Eurobank EFG Economic Research

Eurobank EFG

Greece: Macro Monitor

A Quarterly Review of the Greek Economy

Gikas Hardouvelis
Chief Economist
Director of Research
GHardouvelis@eurobank.gr

Platon Monokroussos
Head of Financial Markets Research
PMonokrousos@Eurobank.gr

Constantine Papadopoulos
Advisor for European Affairs
CPapadopoulos@Eurobank.gr

Costas Vorlow
Research Economist
CVorlow@Eurobank.gr

Theodosis Sampaniotis
Senior Economic Analyst
Tsabaniotis@Eurobank.gr

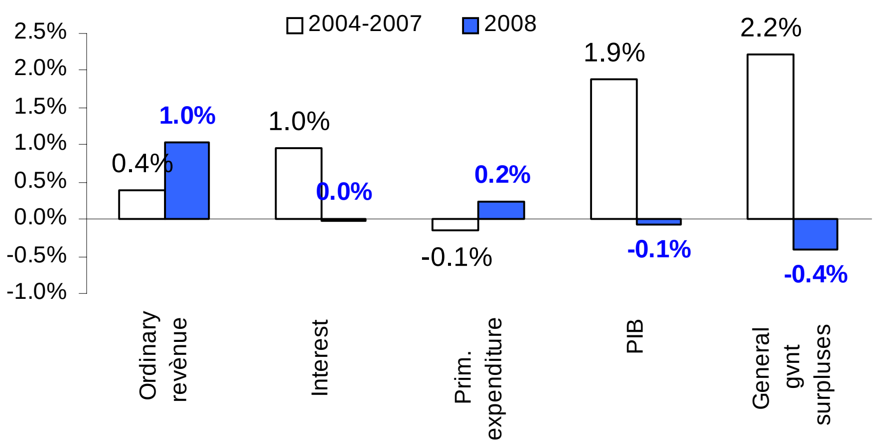
Tackling "hard core" of reforms agenda

- Full-year real GDP growth is expected to come in at around 4.1% in 2007, exceeding a 3.9% initial official projection. Domestic demand remains the main engine of economic activity, while the external sector continues to exert a negative contribution. Economic prospects for the coming 2-3 years look favorable, with annual GDP growth rates expected in the 3.5-4.0% region. Variations in the composition of future growth are likely to be marginal, with economic activity remaining domestic demand-driven.

- According to the 2008 draft budget, the bulk of fiscal adjustment next year is projected to come mainly via higher ordinary-budget revenues, which are projected to slash as much as 1ppt-of-GDP off next year's general government budget deficit. Medium-term challenges to fiscal consolidation include: (i) expenditure pressures due to large interest payments and amortization costs, (ii) the need to run sizeable public investment budgets (PIBs) in the years ahead in order to facilitate the proper absorption of EU structural funds, (iii) widespread tax evasion hindering efforts to maintain a strong pace of revenue growth without resorting to additional indirect taxation, and (iv) the need to generate the necessary surpluses for implementing a long-due overhaul of the country's social security system

- Re-elected conservatives tackle "hard core" of reforms agenda (balanced budget, pensions reform, privatisations) while targeting a more efficient social policy. Government pledges to continue reform of state enterprises, and to extend rationalisation efforts to local government, hospital and pension funds. Creating a truly business-friendly environment and a more transparent system of administration remain among top challenges.

Net contribution to the cumulative adjustment in the general gvnt balance (in % of GDP terms)



Greece: key macro indicators

y/y grwoth	**2006**	**2007f**	**2008f**
GDP (constant prices)	4.3	4.1	3.9
Private Consumption	*3.2*	*2.8*	*2.8*
Public consumption	*3.8*	*4.3*	*2.0*
Gross fixed capital formation	*12.7*	*7.2*	*7.5*
Exports g&s	*5.4*	*7.0*	*6.5*
Imports g&s	*9.8*	*6.8*	*6.0*
National CPI (average)	3.3	2.8	2.8
Budget deficit (% GDP)*	2.5	2.4	1.6
Public debt (% GDP)*	95.3	92.4	89.4
Current account deficit (% GDP)*	11.1	12.6	12.0
Unemployment rate	9.3	8.3	7.5

Source: Realisations & EFG Eurobank forecasts

** Based on the revised GDP data*

Research Team:
Gikas Hardouvelis, *Chief Economist and Director of* Research
Platon Monokroussos, *Head of Market Research*
Paraskevi Petropoulou, Economist
Roubiniana Drakopoulou, Economist

Sales Team:
Fokion Karavias, *Treasurer*
Dimos Arhodidis, Danai Manoussaki
Kostas Karanastasis, Nikos Laios, Alexandra Vogiatzi,
Alexandros Tsourinakis

EFG Eurobank Ergasias, 8 Othonos Str. GR 105 57, Athens, Tel:(30210) 3718 906, 3718 999, Fax:(30210) 3337 190, Reuters Page: EMBA
Internet Address: http://www.eurobank.gr

Political and Economic Overview: *Reforms Agenda to Address the More Contentious Issues*

New Democracy's win in the general elections of 16 September is expected to set the stage for a second round of major reforms aimed at modernising the economy, overhauling the State's administrative capacity and improving the education system. Reform of the state pension system – plagued by the country's dire demographics, huge evasion of dues1 and convoluted administrative structure – has been singled out as a major objective, deliberately pushed back to a second ND term-of-office in order to make room for a preliminary exploratory dialogue during the first term. The latter may not have led to any convergence of views, but it did produce the Analytis[2] report, a first attempt at pointing out the weaknesses and distortions of the present system and proffering in broad outline a list of possible remedies. Fiscal consolidation, too, was (and is) a continued priority, in parallel with a more effective social policy: following the country's exit from the excessive-deficit procedure in June 2007, Greece must now fulfil another goal alongside her EU partners, *viz*., achieving a balanced budget by 2010. (In 2006, ten Member States already registered a budget surplus.[3]) This assumes a more-than-0.5 percentage-point reduction in the budget deficit every year until the goal is achieved, presupposing in turn more effective measures against tax evasion, further spending cuts and a more rational targeting of social expenditures, as the Government is first to admit. On the latter subject, Minister Alogoskoufis presented on 17 October a new bill for the establishment of a National Fund for Solidarity and Social Cohesion (ETAKS).[4]

Events of the last few weeks lend support to Economy and Finance Minister George Alogoskoufis' observation that the Government is now faced with the "hard core" of economic-policy matters. Not only is budget consolidation at the stage where further moves may even require tax increases (VAT has been mentioned and perhaps taxes on tobacco and alcohol – see below), but on a range of issues effective progress will require addressing some of those more-sensitive aspects – politically and socially speaking – that the Government until now had put off while it dealt with certain relatively less-controversial ones (e.g., in addition to pensions reform, the Government will have to decide, as part of its privatisation policy, how far to go in relinquishing control over OTE and DEH; and what to do with chronic loss-maker Olympic Airlines).

The **National Reforms Programme** (NRP) that the Government submitted to the European Commission on 22 October[5] contained a number of promises relating to fiscal consolidation, pensions reform, the privatisation of public entreprises, the "reform of the system of taxation and operation of the fuel trade", and the "simplification" of the taxation system for property ownership. In practice, all of these are still works-in-progress (see below).

Eurostat's rejection this month of the **Economy Ministry's** 25.7% **upward revision of GDP** in favour of a more modest 9.6% (2002-2006) has greatly revived the Government's anxiety over the whole issue of fiscal balance. Whereas the proposed revision of GDP figures would have made for a more comfortable fiscal position in the next few years – and provided greater leeway for a more leisurely implementation of reforms in general, including social security – this is no longer the case. This tighter budgetary environment may explain some of the lapses that have characterised recent attempts to introduce a number of new fiscal measures. Indicative of the contradictory effects of the revision on the country's budgetary position is the calculation that the budget deficit as a proportion of GDP for 2007 will probably be revised downward, from 2.5% to 2.3%, but because of a directly-related retroactive, albeit one-off, €750m payment to the Community budget, the final number may end up being closer to 2.6%. Subsequent years will be relieved of this burden. Therefore, other things being equal, future fiscal data will yield better outcomes.

---

[1] Estimated at €2bn annually; see, *Kathimerini*, 11 October 2007.

[2] Nikos Analytis, a former vice-president of SEV, the Federation of Greek Industries, and until recently chairman of OKE, the Economic and Social Committee, was put at the head of a group of "wise men" entrusted by the Government with the task of submitting a report describing the current state of the social-security system.

[3] Eurostat News Release STAT/07/142, 22 October 2007, http://europa.eu/rapid/pressReleasesAction.do?reference=STAT/07/142&format=HTML&aged=0&language=EN&guiLanguage=en.

[4] The bill sets up income support programmes for specific groups and households living near or under the poverty line, with the use of a range of criteria. ETAKS' budget is planned to rise to €2bn by 2011.

[5] http://www.mnec.gr/export/sites/mnec/el/economics/Ethniko_Programma_Metarrythmisewn_Gia_Thn_Anaptyksh_Kai_Thn_Apasxolhsh/Ekthesi_Efarmogis_18-10-2007.pdf

An issue that grabbed the headlines in the first half of October was the possibility of a one or two percentage-point **increase in VAT**, purportedly to help the Finance Ministry meet its fiscal target for next year (1.7%-of-GDP, down from about 2.5% this year). The rumours were met with much opposition from the business sector (and a few ND deputies), and were seen as contradicting pre-electoral statements by the Government to the effect that a VAT hike was not in the Government's intentions. A few days later, Minister Alogoskoufis proclaimed that a VAT increase was a weapon of last resort, adding that if the Government stuck to its reforms relating to the management of health service, local authorities and public enterprise finances, there will not be a need to raise additional revenues from VAT either next year, or in the subsequent years 2009-2010.[6] One of the biggest challenges facing the Government turns exactly on the issue of whether it will be able to continue down the path of fiscal consolidation without causing a worsening of the current balance between government outlays and government receipts. The draft budget for 2008 posits that this is possible – even as it budgets a 9.5%-increase in the total salaries-and-pensions bill for the central government, an ill omen under the circumstances.

