Foundation for Economic and Industrial Research

The Greek Economy

2/10

Quarterly Bulletin
No 60, July 2010

Editorial Policy

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ISSN 1106 – 4315

With the financial support of:

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Foundation for Economic and Industrial Research (IOBE)
11, Tsami Karatasou Str, 117 42 Athens, Tel. (+30210 9211200-10), Fax:(+30210 9233977)
http://www.iobe.gr

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FOREWORD

The current report on the Greek economy is devoted to the Memorandum of Economic and Financial Policies that will determine the economic policy of Greece for (at least) the next three years.

IOBE, having foreseen the approaching dangers, sent an open letter to the Prime Minister on 21st of January 2010, noting these dangers and the need to change the economic policy that was pursued at that time. The letter emphasised the willingness of IOBE to take initiatives that explain to the public and the social partners the need for such a change.

Today IOBE considers the Memorandum as: a) A necessary medium-term programme for the revival of the Greek economy, which contains specific targets and policy measures. This programme tackles long-standing problems in four areas: fiscal policies, social security, competitiveness and financial sector stability; b) A condition for the disbursement of the emergency funding of € 110 billion in a period when Greece has practically no access to the international financial markets.

In IOBE's view, the implementation of the Memorandum provides the means for Greece to overcome the danger of bankruptcy that would have led to further depravation of its population's most vulnerable segments.

The greatest risk that the country faces today comes from the demonization of the Memorandum by a section of the political world, the press, the labour unions and various professional and business interests that are affected. But among those that oppose the Memorandum, no one has proposed an alternative solution. This is because simply there is no alternative solution. Our choices today can be summarised in the dilemma: the reforms of the Memorandum or bankruptcy and deprivation. Because the right choice in the above dilemma is self-evident, IOBE, amending slightly the usual structure of its quarterly bulletin, presents today a thorough analysis and assessment of the Memorandum. The purpose of this exercise is to inform and enlighten the public on this very important economic policy programme.

1. THE MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. Introduction

The Greek economy went into a recession in 2009, as a result of the deterioration of the global macroeconomic environment and exhaustion of the dynamic of the internal factors that were fuelling its growth in the previous years. Meanwhile, expansionary fiscal policies and especially the excessive growth of public sector expenditure in the past three years led to the country's fiscal derailment. The global financial crisis, which, on one hand, restricted the available liquidity and, on the other, illuminated the imbalances of the global economy, eliminated the possibility of cheap financing of the country's current model of development, which was excessively dependent on domestic consumption. The Greek political and economic system, but also the Greek society at large, abruptly came to face the cost of their past choices. The predominance of consumerism, quick fortune acquisition mentality, selective implementation of laws and principles, toleration of patronage and obscure transactions, all of which were facilitated and supported by the reckless expansion of the public sector, characterise the dynamic interplay of motivation and outcomes that threw the Greek society into its current state of crisis.

As such, the crisis of the Greek economy is multifaceted, extending beyond liquidity and fiscal issues to the established model of development and even to the overall system of values in the Greek society. This crisis is the inevitable result of a long period of structural weakness and systemic delays, which were not tackled when the economic environment in Greece and internationally was supportive and the adjustment cost was substantially lower.

Despite the clear warnings from a number of institutions that the path the Greek economy was on would lead with certainty to a dead-end, the governments in the past few years, recognising the urgency of the problems in their rhetoric, not only showed indecisiveness to implement a programme of economic restructuring, but continued with policies that further exacerbated the problem. The fear of the political cost and/or the inability to negotiate a compromise with the affected interest groups on various policy issues delayed or cancelled the much needed reforms. As a result, the problems today have accumulated to explosive dimensions, threatening the Greek economy and the cohesion of the Greek society. The structural problems can no longer be confronted with opportunistic tactic and delays. The reform effort is essential, if we are to return on a path of economic converges, which in turn would facilitate the difficult task of fiscal consolidation.

2. The memorandum's necessity

The global economic and financial crisis brought to the surface the problems of the Greek economy. The intensity of these problems shook the confidence of the international markets, leading to numerous downgrades of the country's credit ratings and increase in the interest rates at which it borrowed. The crisis peaked near the end of April 2010, when Greece practically lost access to the bond markets, which put it in the position not to be able to refinance its debt obligations.

The technical aspects of the crisis and to some extent the factors that shook the confidence of the markets can be summarised as follows:

a) Large fiscal deficit and debt as a result of rapid growth of the public sector's size and expenditure.

b) Low domestic savings rate and therefore excessive dependence on foreign debt.

c) Low competitiveness, which is largely due to an introspective model of development and outdated forms of transactions in the markets for goods, services and labour, where state interventionalism dominates.

d) Loss of credibility of the country's economic statistics.

e) Limited commitment by the political leadership towards reforms that would strengthen the abilities of the Greek production system to create wealth and generate growth.

Under these circumstances, faced with the deepest economic crisis of its contemporary history, Greece was lucky enough to be under the Euro area's "protective umbrella". However, as the fiscal crisis was spreading to more Euro area countries, the solidarity of the Euro community, regarding a support mechanism with immediately available resources, could not be achieved without Greece committing to an economic restructuring programme, aimed at fiscal consolidation and competitiveness boost. In any case, such a programme had to be implemented in Greece many years ago.

The International Monetary Fund (IMF), the European Commission (EC) and the European Central Bank (ECB) offered the expertise for the implementation of such a programme. These institutions drafted the relevant programme and offered in parallel € 110 billion (80 from the Euro area and 30 from IMF) in order to cover Greece's loan needs in the medium term. The average interest rate of this loan is 4,3%, substantially lower than the rates of the market, to which Greece has practically no access today anyway. This is the largest rescue package as a percentage of GDP (50%) that was ever offered in the contemporary economic history.

A prerequisite for the disbursement of the assistance is the satisfaction of the terms of the "Memorandum on Economic and Financial Policies", which was jointly drafted by the Greek government and the three institutions and has already been adopted as a law of the state (Law No. 3845 / 6.5.2010). The agreement has two main objectives:

a) To eliminate the immediate risk of bankruptcy and to allow the continued financing of the Greek economy.

b) To implement a medium-term reform programme that will remedy the causes of the Greek economy's two more serious contemporary problems, viz. fiscal imbalances and low level of competitiveness, facilitating its revival.

The view that the agreement is a one-off intervention that we were not able to avoid due to the "toughness" of our lenders, a view based on fragmented reading of the Memorandum by a large portion of the public and by a section of the political leadership, is mistaken. The Memorandum is seen by some as a tug of war between the "foreigners" and the Greeks, who are trying to protect what the foreigners covet.

Instead, the essence of the Memorandum is that it proposes a medium-term programme of reasonable and much-needed reforms. It formulates economic policy guidelines for the next three years in order to achieve its objectives. The Memorandum also contains a specific time plan for the tasks that constitute, in a sense, a prerequisite for the success of the economic policies.

For the first time in contemporary history, Greek medium-term economic policy is set out in such a clear and binding way, which leaves no room for backpedalling, deviation or delay. Even under the presumption that the timely achievement of the targets is difficult, or in some cases unrealistic, the policy direction is clear and the tasks are specific. In any case, the implementation of this programme is now imperative. Its adoption by the Greek parliament signifies the political will to advance in areas in which we hesitated to venture in the past. If followed consistently, it is certain that the programme will create the conditions for a new path of development that will be based on solid foundations.

3. The terms and conditions of the Memorandum

The programme contains two separate Memoranda: Memorandum of Economic and Financial Policies and Memorandum of Understanding on Specific Economic Policy Conditionality.

The first document describes the recent economic developments, concluding with the need to strengthen Greece's economic policies and competitiveness in order to lay the foundations of a

robust model of development, based primarily on investment and exports. The main objectives of the programme are:

A) To correct fiscal and external imbalances and restore confidence. The fiscal adjustment will be rapid, aiming at reducing the general government deficit to well below 3% of GDP by 2014.

B) To boost the competitiveness of the Greek economy through structural reforms that will limit the cost of producing goods and services and the excessive profit margins.

Γ) To preserve the soundness of the financial system by establishing a Financial Stability Fund (FSF).

Within this framework, the economic policies that are required to achieve the targets are categorised in fiscal policies (including the restructuring of the social security system), financial sector policies and structural policies. This is the outline that is followed in the remaining of the text here. With respect to the programme's funding, it is noted that if the required fiscal adjustment is achieved, the government would probably be able to return to the markets without the need to withdraw all the available funds of the support mechanism. Nevertheless, the programme's monitoring is strict. The implementation progress will be evaluated based on quarterly quantitative targets, whose achievement would constitute prerequisites for the disbursement of the economic assistance.

The second document contains a time plan with the specific tasks that should be performed per reform area. It is perhaps the most comprehensive text of the agreement, as it contains in sufficient detail all the interventions that the government should make in order to meet the targets of the programme. Nevertheless, it is a fact that the Memorandum in most cases only sets guidelines for reforms in various economic policy areas, without much deliberation of the technical details. Essentially, it leaves space for the government, which is better aware of the national specifics, to determine the manner with which the interventions will be performed. The Greek government has the responsibility to refine, to design, to coordinate and lastly to execute the particular interventions that serve the objections of these policies.

The careful refinement of the measures is necessary for the quantitative assessment of the extent to which the reform effort achieves its goals. How the interventions will be refined and implemented, so that a common ground for the restructuring of certain problematic markets can be found, is of major importance. The strengthening of the social cohesion is absolutely imperative. Meanwhile, dogmatic evaluations and local-level / sectoral cost-benefit analyses would probably ignore wider benefits for society at large and should be performed with caution.

IOBE's position, thus, is that the Memorandum should be systematically studied. The main features of the economic policy that we decided to pursue should be described and analysed, so that all parties concerned understand the responsibilities associated with its implementation. This is the main purpose of this IOBE report, which attempts to codify the measures per sector, make an initial assessment of the possible positive impacts as well as the cost of failure, while identifying, at the same time, noting the uncertainties and the dangers that lurk.

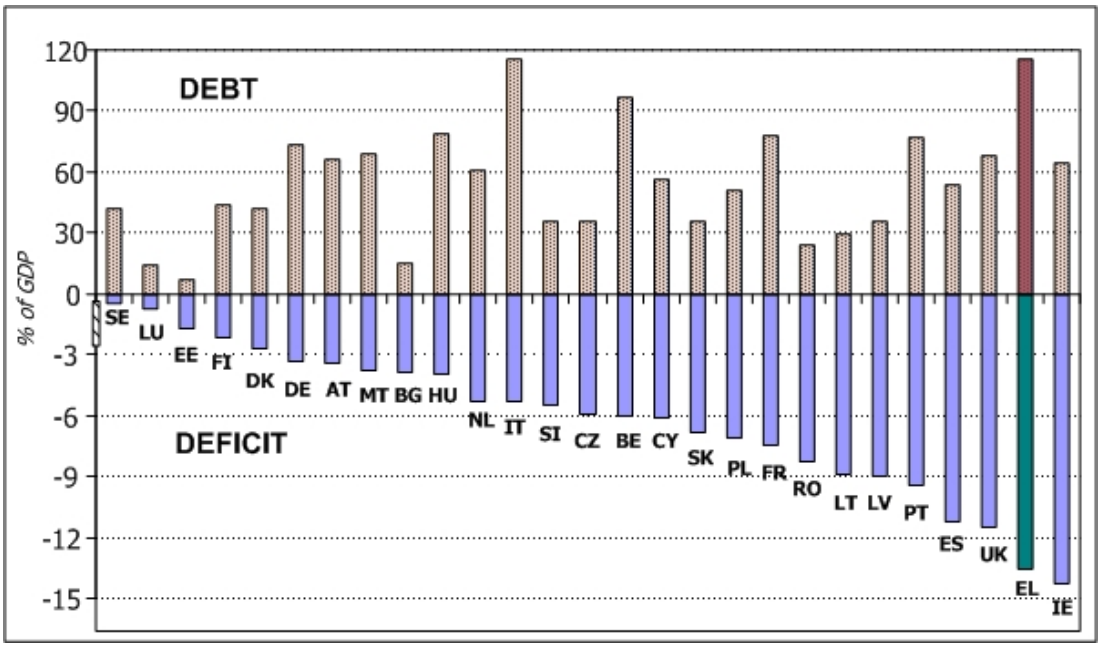
3a. Fiscal policies

3a1. The debt crisis

The deterioration of the fiscal position in 2009 began in the first months of 2010 to exert considerable pressure on the capacity to finance the public debt. In the markets it was clear that - despite the fact that almost all countries in the European Union had excessive deficits due to the crisis - Greece was the country which simultaneously had to deal with such a high government debt (see Figure 1), indeed one with a dynamic that made it look like it might easily continue to spiral out of control. The country was already in a recession, with its public finances in a wretched state, which led to inability to implement an effective counter-cyclical policy.

