentage point cumulative upward revision to its nominal GDP estimates for the period 2000-06. The timing of the announcement and, even more so, the size of the adjustment came as a surprise to many market participants, in spite of the fact that the revision was purportedly implemented in accordance with Council Regulation (EC) 2223/96 (ESA 95)8. According to NSS´s chief Manolis Kontopyrakis, the revisions were fully in line with Eurostat rules, while the European Commission said in a statement that there had been no prior discussions between Greece and Eurostat on the issue. The Commission characterized the scale of the revisions ‘‘unprecedented’’ and noted that verification would take at least a few weeks. At this point we do yet not have much detail about the technicalities of the national accounts revision, but here is what we have learnt from official comments and our discussions with officials at the stats service and the Finance Ministry:

The revision process started four years ago (autumn 2002) and the size of the ensuing (upward) adjustment to nominal GDP for the period 2000-2006 will be as much as 25.7 percentage points. Nominal GDP is now seen reaching €242bn this year, compared with a previous official projection of ca €193bn (updated stability program 2005-08). The revised national accounts will draw data from the latest population census (year 2001) and will also incorporate data from TAXIS, the electronic tax reporting system. Significantly, the current (i.e., unrevised) national account figures are allegedly based on the 1981 census. Greece´s per-capita-GDP in PPP terms (EU-15 = 100) – which, according to the unrevised national accounts rose to 77.1% last year, from 75.4% in 2004 – is expected to be given a strong boost as a result of the GDP data revisions, bringing Greece within the EU-25 average. Furthermore, the country's gross debt (as % of GDP) – which, according to the present (unrevised) GDP figures, fell to 107.5% in 2005, from 109.3% in 2004, with official expectations of a further decline to 104.8% this year – is now seen declining sharply to sub-90% levels, provided of course that Eurostat will verify the revisions proposed. In projecting the ensuing decline in the debt ratio, one needs to take also into account that this is likely to be partially counterbalanced by a concomitant drop in the estimated pension fund surpluses, which would also be affected by the changes. In a statement released shortly after the announced national account changes, rating agency S&P said that the revisions will have no effect on Greece's sovereign ratings (A/Stable/A-1), which are currently one notch below the corresponding ratings by Moody's and Fitch. According to the S&P, the inclusion of the black economy does not fundamentally change the challenge facing the country's authorities, which is to reduce the exceptionally high public debt-to-GDP ratio, since the unrecorded national income is by definition not available for taxation. Our understanding is that the rating agency realizes that the government has made important steps towards clearing up its fiscal accounts but would like to see a more genuine improvement in debt dynamics before considering any revision (i.e., upgrade) in its ratings for Greece. Further reductions in a multitude of stock-flow adjustments which continue to hamper a sustainable decline in the debt ratio[9], higher primary surpluses and continued fiscal prudence ahead of parliamentary elections could be some of the prerequisites for a new rating upgrade, in our view. The Government states that the 2007 budget will not rely on revised GDP figures. Needless to say, if the announced revisions to GDP figures are indeed validated by Eurostat, the net effect will likely be a significant drop in Greek budget deficit ratios to as low as

[8] The last time Greece revised its national accounts was in 1994. Back then nominal GDP growth was revised upwards by 20 percentage points.

[9] According to the European Commission (ECFIN/50368/06-EN), Greece´s stock-flow adjustments amounted to 2.3%of GDP in 2005 and are projected at 1.8% of GDP this year.

2.1-2.2% of GDP in 2006 and 1.9-2.0% of GDP in 2007, provided that the budget targets are met both this year and the next. The Commission will, in turn, confirm Government predictions of an exit from the excessive deficit procedure (EDP) as early as 1H 2007.