Related to this issue is the recent effort, by the Government, to clamp down on **tax evasion in the fuel sector**. The illicit trade in fuel products is estimated to be worth around €1.5bn to €2bn a year, leading to an estimated loss of tax revenues of about €600m annually. After the elections, Minister Alogoskoufis announced that by 15 October (subsequently postponed to 1 January) the special tax on gasoline would also apply to heating oil (this discrepancy was at the root of much of the illegal activity), though consumers would be refunded in full. A week later, and after the Finance Ministry had examined various schemes, it was decided that the measure could not be properly implemented in practice, and was withdrawn.

The substitution of a **single property tax** for the current multiple charge system was also announced after the elections. Implementation of the latter has been postponed pending a closer study of the associated income-redistribution, budgetary and sectoral effects.

[6] Speaking at a press briefing on the sidelines of the IMF meeting in Washington, D.C., 22 October 2007.

The dialogue on **pensions reform** got off to a less-than-auspicious start on 18 October, when the inaugural meeting bringing together (in a parliamentary committee room) representatives of political parties (not including the Communists, who refused to attend) and trade unions was disrupted by the walking out of Pasok's and Syriza's MPs who cited the lack of any framework for the discussions in the form of concrete proposals by the Government supported by any specific working documents (a long-awaited actuarial study will, according to the Government, be submitted by the end of October, thus paving the way for Pasok MPs' returning to the table.) Though trade-union representatives decided to stay (even as they called for rallies and strike action over the next two months), they did pose some conditions for their future participation in the talks which may yet prove critical (unionists want the Government to acquit its debts to IKA[7], honour a legal commitment, made by the last Pasok government in 2002, to transfer 1% of GDP annually to it[8], and explain at the outset how it envisages the future funding of the whole system). And although the Government has promised not to touch the retirement age and the level of pensions, it remains to be seen how the trade-unions will react to attempts to address such thorny issues as the planned amalgamation of a number of funds[9], the level of contributions, early retirement and the designation of certain jobs as onerous and hazardous.[10] Whatever the outcome of this dialogue, Minister George Alogoskoufis has already begun to lower expectations by introducing the possibility of gradual reforms over a longer period, on the grounds that "*no-one expects a single government to solve the pensions problem in its entirety*".

[7] According to Yiannis Panagopoulos, president of the Greek General Confederation of Labour (GSEE), the State owes IKA about €4bn, money owed not only from the government budget, but also as an employer collecting contributions that it has not paid in; see *Kathimerini* (English-language edition), 12 October 2007. In addition,

[8] According to Employment and Social Protection Deputy Minister Sophia Kalantzakou, since 2003 the actual rate fluctuates around 0.88% of GDP per year on average; see, *Kathimerini*, 12 October 2007.

[9] Today, there purportedly exist 174 pension funds. At a minimum, merging some of them would reduce many of the associated administrative costs.

[10] As regards this last category, in Germany only coalminers qualify, while in Japan no such distinct category is recognised. In Greece, 157 professions fall under the "onerous-and-hazardous" category, affecting 47% of those receiving social insurance, according to unofficial data.

On the matter of **privatisations**, successive placements and buy-outs over the years have reduced the range of possible targets. The Government still controls a 44.4%-stake in the Postal Savings Bank (TT) and a 77.3%-stake in the Agricultural Bank (ATE), not including another 1.75% controlled by the pension funds (the two banks' on-going restructuring plans will have to be completed first before any further divestments are considered); the State is also an important shareholder in Attica Bank[11], also considered a potential privatisation target; a 38%-stake in OTE; a 51.1%-stake in DEH; and a 65%-stake in DEPA (another 35% is in the hands of Hellenic Petroleum, itself 35.4%-owned by the State – though we hasten to add that nowhere in the National Reforms Programme is DEPA mentioned as a potential privatisation target). The Government will face once again the dilemma whether to bring in a strategic investor of its own choice in each case, or proceed with piecemeal market placements. However, the latter raise the sensitive issue of what happens to management control down the road. Thus, other than the cases of ATE (where the Government has ruled out relinquishing control) and DEH (where it seems clear that for another two to three years at least the Government will not cede management), it is not entirely clear what the Government's strategy is with respect to management control (TT, OTE). Other areas cited by the Government include a reduction in the State's share in the Athens International Airport (a stock-market listing depends on an agreement with co-owners Hochtief of Germany). With regard to the ports, the Government is said to want to hand over container freight stations to private investors, while the development and management of some smaller ports will be entrusted to private firms *via* the public-private partnership route. Finally, certain properties currently in the possession of ETA, the tourist-asset corporation, including the Phaleron marina, the Corfu casino, the Afandou golf course in Rhodes and various Xenia hotels, are also expected to find their way to commercial exploitation mainly *via* long-term leasing contracts.

Another area requiring more effort on the part of the authorities is that of **public entreprises**, where implementation of Law 3429 of 2005 – by Minister Alogoskoufis' own admission[12] – has so far yielded only "partial" results, with some "gaps" and "distortions" still in evidence. The Government's goal is now – in line with a commitment recently taken up with the European Commission – to extend the kind of reforms applying to public entreprises to local government, public hospitals and the pension funds, entities that currently do not draw up budgets, nor publish financial statements. Hospitals, *e.g.*, do not have at their disposal data describing the use of consumable supplies, medicinal drugs and capital equipment per patient. Minister Alogoskoufis says that a start will be made now, but that completion of this particular reform will take considerable time. Finally, despite a number of legislative and administrative initiatives undertaken by the Government in its previous term, Greece has made little to no progress in terms of her performance in the world-wide competitiveness league-tables drawn up by some of the most authoritative international organisations describing such features as ease of doing business and various key governance indicators.[13] This issue, directly linked to bureaucratic ineptness and inefficiency, should also become a top priority.

All in all, the Government seems to have got off to a less than wholly confident start, despite the positive momentum displayed in the days right after the elections. With main opposition Pasok currently in the throes of a post-election-defeat leadership contest – and therefore to a large extent on the sidelines of day-to-day politics – the conditions would appear at first sight relatively favourable to the Government. However, this view ignores two factors. First, the whole make-up of the reforms agenda, which now is focused necessarily on the more difficult issues left over from the previous period. And second, the Government's slim majority: this may lead to a greater sense of common purpose among ND's 152 members of Parliament, but, equally, it may more easily encourage dissension on the part of the marginal, disgruntled, MP. Be that as it may, some government initiatives may also have to be postponed somewhat until the Pasok leadership issue is settled (reform of the electoral law[14], education reforms).

[11] The State in effect is a main shareholder of Attica Bank *via* the Postal Savings Bank's and the Consignments and Loans Fund's joint possession of 38% of the bank. Another approximately 42% is owned by the Engineers' pension fund TSMEDE. The latter, according to press reports, would be prepared to reduce its stake in order to enable the Government to go ahead with its plans.

[12] Speaking at the Federation of Greek Industries on 16 October 2007.

13 See, Greek Bi-weekly, 20 September 2007, pp. 4 and 5.

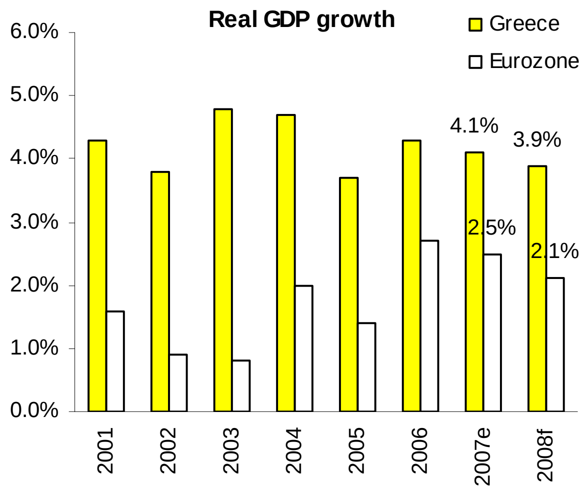
14 ND is known to want a change that will reinforce the winning party, in terms of parliamentary seats allocated, in any electoral contest.

A review of recent macroeconomic developments and outlook

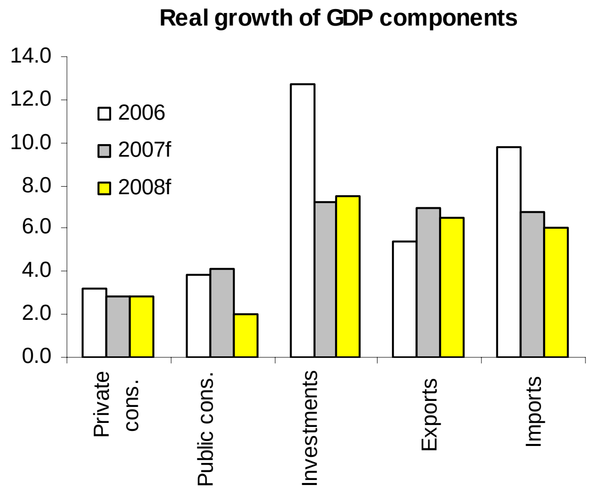
The Greek economy maintained its dynamism in H1 2007, posting average real GDP growth of 4.4 percent y/y (*Q1 07: + 4.6% y/y, Q2 07: +4.1% y/y)*. a pace appreciably faster relative to both that of the same period a year earlier *(H1 07: +4.2% y/y)* and market consensus forecasts. Vibrant investment activity and strong, albeit softening, private consumption were the main drivers of the economy's buoyant growth performance in the first half of this year, while the overall external sector remained a drag, slashing ca 1.1 percentage points off real GDP growth. Exports grew strongly (*H1 07: +9.2% y/y in real terms)* thanks to the dynamic performance of goods and services *(tourism and shipping)* sectors, but the overall external balance remained in the red as imports continued to grow strongly (*H1 07: +9.8% y/y in real terms)* amid buoyant domestic demand.