Figure 1

Government deficit and public debt in EU-27 (2009)

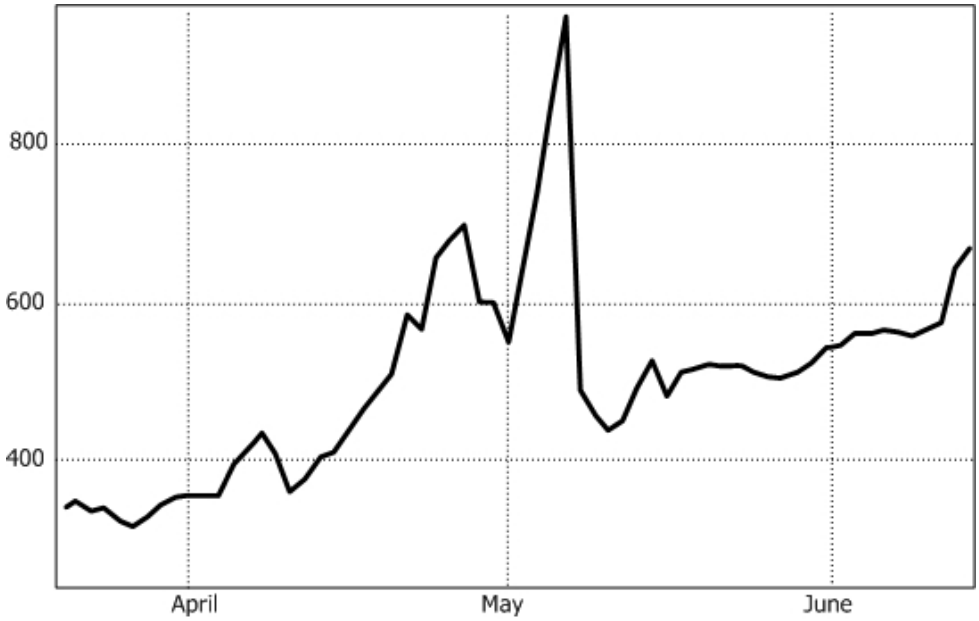


The momentum of government spending from its spectacular increase in 2008-2009, the domestic pressures for expansionary policy due to the economic crisis, the greater debt servicing needs, the economy's long-standing structural weaknesses and the repercussions from more long-term factors, such as the demographic aging of the population, indicated the increased likelihood of further deterioration and fiscal collapse.

Since the beginning of the year, the government has been trying to tackle the debt crisis with three policy packages. The first package, with January's Stability and Growth Programme, was followed by two more in March and in April. Despite these efforts, the spreads in the loan interest rates continued to widen, making it difficult to service the public debt (see Figure 2). At the end of April, the government submitted a request for financial assistance to the European Commission, ECB and IMF, which was accepted on 2 May and was approved by the Greek parliament on 6 May. This agreement contained contractual commitment by the government to implement the measures it had already announced, along with a new package of policy measures. Up to that point, the spreads had reached the extraordinary 1000 bps. They subsequently declined, but not to the extend that would allow access to the markets, remaining at high levels. This development indicated that the markets looked kindly on the agreement, but they still remain cautious, at least until they ascertain its implementation.

Figure 2

Spread of the 10-year bonds against the corresponding German Bund rate



The country faces a double challenge: to restore its fiscal credibility and to place its key indicators on a path that would lead to sustainable fiscal future. The adopted strategy places priority on eliminating the fiscal imbalances, which will form the basis for return to a positive growth path

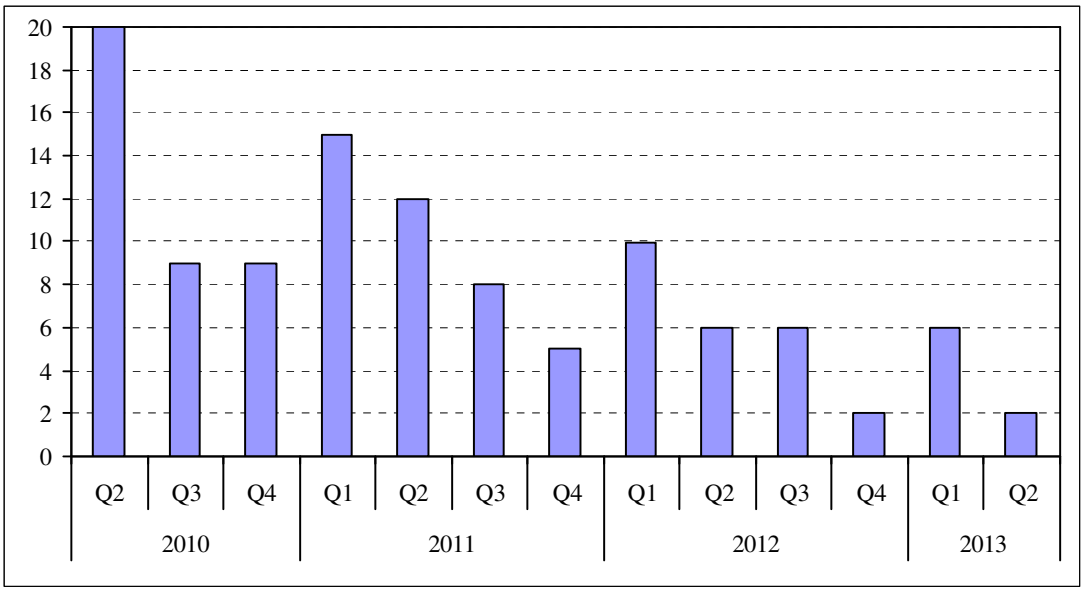
from 2012 onwards. This implies that the adjustment period has at least a three-year horizon. This strategy is aiming at the right direction, because any attempt to support the economic recovery through fiscal expansion would result in evaporation of the possible benefits due to increase in the public financing needs, returning the economy on a recessionary path towards fiscal position that would no longer be sustainable .

3a2. The Support Agreement[1]

The agreement provides Greece with financial assistance in the form of a € 110 billion loan (approximately 50% of GDP!), out of which € 30 billion come from IMF. The purpose of this exceptionally high amount is to enable Greece to refinance its debt and gross deficit without the need to resort to the prohibitively expensive markets. The loan is to be disbursed in quarterly tranches up to mid-2013 (see Figure 3). The disbursement of the tranches is conditional on the fiscal adjustment's degree of success. The agreement has been enacted as a law of the state and in the event of underachievement it contains commitment for further measures. If the fiscal consolidation proceeds faster than expected and the markets begin to accommodate Greek's funding needs, then the amount available for Greece will be reduced correspondingly. Whatever the circumstances, Greece's ability to return to the markets soon is of crucial importance, given the size of the debt that has to be serviced. IMF estimates that the servicing of this particular loan alone will require approximately 17% of GDP (and 62% of exports) in 2015.

Figure 3

Loan disbursement schedule



[1] For an overview, see European Commission, DG ECFIN *The Economic Adjustment Programme for Greece* European Economy, Occasional Papers 61/May2010.

It is estimated (and this constitutes a target) that the Greek state will be in a position to re-connect with the bond markets in early 2012. The interest rate of the loan is estimated at approximately 4.3%.[2] Bearing in mind that the total financing requirements for the period April – December 2010 amount to approximately € 40 billion, the first tranche of approximately € 20 billion was disbursed in May. The distribution of the tranche according to source is presented in Table 1. The size of the loan instalment is equivalent to contributions amounting to 0.11% – 0.26% of GDP (2009) of each country or 0.16% for the Euro area.

Table 1

Distribution of the contributions of the loan's first tranche

	€ million	**% of GDP**
Germany	4,428	0.18%
France	3,325	0.17%
Italy	2,922	0.19%
Spain	1,942	0.18%
Netherlands	933	0.16%
Austria	454	0.16%
Portugal	409	0.24%
Luxemburg	41	0.11%
Cyprus	32	0.19%
Malta	15	0.26%
Euro area total	**14,500**	**0.16%**
IMF	**5,500**	
TOTAL	**20,000**	

This financial assistance programme (and the fiscal adjustment that it requires) is the largest of its kind on record. Furthermore, the seriousness of the fiscal problems provided the impetus for the creation of a European Stabilisation Mechanism. This took the shape of a Special Purpose Vehicle (SPV) with headquarters in Luxemburg and initial capital of € 750 billion.[3]

With the above arrangement, Greece avoided exceptionally disagreeable events, such as debt moratorium, public debt restructuring, etc. Such a development would have eliminated any chance of recovery, generating unsurpassable political and economic problems, putting at further risk the countries that face similar problems, endangering in the end the very existence of the monetary union. In this respect, debt restructuring or similar policies should not be considered as acceptable options, as in practice they would have been equivalent to bankruptcy. The only real

[2] For the IMF amount the interest rate is at about 3.5%, while for the funds from the Euro area countries, it stands at the Euribor rate (appr. 0.7%) plus 4% margin (3% for the first disbursement). According to IMF, these terms will reduce the share of fixed interest debt to 70% from approximately 90%.
[3] European Council Decision, 17 May 2009.

and viable solution is the difficult path of virtue, i.e. fiscal consolidation. The attempt to restore the economy's performance will take time, during which any, no matter how small, sluggishness could be interpreted by the markets as reform fatigue, resulting in the immediate relapse to the situation we experienced in early 2010.

3a3. Greece after the Support Agreement

The reform measures that the government has taken thus far is reflected in a series of legal acts, mainly in the laws numbered **3808/09**, **3833/10**, **3842/10**, **3845/10** and **3847/10.** Law No. 3845/10 contains all the policies and measures and sets out Greece's commitments in accordance with the agreement's memoranda: the Memorandum of Economic and Financial Policies (MEFP) and the Memorandum of Understanding on Specific Economic Policy Conditionality (MUSEPC). MEFP sets out the individual targets and all the policies that the Greek authorities have committed to implement. MUSEPC sets the time frame for examining the implementation of the policy measures and the achievement of the targets. Between the second quarter of 2010 and the third quarter of 2011, provision is made for a total of seven reviews, one per quarter. Overall, the agreement envisages fiscal consolidation, in addition to the measures already taken,[4] roughly equivalent to 11% of GDP in the period 2010-2013 (see Table 2).[5]

According to the three institutions that provide the loan, the measures announced prior to May 2010 would have reduced the deficit only temporarily and to a smaller extent than anticipated. According to that scenario, the deficit would have varied between 15% and 16% of GDP during 2012-2016. This would have been caused by revision of the deficit figures for 2009 (by about 1% of GDP) which has already taken place, deeper recession than anticipated and lack of specific measures from 2011 and onwards. As a result, the Memorandum, without excluding the likelihood of more favourable course of events, sought to eliminate as much as possible the risk of underachievement.

Table 2

The fiscal adjustment required from the programme

(% of GDP)	**2010**	**2011**	**2012**	**2013**	**TOTAL**
REVENUE	0.5%	2.9%	0.7%	-0.3%	3.9%
EXPENDITURE	1.9%	1.2%	1.7%	2.3%	7.1%
BALANCE	**2.5%**	**4.1%**	**2.4%**	**2.0%**	**11.0%**

[4] see IOBE, *The Greek Economy*, 1/10.
[5] The additional measures for 2013 and 2014 are not completely specified, but their size is estimated at 1.8% to 1.9% of GDP.

As evident from the slopes of Figure 4 curves, the fiscal consolidation effort remains front-loaded, as envisaged in the Stability and Growth Program.

The greatest adjustment takes place in 2010, when the deficit reduction is set at 5.6% of GDP, approximately half of the total adjustment for the entire period 2010-2014 (see Table 3). In the final year, 2014, the deficit is to be reduced by less than 3%. The adjustment is equally allocated between revenue and expenditure. However, the anticipated increase of interest payments by 3.3% implies that this burden would have to be offset by a greater reduction of the primary expenditure. This reduction amounts to 8.6%, compared to an increase in revenue of 5,7%. The overall fiscal consolidation effort for the period 2010-2014, as reflected in the primary deficit, stands at 14.3% of GDP.