Implications for EU funding

Greece's unprecedented 25-percentage point upward adjustment in GDP figures has provoked – as is natural – various reactions. Most people would agree that some sort of revision was necessary – if not the whopping 25% proposed by the Government, at least something, perhaps more modest, to account for a standard of living that, it is generally felt, is at some variance with official GDP figures (which, in turn, is attributed mostly to the existence of a large underground economy). Nonetheless, public opinion, on the whole, has treated the announcement with considerable scepticism, since people understand that actual disposable incomes will remain unaffected by such statistical rearrangements. As regards the potential implications of the GDP revisions for EU structural funding for Greece, various critics have estimated the extra contribution that the country may have to face as anywhere between €300,000 and €500,000 for next year. This is basically an extrapolation based on current numbers (*i.e.*, an extra 25% on the €1.85bn that Athens is expected to transfer to the EU under the draft 2007 budget). However, this is an overestimation because roughly 14.9% of Member States' contributions to the Community budget derive from the so-called traditional own resources (TOR)[10] and another 15.3% is accounted for by a VAT-based resource. In the case of Greece, the upward revision of GDP will leave these payments unaffected: first, customs duties and agricultural duties (TOR) are levied on imports of products coming from third countries, at rates based on the Common Customs Tariff, and as such have nothing to do with the kind of revision undergone by Greek GDP; second, the own resource that is based on value added tax (VAT), being levied on Member States' VAT bases[11], will also remain unaffected as the National Statistical Service has not been able to adduce any expansion in the country's tax base concomitantly with the revision of GDP figures. However, the upward revision of GDP will not leave unaffected the third EU budget resource, *viz.*, the resource based on Member States' gross national income (GNI)[12]. As the GNI-based resource accounts for around 68.7 % of total EU revenue, we can expect any increase in Greece's contribution to the budget attributable to the upward revision of GDP to be less than proportional to the increase in GDP in question, and, in particular, to be somewhere in the region of 65%-70% of the aforementioned 25%. In cash terms, this should amount to an extra contribution in the neighbourhood of €234m (in addition to the €1.85bn provisionally budgeted for next year). As regards Greece's expected revenues from the EU budget, the argument is that Greece as a whole will no longer qualify for Cohesion Fund support (*i.e.*, funding given to countries with a per capita GDP of up to 90% of the EU average), having now reached per capita income levels just above the EU25 average. At last December's decisive European Council, Greece was awarded €3.2bn from the Cohesion Fund out of a total of €20.1bn in structural funds as part of CSF IV. Assuming an absorption rate of €470m from the Cohesion Fund every year (2007-2013), Greece risks losing €1.4bn in the period 2011-2013 if Greece is henceforth deemed ineligible for Cohesion funding at

[10] "Traditional own resources" consist of customs duties, agricultural duties and sugar levies.

[11] Member States' VAT bases are harmonised for this purpose in accordance with Community rules, with the same percentage being levied on the harmonised base of each Member State, subject to a small adjustment, benefiting less prosperous countries, in order to rectify the fact that VAT tends to account for a higher percentage of a country's national income at relatively lower levels of prosperity.

[12] The GNI-based resource is used to balance budget revenue and expenditure, *i.e.*, to finance the part of the budget not covered by any other sources of revenue. The same percentage rate is levied on each Member States' GNI, in a manner that accords with Community rules.

the mid-way review planned for 2010. For their part, funds originating from the main Structural Funds are not, for the time being, at risk because they were calculated on the basis of 2000-2002 GDP figures and no mid-way review is planned in their case.

Part B

Special Focus Topics

- **Progress on EU structural funding for Greece**
- **The impact of housing wealth on Greek economic activity**
- **Structural issues**

Progress on EU structural funding for Greece

- **The share of the EU co-financed component of the Public Investment budget (PIB) for 2007 is planned to reach previous record levels (72.6% relative to 72.8% in 1998), reflecting the need to accelerate the execution of the 3rd CSF.**
- **The EU Commission declined the Greek government's requested one year extension for the execution of the 3rd CSF, but proposed a set of measures which facilitate the absorption of €2.7bn of EU funds, but at the cost of simultaneously reducing the size of the 3rd CSF by €1.7bn.**
- **The reduction in the size of the 3rd CSF results in a reduction of the public deficit by a cumulative amount of €1.7bn over 2007-2008.**
- **Total funds under the 4th CSF, now renamed as: the "National Strategic Reference Framework" (NSRF) for 2007-2013, amount to €36.3bn, out of which €24.3bn are EU funds and €12bn are national funds.**
- **NSRF´s available EU funds for Greece are less than those under the 3rd CSF not only as a percent of GDP but in euro amounts as well, reflecting the reality of the EU enlargement and the nature of the new EU objectives, a possible weakening in the Greek bargaining position, but mainly the rise in Greek living standards and the subsequent ineligibility for funding by the richer Greek regions.**
- **81% of EU funds under the NSRF are expected to be allocated to regional projects.**

The Public Investments Budget (PIB) for 2007 reflects the need to accelerate the execution of the 3rd Community Support Framework (CSF) 2000 – 2006[13] and to facilitate the inception of the National Strategic Reference Framework (NSRF) 2007 – 2013. According to the 2007 draft budget, PIB expenditure is projected to reach €8.75bn in nominal terms next year. As a percentage of GDP, PIB expenditure is expected to amount to 4.2% in 2007, same as in the current year. The purely nationally-funded part of the PIB will be reduced in nominal terms for a third consecutive year in 2007 to €2.4bn (1.15% of GDP), as part of the effort to curb spending and achieve the targeted reduction in the general government budget deficit. However, the EU co-financed part of the PIB is expected to increase to €6.35bn (3.05% of GDP) next year, remaining in a rising trajectory since 2002.