Looking at the recent performance of various key conjectural indicators of domestic activity, retail sales *(volume terms)* posted a solid 3.0% y/y rise in January-July 2007, while registrations of new passenger cars grew by a brisk 5.4% y/y rate over the first eight months of the year. Moreover, the retail-business confidence index stood close to a 7-year high in August, buoyed by positive developments in the domestic retail market. For the full-year 2007, we expect real GDP growth to come in at around 4.1%, exceeding a 3.9% initial official projection *(Hellenic Stability & Growth Programme 2006-2009)*. Domestic demand is again expected to remain the main engine of economic activity, but its growth pace is likely to decelerate somewhat relative to 2006 as a result of decelerating housing investment and a slight moderation in consumer spending. For its part, 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.

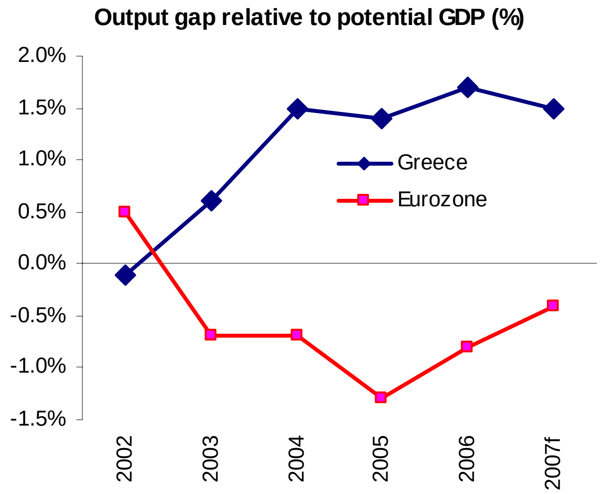
With regard to investment activity, the annual growth-rate of gross fixed capital formation is likely to register a small deceleration in 2H 2007 after posting real growth of 10.4% y/y in the first half of the year, mainly on the back of cooling housing activity.



Source: Ministry of National Economy, EC, EFG Eurobank



Source: National accounts, EFG Eurobank

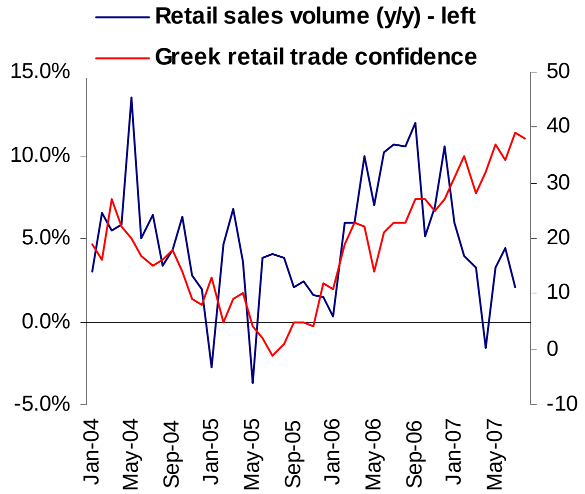


Source: EC

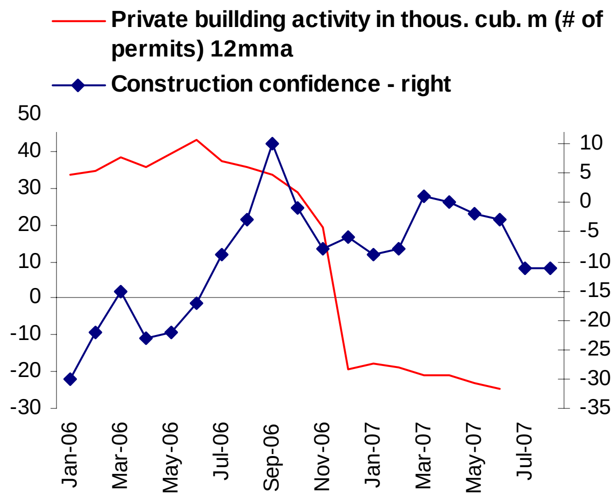
Residential investment growth is expected to remain positive this year**,** but it is likely to decelerate appreciably from the 32.3% y/y red-hot pace recorded in 2006 in line with negative growth *(i.e., -5.6% y/y)* in the volume of building permits over the first six months of 2007. On a more positive note, buoyant mortgage lending, strong demand for housing and the high stock of building permits issued in the past two years are likely to provide support to overall investment activity. Moreover, rising profitability of domestic business, buoyant domestic demand, strong EU co-financed infrastructural spending and the pressing need to improve the production capacity of domestic firms will continue to favor business investment, as also suggested by the hefty year-on-year gains in manufacturing output and the strong performance of exports over the first eight months of this year.

A more friendly business environment following recent reforms is also likely to continue supporting business investment in the period ahead. According to the most recent data, more than four thousand applications corresponding to ca €11.9bn of new investment in the manufacturing, tourism and other sectors have been submitted to the authorities, aiming to reap the benefits of the new development law, of which investment plans corresponding to €8.8bn have already been approved. Moreover, the Development Ministry has already approved proposals for a series of PPP partnerships, corresponding to some €3.1bn of new investments in construction, tourism infrastructure, as well as in the areas of education, health, and regional development.

Economic prospects for the coming 2-3 years look favorable, with annual GDP growth rates expected in the 3.5-4.0% region. Variations in the composition of future growth 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 domestic households *(ca 43% of unrevised GDP in July 2007)* 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 extent that the sizeable external imbalance will continue to be mainly a reflection of buoyant consumer spending and housing investment rather than investment activity intended to raise the economy's productive capacity, the external sector will remain a drag on economic growth, preventing 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 necessitate a further strengthening of the economy's productive capacity and greater flexibility so as to produce higher value added products that will compete more successfully in international markets.



Source: Greek stats, EC



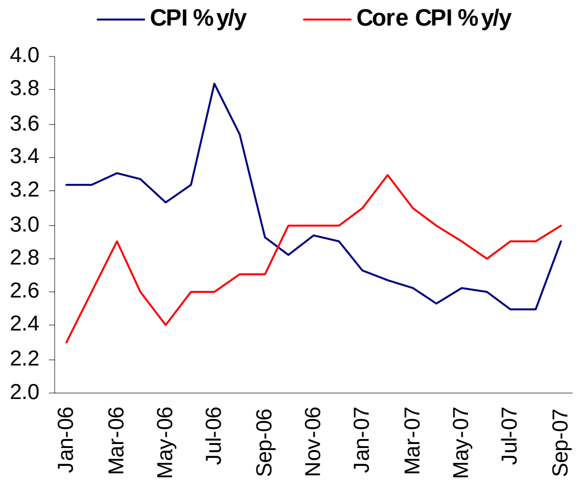
Source: Greek stats, EC

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. All in all, product and labor markets in Greece continue to suffer from serious rigidities and the needed transformation of the productive base of the economy requires the correction of long-standing imbalances, obvious consequences of which are the relatively high levels of inflation and the current account deficit.

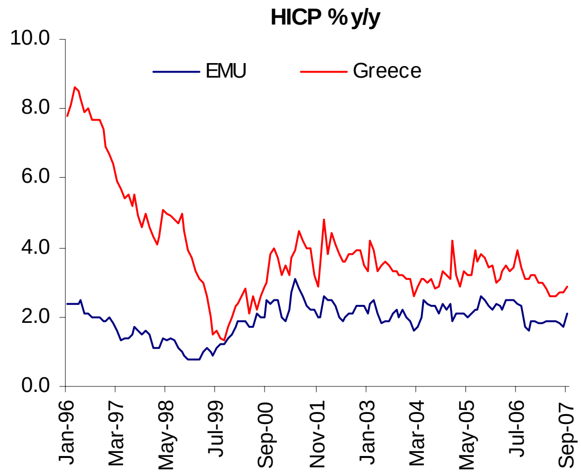
Lower y-o-y inflation but upside risks linger

Year-on-year CPI moved lower in the first three quarters of 2007, reflecting favorable base effects related to domestic oil price developments, lower imported inflation and a deceleration in the growth rate of processed food prices. Domestic fuel prices *(5.98% weight in the CPI basket)* eased by 2.4% y/y in January-September 2007, after rising by 15.5% y/y in the same period a year earlier, while imported industrial good prices rose by an average rate of just 0.7% y/y in January-July 2007, *(vs. 6.7% in the same period a year earlier),* mainly on the back of significant year-on-year declines in energy product prices and the strengthening of the EUR´s trade-weighed value. [15,16] Reflecting these favorable trends, average headline CPI fell to 2.6% y/y in the first nine months of 2007, from 3.3% y/y in the same period a year earlier, bringing the year-to-September average Greek/Eurozone inflation differential *(harmonized terms)* to 0.9ppts, from 1.1ppts last year. On a less positive note, core inflation has been on an upward trajectory in recent months *(+3.3% y/y in August)*, boosted by the lagged effects of past hikes in oil and commodity prices, persisting demand-side pressures and higher unit labor cost (ULC) growth relative to main trading-partner economies.

Looking ahead, we expect domestic headline inflation to edge higher to the 2.9%-3.0% y/y region in the fourth quarter of the year on oil price-related adverse base effects, while core CPI is likely to ease to sub-3.0% y/y levels over the same period assisted by the contained growth in non-processed food prices and the stronger euro. For the full-year 2007, we stick to our earlier forecast of 2.7% y/y for headline inflation and see core inflation rising to ca 3.1%, from 2.9% in 2006. Subdued imported inflation thanks to favorable exchange-rate developments and easing inflation expectations of domestic businesses and households are factors supporting an improved inflation trajectory in the months/quarters ahead, with higher world oil and commodity prices and strong ULCs growth domestically posing upside risks. Expectations-wise, according to a recent survey conducted by the Foundation of Economic and Industrial Research *(IOBE),* the percentage of domestic businesses in the retail and services sectors *(excl. banks)* foreseeing price increases in their products and services 3-4 months ahead declined in the third quarter of the year; the percentage of manufacturing businesses forecasting future price increases remained broadly unchanged relative to Q2; and businesses in the domestic housing construction sector actually foresaw future declines in their prices. At the household level, according to a recent survey conducted on behalf of the European Commission, 12-month ahead consumer inflation expectations in Q3 eased slightly relative to the prior quarter.