Figure 4

Public debt and deficit (2009-2014)

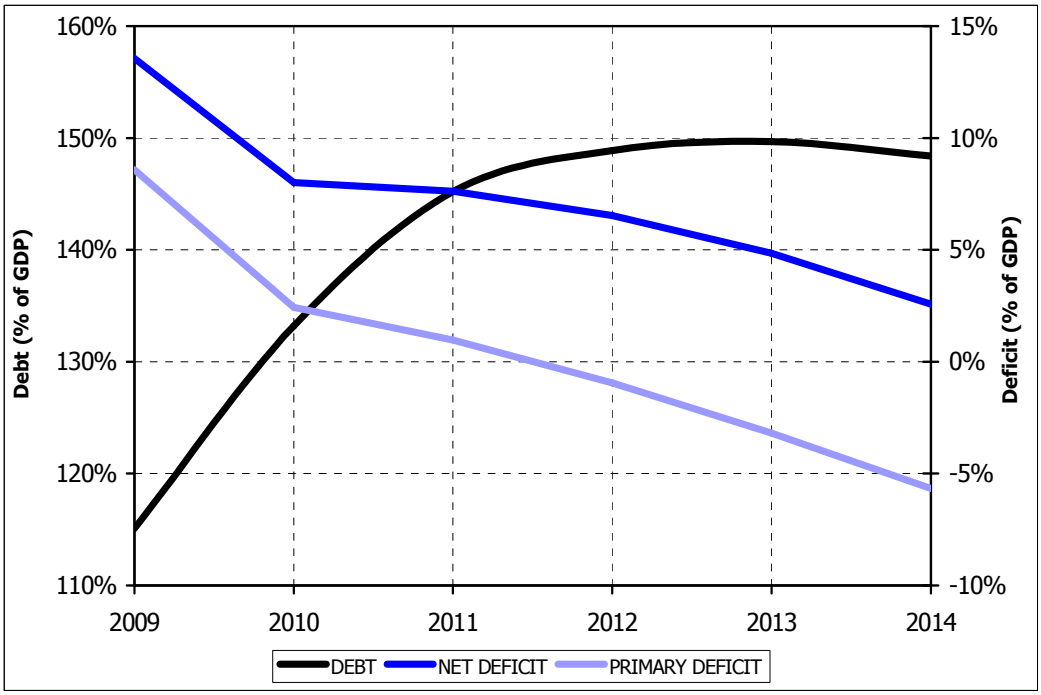


Table 3

Key fiscal figures (2009-2014)

	2009	2010	2011	2012	2013	2014
REVENUES	36.8%	39.6%	42.6%	42.8%	43.0%	42.4%
PRIMARY EXPENDITURE	45.4%	42.1%	43.6%	41.8%	39.8%	36.8%
INTEREST PAYMENTS	5.0%	5.6%	6.6%	7.5%	8.1%	8.2%
PRIMARY DEFICIT	8.6%	2.4%	1.0%	-1.0%	-3.2%	-5.7%
NET DEFICIT	13.6%	8.0%	7.6%	6.5%	4.9%	2.6%
DEBT	115.1%	133.2%	145.2%	148.9%	149.7%	148.4%

What becomes clear from the above figures is that this truly impressive fiscal consolidation effort is only sufficient for stabilising the debt ratio at levels close to 150% of GDP. This level is still considered to be very high and it is clear that the described fiscal consolidation is the minimum that has to be achieved. Otherwise, the momentum of public debt would place it on a path of further rise to unsustainable levels. According to IMF's baseline scenario,[6] the public debt will reach 150% in 2012 and 2013, contracting to 120% in 2020. Basic assumptions in this scenario are that the real growth rate reaches 2.7% (from 2015 onwards) and that inflation (the annual change of the GDP deflator) under no circumstances exceeds 1.5%. In addition, until 2013 public debt will be higher by approximately 8% from taking further loans.

These estimates might seem reasonable, but just as there are risks for worse performance, there are also possibilities for a more favourable outcome. These possibilities may first of all arise from higher nominal growth rate, due to faster recovery and higher inflation than anticipated by IMF. Additionally, there are factors, such as the successful implementation of measures against tax evasion (whose effects are not included in the scenario) and other policies which may result in higher primary surpluses. Lastly, a more daring privatisation policy could further contribute to the debt reduction (by raising revenue and reducing the need to finance the losses and the debt of state-owned companies), while we should not ignore technical factors, such as the forthcoming revision of the GDP estimates. According to a recent report by the Institute of International Finance,[7] it is estimated that such factors can contain the debt to at most 134%. We should not forget that the indirect taxation increase (but also euro's devaluation) have already pushed the (CPI) inflation rate to 5%, while IMF's estimate for reduction of the nominal GDP by 2.8% has already been surpassed. If the nominal GDP remains at the 2009 levels, this would imply a lower debt by approximately 5% compared with IMF's baseline scenario (while the deficit would also be reduced by 0.2%).

Keeping IMF's assumption regarding the interest rates for the public debt and adjusting the remaining basic assumptions as per Table 4, the picture changes significantly. Specifically, if we assume that the nominal GDP will increase by 3.5% on average per annum in the period 2010-2020, instead of 2.4% as estimated by IMF, the primary deficit after 2014 will be slightly lower. Meanwhile, combined with a higher but more evenly distributed autonomous debt adjustment, the public debt reaches levels marginally lower than 110% in 2020.

[6] IMF (2010), Greece: Staff Report on Request for Stand-By Arrangement, IMF Country Report No. 10/110, p. 38.
[7] IIF (2010) *Greece: Deflation Deferred*, IIF Insight, June 4, 2010.

Table 4

Long-term public debt projections (2010-2020)

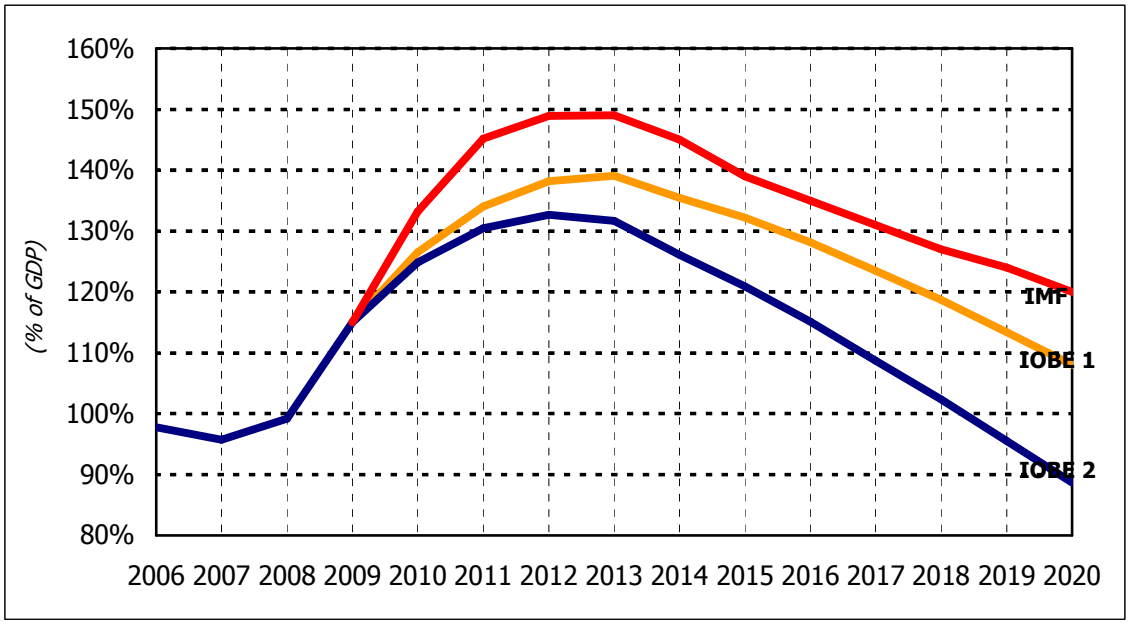
	Nominal GDP (% change)		**Primary deficit**		**Autonomous adjustment**	
	IMF	IOBE	IMF	IOBE	IMF	IOBE
2010	-2.8	0.0	2.4	2.4	6.7	3.0
2011	-3.1	1.0	0.9	1.0	0.1	1.0
2012	2.1	2.0	-1.0	-1.0	0.1	0.5
2013	2.8	3.0	-3.1	-3.1	-0.3	0.5
2014	3.1	3.5	-5.9	-5.7	-2.7	0.5
2015	3.8	4.0	-6.0	-5.7	-2.3	-1.5
2016	4.2	4.5	-6.0	-5.7	0.0	0.0
2017	4.2	5.0	-6.0	-5.7	0.0	0.0
2018	4.2	5.0	-6.0	-5.7	0.0	0.0
2019	4.2	5.5	-6.0	-5.7	0.0	0.0
2020	4.2	5.5	-6.0	-5.7	0.0	0.0

As evident in Figure 5, a variation of 10 percentage points of GDP between IMF and IOBE1 scenarios occurs during the crucial first two years of the programme (2010-2011). The inflationary "surprise", however, during these two years should be almost taken for granted.[8] If the primary surplus is slightly higher (6.2% of GDP) compared to IMF's basic scenario during the period 2014-2020, then the public debt falls to levels below 90% (IOBE2 scenario).

From the above it becomes clear that both the fiscal consolidation, as expressed in the primary surplus, and the real growth rate, play a crucial role in the future developments. Thus, fiscal discipline should be preserved and if needed intensified during the whole decade, while in parallel the structural changes should be implemented in a fast and efficient way so that the economy can return on a growth path as soon as possible. Also, it becomes clear the debt-to-GDP ratio in 2014 (irrespectively whether it stands at 145% or 125%) remains very high. This implies that the markets should be persuaded of the existence of a long-term policy target of debt ratio of at most 100% until 2020, which should be supported by relevant fiscal policies and an ambitious programme of privatisation and utilisation of public assets.

[8] It should be noted that in its sensitivity analysis, IMF examines a scenario where the real GDP growth is higher by 1% compared to the baseline, which reduced the public debt to 80% by 2020.

Figure 5
Long-term public debt projections (2010-2020)



3a4. Fiscal measures

The fiscal measures envisaged in Law No. 3845/2010 are of vital importance for the success of the programme. The fiscal measures are categorised as direct, mainly oriented at adjusting key fiscal indicators and structural. The structural policies relate mainly to reforms in the pension system, in the health sector, in the tax system and administration, in the public financial management and fiscal framework, in the debt management framework and in the fiscal and other public sector reporting of information. The structural changes form a very important (if not the most important) part of the fiscal measures package, spanning the following directions:

- Pension system (see more in the special section below)

The goal is to make the system viable. For this reason, among other measures, the number of pension funds will be reduced to three. The link between contributions and benefits will be strengthened. A means-tested social pension for all citizens above the normal retirement age will be introduced. The pensions will be computed on the basis of an individual's entire working life, introducing the age of 65 and 40 years of work as preconditions for full pension eligibility. Lastly, early retirement, either on the basis of special provisions or infirmity, will be restricted. The reform process is already under way and according to MUSEPC it should be completed by the end of the 3rd quarter of 2010. At this point we should note that the merger of pension funds requires a high degree of administrative efficiency. The experience to date is rather disappointing, with

such moves being mere formalities, as the merged funds in practice have retained their own separate administrative systems (see next section for details).

- Health sector

The direction taken here is to separate the health funds from the administration of pensions and to place all health-related activities under the supervision of one ministry. At the same time, the sector should improve the transparency of its accounts, save resources from overhauling its procurement system and achieve better integration.

- Public administration

The reforms include a number of important commitments, such as merger of municipalities ("Kallikratis plan"), introduction of an evaluation system for the public administration and for the absorption of EU structural and cohesion funds and establishment of a single payment authority for wages. The expected savings from the Kallikratis plan reach € 1.5 billion over three years. Apart from this amount, which may be optimistic and if not attained will have to be replaced by some other means, the issue at stake is the radical restructuring of local government. Specific and enhanced powers should be delegated to the new levels and agencies of local government, something which the central administration so far has been reluctant to do. Meanwhile, infrastructure that will accommodate the new functions should be created to ensure a financing system that will be sufficient and efficient, providing enough resources to the local authorities (e.g. through all local and property taxes) for which they will be solely responsible. In such a way, the local authorities will be unhooked from the easy solution of automatic central financing (share of tax revenues from specific sources), which potentially undermines national fiscal consolidation (since an increase in the national tax revenue automatically leads to higher income to the local authorities, resulting in higher expenditure levels). Providing grants based on verified needs and evaluation of results seems to be most appropriate policy in this case.