CSF III

In June 2006, the Greek Government requested an extension of the December 2008 deadline for the execution of 3rd CSF projects to December 2009. As we have pointed out in our previous issue (July 2006) of our Greek Macro Monitor, without the extension, a significant acceleration in the execution of the 3rd CSF would be required. The extension was deemed necessary in order to ensure both the completion of critical infrastructure projects and to avoid the loss of available EU funds. Not surprisingly, this request was rejected by the EU Commission. Nevertheless, the Greek government succeeded in pushing a number of measures that facilitate the future absorption of EU funds:

- ✓ A restructuring of the Operational Programs with the introduction of new projects, presumably with a higher possibility of being ready on time, of an estimated value of €0.5bn of EU funding.
- ✓ According to the initial rules of the 3rd CSF, a project is eligible for EU funding only if it is completed by at least December 2008. This rule will be partially abolished,

[13] The projects of the 3rd CSF will have to be completed by the end of 2008.

since the Commission will accept the EU co-financing of expenses for 180 projects that will not be ready by December 2008. The estimated value is €1bn of EU funding.

- ✓ The Commission will allow higher levels of co-financing for 2006. That means that a higher percentage of project expenses will be financed by EU funds than was initially planned. The estimated value is €1.2bn of EU funding.

The above measures,

- ♦ Will facilitate the absorption of €2.7bn of EU funds or 11.9% of total available EU funds. At the beginning of September 2006, 49% of total EU funds were cashed out.
- ♦ Will reduce the size of the 3rd CSF. The increase in the co-financing levels for 2006 deprives €1.7bn of public funds (EU plus national funds) from projects planned for 2007 and 2008. These projects will now have to be cancelled. The total available national funds under the 3rd CSF were reduced by €1.7bn.
- ♦ Will reduce the public deficit. In 2007, it is estimated to decrease by at least 0.8 percentage points of GDP, assuming that the €1.2bn of EU funds for 2006 projects will be collected in 2007 and that €0.5bn of national funds will not have to be spent. These assumptions seem to be incorporated in the 2007 budget.

Despite the above measures, the pressure for an acceleration in the execution of the 3rd CSF though remains strong. The most recent official data prepared for the 9th Monitoring Committee in June 2006 imply that public expenditure on 3rd CSF projects would need to accelerate to approximately €568m per month between June 2006 and December 2008 from €342m per month in 2005, so as to prevent any losses of available funds. No updates of these figures have been made public since June. Updates have been available, however, for new contracts for CSF projects and the absorption rates of EU funds.

New Contracts

By the end of October 2006, 77% of the 3rd CSF had reached and/or passed the first stage of a signed contract. The timely signing of contracts 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. 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.

The Flow of New 3rd CSF Projects with a Signed Contract (% of total CSF III public funds)						
	2001	2002	2003	2004	2005	Jan. – Oct. 2006
Annual Rates	12.6	13.0	12.5	10.8	13.3	14.8
Cumulative Rates		25.6	38.1	48.9	62.2	77.0

Absorption Rates

As we mentioned before, at the beginning of September 2006, 49% of total EU funds were cashed out, or €11.1bn out of a total available amount of €22.7bn.

The Absorption Rates of EU 3rd CSF Funds (% of EU funds)						
	2001	2002	2003	2004	2005	Jan. – 5/9/06
Annual Rates	9.2	5.8	6.1	9.6	9.4	8.8
Cumulative Rates		15.0	21.1	30.7	40.1	48.9

NSRF 2007 – 2013

At the end of October, the Greek Ministry of Economy and Finance submitted to the European Commission the National Strategic Reference Framework (NSRF) for the programming period 2007 – 2013. The NSRF will be finalized after taking into account the Commission's remarks. The government also plans to submit for approval by the end of 2006 all Operational Programs (Sectoral and Regional). Down-payments for these programs will be made only after their approval by the Commission. The Ministry has expressed the belief that all programs will be approved by the summer of 2007.

EU Funds

The expected allocation of EU funds to Greece for the period 2007 – 2013 amounts to €20.4bn in current (2006) prices. The sources of these funds will be the European Regional Development Fund (€12.5bn), the European Social Fund (€4.2bn) and the Cohesion Fund (€3.7bn). Apart from these sources, Greece is estimated to receive another €3.9bn for rural development and from the Fisheries Instrument. These would amount to a total €24.3bn of EU funds allocated to Greece in the period 2007 – 2013. Allocated funds from the first three sources (i.e., not including the allocations for rural development and from the Fisheries Instrument) under the 3rd CSF 2000 - 2006 were €24.7bn (2004 prices), an amount higher than the €18.2bn Greece is set to receive from these sources between 2007 – 2013 if the latter amount is also expressed in 2004 prices[14]. The main reason for this reduction is the change in regional eligibility and the number and nature of objectives in the two programming periods.