Source: Greek stats office



Source: Eurostat

[15] Prices of imported industrial goods excluding energy rose by 3.4% in Jan-Jul 2007, from 2.4% in the same period a year ago with prices of imported capital goods rising by 0.8% in the first seven months of the year vs. +1.0% over the same period a year earlier and those of imported consumer goods increasing by 1.3% vs. +0.1% in 2006. Note also that in Jan-Oct 2007, prices of non-energy materials in $ terms rose by an average annual rate of 21.5% (vs. 25.9% for the year 2006 as a whole.

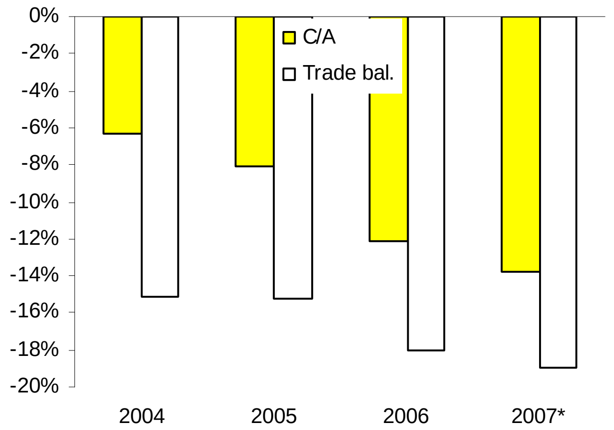
[16] The nominal effective rate of the euro against 24 major trading partners of the euro area as calculated by the ECB posted cumulative gains of ca 3.0% in the first three quarters of 2007.

The persistence of sizeable inflation and ULC growth differentials with the main trading partner economies suggests that Greece's international economic competitiveness is likely to erode further this year. As a reflection of these effects, BoG´s *(CPI-based)* real effective exchange rate index against 28 trading partners of Greece rose by 0.4% in the first half of 2007 *(latest available data)*, having posted cumulative gains in excess of 12% in the 2001-2006 period. Regarding labor cost developments, Greece's ULC growth differential in €-terms, has risen by more that 35% cumulatively in manufacturing and 15% economy-wide over the last 6 ½ years. For this year, the BoG estimates that economy-wide ULC growth accelerated to 3.8%, from 3.3% in 2006, while, in the business sector, the corresponding growth rate was 4.4% vs. 4.0% last year. These reflect an average rise in the nominal gross wage bill by 5.9% y/y this year, from 5.7% y/y in 2006 along with an easing in labor productivity rate to 2.0%, from 2.5%. In the euro area, ULC growth will remain well below the Greek equivalent and will come in at 1.2% this year, from 0.8% in 2006. In regards to corporate profitability, net profits of listed domestic companies rose by 31% in the first half of 2007 *(profits in the non-banking sector up by a much lower rate of 11.4% y/y)*, while total revenues grew by 8% over the same period.

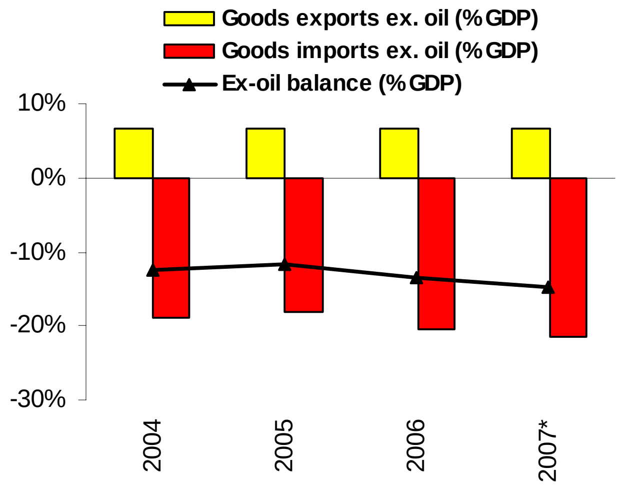
External sector developments raise medium-term macro risks

Greece's current account (c/a) deficit, as measured by BoG´s balance of payments statistics, is set to widen further this year to around 14%-of-GDP, from 12.1%-of-GDP last year and an average annual rate of 7.4%-of-GDP in the 2001-2005 period. As we have noted in the past, the deterioration in the c/a balance is the outcome of a growing savings-investments imbalance and also reflects important cyclical and underlying structural factors, ranging from eroding price competitive to the recent appreciation of the trade-weighted euro. Several special influences have also played a role in the widening of the overall deficit over the last couple of years, including elevated oil prices, increased net payments for ships and higher interest and dividend costs (without these special factors the 2006 current account gap would have been 9.5%-of-GDP, instead of 12.1%-of-GDP realized). In January-August 2007, the c/a deficit grew by 29.2% y/y, reaching €19.3bn (or 9.2% of estimated annual GDP), from €14.92bn (7.6%-of-GDP) in the same period a year earlier. Key driving factors behind this deterioration were: (i) a higher trade deficit excluding fuels and ships (52.9% contribution to the cumulative widening of the c/a gap in the first eight months of 2007), (ii) a further rise in the deficit of the incomes balance (31.0% cumulative contribution),

C/A and trade balances (% of GDP)

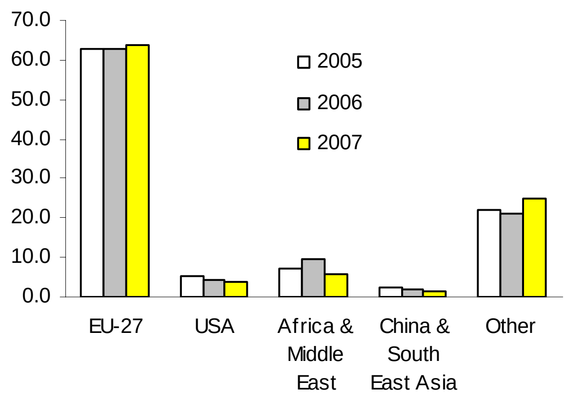


Source: BoG, EFG Eurobank



Source: BoG, EFG Eurobank

Greek exports (% of total exports)



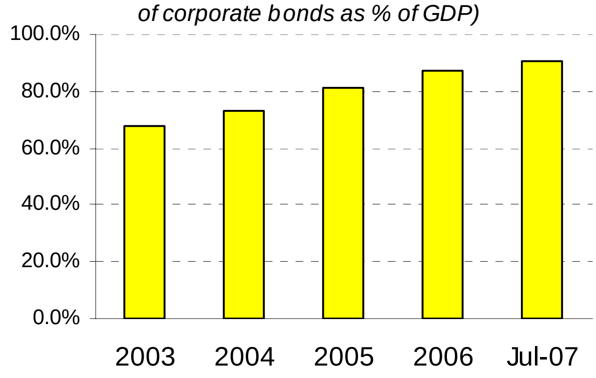
Source: BoG

and (iii) net payments for the purchase of ships (27.5% cumulative contribution). These negative effects were counterweighed only partially by realized surpluses in the balances of services and current transfers and a small decline in deficit of the oil balance. With regard to the €3.3bn widening in the trade deficit over the first eight months of 2007, total revenues from exports of goods excluding fuels and ships grew by €0.4bn or 6.0% y/y in Jan-Aug 2007, while imports rose by €2.7bn or 12.2% y/y over the same period. The continuing strong growth of imports reflects buoyant domestic demand trends and the fact that the domestic production base does not fully meet domestic consumption and investment needs. As for the structure and destination of exports, the first seven months of 2007 saw a significant rise in revenues from exports of metallurgical products and machinery, while the most recent customs statistics indicate an ongoing redirection of exports to Balkans and central CEE countries, with the share of Greek exports to EU-27 members now exceeding 60% following also the accession of Bulgaria and Romania into the EU (1.1.2007). On the capital account, net inward direct, portfolio and other investment amounted to €16.86bn in Jan-Aug 2007, compared to €12.64bn in the same period a year earlier. The balance of direct investment turned out a €2.2bn net outflow in the first eight months of the year, mainly as a result of payments for the completion of Finansbank´s buyout of by the National Bank of Greece. Over the same period there was also a €13.3bn net inflow in the portfolio-investment balance while other investments amounted to a net €5.9bn. On a more inter-temporal basis, although Greece's Eurozone membership effectively secures the adequate financing of the country's external deficit and debt, the wide current account gap poses a threat to the medium-term growth prospects of the economy. 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 medium-term growth and employment prospects.

Private-sector credit continues to grow strongly

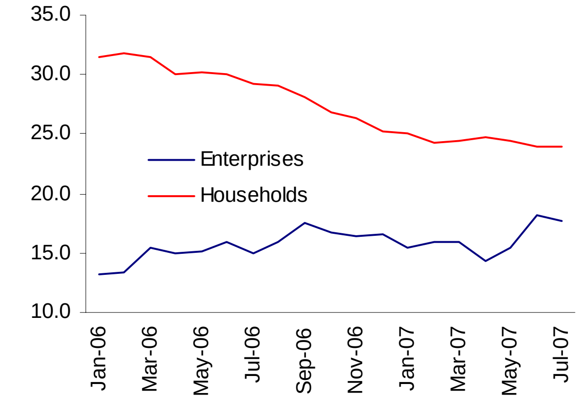
The Greek component of Eurozone's M3 growth excluding currency in circulation accelerated further during the first five months of 2007 *(+11.1% y/y vs. 10.3% y/y in 2006)*, a development that can be partly attributed to the flattening of the government bond yield curve, which stimulated a shift of funds from longer-maturity instruments *(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 (MFIs) decelerated further January-May 2007, but this was mainly the continuing decline in the growth rate of lending to the general government *(the latter has turned negative since Q4 06 after recording small positive growth over the first three quarters of last year)*. On the other hand, MFI lending to the domestic private sector remained strong, recording year-on-year growth of 19.7% in the first five months of the current year, after rising by 20.6% and 21.8% in the years 2006 and 2005, respectively. Total outstanding MFI loans to domestic households reached 36.7% *(of the revised)* GDP in May 2007 from 31.9% of GDP in the same month a year earlier, compared to ca 60% of GDP in the Eurozone.