As for the new remuneration system in public administration, it should introduce bold changes, such as the abolition of allowances (except family allowances), as well as hiring and placement of employees in specific consolidated branches, as opposed to individual agencies. Based on this, each branch should have its own remuneration system, in which qualifications, years of service, level of responsibility and performance are reflected in the basic regular wages. Lastly, the granting of social benefits should be scrupulously reviewed. Greece has one of the least efficient social benefit system, as evident in the relevant Eurostat data, which shows that the reduction of the relative poverty index after the provision of social benefits is minimal.

- Tax system and tax administration

The new tax system that has already become legislation broadens the tax base and is more equitable since it treats income from different sources uniformly and is more progressive. Future improvement should be along the same lines, aiming at more equitable income distribution, improved effectiveness in relation to the purposes served and greater efficiency. The complete review of implicit expenses and third-party revenue and their comprehensive replacement with direct expenses can certainly contribute towards this goal. The same can be said about the simplification and the automation of the tax system. Reforms have also begun to appear in tax administration. The axes set forth in the memorandums relate to the establishment of a comprehensive framework for management of compliance risk, the improvement of enforcement operations using risk-based approaches and the development of taxpayer service capacity to support compliance improvement efforts.

- System of expenditures

In the context of reforming the system of expenditures, the role of the General Accounting Office (GAO) will be strengthened, while the process of drafting, implementing and monitoring of the State budget will be made more robust. In addition, the operation of the Single Payment Authority will soon commence, the procurement framework is being overhauled, while the system for the absorption of EU structural and cohesions funds is also being restructured, for which the MUSEPC sets specific annual quantitative targets.

- Debt management

According to the MUSEPC, the operational and risk management framework for debt management will be reviewed with technical assistance from IMF.

- Information reporting system

The support agreement envisages extensive transparency, through legally committing GAO to publish monthly data on public sector expenditures pending payment, including arrears. In addition, an appendix to the MUSEPC specifies a long list of data items that the Greek authorities are obliged to provide. There is a commitment in the agreement to improve the effectiveness of the information reporting system and to strengthen its institutional standing. In the context of this commitment, the National Statistical Services of Greece was granted full independence and renamed Hellenic Statistical Authority.

The effect on the fiscal balance from all the policies in the period 2010-2014 is estimated at € 30 billion. About one third of this amount (€ 9,8 billion), which refers to the period 2012-2014, is not connected to specific policy measures. The policies will be further specified in the reviews of the

agreement, the first of which is planned for the end of 2010. The two memoranda envisage the following:

2010

- VAT rate increase to 23% and 11% (€ 800 million)
- Increase in the excise taxes on fuel, cigarettes and alcohol (€ 450 million)
- Further cutting of the bonuses and the allowance reduced under the Law No. 3833/2010 (€ 1,100 million)
- Elimination of pension bonuses (except for minimum pensions) (€ 1,500 million)
- Additional pension reduction above a certain threshold (€ 350 million)
- Cancel second instalment of solidarity allowance (€ 400 million)
- Cut intermediate consumption (€ 700 million)
- Cut domestically funded investment spending (€ 500 million)

2011

- Additional savings / revenues from 2010 policies (€ 2,500 million)
- Broadening the base of the high VAT rate (€ 1,000 million)
- Excise tax on luxury goods (€ 100 million)
- Presumptive taxation of professionals (€ 400 million)
- Book specification of incomes (€ 50 million)
- Taxation of income in kind (cars) (€ 150 million)
- Special levy on highly profitable firms (€ 600 million)
- Increase of real estate's legal value (€ 400 million)
- Amnesty land use violations (€ 500 million)
- Taxation of unauthorised establishments (€ 800 million)
- Green taxes (CO_2 emissions) (€ 300 million)
- Gaming royalties and licenses (€ 700 million)
- Cut intermediate consumption (€ 300 million)
- Savings from introduction of unified public sector wages (€ 100 million)
- Nominal pension freeze (€ 100 million)
- Additional pension reduction above a certain threshold (€ 150 million)
- Savings from "Kallikratis" plan (€ 500 million)
- Cut domestically funded investment spending (€ 500 million)

2012

- Excise goods on non-alcoholic beverages (€ 300 million)
- Broadening the base of the VAT rate (€ 300 million)

- Presumptive taxation of professionals (€ 200 million)
- Increase of real estate's legal value (€ 200 million)
- Gaming royalties and licenses (€ 625 million)
- Workforce reduction beyond the 5:1 rule (€ 600 million)
- Nominal pension freeze (€ 250 million)
- Means-tested unemployment benefit (€ 500 million)
- Savings from "Kallikratis" plan (€ 500 million)
- Cut in operating expenses (€ 800 million)
- Cut in domestically funded investment spending (€ 500 million)
- Cut in transfers to public enterprises (€ 800 million)

2013

- Presumptive taxation of professionals (€ 100 million)
- Workforce reduction beyond the 5:1 rule (€ 500 million)
- Nominal pension freeze (€ 200 million)
- Savings from "Kallikratis" plan (€ 500 million)

Apart from the above policies, the government already decided to commence a privatisation programme. In particular, the government approved the sale of 49% of TRAINOSE to a strategic investor and the utilisation of the train operator OSE's real estate. In addition, 23% of Thessaloniki water utility EYATH and 10% of Athens water utility EYDAP will be put on offer, together with 39% of the mail services ELTA and the stake of the state in Corfu and Parnithas casinos. Additional sources of revenue come from the renewal of the licenses of all seven casinos operating today and the extension of the Athens Airport's contract duration.

The announced privatisation programme is not as ambitious as it should have been, taking into account the urgent need to reduce public debt. There are additional privatisation opportunities, some relatively easier, such as the metallurgical company LARCO, and other perhaps more difficult due to the current unfavourable conditions, such as banks (Agricultural Bank of Greece and Greek Savings Bank), the national lottery operator (OPAP), the gas trading company (DEPA), the electricity utility (PPC) and the remaining 20% stake in the telecommunications company OTE that still belong to the state. Furthermore, the state can certainly extract more revenue from its sea ports, airports and remaining real estate. Lastly, a more effective management of the licence granting procedures can help not only generate additional revenue, but also it can contribute to better functioning of the markets.

3a5. The state of programme implementation thus far

According to the data on the execution of the state budget, during the first five months of the year the net deficit decreased by approximately € 5.5 billion, which is within the set targets.[9] The improvement is more due to much larger reduction of expenses than the target (-13% against -4%) than to an increase on the revenue side (+6,8% against +14,9%). A significant reduction to the amount of € 382 million comes from expenditure on defence programmes, which are not part of the state budget. The gap in the revenues should trigger warning signs, but we should take into account the fact that the latest measures are coming into effect in June. In any case, there is some implementation uncertainty that is related to expenditure pending payment, delays in tax rebates, debt transfers from state-owned enterprises to government accounts, financial loses by institutions outside the central government, together with a doubt on the extent to which the reduction in defence expenses is permanent or reflects payment delay. In a joint statement, EC, ECB and IMF state that the intermediary mission acknowledges the positive developments. The final evaluation that will lead to the disbursement of the second instalment will take place at the end of July.

3a6. Pension reform

Despite the frequent changes in the social security's legal framework (Laws No. 2084/1992, No. 3025/2003 and 3655/2008) during the past 20 years, few of those reflect radical modification of its structure. The reforms of the pension system can be characterised as quite fragmentary. The pension system is essentially guaranteed by the state, with obligatory participation and redistributive functions. Until recently, a beneficiary's pension level was determined based on the remuneration she had received during last few years of her employment. There are two remuneration levels (main and supplementary pension), together with a number of pension benefits. A characteristic of the system is its three-party funding (employer, employee with contributions and the State with subsidies and benefits), while a small share of the pensions comes from employer-based schemes, which the employees have the option to join. Despite the fact that the pension business of insurance companies is growing, the personal pension plans still face limited interest.

The social security system has started to wobble in the past decade, showing increasingly weakening signs of viability. This led to two amendments in the legal framework in a relatively short time span. The increasing difficulty of managing the system comes from a number of factors, amongst which we can list the following:

a) Deterioration of the demographic characteristics of the country's population, with a gradual fall in the young / elderly ratio.

b) Low average number of years of contribution of those that retire

[9] GAO, *Budget Execution Bulletin,* 5/2010.

c) Legal complexity and fragmentation of the social security system in a large number of funds

d) Evasion of contributions and inability to collect attested contributions

e) Limited utilisation of the pension funds' assets

Regarding the demographic trends, Greece follows a similar pattern with most of the remaining EU countries, where birth rates are falling, while life expectancy at birth is increasing. As a result of this, the old age dependency ratio[10] increased from 26.4% in 2004 to 27.7% in 2008. The indicator is expected to reach 38.5% in 2030.[11] Meanwhile, the ratio of contributors to main pension beneficiaries fell from 2.75 in 1988 to 1.73 in 2008.[12]

The escalating aging of the population unavoidably increases the cost of providing benefits to retirees. Greece already ranks 4th in terms of public expenditure on pensions as percentage of GDP,[13] which was slightly higher than 12% of GDP in 2008 (EU-27: 10%). Until 2060, this indicator – if no measures are taken – is expected to almost double from 13% to 24% in EU-27.

The fragmentation of the social security system in a large number of funds is a long-standing problem in Greece. These funds operate in a complex legal framework that makes them inflexible and serves as a source of inequality. There are still many subsystems of compulsory insurance, each for a particular employment sector or professional group, while even within the same fund different professional categories can be subjected to different contribution rules, which results in different pension levels.

Even though with the latest social security law the number of pension funds was reduced from 133 to 13, the constituents of the merged funds kept their statutes. In such a way, the beneficiary categories remain under the same statutory rules of the fund to which they belonged prior to the mergers. Moreover, the constituents of the merged funds have kept their accounting and financial autonomy. As a result, the financial obligations continue to burden each constituent individually, while the real and other assets have not been transferred to the new funds. In essence, the social security system remains fragmented and administratively inefficient.

Administrative problems characterise the revenue side as well. The average of the years during which the retirees make pension contributions is relatively low in Greece at 27.5 years for the men and 20.8 for the women.[14] The reason behind the low indicator is the existence of many exceptions to the main pension plan, which results in a relatively low contributions-to-benefits ratio.

[10] The number of persons aged 65 or above divided by the number of persons aged 15-64.
[11] Demography Report 2008: Meeting Social Needs in an Ageing Society, European Commission, 2008.
[12] From the year 2000, this indicator does not include beneficiaries of the Agricultural Insurance Organisation's main pension (Social Budget 2009).
[13] Ahead in this ranking are Italy, France and Austria, according to the European Commission's 2009 Ageing Report.
[14] Report on Adequate and Sustainable pensions, European Commission, 2006

The limitation of contribution evasion and unregistered employment and the collection of attested contributions are crucial for the immediate invigoration of the cash inflows to the social security system. The state is the main debtor to the funds, whose unpaid contributions reached € 12.6 billion by the end of 2009, against € 2.7 billion at the end of 2003.[15] The obligations of the private sector and the state-owned enterprises reached € 7.5 billion by the end of 2009, while total evaded contributions for 2009 are estimated at € 8.5 billion.

In addition, an improved utilisation of the pension funds' assets is a significant potential source of additional revenue. The value of the real estate and other assets of the social security funds is estimated at € 31 billion,[16] growing at 3.8% on average annually in the period 2005-2009. Over 95% of this amount is held in financial assets (52.4% cash and 42.8% bonds) and only 4.5% in real estate.[17] Furthermore, real estate has the lowest growth rate in the past 5 years, which implies that there is a potential for extracting additional rent.[18]

The above developments not only create doubt over the viability of the system in the future, but have already led to substantial malfunctioning. The pension funds report high deficits year after year, which are in part covered by direct subsidies from the regular State Budget. Meanwhile, however, the need for special subsidies broadens over time.[19] During 2010, the liquid assets of the pension funds, including the state subsidy, are expected to deplete earlier than in the previous year (in some funds even as early as in the third quarter). At the same time, this year the support mechanism and the bad state of the public finances does not leave room for granting additional subsidies.

The prospects of the county's social security system in the medium and the long term, together with its current weaknesses, has made a new reform, third in only a decade, urgently needed. Irrespective of the Greek government's commitments under the memorandum, immediate reform of the system is imperative for the reasons we just presented. The process of restructuring the social security system had been planned by the Ministry of Labour and Social Security long before the request for support anyway.