Five Greek regions (Attica, South Aegean, Central Greece, Central Macedonia and Western Macedonia) are now in a transitional stage since they have achieved development levels that reduce the need for EU structural funding. These five regions are not considered Convergence Regions anymore (i.e., what was called regions supported under Objective 1 in the 3rd CSF) and from now on they will be receiving less funding[15]. Central Greece and South Aegean in particular will see EU structural funding being reduced to zero by 2011. Available funding is not negligible though, with 34.8% of total available EU funds (€7.1bn out of €20.4bn) having been allocated to these five transitional regions. Moreover, the total amount allocated to the broader region is €16.5bn, meaning that 81% of EU structural funds will go outside Athens.

The recent upward revisions to Greek GDP figures for the period 2000 – 2005 has raised

Indicative Financial Allocation of EU funds for 2007 – 2013 (ERDF, ESF & CF)		
	Billions €	**% of EU - 27**
Greece	*20.4*	*5.9*
Poland	67.3	19.4
Spain	35.2	10.1
Italy	28.8	8.3
Czech Republic	26.7	7.7
Hungary	25.3	7.3
Portugal	21.5	6.2
Slovakia	11.6	3.3
Slovenia	4.2	1.2
Ireland	0.9	0.26
EU – 27	**347.4**	**100**

Source: EU Region Policy, Inforegio Factsheet October 2006

[14] Source: EU Region Policy, Inforegio Factsheet October 2006

[15] In 2000 – 2006 all Greek regions were supported under Objective 1

concerns about possible reductions in the allocated EU funds to Greece. As we have already noted, however, there is a risk of losing only part of the €3.7bn of Cohesion Funds allocated to Greece for the period 2007-2013, provided that a mid-way review planned for 2010 would deem the country ineligible for such funding.

National Funds

According to the Minister of Economy Mr. Alogoskoufis the national contribution to the 4th CSF will be €12bn, making a total of €36.3bn available for spending under the NSRF 2007 – 2013. 42% of these funds concerns infrastructure, 21% innovation, competitiveness and the information society, 12% employment, 14% education and 4% health infrastructure.

Operational Programs

The NSRF 2007 – 2013 is structured around five strategic priorities:

- ✓ Investing in the productive sector of the economy
- ✓ Information Society and Innovation
- ✓ Employment and Social Cohesion
- ✓ Institutional Environment
- ✓ Attractiveness of Greece as a place to invest, work and live.

The NSRF 2007 – 2013 will be executed through 26 Operational Programs: 8 Sectoral Programs (there are 12 Sectoral Programs under the 3rd CSF), 5 Regional Programs (13 in the 3rd CSF) and 12 Territorial Cooperation programs (interregional and cross-border cooperation). There will also be an Operational Program called National Reserve for unpredictable expenses. The allocation of EU funds to the Operational Programs is presented in the table below.

Operational Program[16]	**Millions €**
Sectoral Programs	*12,048*
Environment & Sustainable Development	1,800
Reinforcement of Accessibility	3,700
Competitiveness & Entrepreneurship	1,291
Digital Convergence	860
Human Capital Development	2,260
Education and Life-long Learning	1,440
Public Administration	505
Technical Support	192
Regional Programs	*8,003*
Macedonia – Thrace	2,675
Western Greece, Peloponnesus and Ionian Islands	914
Crete & Aegean Islands	871
Thessaly, Central Greece & Epirus	1,105
Attica	2,438
National Reserve	159
Territorial Cooperation	209
Total	**20.419**

[16] The translation in English of the Operational Programs' names is ours from the Greek version of the NSRF 2007 - 2013.

What is the impact of housing wealth on Greek economic activity?

Manolis Davradakis

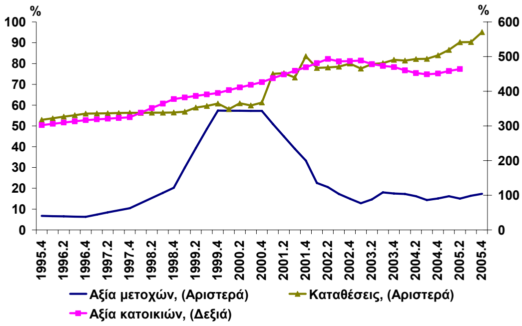
- **The growth of housing-related household wealth in Greece has a strong impact on the country's overall level of economic activity.**
- **According to our estimates, a 10% increase in housing-related wealth increases private consumption by 1.82% and GDP by 1.22%.**
- **Strong housing-related wealth effects in Greece can be attributed to the large share of real estate in households' total portfolio of assets (~ 81.5%) and the relatively low volatility of home prices.**
- **Wealth effects from housing are stronger in semi-urban areas and the countryside where the homeownership rate is higher.**

Buoyant housing market conditions contribute to economic activity via their positive side-effects on other economic sectors, namely construction and consumption. Strong housing demand stimulates residential constructors to invest more in order to widen their profit margin. Increasing investment by residential constructors improves employment in the construction sector and decreases the unemployment rate. As a result, improving labor market conditions enhance consumption and economic activity. Consumption of durables benefits more compared to consumption of non-durables, since new homeowners spend considerable amounts of money on new home appliances and furniture.