Domestic MFI credit to domestic enterprises and households
(outstanding balances of loans and holdings of corporate bonds as % of GDP)



Source: BoG, EFG Eurobank

Domestic MFI credit growth (% y/y)



Source: BoG, EFG Eurobank

New government releases 2008 draft budget

Earlier this month, Greece's re-elected conservative government released its draft budget for fiscal year 2008, which is expected to receive parliamentary approval by mid-December. The new budget is based on the old GDP figures and foresees a further drop in the general government budget deficit to 1.7%-of-GDP in 2008 from an expected deficit of 2.5%-of-GDP this year. Note that release of the draft took place a few days before Eurostat announced that it had approved 9.6 percent of the 25.7 percent upward revision to Greek GDP figures for the period 2002-2006 earlier proposed by Greek authorities. The new budget is framed on a favorable macroeconomic environment envisioning a continuation of strong economic growth and easing inflationary pressures *(real GDP growth: 4.0% y/y in 2008 vs. 4.1% y/y in 2007; PCE deflator: 2.6% y/y in 2008 vs. 2.7% y/y in 2007)*. The main targets of the 2008 budget are in line with authorities´ medium-term goals of attaining a balanced budget position by 2010 and succeeding to reduce sizeable deficits in state enterprises and the national health-care system. Challenges to these goals include: (i) expenditure pressures due to large interest payments and amortization costs *(public debt-to-GDP ratio seen at 101.9% in 2007 and 98.9% in 2008)*, (ii) the need to run sizeable public investment budgets (PIBs) in the years ahead in order to facilitate the proper absorption of EU structural funds, (iii) widespread tax evasion hindering efforts to maintain a strong pace of revenue growth without resorting to additional indirect taxation, and (iv) the need to generate the necessary surpluses for implementing a long-due overhaul of the country's social security system. An intensification of efforts to broaden the tax base and reduce tax avoidance, renewed emphasis on containing budgetary expenditure and social security and public administration reforms will be the government´s obvious response to the challenge of promoting further fiscal consolidation in the period ahead, with the continuing generation of sizeable privatization receipts *(€1.6bn in 2008 vs. €1.7bn expected this year)* facilitating a faster pace of reduction in the debt-GDP ratio *(the revised government debt for 2006 is put at €204bn.)*

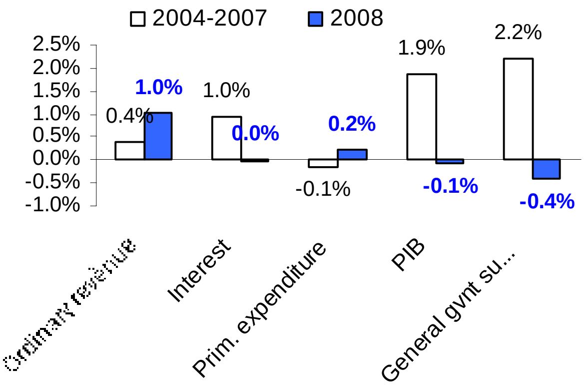
Main budgetary figures

Table A below shows the 2008 draft budget's main figures expressed in both € million and %-of-GDP terms. Graph A takes a more inter-temporal view on the realized fiscal adjustment *(and its main drivers)* following a peak in the general government deficit to 7.9%-of-GDP in 2004. The graph implies that the bulk *(i.e., over 95%)* of the 5.3ppts cumulative reduction in the Greek general government budget deficit over the three-year period 2005-2007 was due to: (i) higher surpluses in the overall balance of public utilities, transfers to the social security system, defense expenditure and various general-government-level adjustments *(cumulative contribution: 2.2 ppts-of-GDP)*, (ii) a sharp reduction in public investment spending following the 2004 Olympic Games *(cumulative contribution: 1.9 ppts-of-GDP)*, and (iii) lower debt service costs due to the lengthening of the average maturity of public debt and the rolling-over of government securities at lower effective interest rates *(cumulative contribution: ca 1.0 ppts-of-GDP)*. At the central government level, the fiscal consolidation attained in the 2005-2007 period was not as pronounced and, in fact, lower deficits in the ordinary budget balance *(excl. interest costs)* reduced by no more than ca 0.3ppts-of-GDP the general government budget gap.

Table A: 2008 draft budget	*In € mio*		% GDP	
	200f (e)	**2008 (b)**	**2007 (e)**	**2008 (b)**
1. Ordinary Budget				
a. Gross ordinary revenue	52,050	57,920	24.9%	25.9%
a1. Tax reinbursements	2,450	2,550	1.2%	1.1%
a2. Special revenue			0.0%	0.0%
a3. Net revenue (a-a1+a2)	49,600	55,370	23.7%	24.7%
b. Expenditure	54,827	58,218	26.2%	26.0%
b1. interest	9,750	10,500	4.7%	4.7%
b2. Primary expenditure (b-b1)	45,077	47,718	21.5%	21.3%
2. Ordinary budget balance (1a3-b)	-5,227	-2,848	-2.5%	-1.3%
3. Public Investment Budget				
a. Revenue	4,380	4,410	2.1%	2.0%
b. Expenditure	8,700	9,200	4.2%	4.1%
4. PIB balance (3a-3b)	-4,320	-4,790	-2.1%	-2.1%
5. Central government balance (2+4)	-9,547	-7,638	-4.6%	-3.4%
5a. Primary balance (5+1b1)	203	2,862	0.1%	1.3%
6. Public sector surplus & adjustment	4,315	3,730	2.1%	1.7%
6a. Public utility & other surpluses	3,985	4,022	1.9%	1.8%
6b. Transfers to social security	-415	-420	-0.2%	-0.2%
6c. Diffence expenditure	-1,300	-1,400	-0.6%	-0.6%
6d. Adjustments	2,045	1,528	1.0%	0.7%
7. General govnt balance (5+6)	-5,232	-3,908	-2.5%	-1.7%
Nominal GDP (EUR bn)	209,268	223,917		

Source: 2008 draft budget, EFG Eurobank Research

Net contribution to the cumulative adjustment in the general gvnt balance (in % of GDP terms)



The latter occurred despite strong GDP growth and special measures *(i.e., VAT and other indirect tax hikes)* adopted over the corresponding period to boost indirect tax revenue.

Graph A also illustrates that the bulk of fiscal adjustment in 2008 is projected to come via higher ordinary-budget revenue *(+11.6% y/y vs. +7.1% y/y in 2007),* which are projected to slash as much as a whole percentage point of GDP off next year's general government budget deficit. Lower growth in primary spending *(+5.9% y/y vs. +11.2% y/y in 2007)* is also expected to be a net contributor to the 2008 fiscal adjustment to the tune of ca 0.2% ppts-of-GDP, while a higher PIB deficit and a lower surplus in the overall balance of public utilities, transfers to the social security system, defense expenditure and adjustments will add ca 0.5%-of-GDP to next year's overall budget deficit. In particular, central government budget revenue (as %-of-GDP) is projected to rise by ca 0.9ppts in 2008 and this, together with a 0.3ppts-of-GDP reduction in expenditure, is expected to lead to a significant drop in the central government deficit *(to 3.4%-of-GDP from 4.6%-of-GDP in 2007)* and a concomitant 1.2ppts-of-GDP rise in the corresponding primary surplus.

With regard to revenue growth, next year's 11.3% y/y rise in gross ordinary budget receipts is projected to come despite lower corporate taxation, a gradual reduction in personal income tax rates starting from 1.1.2008 and the abolition of inheritance taxes on property[17]. This revenue target is based on a 7% y/y growth forecast for nominal GDP, a new special consumption tax hike on oil and the establishment of a uniform taxation framework for property. A renewed strengthening of efforts to boost direct tax receipts and crack down on smuggling and tax evasion in the transportation of fuels is also expected to assist in the fulfillment of the - admittedly ambitious - target for revenue growth next year. Direct tax revenues are projected to grow by 10.1% y/y in 2008, after rising by 6.1% y/y this year, and by just 1.8% y/y in 2006, while indirect tax receipts are expected to increase by 13.8% y/y bringing the ratio of indirect-to-direct taxes to 1.50, from 1.45, 1.41 and 1.29 in the years 2007, 2006 and 2005, respectively. Finally, non-tax revenues are projected to drop by 2.9% y/y in 2008, following +17.9% y/y growth this year as a result of several non-recurring revenue items realized in 2007 and an expected decline of dividends from public corporations.

On the spending side, the projected adjustment is expected to come mainly from a reduction in primary expenditure growth, implying a qualitative improvement in next year's overall deficit reduction. Specifically, ordinary outlays *(as %-of-GDP)* excluding amortization costs are expected to decline to 26.0% from 26.2% this year despite a 0.4ppts-of-GDP rise in social transfers to lower income households as well as higher wages and pensions to military personnel and special benefits to families with three or more children worth 0.3ppts-of-GDP. Pension and wage-related costs are expected to rise by 9.2% y/y and reach 48% of primary expenditure in 2008, while social security and health-related costs are projected to increase by 11.1% y/y and exceed 23% of primary expenditure. Finally, central government operating and consumption costs are projected to decline by 7.5% y/y next year, a rather ambitious goal given that this - relatively discretionary - general category of primary expenditure has been consistently undershooting the relevant budgetary targets in recent years.

In line with the above projections, the general government debt-to-GDP ratio will decline below 100% for the first time since 1992 and reach 98.9%, from 101.9% expected for this year *(based on the old GDP figures).* Interest rate expenditure for the servicing of public debt will amount to 4.7%-of-GDP in 2008, having been on a constant declining trend since Greece's eurozone entry. The management of public debt for next year will continue to target lower servicing costs and a further containment in interest rate risks. Specifically, next year's debt rollover ratio will not exceed 35%, while the ratio of floating-to-fixed will be maintained at ca 0.25%. The 2008 issuance program will include new 3-, 5-, 10-, and 15-year benchmark bonds and T-bills, a re-taping of the Jul. 2030 inflation-linked bond, strategic private placements of debt denominated in EURs or foreign currency and the issuance/retaping of higher maturity bonds on a discretionary basis.