The main directions of the social security reform, as stated in the relevant law, are summarised in the text box below:

[15] The obligations that stem from Law No. 3025/2003 to the effect that the state should contribute 1% of GDP to the IKA-ETAM fund (€ 980 million) are included here.
[16] As of 31/08/2009 (source: http://www.periousia.gr).
[17] Estimate, based on the real estate's legal value.
[18] The property rents of the pension funds remain low (€ 1.32 billion in 2009), recording small increase over time (2009 Social Budget).
[19] In 2008 they reached € 850 million, while in 2009 they tripled, reaching € 2.5 billion.

Text Box: Key elements of the reform of the social security system
a) Strengthening of the link between contributions and benefits
b) Setting the benefit level according to full employment history
c) Increase of the minimum contribution period for full pension from 37 to 40 years until 2013 to 2015[20]
e) Normal retirement at the age of 60 or 65 for all, with 40 years of employment requirement until 2015
f) Reduction of the average annual replacement rate
g) Reduction of the number of pension funds to three[21]
h) Means-tested social pension for all who satisfy the retirement conditions after 1/1/2015
i) Rule for adjusting the retirement age every 3 years from 2020 that will link it with life expectancy at the year of retirement[22]
j) Reduction (by 6% per year) of the normal pension for those that retire before reaching the required age
k) Indexation of the benefits with the price level

Irrespectively of the specifics of the social security system reform that will be determined through negotiations with the three donor institutions, certain important structural changes have already come to the surface. More specifically:

An attempt is made to establish a new pension system that has uniform rules for the majority of beneficiaries. The age limit for the normal pension across gender will be set equal to 60 or 65 years of age until the end of 2015 and the pension funds will be merged.[23] The list of heavy and arduous professions will be shortened to no more that 10% of the total, while the rules for granting disability pension will be tightened.

Regarding the contributions policy, the benefits acquire contributory character, while the redistributive function of the system is taken up by ensuring a minimum means-tested pension for all. The calculation of the benefits level according to the wage path during full employment history also contributes to the contributory character of the pensions.

In order to ensure the sufficiency of the funds, the social security reform bill contains specific regulations such as: a) increase of the minimum contribution period for normal pensions from 37 to 40 years until 2015; b) reduction of the average annual replacement rate and c) reduction of the normal pension for those that retire before meeting the age requirements by 6% per year. As

[20] According to the second bill, the timing of the implementation of the measures differs across the pension funds (25/06/10)
[21] For the time being under the latest draft of the bill, the main pension branch of the navy fund (NAT) will be merged with the main social security fund (IKA).
[22] From 2021, according to the latest draft of the bill.
[23] The equalisation of the retirement age for men and women was in any case inevitable, after the resolution of the European Court against Greece in March 2009 for equal treatment of the genders with respect to the retirement age and the minimum employment experience.

a result of these modifications, the replacement rate of the benefits from contributory system and the basic pension will reach 64%, to which the supplementary pension will be added. The financial state of the pension funds will improve from the increase of the average contribution period and the gradual unification of the security system rules.

The repercussions of the intense demographic changes that are anticipated for the forthcoming decades in Greece are expected to be met with the establishment of a mechanism for automatic adjustment that will link the retirement age with the increasing life expectancy. This mechanism will commence in 2021 and will follow a three-year cycle. The ability to maintain the real purchasing power of the benefits is to be achieved through their indexation with the price index. The latest draft of the bill, however, contains a proposal to index the pensions with a coefficient that reflects half the GDP growth rate and half the change in the Consumer Price Index, without surpassing the annual rate of change of the CPI.

The implementation of the above measures is expected to contribute in the medium and long term to the strengthening of the viability of the social security system. Beyond the legal clauses that take effect immediately after the bill is passed or when the law specifies explicitly, important is also the implementation of the tasks of organisational or procedural nature, such as the merging of the pension funds. Irrespectively of the form or extent of the mergers, substantial, and perhaps time-consuming effort is required in order to unify their statutes, accounting, assets and management. This process is imperative in order to eliminate the complexity and the ambiguity in the distribution of responsibility between the social security organisations, which feeds their lack of transparency of operation and mismanagement. In addition, it will eliminate the discriminating treatment of professions and professional groups.

The financial circumstances of the pension funds are further aggravated by the current economic conditions. The need for additional funding from the state for this year is estimated at levels higher than those of last year (€ 2.5 billion), but the state can no longer provide this solution. In the short term, sources outside the budget of the funds are expected to come from contributions to the Social Security Solidarity Account ('LAFKA') and, mainly for the pension funds that do not cover exclusively the public sector, from reduction in the seasonal benefits (summer vacation and Christmas). To these measures we can add increase in the collection of attested contributions and intensification of inspections for contribution evasion and unregistered employment.

Additional revenue could come from implementation of the commitment in the Memorandum for institutional strengthening of the collection mechanism until the end of the third quarter of this year, a measure that aims at collecting the obligations of large debtors. The social security bill of the Ministry of Labour provides for the creation of inspection teams that will detect uninsured employment and contribution evasion. Furthermore, until mid-2011, according as always to the text of the Memorandum, the registration of all new employees before the start of their employ-

ment will be legally binding. The labour force of the Employment Inspectorate will be increased so that inspections can be intensified, which is imperative in order to achieve the quantitative target that have been set.

In the medium term, the revenues of the pension funds could be improved from better utilisation of their assets, and in particular their real estate. The share of real estate in the pension funds assets has fallen from 16.9% in 1993 to 4.1% in 2009, despite the significant increase in the legal value of property during this period.[24] The rent receipts from real estate are also quite low: they correspond to slightly above 2% of the revenue from assets of the pension funds for the years 2008-2009.[25] A recent, sample-based research of the Ministry of Labour showed that the pension funds lease their real estate at symbolic rent rates, while they rent property at market prices. Thus, there is a possibility for restructuring the housing cost of the pension funds if they cover more of their needs with their own property and if they increase the rent rates through contract renegotiations with the leaseholders, with priority given to the contracts that expire sooner. The social security system bill contains articles for reform of the regulations regarding the pension funds' asset utilisation and investment.

A number of additional measures included in the Memorandum influence to a larger or smaller extent the operation and the viability of the social security system. The reforms in the health sector, among others, have close relation with those in the social security system, as they envisage separation of the health insurance branch, whose deficit is estimated at € 3.3 billion in 2009, from the social security funds' pensions branch, which includes a separation of the relevant accounts and a reform of the regulation regarding procurement of medical supplies.

The measures of controlling public spending are expected to have positive effect on the finances of the social insurance funds too. Rolling spending limits will be instituted in order to achieve better control of the General Government spending in the medium term. Related to this is the establishment of detailed upper spending limits per fund in the state budget bill that will be presented to the Parliament in the third quarter of the year. These measures will be included in the mechanism of spending control that will be instituted by the end of 2010. Under that mechanism, the pension funds and all other units of government with sizable expenses will report to the Finance Ministry for the execution of their budget.

In summary, the effects of key indicators of the social security system on the viability not only of the pension funds, but public finances in general, has become a major issue for the European Union. The long term impact of the aging of the population on the public finance viability for most EU countries is estimated to be several times more severe, compared with the impact of the

[24] According to data from http://www.periousia.gr
[25] Refers to the pension funds under the Ministry of Labour and Social Security. Data from the Social Budgets 2008-2009.

global financial crisis.[26] In this respect, it is quite likely that the reform of the social security system, which is underway in Greece and in France will evolve in a trend that will be followed by the majority of the EU member countries in the coming years. The particularity of the Greek case comes from the conjunction of accelerating fiscal instability and significant long-standing problems of the social security system. This particularity explains the urgency for an extended reform of the social security system, if we are to avoid explosive growth of public debt.

3b. Financial sector

3b1. The Greek banking sector in the aftermath of the financial crisis

With impetus the collapse of Lehman Brothers (September 2008), the global financial system entered its most serious crisis in the past few decades. Major global banks were compelled to write-off debt or merge, while governments and central banks took upon the burden of restructuring the financial sector, increasing in this way public debt. As an integral member of the global economic system, Greece could not remain untouched by the crisis. Still, the effect on the Greek banks was not particularly significant at first, as the local banking sector was not particularly exposed to "toxic" assets, unlike important bank groups in Europe and USA.

Still, given that a key feature of the globalised economy is the banks' interdependence (mainly through the interbank lending market) illiquidity and large debt write-off in the foreign banks caused concern for possible losses within the Greek borders too. For this reason in October 2008 the then Greek government, following the example of many other governments, decided to provide support to the local banks, amounting to € 28 billion (Law No. 3723/2008).[27]

At first, the Greek banks utilised the support measures, by drawing liquidity through special bond issues of the Greek state. Until the beginning of February 2009, six banks withdrew about € 3.4 billion, while 10 more banks had applied for about € 1 billion. With respect to the option to strengthen the capital base through the issue of preferred shares, 12 banks resorted to that measure, taking up about € 4 billion.

In general, the Greek banks proved to be resilient during the global financial crisis. In 2009 the equity base of the system increased significantly from € 24 billion to € 33 billion (including the capital injections from the state). By the end of 2009, all bank were meeting the 8% capital adequacy requirement, while the average capital adequacy ratio increased to 11.7%.

[26] «Report on the long-term sustainability of public finances for a recovering economy», European Parliament, Session Document A7-0147/2010, 07.05.2010.

[27] This support measure had three separate parts: a) provision of state guarantees to all banks to cover liquidity needs to the amount of € 15 billion; b) direct support of the banks' liquidity to the amount of € 8 billion through the provision of low cost funding through ECB with special bonds as collateral and c) increase of the bank's capital base with up to € 5 billion for those banks that according to Bank of Greece lack the necessary regulatory capital.

3β2. The Memorandum's policies

Since the end of 2009, the economic climate in Greece has changed drastically. The revelation of the fiscal deficit's actual level expanded the insecurity and the disbelief of the markets in the Greek economy, which was reflected in the sudden jump of the lending rate spread. Due to the interdependence of the banking system and the fiscal / macroeconomic situation of the country, the Greek banks could not have remained unaffected. They practically lost access to the global financial markets at the end of 2009 too. Additionally, the economic conditions caused great concern and deposit outflow during the first quarter of 2010, while maturing interbank liabilities were not renewed or were renewed at substantially higher cost. These developments put pressure on the liquidity position of the Greek banks, which increased their dependency on ECB.

The government, in order to meet these challenges, has extended the duration of the banking assistance package, providing € 17 billion, which corresponds to the amount that had not been used from the initial budget of € 28 billion. The support of ECB, which decided to postpone the implementation of the minimum creditability evaluation, based on which it was accepting state bonds as collateral for providing liquidity to commercial banks, had crucial importance. Despite all that, the spreads did not bulge, which forced the Greek government to resort to the support mechanism and to adopt the memorandums.

The memorandums also contain regulations that aim at the further strengthening of the Greek banking system. Most important of this is the establishment of a Financial Stability Fund (FSF). The FSF is a private-law legal person, which provides it with the flexibility to hire specialised staff and to have private equity involvement.[28] The FSF will operate in this form for seven years initially, after which the control of the FSF will pass on to the Greek state in accordance with its share in the equity capital. The FSF's purpose is to preserve the financial sector's soundness by providing equity support to any bank unable to meet the capital adequacy requirements. The equity capital that the FSF will provide will have the form of preferred shares, which will be transformed in common shares if they are not bought back within a specified time frame.

The FSF will start with a € 10 billion grant, which will come from the joint EC/IMF programme. This sum will also cover the fund's operating expenses. This implies that any operating losses will be covered by the Greek state. The utilisation of the fund from a bank that fails to meet the capital adequacy rules is obligatory – as it was under the € 28 billion assistance package. This regulation emphasises FSF's commitment to preserve the capability of all banks (and the sector as a

[28] The Fund will comprise a board of directors of 7 members with one chair, one chief executive officer, three directors that will be appointed by the Governor of the Bank of Greece and two ex officio directors which will represent the Finance Ministry and the Governor of the Bank of Greece. One EC representative without voting rights will also be appointed. The mandate of the chair and the ex officio directors will span five years, with the possibility of a further renewal for a two-year term.

whole) to operate, ensuring at the same time that the servicing of the banks' creditors and clients is not put at risk due to indolence or inability of its shareholders.