The aforementioned positive externalities stemming from improving housing market conditions complement the direct impact of housing on household wealth[17]. In particular, as housing prices increase the average homeowner becomes richer and thus, affords a more extended set of consumption choices than otherwise. In such a context, private sector consumption depends on the value of assets in households´ total asset portfolio, which may include deposits, stocks and real estate property.

Table 1 presents the composition of household wealth in financial assets and houses in seven European Union member countries, the US and the UK. Data are provided in percentage-of-GDP terms from 1995 to 2000. The table shows that over that period, housing wealth grew stronger in Greece than in any of the other countries, reaching levels slightly above 400%-of-GDP in 2000. On the flipside, Greek households allocated a far smaller share of their total wealth in financial assets, (2000: 54% of GDP), with the corresponding ratio being highest in the US (US: 341% of GDP), followed by the UK (299% of GDP) and the Netherlands (297% of GDP).

Chart 1.
Value of assets in Greek households' portfolio (% of gross disposable income)



Source: Bank of Greece, ECOWIN, Eurostat, Eurobank EFG Research

[17] Wealth effect of an asset relates to an increase in personal consumption attributed to a price increase of that asset.

Table 1.
Financial and real estate assets of households

	France		Germany		Greece		Italy		Spain		Netherlands		UK		US	
	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000
Financial assets % GDP	165	234	149	180	7	54	189	227	150	187	254	297	261	299	292	341
Real estate assets % GDP	170	206	191	191	331	403	234	220	298	334	112	182	146	191	120	130

Source: Altissimo F., E. Georgiou, T. Sastre, M. Valderrama, G. Sterne, M. Stocker, M. Weth, K. Whelan and A. Willman (2005), "Wealth and asset price effects on economic activity", *European Central Bank Occasional Papers*, 29.

Continuously rising housing prices in Greece in recent years have increased the overall value of households´ total asset portfolio. Chart 1 indicates that in 2005Q1 the value of housing stock was more than four times larger than gross disposable income. Furthermore, deposits made a considerable contribution to the total asset portfolio's value and were equal to gross disposable income at the end of 2005. On the other hand, the value of wealth in stocks has declined considerably after peaking in 1999 i.e., prior to the collapse of the Athens Stock Exchange (ASE) General Index in mid 2000.

In order to evaluate the wealth effect related to different asset classes within households' total portfolio of assets, a simple model of private consumption has been constructed. According to the model private consumption in Greece is determined by the value of stocks, deposits and houses in the households' total portfolio.[18] Variables in the model are expressed as percentages of gross disposable income. Model estimates suggest that a rise in housing prices has a more pronounced wealth effect compared to that stemming from an equiproportional rise in stock prices. According to our model, a 10% increase in housing prices will increase private consumption by 1.82% and GDP by 1.22%.

Economic literature in this area has recorded similar estimates of housing wealth for other countries. A panel study by Case, Quigley and Shiller (2005)[19] for 14 developed countries concluded that a 10% increase in housing wealth will enhance private consumption by 1.31%.

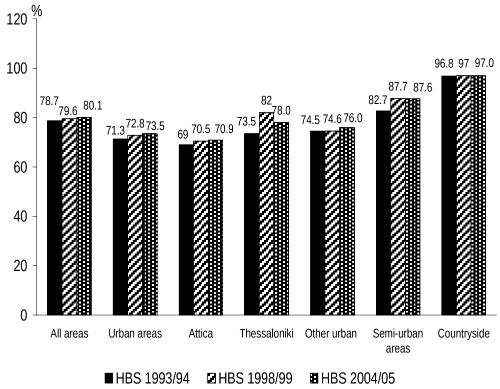
High homeownership levels reinforce wealth effects as homeowners who have a high value asset in their possession may sell it and use the proceeds to service old mortgage loans, consume or buy a cheaper house. Homeownership rates in Greece have been on the rise in recent years as indicated by three consecutive Household Budget Surveys (HBS) conducted by the National Statistics Service of Greece for the periods 1993/94, 1998/99 and 2004/05, respectively. Chart 2 shows the evolution of homeownership rates in Greece over the last two decades. The average homeownership rate (all areas) stood at 80.1% in 2004-2005, compared to 79.6% in 1998-99.

As Chart 2 shows, homeownership rates in Greece vary inversely to the degree of urbanization of the area where the homeowner lives. Specifically, the lower the degree of urbanization, the higher the

[18] Technical details on the estimation and the data set used are available in Greek at Davradakis, E. (2006), "What is the impact of global de-leveraging to Greek GDP?", Eurobank Research Economies and Markets, Issue 5, June.

[19] Case K., J. Quigley and R. Shiller (2005), "Comparing wealth effects: the stock market versus the housing market", *Advances in Macroeconomics*, 5, pp. 1-32.