Fiscal outlook and main policy issues ahead

The last three years witnessed an unprecedented improvement in Greece's fiscal accounts, as suggested

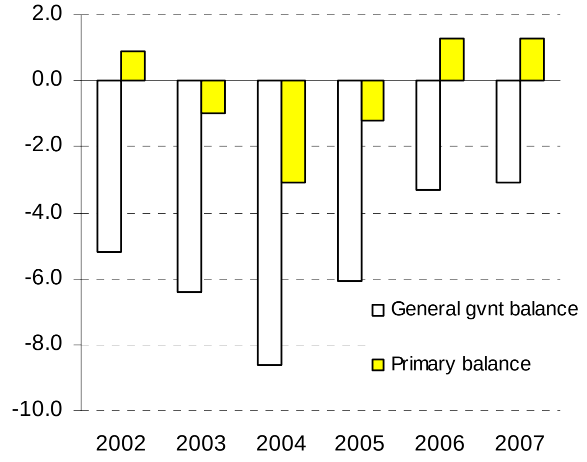
[17] The present personal income tax rate of 29% will be reduced to 27% in 2008 and to 25% in 2009. Also, the current 39% tax rate will be cut to 37% and 35% in 2008 and 2009, respectively. The 2008 budget also provides for a rationalization of the existing system of property taxation via, among other measures, the simplification of inheritance taxes and real estate transactions and the introduction of a more uniform system for taxing property.

by the sharp reduction in the country's cyclically-adjusted general government deficit and the concomitant generation of a cyclically-adjusted primary surplus for the first time in four years - graph 1. *(The cyclically-adjusted measure strips the cyclical component from the corresponding headline budget figure and, thus, constitutes a more reliable indicator of the realized fiscal adjustment effort).* These positive developments contributed to a sizeable decline in the general government budget deficit to an expected 2.5%-of-GDP in 2006, from 5.5%-of-GDP and 7.9%-of-GDP in 2005 and 2004, respectively, thereby allowing the country's exit from the excessive deficit procedure (EDP) in June 2007. Note that the realized/projected fiscal ratios mentioned above are expressed in terms of the old GDP figures. If the 9.6 percent upward revision to nominal GDP level recently validated by Eurostat is taken into account, the net effect is a 0.1-to-0.2ppts-of-GDP decline in the general government budget deficit along with a 9-10ppts-of-GDP reduction in the public debt.[18] Looking further ahead, the country's latest updated stability and growth program *(period 2006-2009),* which is based on the old GDP estimates, foresees a gradual decline in the general government budget deficit to 1.2%-of-GDP by 2009, from 2.5%-of-GDP this year, implying a 0.9ppts-of-GDP adjustment in the primary balance to a surplus of 2.9%-of-GDP at the end of the reference period.

Medium-term fiscal risks remain despite recent adjustment

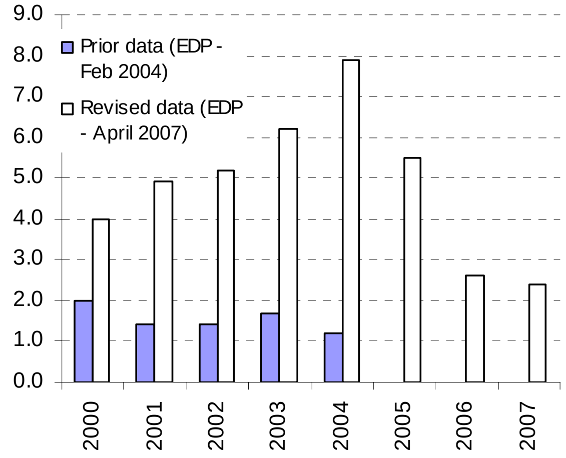
Despite the impressive reduction in the general government budget deficit over the last three years – admittedly, an encouraging development in view of the explosive worsening of fiscal accounts in the 2000-2004 period *(graph 2)* – significant fiscal imbalances remain. The latter is true especially in view of the burgeoning public debt level and the fact that a significant portion of the recent fiscal adjustment has been implemented via measures of a temporary nature. Indeed as we indicated earlier, more than two-thirds

Graph 1. Greece: Cycllical balances (% of GDP)



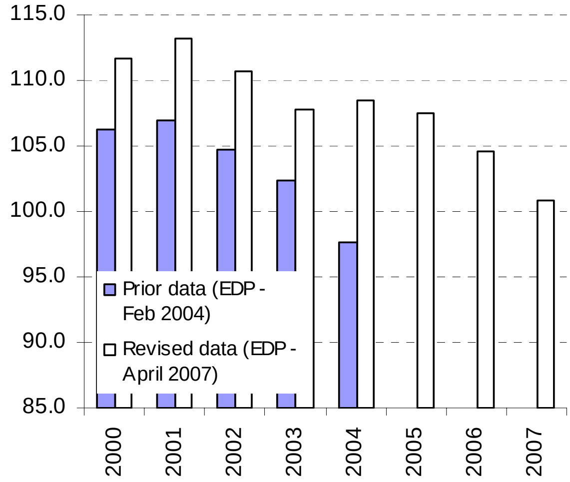
Source: EC

Graph 2: Greece - General gvnt budget deficit (% of GDP)



Source: EC

Graph 3: General gvnt gross debt (% of GDP)



Source: EC

[18] Last year, the government announced a 25.7% cumulative upward revision to its nominal GDP estimates for the period 2002-06. The revised national accounts drew from the latest population census *(year 2001)* and sought to incorporate data from TAXIS, the electronic tax reporting system. However, Eurostat said in early October that it approved only around one-third *(i.e., 9.6%-ppts of GDP)* of the proposed revision, citing methodological differences with the estimates proposed by the Greek authorities as well as a smaller contribution from the domestic construction sector relative to that calculated by the Greek statistics service.

of the 5.5ppts-of-GDP cumulative reduction in the overall budget deficit in the 2004-07 period was due to significant post-Olympic cutbacks in the public investment budget (PIB) and to the surpluses of public utilities entering the calculation of the general government budget accounts. If the cumulative reduction in interest costs – mainly as a result of the collapse of domestic interest rates post-EMU entry and the strengthening of the so-called global ‘‘conundrum’’ forces – is also taken into account, then no more that 15% of the cumulative adjustment in the general government balance over the corresponding period can be attributed to the decline in the deficit of the ordinary budget. The latter, which constitutes the balance of net current revenue and primary expenditure, needs to be contained in the period ahead so as to attain a more sustainable pace of fiscal consolidation. This is because the need to facilitate a faster pace of absorption of EU structural funding in the years ahead does not allow further sizeable cutbacks in the public investment budget, while the future evolution of interest costs will, to a certain extent, depend on prevailing market conditions.

Additional measures needed to boost revenue growth in the medium-term

With regard to ordinary budget revenue *(direct and indirect tax receipts + EU transfers + other non-tax revenue),* a series of revenue-boosting measures taken over the last three years, ranging from the settlement of outstanding tax liabilities to the state to VAT and other indirect tax hikes, have apparently yielded positive results.

Table: Tax revenue (% of GDP)

	Indirect taxes	Direct taxes
1997	36.4	63.5
1998	40.6	59.4
1999	40.9	59.1
2000	42.4	57.6
2001	41.1	58.9
2002	41.4	58.6
2003	41.7	58.3
2004	41.7	58.3
2005	43.6	56.4
2006	41.4	58.6

Source: 2006 budget

On the other hand, the 10ppts cumulative reduction in the main corporate income rates over the last three years has been weighing on direct tax receipts. Moreover, despite additional measures taken to track down widespread tax avoidance and evasion, the problem remains as indicated by the fact that budget revenues *(%-of-GDP terms)* from income and property taxes and social security contributions in Greece are currently lower than the corresponding Eurozone averages[19], though most euro area countries currently enjoy similar *(or even lower)* direct tax and contribution rates. The above suggest that maintaining a strong pace of revenue growth will be a challenge in the years ahead, especially taking into account the planned reductions in personal income tax rates in the period 2007-09. In fact, we can not easily conceive of other possible measures to sustainably boost revenue growth in the medium-term besides further indirect tax hikes and additional steps to rein in tax evasion. Regarding the former, the reelected conservative government indicated before the recent elections that a new VAT hike was not on the government´s present agenda but did not totally rule out such a move at a later time. Moreover, speculation for a new 1-2ppts hike in the domestic VAT rates has abounded in the local press recently should the first months of 2008 see a significant divergence from fiscal targets.

Need for further cutbacks in discretionary outlays, more prudent hiring policies

On the spending side, central government operating and other outlays *(~ 21% of primary expenditure in 2006),* which constitute the most discretionary part of primary expenditure, have been consistently overshooting budget targets in recent years. Naturally, we see room for significant cutbacks in this major spending category as a means of attaining a more sustainable fiscal position in the medium-term. There is also room for containing the government´s total wage bill, which is projected to rise by 9.2% y/y in 2008, after growing by an estimated 6.7% y/y rate this year, despite civil-servant wage growth growing broadly in line with inflation *(i.e., by ca 3% y/y)*. The latter aim can be attained via more prudent hiring policies in the broader public sector and, more generally, by measures aiming to attain a leaner and more efficient public sector.

Debt dynamics improving but level remains alarmingly high

With regard to debt dynamics, despite the recent improvement[20], the annual pace of debt reduction over the last ten years has not been much faster than 1%-of-GDP *(graph 3)*. This was despite the confluence of exceptionally favorable conditions, including strong

[19] 12.1% vs. 14.4% for contributions and 9.3% vs. 11.7% for taxes at the end of 2006.

[20] The debt-to-GDP ratio is expected to drop to slightly over 100% this year, from 107.5% in 2005 using the old GDP figures. Using the new GDP figures, debt-to-GDP was 95.3% in 2006 and 98.0% in 2005.