The memorandums also contain a provision that in case the banks that received capital from the Fund are not in the position to return it, "a restructuring process will take place under the lead of the FSF, in line with EU competition and state aid requirements". In such a way, the shareholders will not be able to avoid their responsibility in case of insolvency due to mismanagement, while if they are not in the position to contribute, the capital received from the Fund will have to be used in a way that does not distort the competition within the sector. Beyond this, FSF, in close cooperation with Bank of Greece, will evaluate the solvency of the Greek banking system through regular stress tests. In such a way, and through the intensified supervision of the financial sector by Bank of Greece, FSF will provide an additional safety net.

We should emphasise here the importance of the independence and the capabilities of FSF's Board of Directors (BoD). First, its members can only be dismissed following a Greek court verdict after a request by Bank of Greece or the Fund's BoD. Second, its members are not allowed to participate in parallel in the BoD of a financial institution. Third, while performing their duties, the members will make decisions and take actions without receiving instructions from the Greek government or any other state institution. Fourth, the board is obliged to compile a report of its activity and the state of the banking sector every six months and to present it to the Greek parliament, but also to EC and IMF. As the global financial crisis of 2008 exposed the importance of the role of the system's "custodians" and the contribution of the banks' BoDs in the process of taking risky decisions, these two elements of the Memorandum emphasise the importance not only of the capabilities and the prestige of the FSF's directors, but also of maintaining their lack of bias, envisaging punishment in case of malpractice on their part.

The FSF acquires specific powers over a bank that it has funded, the more important of which are: i) it appoints one member of the BoD of the funded bank; ii) it requires from the bank to draft a restructuring plan, if necessary; iii) it has veto powers on decisions related to the bank's strategy, assets / capital management, liquidity management and others; iv) it can order the transformation of the preferred to common shares, in case the bank is not able to cover the minimum equity requirement or specific financial requirements that stem from its restructuring plan.[29] Obviously, all banks are obliged to report the data related to their supervision by the Fund.

The strengthened powers of Bank of Greece that are envisaged in the memorandums and the establishment of FSF with its enhanced regulatory role are measures that correspond, in a significant degree, to older proposals of IOBE related to the need for strengthening the supervision of the Greek financial system. The global financial crisis revealed the lack of effective control of the

[29] The rates of exchange, together with the remaining technical details of the above procedure will be determined in the legal acts that will establish the Fund.

financial markets during periods of high growth and economic prosperity. For this reason, IOBE had proposed[30] to grant independence to the Hellenic Capital Market Commission, to increase Bank of Greece's labour force and to extend its supervisory and regulatory powers to include, among others, the supervision of the insurance companies. We consider that the tasks contained in the memorandums follow this line, as they meet the increased need for supervision today, when the financial sector faces significant risks and challenges.

3b3. Risks and challenges for the Greek banking sector

It is evident that the liberalisation of the Greek banking sector in the mid 1990s provided impetus for growth of the Greek economy. Already from the beginning of the 1990s and until the beginning of the crisis, the banking sector and the real economy evolved through a virtuous circle, despite the loosening of the lending criteria towards the end of this period. However, the interdependence between the banking sector and the economic activity is present not only at times of prosperity. The current adverse economic conditions have turned this interdependence into a vicious circle: the country's fiscal derailment has affected immediately and negatively the banking sector, while even after the adoption of the Memorandum, the concern over the capability of Greece to achieve the set targets puts pressure on the credit ratings of the domestic banks.

The GDP decline in 2010 will reduce the profitability of the Greek banks, which is already reflected in their first quarter financial statements. The shares of the Greek banks stood at levels lower by 25% compared to their European peers, as it seems the investors were concerned over the deposit outflow at the beginning of the year, the lack of access of the Greek banks to the global financial markets and, naturally, from the overall developments in the Greek economy. Overall, the Greek banks are facing the following risks / challenges:

1) Reduction of GDP growth rate and increase in unemployment

The fall in GDP, as a result also of the three-year program of fiscal consolidation, will affect all sectors and the results of the banks in particular. At the same time, the increase in unemployment creates concern about the capability of the banks' customers to servicing their loans, as the Greek banks have increased substantially their exposure to retail banking products. The mortgage and consumer lending growth rates in the past few years prior to the crisis had surpassed 20%. As a result of this development, the loan dependency of the households is quite high. Thus, the increase in unemployment constitutes significant risk, as more and more debtors will have increasing difficulties to meet their obligations. As such, the non-performing loans are expected to increase with accelerating rates, which will worsen the quality of the banks' assets. Obviously, the banks that have larger exposure to consumer lending or bad quality commercial loans will be under more pressure.

[30] "IOBE's Economic Policy Position", June 2009.

2) Reduction of the growth rate of the Balkan and Eastern European countries

The Balkan, Central and Eastern European markets provided fertile ground for expansion of the Greek banks and Greek enterprises in general during the last 15 years. At first, the investments were limited to neighbouring countries, while with time they expended to Ukraine and countries of lesser political risk, such as Cyprus and Poland. The branch network of the Greek banks grew rapidly (there are now 3,500 branches that employ 40,000 people), which resulted in high growth of credit to the local households and enterprises.[31] This coincided with a period of rapid economic growth in these countries, which abruptly ceased in 2008 due to the adverse global conditions.

During the financial crisis, there was a concern over the possible effects on the profitability of the Greek banks from the economic situation in these countries. The significant exposure, not only of Greek but also of other European banks, created fear for broad financial distress, mainly due to the high levels of, mainly commercial, lending in foreign currency there. Despite the fact that until early 2009 it was believed that this region could even capsize the global recovery, it managed to become the investors' safe-haven for the vulnerable bank systems of Western Europe.

The Greek fiscal crisis, if not tackled on time, might redirect the currently established causal flows. The significant exposure of the Greek banks to the economies of SE Europe might cause problems for the economies of the countries rather than the opposite. The Greek banking investments in SE Europe and Turkey are estimated at 17% of the total assets in the banking sector of these countries. In the present adverse conditions for the Greek banks, their subsidiaries contribute to better financial performance at group level. On the other hand, the difficulties of Hungary have triggered once more concern over the future of the SE European economies. Despite the fact that many of these economies do not belong to the Euro area, which allows them to depreciate their currency, it cannot be stated that the present crisis leaves these countries unaffected.

3) Slowdown of the credit expansion rate and deposit outflow

In May 2010, the annual expansion rate of commercial and consumer credit stood at 2.8%, significantly lower compared with December 2009 (4.2%). The strict fiscal measures planned for the next three years might limit the demand for loans, but will definitely lead to stricter lending criteria. Meanwhile, the banking system has approximately 7.4% less deposits and repos in April 2010, compared with the same month of 2009. Still, part of the deposits was transferred to subsidiaries of Greek banks mainly in Cyprus and to a lesser extent to subsidiaries in other countries abroad.

4) Worsening of the portfolio's quality

[31] According to the Hellenic Bank Association, the assets of the Greek banks in the South Eastern European countries stand at € 53.3 billion (14% of the Greek financial sector's total assets).

The quality of the assets of the Greek banks will quite probably worsen from the GDP contraction. The main concern is related to the bonds of the Greek state in the portfolio of the Greek banks. Still, it is noted that the Greek banks own less than 16% of the total Greek public debt. This corresponds to about 10% of their total assets.

The above risks underline the importance of the speed with which the fiscal consolidation and the structural changes will be implemented. The interdependence of the fiscal developments and the developments in the financial sector and the systemic risks that stem from this relationship constitute an additional reason for accelerating the implementation of the memorandums. Moreover, following the example of the remaining member countries of the Euro area, the results of the stress tests of the Greek banks should be published whenever these take place. The existence of the FSF ensures the soundness of the Greek banks and thus the publication of the results will contribute to the transparency of the decision making process related to their future.

3c. Structural policies

The memorandums determine a framework of guidelines for the promotion of specific structural reforms that run though many fields of economic policy. In essence, the memorandum reinstates within a specific time plan reforms that have been suggested in the past by a number of national and international institutions (EC, OECD, Bank of Greece, IOBE). This is what differentiates it from past initiatives and recommendations that fell on deaf ears. Still, it should be noted that in most cases the memorandum does not go into technical details, as it leaves the government and those that are aware of the local particularities room to elaborate these policies. For example, it requests the liberalisation of road transport in order to lift existing limitations and minimum prices, without determining the quantitative details of this regulation. The Greek government should elaborate, plan, draft and lastly implement the specific measures that serve the goals of the structural policies. Given today's difficult circumstances, the government should take advantage of this opportunity, so as to maximise the benefits in terms of economic development from these reforms.

The way these policies will be implemented is particularly significant, mainly regarding the attempt to find common ground for the rationalisation of the operation of certain markets. It is of course necessary to evaluate the specific regulations through local / sectoral cost-benefit analysis, but we should bear in mind the likelihood that performing such analysis we might miss goals and benefits at the broader level of the economy as a whole and the society overall. Careful specification is necessary for the quantitative validation of what the reforms attempt to achieve, particularly when large part of the benefits is not expected to occur immediately.

The implementation of the structural measures has become urgent. Opportunistic reactions are not welcome. Despite the short-term pains, their implementation will serve, in the medium term,

the developmental goals of economic policy which has to come hand in hand with the difficult task of rapid fiscal consolidation.

The sections that follow contain a discussion of the specific sectors for which the Memorandum indicates that they have to be reformed, except for the social security system that was described earlier. The next chapter presents a quantification of the medium term benefits from the implementation of the reforms in terms mainly of growth and employment, using a special econometric model and methodology.

3c1. Public administration

Simplification of the public employees payment system

The explosive growth of general government spending in the past few years is due to some extent also to the fragmented system of employment in the public sector. Irrespectively of the broader issues of measuring productivity and the quality of the services offered by the public sector, the inability to record the exact number of employees that work in all levels of government (including local authorities and public-law legal persons) on a permanent or contractual basis and their corresponding regular and supplementary wages and benefits hinders the process of making rational human resource management decisions. The creation of such registry is essential in order to enhance the transparency of public sector's payments, to achieve full control of payroll expenditure and lastly to reduce unfair treatment of employees with common characteristics.

In addition to the public servant census that will take place in July 2010, a Single Payment Authority (SPA) will be established. Its purpose will be to process all kinds of remuneration of the public servants and the individuals that work on project-based contracts for the public sector (including public-law legal persons, local authorities and their elected bodies). The centralised payment management offers better control of expenditure and its timing, which will also eliminate unequal treatment where some are paid without delay while others have to wait up to one year in order to receive a payment. Even under the hypothesis that the fragmented way of paying does not lead to lack of transparency and corruption, the existence of a single payment authority leads to economies of scale that eventually result in a more efficient state.

The above measure constitutes a true breakthrough for the public sector. It will enable one more reform related to the public sector's efficiency: the establishment of productivity rules that reward the more capable public servants. This dimension was largely absent from the existing remuneration structure of wages and benefits, which did not allow the rewarding of capable, responsible and conscientious employees.

Lastly, the SPA paves the way for creating a uniform remuneration system. The calibration of such a system, in cooperation with the trade unions, requires information on all public agencies and organisations. At last, the centralised planning of a public sector remuneration system, free from political and other interventions, has become feasible.

State procurement and transparency in decisions on public spending

The state procurement system has been accused in the past for lacking transparency and wasting public resources. The improvement of the state procurement process is probably the most important measure in the current tight economic conditions, while it also has a developmental dimension. In particular, the state is now required to function as an "intelligent customer", contributing to the creation of new markets, to the promotion of high-tech and innovative methods and applications, to the upgrade of the products and the services that it uses / offers to the citizens and the enterprises. The adoption of information and communication technologies (ICT) at various levels of the system can contribute to both expenditure savings and economic developmental. Direct costs, for example, can be reduced with ICT by locating more suppliers, at a national or international level, by boosting competition (e.g. with e-auctioning) or by enhancing transparency through avoiding concerted practices. But indirect cost can be reduced as well by reducing overhead costs and by shortening the duration of the procedures.

In addition, the requirement to publish all the expenditure decisions of the government on the internet contributes to transparency enhancement. Obviously, not all of the citizens will be in the position to check the legitimacy or the propriety of these decisions. Nevertheless, the involved parties in these procedures acquire access to information that was not widely available before. In any case, the essence of the publication requirement is its role as a factor for deterring corruption.