Chart 2.
Homeownership rates by degree of urbanization



Source: Household Budget Surveys-National Statistical Service of Greece

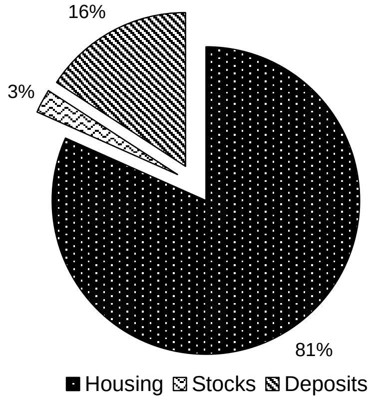
homeownership rate. Areas with different degrees of urbanization appear to have different homeownership rates due to differences in cultural norms, house building legislation, lags in the construction side etc. Thus, the significance of housing-related wealth effects depend on the urbanization of the area the homeowner lives. In the most recent Household Budget Survey for the period 2004/05 (HBS, 2004/05) the homeownership rate in urban areas was 73.5%.

The homeownership rate is higher in semi urban areas (87.6%) and reaches 97% in the countryside. These imply that the strong wealth effect due to housing found at a national level is even stronger for areas with a lower degree of urbanization, like semi-urban areas and the countryside.

Moreover, the high sensitivity of economic activity to variations in housing prices in Greece is supported by the large share of real estate property in the Greek household's total asset portfolio. In 2005Q2, 2.6% of total household wealth was invested in stocks, 15.8% in deposits and 81.5% in real estate (Chart 3).

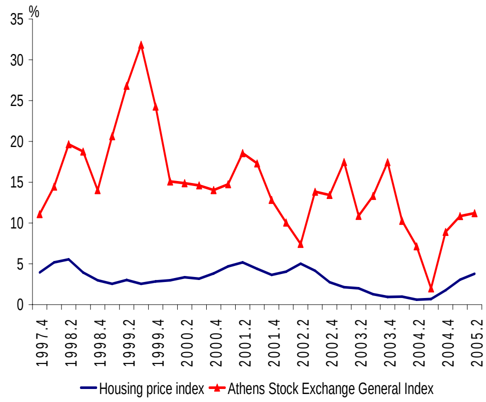
In general, the pronounced wealth effect of housing is attributed to the less volatile behaviour of housing prices relative to the price volatility of other asset classes. Low volatility of housing prices encourages

Chart 3.
Composition of Greek households' portfolio of assets, 2005Q2



Source: ECOWIN, Bank of Greece and Eurobank EFG Research

Chart 4.
Coefficient of variation of stock prices vs housing prices (four quarters rolling window)



Source: ECOWIN, Eurobank EFG Research

households to consider an increase in home prices as a more permanent one compared to, for example, an increase in stock prices, implying a stronger wealth effect from housing. On the other hand, the considerable variation of stock prices makes it more difficult for households to decide whether a stock price increase is permanent or not. Chart 4 shows the coefficients of variation of the ASE General Index and the housing price index.[20] As the chart clearly shows, the coefficient of variation for the ASE General Index is

[20] Coefficient of variation is defined as the ratio of the standard deviation to the mean of the series considered.

more volatile relative to housing prices over period 1997-2005.

According to our estimates, a 10% increase in the Athens Stock Exchange General Index raises private consumption by 0.16% and GDP by 0.11%. The much lower sensitivity of private consumption to stock prices relative to home prices can be primarily attributed to i. the small proportion of total wealth held in stocks by Greek households (2005Q2: 2.6% of total wealth) ii. the limited ownership of total stock market capitalization Greek households have and iii. the high variation of stock prices.

In conclusion, our analysis suggests that a 10% increase in households' housing-related wealth increases private consumption by 1.82% and GDP by 1.22%. The pronounced wealth effect of housing in Greece is attributed to the large share of real estate in households' total portfolio of assets (81.5% of the overall portfolio). The wealth effect from housing is stronger for semi urban areas and the countryside where the homeownership rate is higher. Existing literature suggests that the magnitude of the wealth effect due to housing recorded in other developed countries is attributed to the lower volatility of housing prices relative to other asset classes. This feature is particularly strong in Greece where for almost a decade now volatility of home prices is considerably lower than that of stock prices.

Education reform stalls

Certain key areas in the Government's reforms programme have not fared well. An important pledge was that of education reform. A government-appointed panel, the "Veremis Commission", made public its proposals in early May[21]. Educators and students generally objected, including to government proposals for a constitutional amendment that would allow the establishment of non-profit universities. Instead, they demanded that the Government increase spending on state education. (New Democracy had promised to channel 5% of GDP to public education; the draft budget for 2007 foresees no more than 3.1%, *down* from 3.67% this year and 3.62% last year. In the EU it is 5.2%). Protests culminated a month later with violent clashes and occupations of faculty buildings. The Government backed down and announced that it would postpone submitting to Parliament its tertiary-education reform bill until September, purportedly to allow "more debate". This debate was to open with the unveiling of a draft bill on 21 June[22], but student activists backed by some academics rejected it out of hand, and sit-ins gave way to more violent protests.