GDP growth rates and the sharp decline in domestic interest rates post-EMU entry. In general, a faster pace of reduction in the debt-to-GDP ratio will require the generation of significant primary surpluses in the years ahead and this, in turn, will necessitate additional measures on both the revenue and expenditure sides. The necessity of that objective is indisputable given the heavy burden current sizeable debt-servicing costs place on public finances. Indeed, annual interest payments currently stand at 5-6% of GDP, equivalent to some 65% of the total bill for public-sector wages and pensions. If amortization costs are also taken into account, the total annual bill for interest and amortization is currently around 17-18% of GDP, an amount equivalent to slightly more than 80% of total primary expenditure.

EU structural funding for Greece: The EU Commission comes to the rescue

- **The European Commission is expected to extend by one year i.e., until the end of 2009, the deadline on public spending for most CSFIII programs, easing implementation pressures considerably. Even so, Greece needs to accelerate significantly public spending on many EU co-financed projects in order to avoid loss of available funds.**

- **According to the 2008 draft budget, PIB expenditure is expected to amount to 4.1% of GDP next year. This represents the lowest level in a decade as the government appears to have already taken into account the deadline extension of public expenditure on EU co-financed projects.**

- **A recent European Commission report on the short- and long-run economic impacts of EU structural funds allocated to Greece in the period 2000–2013 estimates an associated boost to the country's GDP and employment levels by 2.8% and 2.0% in 2006 and by 3.5% and 2.3%, respectively in 2015.**

October 2007

I. European Commission allows Greece to extent implementation period for CSF III by one year

Significant delays in the implementation of the 3rd CSF program over the past few years have increased the pressure on public authorities to promptly deliver projects eligible for EU funding. As we noted in our previous Greek Macro Monitor *(May 2007)*, the current year was going to be a critical one for the future of EU funding, as according to end-2006 data on CSF III projects, the pace of public *(i.e., EU + national)* spending would need to reach €567m per month in 2007–2008, from €375m per month in 2006, to prevent the loss of available EU funds. In November 2006, the Greek government requested from EU authorities an extension of the CSF III program's 2008 deadline by one year. The request was rejected and instead a set of measures was adopted in agreement with the European Commission in order to facilitate the future absorption of EU funds resulting, among other things, in a reduction of available public funds by ca €1.8bn to €32.4bn. Although these measures gave a temporary boost to public expenditure on EU co-financed projects, they generally proved unable to prompt a significant acceleration in the pace of implementation of the CSF III program. Indeed, according to the latest available data[1], some 61.3% of public funds were spent by May 2007, leaving €12.55bn (or €660.7mn per month) to be spent in the remaining 19 months, a rather difficult task as recent history indicates.

The flow of monthly public expenditure on CSF III projects (million euros per month)						
2001	2002	2003	2004	2005	2006	Jan. 2007 – May 2007
142	**192**	**266**	**250**	**342**	**375**	**215**

The solution to that problem came from the European Commission, which is now expected to grant a one-year extension to all *sectoral* programs and three *regional* programs (Peloponnese, Western and Central Greece) in the CFS III. The tragic events of August 2007[1] allowed the Greek government to request an extension, utilizing a relevant EU regulation for the granting of deadline extensions in the case of natural disasters. The extension is expected to ease implementation-related time pressures significantly but not by as much as one would expect.

The flow of public expenditure on CSF III projects (% of total CSF III public funds)							
	2001	2002	2003	2004	2005	2006	1/1/2007 - 31/5/2007
Annual Rates	5.3	7.1	9.8	9.3	12.6	13.9	3.3
Cumulative Rates		12.4	22.2	31.5	44.1	58	61.3

Even with the 2009 extension, the monthly rate of public expenditure should reach approximately €463m in the period June 2007–Dec 2008 when all 25 programs will be in operation. In January 2009–Dec 2009, when only the 15 programs granted an extension will be in operation, the monthly rate will fall to €313m. Apart from this, the government plans a new restructuring – the 4th since the beginning of the program – of operational programs. EU regulations do not permit the reallocation of funds between programs, prompting the government to focus on reallocating funds from projects lagging behind to ones that have gained pace within the same program. According to press articles, the government also plans to ask for an extension beyond 2009 for projects worth €800m that have stagnated due to legal and physical obstacles.

II. Public Spending on CSF III programs

The following table shows the required acceleration of public expenditure per operational program. The reduction in available public funds after the November 2006 agreement is also presented in order to have a clearer picture of implementation progress attained so far.

Public expenditure per operational program

	Program	Reduction of available public funds after Nov. 06 agreement (%)	Expenditure of public funds until 31/5/07 (%)	Realized monthly expenditure until 31/5/07 (mil. €)	Required monthly expenditure (mil. €)	Rate of required acceleration
Programs granted an extension						
1	Highways, Ports, Urban Development	6.8	61.4	50.3	78.5	56.1
2	Competitiveness	6.2	66.7	26.1	32.4	24.1
3	Education & Initial Vocational Training	4.1	64.1	21.8	30.3	39.0
4	Railways, Airports, Public Transport	6.8	55.1	17.2	34.9	102.9
5	Information Society	4.9	57.7	16.2	29.5	82.1
6	Employment & Vocational Training	2.8	62.5	17.3	25.7	48.5
7	Rural Development	4.7	60.9	16.1	25.7	59.6
8	Culture	5.4	55.0	4.6	9.4	104.3
9	Environment	5.1	50.6	3.4	8.3	144.1
10	Health & Welfare	2.7	56.6	3.7	7.0	89.2
11	Fisheries	4.1	57.7	2.5	4.5	80.0
12	Technical Assistance	2.5	48.2	0.7	1.9	171.4
13	Peloponnese	5.1	60.4	4.7	7.6	61.7
14	Western Greece	5.0	58.0	5.2	9.3	78.8
15	Central Greece	4.9	65.8	5.9	7.6	28.8
Programs not granted an extension						
16	Attica	4.5	71.7	14.0	22.4	60.0
17	Central Macedonia	4.2	66.4	10.9	21.7	99.1
18	Eastern Macedonia – Thrace	3.5	60.1	7.8	20.9	167.9
19	Thessaly	4.6	63.5	6.2	14.3	130.6
20	Crete	4.8	56.3	5.1	16.0	213.7
21	Epirus	5.2	60.6	4.9	13.0	165.3
22	South Aegean	6.0	56.4	3.8	11.8	210.5
23	Western Macedonia	4.4	59.8	4.0	11.0	175.0
24	North Aegean	4.9	54.8	3.5	11.6	231.4
25	Ionian Islands	6.4	56.8	2.5	7.6	204.0
	TOTAL	**5.24**	**61.3**	**258**	**405**	**57.0**

Source: Greek Ministry of Finance, authors' calculations

From the 25 operational programs, 15 are now expected to be granted an extension until the end of 2009. The ones facing the largest execution problems are Railways and Environment and Health programs as well as Ionian Islands, Crete and North & South Aegean regional programs.

III. EU funds absorption rates

At the beginning of June 2007, 69.9% of total EU funds had been cashed out, or €14.5bn, out of a total available amount of €22.7bn.

The absorption rates of CSF III funds (% of EU funds)							
	2001*	2002	2003	2004	2005	2006	5/6/2007
Annual Rates	9.2	5.8	6.1	9.6	9.4	13.2	10.6
Cumulative Rates		15.0	21.1	30.7	40.1	53.3	69.9

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

IV. CSF IV: Awaiting the new law and EU down payments

The National Strategic Reference Framework 2007–2013 *(NSRF or CSF IV as it is sometimes called)*[1] was put on hold due to national elections in September 2007. The government currently awaits the European Commission's approval of 8 operational and 5 regional programs under NSRF, in order to collect a long-awaited down payment of €400m. On October 4th, the new government presented to Parliament a law for the setting up of an administrative mechanism for the execution of NSRF. The law provides for faster expropriation procedures, stricter deadlines for the completion of projects and "lighter" administrative procedures.

V. Public Investments Program 2007 – 2008

The Public Investments Budget (PIB) for 2008 reflects the need to accelerate the execution of the 3rd CSF program and to facilitate the beginning of NSRF. According to the 2008 draft budget, PIB expenditure (EU + national) is projected to reach €9.2bn next year, up from an estimated €8.7bn in 2007. In percentage-of-GDP terms, PIB expenditure is expected to amount to 4.1% in 2008, the lowest rate in a decade. The purely nationally-funded part of the PIB will be reduced in euro terms for a fourth consecutive year in 2008 to €2.5bn, 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 €6.7bn next year, having been on a rising trajectory since 2002. The latter amount is lower than would be necessary for the absorption, by the end 2008, of all available EU funds under the 3th and 4th CSF programs, clearly suggesting that the government assumes that the deadline extension for the implementation of the CSF III program will be granted. Finally, note that the 2008 draft budget estimates EU co-financed expenditure in the PIB to reach €6.1bn this year, an amount lower than the €6.35bn envisioned in the 2007 budget.

VI. The macroeconomic impact of EU cohesion policy

Since 1986, the European Union has financed thousands of projects in Greece, either through the **Integrated Mediterranean Programmes** or the successive **Community Support Frameworks**. These projects included a variety of infrastructure investments, e.g., modern highways, environmental projects and hospitals, as well as various "soft" actions, e.g., training seminars for the unemployed. The aim of EU structural funding is to support economic activity, improve living standards (especially in rural and underdeveloped areas), promote competitiveness and reduce social inequalities. The European Commission's latest report on economic and social cohesion, published on May 30th 2007, offers an evaluation of the macroeconomic impact of cohesion policy on recipient member states. The results for Greece show a net 2.8% rise in the level of nominal GDP and a 2% gain in employment in 2006. The projected gains are even higher in 2015: a 3.5% boost to GDP levels and a 2.3% gain in employment (see table below). Significantly, the beneficial impact on the Greek economy is deemed to be greater than on any other member state in 2006. This is not the case for 2015, however, as EU funding in the period 2007–2013 focuses more on the new member states.