Local government reform

The main axis of reforms in local government is the "Kallikratis plan". It constitutes an important initiative for rationalisation of the size of local authorities to reflect a critical mass of citizens, infrastructure and resources. Which of the existing local authorities should be merged and what is the exact number of municipalities that are established are issues that do not have optimal solutions, besides, this is not the plan's ultimate goal. Still, in such a reform a strict methodological approach in the determination of the criteria can justify the choices made and to enhance their acceptance, which seems to be the case in the Kallikratis plan to a significant extent. The main issue is whether the new municipalities will have the integrity to plan and implement projects, actions and initiatives in a more efficient way than their predecessors. Nevertheless, it is worthwhile to mention that the savings that are achieved from reducing the number of local administration and elected officials is of secondary importance. What is of primary importance is the in-

creased efficiency from achieving economies of scale in various functions of the municipalities and the gradual upgrade of the services that the municipalities offer through their improved coordination.

Independent evaluation of the operation of the central government – Improved law-making process

According to the memorandums of the support agreement, an independent external organisation will evaluate the quality of the central government's organisation and operation. The aim is to adopt regulations and measures that will rationalise the use of resources, the organisation of the public administration and the effectiveness of the social programmes. Even though this initiative is intriguing, it should be noted that on enough occasions in the past various independent organisations were requested to perform similar evaluations, with varying success. The issue is to ensure that the evaluation will lead to some sort of corrective action based on its outcome and will not remain void exercise on paper.

In addition, the memorandums recommend rapid action in the direction of adopting "better regulation strategy". It should be noted that this is a EU strategy that the Greek governments have been obliged to follow. In this light, the memorandums perhaps demand greater commitment to the strategy's goals.

It should be reminded that IOBE has expressed its position regarding improved regulation,[32] stressing the need for:

- Systematic inspection of all laws in order to limit overregulation and regulation multiplicity.
- Impact assessment of all new laws with competitiveness as the main criterion.
- Regulation simplification to avoid the need for explanatory memos.

We consider the competitiveness impact assessment, in particular, as imperative in the current adverse economic situation. It will evaluate the cost and the benefits of a particular regulation for the whole economy, rather than for the limited, in most cases, field of the regulation's implementation.

[32] IOBE's Economic Policy Position, June 2009.

3c2. Income policy and labour market reforms

The Greek labour market is characterised by limited flexibility and "duality" between the public and the private sector, where the private sector is substantially more flexible. The most important issue in the public administration and the wider public sector is the modernisation of the employment regulations, in order to increase productivity and improve the level of service to the public.

This is clearly a policy area that needs quite a few interventions, which however would have been easier to implement in periods when employment was rising. The reforms have adverse consequences for unemployment in the short term, but improve competitiveness and productivity in the medium term. In this case too, the needed restructuring was not performed at suitable time in the past. Now, the reforms have to be implemented in a period when employment is declining.

It is clear that the memorandums touch upon quite a few sensitive labour market issues. According to the memorandums, the framework for wage bargaining in the private sector (including employment agreements at local level) between the social partners has to be reorganised in order to keep the wage growth low. The memorandums refer to a number of other contractual arrangements that have to be modified: level and conditions of severance payments; collective dismissal thresholds; minimum wages with an introduction of sub-minima for groups at risk such as the young and the long-term unemployed and a freeze in nominal terms for 3 years; temporary contracts and part-time work with enhanced facilitation; working time with more flexibility through an introduction of calculation of total annual employment time; overtime work pay rates (reduction); remuneration with enhanced link to productivity; arbitration system; etc. Most of the main characteristics of the Greek labour market, which for many years have been points of "friction" between workers and employers, are about to be reformed.

Indeed, there is a provision that the regulations regarding the private sector wage bargaining will be determined through dialogue with the social partners. This could become a good opportunity to use this framework to establish real social dialogue that will take into account the new economic environment. This dialogue can serve as a vehicle to promote a reform that serves the economy and the society as a whole, taking into account the structural problems not only of employment, but mainly of unemployment at sector and/or local level.

3c3. Health care reforms

The reforms in the health sector included in the memorandums focus on one more relatively obscure area of public procurement that, despite the recommendations from a number of international and local institutions, has still not been consolidated. Double-entry accrual accounting and preparation of financial statements, in combination with the existing for years control of the pharmacy pricing and rationalisation of the supply of consumables and medical equipment

through auctioning will allow improved control of the revenues and the expenses of the hospitals and will assist the detection of mismanagement practices and waste. The implementation of double-entry accounting system and integrated computer system for the social security funds and the hospitals, together with electronic monitoring of doctor's prescriptions, will not only improve the transparency in the management of public resources and rationalise the expenses in the health care sector, but will also ensure the supply of reliable data that will allow for better planning of health care policies per organisation (hospital, health care centre, etc.) and administrative region.

The new technology offers the proper tools for enhancement of the transparency of public procurement. The reason why these control tools have still not been adopted is not that they were not available, but because political will to implement was weak for fear of conflict with interest groups). Besides, the issues of mismanagement, deficits, accumulated debt, lack of control and absence of procedures for appraising personnel and practices have been present in the political, social and academic discussion on health care all these years. Despite this, the lack of a coordinated effort, in combination with the uncertainty stemming from the associated political cost, often created reactions from the involved stakeholders and delayed the implementation of reforms. This problem can and must be mitigated under the current circumstances through the strict implementation of the memorandums.

3c4. Business environment reforms

Facilitation of company establishment – simplification of the licensing of industrial clusters – implementation of the services directive

Nearly all projects that measure competitiveness (including World Bank's Doing Business reports) show that the business activity in Greece, both existing and perspective, faces obstacles and incurs significant costs, which makes the country unattractive to both domestic and international investors.

From start-up to closure, the enterprises in Greece encounter procedures, whose costs and duration are disproportionately larger in comparison with other developed European economies. In this light, any initiative that lifts any of the existing obstacles and simplifies the procedures, reducing the corresponding costs, without a doubt should be evaluated positively. In periods when the companies need to broaden their customer base, the measures related to the simplification of the exporting procedures and the adoption of the services directive, which lifts legal and administrative restrictions for cross-border provision of services in all EU countries, are especially useful.

The establishment of points of single contact between the enterprises and the state has featured in the inauguration speech of every Development Minister for the past six years, yet its implementation has been delayed.

Another important step is the curtailment of tax restrictions on mergers and acquisitions. It has been repeatedly mentioned in the past that the structure of the Greek production system hinders its competitiveness. Many small enterprises and a few large conglomerates characterise the Greek business environment. This results, on one hand, in inability to form a critical mass of large, competitive companies with international presence and, on the other, in increased difficulties for innovation penetration in domestic manufacturing. As a result, systemic lags that prevent the adoption of a more outward-looking approach and impair the competitiveness of the Greek economy are sustained.

Mergers and consolidation of large enterprises in a number of sectors would allow these companies to take advantage of scale economies on both the supply and the demand side. This will contribute to the effort to transform the Greek production system so as to enable more efficient utilisation of its resources. Every initiative for institutional support and facilitation of the implementation of these mergers is thus desirable.

Liberalisation of restricted professions

Despite the measures that have been taken in the past few years towards the gradual removal of entry restrictions in certain professions, in many product and input markets there are distortions that prevent the markets from operating competitively. IOBE has recommended the liberalisation of restricted professions and the removal of the obstacles to competition in product and services markets since June 2009. Minimum or recommended prices, legally fixed profit margins, reduced working hours in various sectors, restrictions on the mooring of cruise ships, restrictions on the baking and selling of bread, restrictions on licences for numerous activities, etc. constitute barriers to entering – but also to exiting – particular sectors of economic activity, which stifle competition. As a secondary effect, these restrictions add cost to the provision of certain services, which results in permanently high relative prices.

The memorandums note cases where there are distortions which ought to be eliminated, as they constitute protective niches in services where competition could promote the common good. Numerous prohibitions, restrictions and minimum tariffs / profit margins that exist in the legal, notary, auditing, pharmacy, architectural and engineering professions will be amended or eliminated. The specifics of the liberalisation legislation are left to the discretion of the Greek government.

The proposal to remove all unnecessary restrictions in road freight transport, including the minimum regulated prices, can serve as a useful guide for the remaining initiatives. In this specific field, IOBE published in 2006 estimates of the impact of liberalisation on the particular market and the economy in general.[33] In summary, this study indicated that we should expect: 1) Significant reduction in haulage tariffs (1.5%-2.5% annually), resulting in lower inflation rate by 0.2-0.3 percentage point annually; 2) Increase in the number of enterprises in the sector (1%-2% annually) and employment (2%-4% annually); 3) Significant productivity enhancement (1.5%-2.5% annually); 4) Reduction in the operating cost of the companies (2.5%-4.5% annually). The study also stated that there would be qualitative benefits, such as improvement in the quality of the offered services, renewal of the obsolete fleet, environmental impact reduction and road safety improvement.

Still, the draft bill that was presented for public consultation earlier in the year had enough of problems, the most significant of which was that significant entry barriers to the profession were preserved. It is evident that the issue in this case is the radical reduction of the cost of entry to the sector, so as to boost competition and reduce transport cost.

Railways – Energy

These two areas mentioned in the memorandums do not have the same characteristics, nor do they suffer from the same problems. In the case of the railway company OSE, to restructure radically an organisation that generates financial losses and burdens public finances on a daily basis is an issue of highest priority. Just as in the case of Olympic Airlines, the preparation of a consolidation plan in order to make the company more attractive, utilising advantages that it still possesses (buildings, land, etc.), is a necessary prerequisite for any possible privatisation, as the price should reflect the potential benefits for an investor from acquiring a part or the whole of an organisation and its subsidiaries.

In contrast, in the energy sector the problems relate mainly to the conditions and the progress of the market liberalisation process, as well as with specific parameters of a more general energy planning effort. The memorandums note specific tasks (liberalisation of the wholesale electricity market, rationalisation of the retail tariffs, the adoption of laws for the further unbundling of the transmission and distribution parts from the competitive operations in the gas and electricity state-owned companies), emphasising the need to strengthen the independence and the capacity of the Regulatory Authority for Energy. Specifically regarding the last point, IOBE has recommended in the past to secure the effective independence of the regulatory agencies through management continuity, funding on a long-term basis (e.g. from own resources coming from the regulated activity), recruitment of highly qualified experts, ability to resort to the market for stud-

[33] Palaskas, T. and C. Stoforos "The restricted market of public freight transport: Problems and prospects". IOBE, 2006

ies and consulting services, adoption of public consultation practices and lastly enhanced authority to intervene in state-owned enterprises too when these follow practices that distort the market.

Privatisation

IOBE has always supported the withdrawal of the state from activities that generate products and services already produced competitively by the private sector (banking, telecommunications, manufacturing, tourism), which would improve the productivity and the competitiveness of the Greek economy. However, as IOBE has emphasised, privatisation is not an end in itself, but a means of achieving more efficient use of available resources. That is why the privatisation plans should be evaluated not only based on their cash benefits, but on their overall impact on the Greek economy as a whole. The need to raise a particular sum (€1 billion per year for the period 2011-2013 according to the memorandums) should not lead us to ignore the fact that every privatisation effort should aim at certain additional gains, such as administrative and organisational modernisation, provision of high quality products and services, expansion of the product base, strengthening of entrepreneurship and human resources enhancement, while safeguarding the public interest in the meantime. Still, given the immediate need for public debt reduction, the price criterion should have increased weight in the current period of crisis.

The utilisation of the state-owned real estate could generate significant benefits, both in terms of cash inflow and economic development. In contrast to other Euro area member countries from the South, which experienced excessive land utilisation (e.g. Spain), in Greece significant opportunities in this direction are minimally exploited.

3c5. Promotion of foreign direct investment and exports – R&D and innovation

The promotion of foreign direct investment (FDI) in the country and in general investment in strategic sectors is connected with the improvement of the business environment and the abolition of entry barriers. Greece is placed very low (last from the OECD countries) in rankings based on the inflow of FDI. This result is, on one hand, due to entry barriers, time-consuming procedures, restrictive regulatory framework and frequently changing tax system, and, on the other, a result of the protectionist attitude that characterises the political establishment, trade unions and local communities, while vested business interests have also contributed to this.

Particularly in the current conditions of extreme liquidity drought and capital dearth that characterise the Greek economy, the elimination of the multitude of barriers that prevent the inflow of foreign investment is even more pressing.

In addition, there are also delays in the efficient utilisation of existing tools (new development law, whose adoption is already behind schedule; Public-Private Partnerships; National Strategic Reference Programme).