By the end of August, more unrest was brewing, this time at the level of university candidates, as a result of a new rule introduced last year by the Education Ministry mandating that students must achieve average grades of at least 10 out of 20 to be admitted to a university or technical college (TEI). This resulted in 18,768 vacant positions, mostly in regional TEIs, which help sustain the economies of many small communities. Things took a turn for the worse on 18 September when members of the Greek Primary Teachers' Federation (DOE) embarked on a six-week-long strike demanding major pay rises[23]. They were joined, in solidarity, by high-school teachers two weeks later. The Government maintained a hard line, and teachers returned to their duties on 30 October, only to be succeeded in their protestations by pupils occupying their schools. Meanwhile, the Government – while insisting all the while that it will not backtrack on education reforms – decided to push back until January (from end-October) the submission to Parliament of the draft bill on tertiary-education reform, allegedly in order to avoid exacerbating tensions in the sector. In this, it received indirect backing from Pasok, who took the initiative to ask for a postponement of a debate in Parliament scheduled for 25 October on Article 16 of the Constitution on non-state universities (Pasok is divided on the issue). A week later, it transpired that the bill would not be tabled in Parliament before next June, while the parliamentary debate on Article 16 will take place at the end of January.

2007 Budget: Focus on fiscal rectitude

The Government's main concern now is to ensure that the excessive deficit procedure against Greece is brought to

[21] These included the adoption of common programmes with foreign institutions; that teaching should also be carried out in languages other than Greek; that theses for some courses could be written in foreign languages, thus allowing non-Greek professors to teach at Greek universities; that universities should be able to remove students who failed courses repeatedly or took too long to complete their studies (a.k.a. "perennial students").

[22] Its main proposals included boosting universities' financial autonomy, introducing internal regulations for universities' operation, and offering students an extra five years to complete their studies beyond the normal duration of courses (it is practically limitless now). Another proposal to grant more power to deans at the expense of governing councils (which include students) to decide when to lift university asylum – the institution most abused by anarchists – also antagonised students.

[23] Teachers demanded a starting salary of €1,400 as compared with the current €950.

an end by spring 2007, having in the meantime effectively met an Ecofin Council deadline (imposed in February 2005) to bring the budget deficit to under 3% of GDP by end-2006.[24] For its part, the 2007 draft budget purports to bring the deficit down even further (from 2.6% of GDP to 2.4%). Not only will this be touted as a great success in itself[25]; it will also give the Government more room to manoeuvre in the run-up to the general election, whenever the latter is held.

Be that as it may, the 2007 budget was seriously criticised in many quarters. Pasok's Vasso Papandreou called it a "*worthless parchment*" that was "*up in the air*". She wondered how it was that the public debt in 2006 fell by only €1.2bn when privatisation receipts exceeded €1.7bn.[26] She also asserted that the new distribution of the tax burden would privilege the "haves". To support her point, she highlighted the case of those who were within the €12,000 to €23,000 income range: these taxpayers not only would be facing a higher tax rate (the low, 15% rate, is abolished), but would also have to confront the effects of the more general shift toward greater indirect, as opposed to direct, taxation underlying the budget.

SEV, the Federation of Greek Industries, was equally scathing. SEV President Dimitris Daskalopoulos not only called the 2007 budget "*timid*", but also questioned the transparency of the figures. He claimed that the budget did not contain "*measures that will ensure permanent fiscal health and does not reflect any wish for real structural reform*". As part of the effort to reduce the budget deficit, he said, investment expenditures are kept low (in real terms, levels for 2007 are almost at those for 2002). Yet such investments, including in infrastructure and education, "*are the most crucial economic policies*". For its part, GSEE insisted that the budget favoured those with higher incomes, while at the same time decrying the low level of spending on education which, according to the unionists, leads to "*an even worse social policy*".

Reforms in practice

Since the Government has undertaken a substantial number of initiatives in the area of structural and institutional reforms, it may be worth reviewing how these are faring in practice. The record is mixed:

- Efforts to push forward **social-security reform** are restricted to a "dialogue" among social partners within the framework of the Economic and Social Committee (OKE). The Government says it will not put forward any definitive proposals for the duration of its current term-of-office, despite mounting evidence of the longer-term unsustainability of the system[27]; at the same time, it insists that it has no intention of prolonging people's working lives (for the vast majority of workers), increasing their contributions or reducing their pensions. (This lack of urgency has seemingly also afflicted the merger of seven main pension funds into IKA, despite the fact that a law voted by the previous government in 2002 made this merger, as well as one among 27 auxiliary funds, mandatory.)
- Government lawyers redrafted a **presidential decree** on the implementation of a law setting up **ETAT** (3371/2005), the new

24 The Ecofin Council's first decision on the existence of an excessive deficit was issued on 5 July 2004.

25 It is recalled that the budget deficit for 2004 was finally recorded at a sky-high 7.4% of GDP and the 2005 deficit at 5.1%. Therefore, 2006 was a critical year insofar as the deficit fell by an alleged 2½ percentage points.