Effect of cohesion policy 2000–2013 on national GDP and employment

	2006		2015	
	GDP gain (% above baseline)	**Employment gain** (% above baseline)	**GDP gain** (% above baseline)	**Employment gain** (% above baseline)
Greece	*2.8*	*2.0*	*3.5*	*2.3*
Bulgaria	:	:	5.9	3.2
Czech Rep.	1.6	0.8	9.1	7.1
Estonia	1.8	1.3	8.6	5.4
Ireland	0.9	0.7	0.6	0.4
Spain	1.0	0.7	1.2	0.8
Cyprus	0.1	0.1	1.1	0.9
Latvia	1.6	1.2	9.3	6.0
Lithuania	1.2	0.9	8.3	4.8
Hungary	0.6	0.6	5.4	3.7
Malta	0.4	0.4	4.5	4.0
Poland	0.5	0.4	5.4	2.8
Portugal	2.0	1.4	3.1	2.1
Romania	:	:	7.6	3.2
Slovakia	0.7	0.5	6.1	4.0
Slovenia	0.3	0.3	2.5	1.7
East Germany	0.9	0.7	1.1	0.9

Source: Growing regions, growing Europe, Fourth report on economic & social cohesion, European Commission, 5/07

Greek Tourism Industry: How well are we actually doing?

- **Greek market shares are rather stable between 2000 and 2006, while competitors such as Turkey are increasing theirs.**

- **Volatility in tourist arrivals and a further diversification of the tourist portfolio are important issues that need to be addressed.**

- **Initial figures indicate that 2007 will be a good year for the Greek tourism industry. However, there is no room for complacency and continued efforts are needed to boost its revenues and competitiveness.**

The Greek tourism industry has enjoyed a significant boost since the 2004 Olympics. While the Olympic Games year itself was rather disappointing in terms of arrivals, Greece lately has also benefited from geopolitical tensions in the Middle East and North Africa, as well as the coordinated advertising campaigns of recent years. However, as tensions are cooling down in those areas, destinations such as Turkey and Egypt, among others, are picking up again with renewed vigour. These markets offer similar services at very competitive prices. Moreover, newcomers such as Montenegro, Croatia and Libya increase competition and pose a significant challenge to the longer-term prospects of the Greek tourism industry.

Diagram 1 shows the dynamics of monthly arrivals from main countries of origin (according to nights spent), namely, the UK, Germany and Italy (accounting collectively for roughly 50% of nights spent by non-residents in collective accommodation). We see clearly the seasonal patterns and (Diagram 1(D)) that tourist arrivals from Germany have been dropping to the lower levels displayed by UK tourist arrivals, which, for their part, are now significantly higher than they were a decade ago. Moreover, there is a shift in the patterns of demand of Italian tourists from August (Diagram 1(C)) to July (Diagram 1(B)), since 2000. This shows that arrivals can be volatile and when this volatility comes from the countries which provide the main source of tourism demand, there is a significant impact on tourism receipt figures.

Table 1 shows the market shares enjoyed by South Mediterranean European destinations. Between 2003 and 2005, the rate of growth of tourism receipts fell from 9% (2004/2003) to 6.7% (2005/2004). Turkey has managed to raise its rate of growth in the same period by almost 5 ppts (from 9.4% to 14.2%). While Turkey is slightly “cheaper” than Greece (per arrival receipts coming at €760, €15 less than in Greece), this country managed to double its market share on the basis of tourist receipts between 1990 and 2005 (from 6.3% to 12.9%). Since 2000, Greece’s market share in the area has been rather stable, losing only 0.1 ppt from its 9.9% level since 2000. In contrast, Turkey increased its market share in the same period (2000-2005) by 4.7 ppts. Spain and Portugal have been losing share. This may reflect the inability of traditional sea-and-sun mass tourism destinations to compete with newcomers such as Turkey and North African destinations at the level of price-competitiveness.

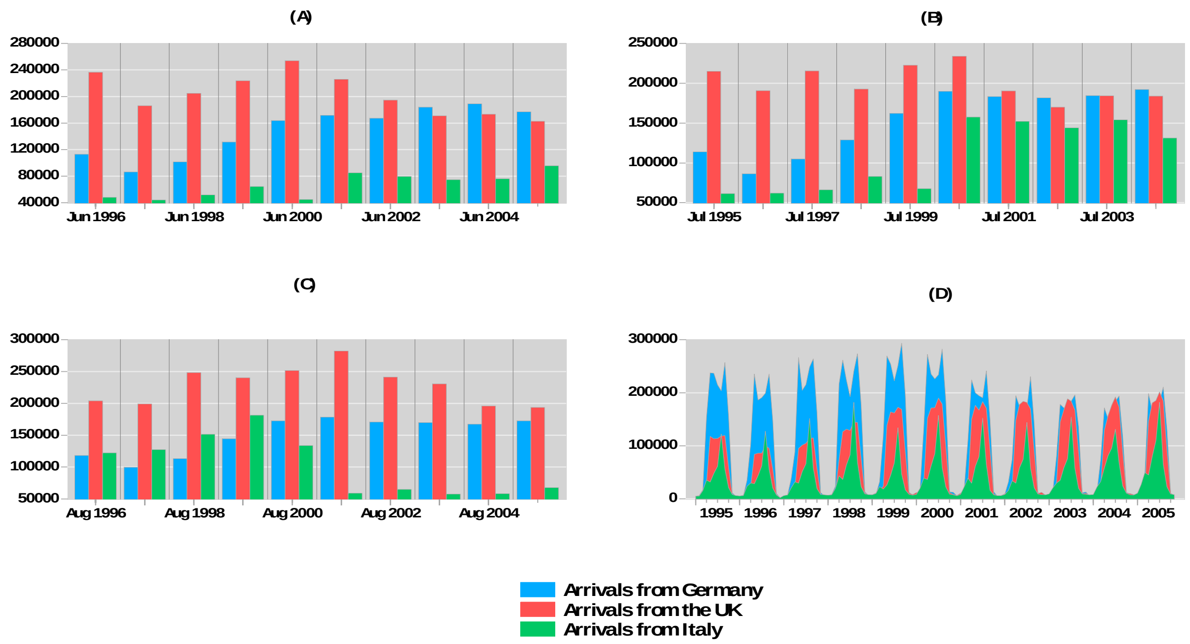
Malta and Portugal also show steep drops in receipts. Only Spain was able to increase its receipts by 5.8% in the year 2005/2004 (a 2 ppts rise over the previous year). This volatility or drops in receipts are also indicative of a market dominated by mature tourist destinations (Spain, Greece, etc.) that are, however, facing significant competition from newcomers such as Turkey and other destinations in North Africa and the Balkans. Recently, Montenegro and Croatia have been attracting larger numbers of European tourists, while Egypt, Morocco and Libya are proving that they, too, can pose strong competition to traditional south European destinations.

Volatility and structural changes in receipts and tourist arrivals can also be attributed to the changes that a country's tourist portfolio is undergoing. Popular destinations, such as Greece, seek to diversify their product and attract more diverse clientele, downplaying their mass-market "sea and sun" image while trying to upgrade their product and its packaging. This could bring about the opening of new country-markets and the inflow of more affluent tourists. In the meantime, however, the inflow of tourists from traditional markets (usually dominated by a few large tour-operators) may be disrupted. As we see in Table 2, hotel arrivals from Germany and the UK are mostly down from their 2000 levels, as a percentage of total arrivals.

While part of the 2000-2006 volatility and diminishing trends in receipts and arrivals can be attributed to the "fight against terrorism" and geopolitical tensions in the Middle East, Greece must seek to maintain the levels of tourist inflows from its traditional markets such as the UK and Germany, while trying to increase tourist arrivals from other countries. According to SETE, the Association of Greek Tourist Enterprises, 2007 has been so far very promising for the whole sector, with the first 6 months tourist arrivals registering a 5.95% increase compared with the same period last year. However, it remains to be seen if this increase is also reflected in tourism receipts and market shares in the area.

Diagram 1

Monthly tourist arrivals



Source: Eurostat

Table 1
International Tourism Receipts by Country of Destination

	International Tourism receipts (€, mil.)			Market share in the region (%)			change (%)		Receipts (€)	
	1990	2000	2005	1990	2000	2005	04/03	05/04	per arrival	per capita
Southern/Mediter. Europe	40,369	101,130	112,673	36.0	40.2	40.3	5.2	5.4	715	479
Greece	2,032	9,981	11,037	5.0	9.9	9.8	9.0	6.7	775	972
Turkey	2,533	8,268	14,590	6.3	8.2	12.9	9.4	14.2	760	185
Malta	389	660	623	1.0	0.7	0.6	2.8	-1.9	550	1,600
Portugal	2,792	5,677	6,375	6.9	5.6	5.7	7.8	1.1	545	599
Spain	14,515	32,446	38,495	36.0	32.1	34.2	3.8	5.8	695	903

Market shares for individual countries are reported as % of Southern/Mediter. Europe. Southern/Mediter. Europe reported as a % of World.

Source: World Tourism Organization (UNWTO), Tourism Market Trends, 2006 and author's calculations. Receipts data include expenditure from overnight as well as same-day trips. Data are collected by the International Monetary Fund (IMF). See the Balance of Payments Statistics Yearbook, Part 2 and Part 3 of the IMF for further details on methodologies, compilation practices and data sources.

Table 2
Tourist arrivals to hotels and similar establishments

		Arrivals as a pct of world				
	Arrivals from EA	EA	Germany	ITALY	UK	US
2000	3,782,899	48.7%	20.9%	6.6%	13.5%	7.7%
2001	3,360,535	48.0%	19.5%	7.1%	14.6%	7.0%
2002	3,256,980	48.9%	18.4%	7.0%	15.4%	5.5%
2003	3,268,123	49.7%	17.8%	7.4%	15.5%	4.8%
2004	3,043,525	48.2%	17.5%	8.7%	15.6%	5.9%
2005	3,373,147	47.2%	16.1%	8.6%	14.9%	8.1%
2006	3,402,456	45.1%	14.5%	8.4%	13.3%	9.0%