26 Having said that, the draft budget for 2007, on p. 107, posits an estimated public debt for 2006 of €203,190m, *vs.* €194,666m for 2005. That is a 4.37% *increase* in nominal terms. Translated into real terms, it is still positive – though declining as a proportion of GDP.

27 There are now 1.77 contributors for each pensioner. 15 years ago, the ratio stood at 1-2.4.

banking-sector auxiliary fund[28]. In so doing, they successfully overcame a number of fundamental objections put forward by the Council of State (12 July). The Government claims that this has contributed to the smooth working of the industry and allowed such things as the privatisation of Emporiki Bank to go ahead. Despite most banks' willingness to go along with the new arrangement, hardly any progress has been registered on the ground, probably because the strong objections of a number of workers' unions are well known, and because of an on-going dispute between banks and their employees over collective contracts (negotiations were broken off on 2 October).

- The **Law on Reform of Public Entreprises** (3429/20.12.2005) has produced mixed results. In many if not most DEKOs, collective wage pacts agreed earlier this year flouted rules compelling them to remain within the limits of incomes policy. Further, according to press reports, the business plans submitted to date generally have been under par. Lastly, managements are apparently dragging their feet over the obligation to revise rules of internal operation, forcing the Government to extend the deadline several times. Having said that, the Government moved unilaterally in the case of OTE on 10 November (as allowed by the law in case of disagreement between employers and employees) and said it would introduce new provisions on hiring and employment based on private-sector practices.
- The **OTE telecom's voluntary retirement scheme** – the Government's flagship reform in the public-entreprise sector – is under investigation from the European Commission, which is citing the possible presence of illegal state aid.[29] (As part of its privatisation plans for next year, the Government will be putting up for sale a substantial portion of its 38%-stake. It is not clear at this stage whether the Government will insist on finding a strategic investor, or whether it will opt for a straightforward divestment. The Government hopes to complete the process by June 2007.)
- A solution to the **Olympic Airlines** conundrum seems no closer, despite the fact that the European Commission has asked the European Court of Justice (18.10.2006) to fine Greece for its failure to recover €160m in illegal state aid given to OA between 1998 and 2002[30]. (The Commission has also taken Greece to court for failing to recover about €540m of state aid given to Olympic from 2002 to 2004.) Yet, the Government insists that this does not imply automatic bankruptcy of the company. It is not clear where the situation is heading as all attempts to sell the company so far have led nowhere.
- The very slow pace of liberalisation of the energy sector.
- Although the 2007 draft budget paints a rather rosy picture regarding the rate of implementation of the **CSF III**[31], it has been clear for some time that Greece risked losing billions of EU funds as a result of delays in implementation. Following negotiations with the Commission, it was announced (15.11.2006) that Greece would now be able to transfer some funds to CSF IV (2007-2013). (A request to add an extra year to

[28] See *Efimeris tis Kyverniseos*, No. 209, 5 October 2006.

[29] Under Law 3371/2005, the Government was to transfer, for free, shares equivalent to 4% of OTE's equity in its possession to TAP-OTE (worth about €300-350m). This was meant to underwrite 20% of the cost of OTE's voluntary retirement programme.

[30] The Commission asked the Court to impose a fine of €10,512 a day retroactive to 12 May, the day the ECJ confirmed that Greece had not recovered the money.

[31] For example, projects worth over ¾ of the total CSF have now been contracted out, while Community inflows have exceeded half those earmarked for Greece. See pp.29-20 of the draft budget.

the two normally allowed to complete implementation of projects already contracted out was refused). At the same time, Greece would be able to reduce the size of the national contribution on a number of projects. This will reportedly save Greece about €1.2bn in matching funds and help absorb some of the €10.5bn in EU aid that remain unabsorbed. The country's tight fiscal policy meant that Greece, until now, lacked the resources to put up the required matching funds. At first sight, the deal will not entirely prevent the loss of EU funds.

All the above features are not unrelated to Greece's poor standing in the international economic and business competitiveness league tables published by various international organisations. Thus, Greece ranks 109th among 175 countries in the World Bank's latest *Doing Business Report*. And while it may have climbed to 42nd position in 2005 from 50th the year before (out of 61 countries) in the IMD's 2006 report, between 2000 and 2002 it ranked between 31st and 36th.[32]

[32] Institute of Management Development, *World Competitiveness Yearbook 2006*.