In addition, Greece still exhibits systemic lags in the National Innovation System (NIS). Key indicators of the NIS lag behind (weak private investment in research and development (R&D), poor exports of high added value products, limited cooperation between universities and the business sector, etc.). The Greek businesses do not as a rule venture beyond the adoption of innovations that are developed abroad. In such a way they do not invest in a national 'innovation pipeline', with the result that they are unable to develop in the medium term new competitive advantages even in traditional branches. In this way, Greece is strategically trapped between cheap producers on one side (low cost countries) and high quality producers on the other (countries with significant technological capabilities).

In conclusion, the measures that are planned for the promotion of research and innovation are not s luxury in a period of crisis, but prerequisite for improving key parameters of NIS, and ultimately enhancing the content and the value added of Greek production.

3c6. Structural and cohesion funds

Given the limited funding of the Public Investment Programme (PIP) from other sources, the National Strategic Reference Framework (NSRF) constitutes today the only monetary instrument[34] for stimulating growth in the hands of the government. Up to today, implementation of the programme is significantly delayed, for the following reasons (among others):

- Large part of the implementation of CSF III was transferred to the fourth programming period (2007-2013), while the expenses eligibility period of CSF III was extended to the end of 2009.

- The administrative structure of NSRF and its system of management and control differ substantially from the corresponding structure and system of CSF III, which led to delay in the integration of the new elements into the existing infrastructure and control systems.

- The practice of outsourcing administrative tasks caused problems for the coordination of management and planning and added red-tape.

- The implementation of the new policy of validating the managerial competencies of the beneficiary was delayed.

[34] We emphasise the term "monetary", because the most significant means for growth stimulation are of course the structural reforms.

- The elaboration and the planning of initiatives was completed behind schedule.

The need for faster implementation of the NSRF projects and for improved absorption of resources from the structural and cohesion funds is recognised in the memorandums. To achieve this, the memorandums envisage the setting of binding six-monthly absorption targets and the adoption of a mechanism of fast-track project production. Another measure contained in the memorandum is the obligation to submit at least 10 major project applications each year, based on the priorities set at policy level. The memorandums also contain a table specifying the amounts of payment claims that should be submitted between 2010 and 2013.

IOBE's position is that a prerequisite for the achievement of these goals is the simplification of the management and control system procedures and the utilisation of the experience gained from implementing CSF III. Irrespectively of the delays and the blunders that were observed during the implementation of CSF III, the infrastructure that was developed and the human resources that were trained and in general the experience that was gained should not be set aside.

In this light, there is no time for radical revision of NSRF, as this presupposes the preparation of mid-term evaluations. It is preferable to direct the effort into specification of the general directions and budgets of the axes and the priority codes, in order to promote the reforms dictated by the recent socioeconomic developments and the necessary interventions to tackle the current economic crisis. In any case, the acceleration of the implementation cycle of the projects, the simplification of the procedures and the preservation of the managerial expertise of all the Managing Authorities and Special Services of the Operational Programmes should become the main goal in this policy area. The acceleration of the project implementation and the simplification of the procedures do not contradict the transparency principles, as they limit the margin for subjective or selective law enforcement and make the control procedures more efficient.

4. The macroeconomic impact of the structural policies for strengthening competition in the market for non-tradable goods and services and in the labour market: An assessment for the Greek economy

4a. The need for immediate implementation of structural reforms in the Greek economy

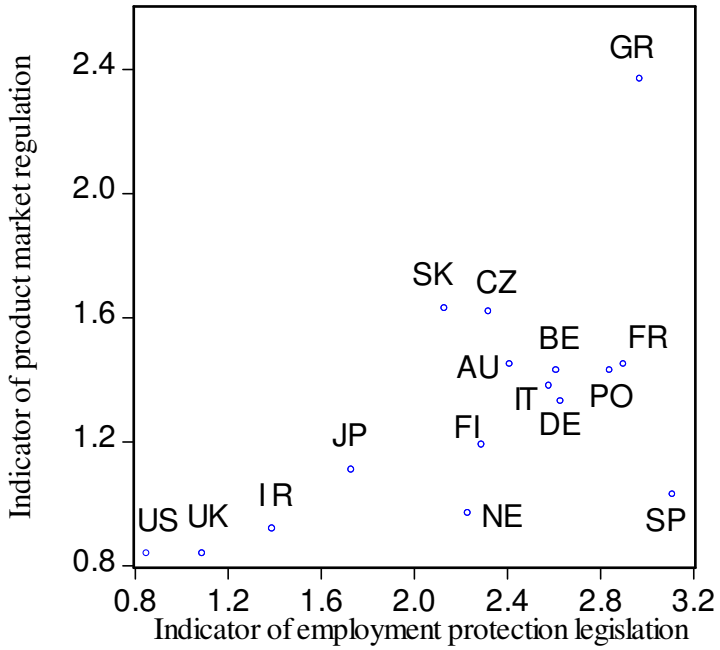
Fiscal consolidation and regaining the confidence of global markets constitute the cornerstone of the Memorandum of Economic and Financial Policies. Nevertheless, the Memorandum also contains a series of important structural interventions (presented in detail previously), which aim at boosting competitiveness, reorienting and restructuring the economy towards investment and exports, increase of the total national savings and lastly increase of the medium-term potential economic growth rate. It should become clear from the start that the structural interventions are not

additional nuisance or a forced additional requirement under a fiscal stability memorandum, but one of the pillars and an essential element of a holistic economic policy approach with multiple targets and multiple policy instruments. The effective and strict implementation of the structural interventions is a prerequisite for the success of the whole endeavour of stabilising and repositioning the Greek economy on a path of sustainable development.

According to the publicly available structural indicators, but also in the competitiveness indicators compiled by OECD and the World Bank,[35] the Greek economy, despite its progress in the past few years, occupies an exceptionally low place in the country rankings, both in terms of direct indicators and from the perspective of competition law enforcement, competition inspections, import restrictions and licensing and labour market protection.

Figure 6

The structural gap: Extent of intervention in the labour and product markets



Source: OECD

Figure 6 shows two main indicators that are complied by OECD for monitoring the progress of structural reforms in its member countries – the Product Market Regulation index and the Employment Protection Legislation index. The position of Greece on the graph is revealing for the extent of its existing economic regulations and restrictions. It is clear that there is ample room for improvement, which is the optimistic interpretation of this figure. It is fortunate that in the current adverse circumstances there is this "structural gap" which should be covered.

[35] Indicatively, we refer to the working papers of OECD's WP1 group and the papers by Hoj (2007),Jean and Nicoletti (2008) and Wolfl et al (2009), which were also written as part of OECD projects. Also, World Bank's Doing Business report contains many useful structural statistics for a large number of countries.

With a robust and effective implementation of the Memorandum's structural interventions, Greece will approach a satisfactory level of efficiency and competitiveness and will achieve a clearly better resource allocation, contributing to its citizens' welfare. In the new equilibrium state, output and employment will be at substantially higher levels, while inflation will be significantly lower. In addition, during the transition to the new equilibrium, the beneficial effects from the reform programme implementation will neutralise – partially, at least – the short-term adverse effect on the economic activity and employment from the highly restrictive fiscal policy, which would improve the social acceptance of the whole programme.

It should be noted that both in the international bibliography and in the current policy discussions in global institutions, there is a conceptual shift towards the recognition that the inter-country differences in terms of per capita GDP levels and growth rates are due more to structural weaknesses and lags rather than differences in technological progress, which until recently was considered the main factor in the catching up process.

The reform proposals contained in the Memorandum are not something novel. The implementation of structural reforms that boost competition and the need for change of the Greek economy's model of development have been emphasised in other recent publications and compiled volumes, including reports of the Bank of Greece.[36] We should also mention the recent OECD report 'Greece at a glance' (2010), which stresses the need for immediate implementation of a wide range of structural policies in Greece as the only solution for boosting its productivity, for promoting its sustainable development and for alleviating its structural misbalances.

The difference between the Memorandum and the aforementioned publications comes from the fact that the proposals it contains are now a law of the state and as such they should be implemented. Still, it should be stated that the various scenarios for the medium term prospects of the Greek economy that were compiled by IMF and EC, do not incorporate the positive impact from the structural policies. The introduction of the additional impact from the reforms would have generated a more optimistic picture on the Greek economy's prospects, which would have helped in the formation of a different public opinion by both the social partners within the country and the agents in the global markets.

4b. Structural reforms assessment

IOBE, as part of the assessment of the impact of the measures contained in the Memorandum on the Greek economy, prepared a special study that focuses on category of structural reforms that are aimed at boosting competition in the non-tradable goods and services sector and the labour market.

[36] IOBE and most domestic commercial banks have also taken similar positions in their studies.

These sectors were chosen not only because of their large contribution to the Greek economy[37] or the fact that they are specifically mentioned by the Memorandum. They have special significance because the strengthening of competition and flexibility of sectors not exposed to international competition leaves more room for improvement, allowing for more immediate reallocation of productive resources to sectors with higher added value and openness. For a small economy such as the Greek, which belongs to the Euro area, this will contribute to the utilisation of the potential benefits from its participation in the single European market. It is a fact, supported by empirical evidence, that competition strengthening motivates the enterprises to achieve greater efficiency and to search for high-tech innovations, which are the primarily drivers for enhancing total productivity of the factors of production. Furthermore, it should be noted that market liberalisation and competition strengthening limit the excessive rents that are created by imperfect competition (mainly in the services sector), which usually accrue to organised minority groups. The elimination of excessive rents results in better alignment of productivity and real wages and in lower inflation rate.

The reduction of the excessive protection of employment and the alleviation of inflexibilities in the labour market are additional important potential factors for boosting employment. Meanwhile, the demolition of market entry barriers and the reduction of red-tape and other entrepreneurship obstacles could generate significant gains in terms of employment and value added, but also in terms of more foreign investment. In addition, the non-tradable goods and services sectors include the network enterprises, for which there are significant entry barriers and significant state ownership, which creates additional inefficiency.

In this study an attempt is made to:

1. Estimate the impact of the structural reforms on key macroeconomic indicators.
2. Outline general recommendations for their effective design and planning.
3. Examine the redistributive effects of the reforms, i.e. which social groups are expected to benefit relatively more from them.

In other words, the research questions here can be summarised as follows: if a structural reform programme, such as the one contained in the Memorandum is implemented in the Greek economy and the markets for goods, services and labour become as flexible and competitive as the corresponding markets in the Euro area what is the impact on output, employment, prices, etc. ? And secondly, how should the measures be prioritised and synchronised in order to minimise the short-term cost? The answers to these questions are provided through comparative assessment of alternative scenarios, which are compiled with an empirical general equilibrium model.

[37] The services sector in Greece, which generates mainly non-tradable goods, covers more that 75% of the country's gross added value.

This study is an instance of a wider research effort of IOBE, which aims to contribute to the public dialogue by providing constructive criticism of applied economic and structural policies by contributing specialised and, to the widest possible extent, quantified proposals.

Relevant recent theoretical and empirical studies have been conducted by Blanchard and Giavazzi (2003), Bayoumy T. Laxton and P. Pessenti (2004) F. D' Auria et al. (2009) and Forni et al. (2009). These studies highlight the implementation of structural reforms in product and labour markets as the main factor in the medium term for significant, permanent boost to the level of output, investment, employment and welfare.

4c. IMF's dynamic general equilibrium model GIMF

It is now recognised that the economic policy's effectiveness depends to a large extent on the possibility to explain it so that it can be comprehended by the wider public. In this respect, contemporary quantified macroeconomic policy is tightly linked with appropriate econometric models. These models constitute formal and detailed representations of the decisions of the economic agents and the authorities within a consistent, specialised, theoretical framework. These models, apart from their use to assist in the design of economic policies, provide additional effective means to communicate policy proposals to the wider public.

In this study the main analytical instrument is a version with two control areas (Greece and the Euro area) of the multi-country, multi-sector, general equilibrium model GIMF (Global Integrated Monetary and Fiscal Model), that was recently developed at the IMF (M. Kumhof et al. 2010).[38] GIMF is a Neo-Keynesian dynamic stochastic general equilibrium model (DSGE). It contains enough detail to cover a wide range of policy questions through alternative scenarios. The model has many sectors, while its theoretically sound microeconomic foundations make the interpretation of the results easier. The model is characterised by high degree of realism, i.e. from a sufficient number of real and nominal rigidities, which extend across sectors, while monopolistic competition characterises labour and product markets. The input market is completely competitive. The presence of adjustment cost (investment, imports), but also the presence of exogenous habits in consumption, together with other characteristics, allow for sufficiently realistic short-term dynamic behaviour in the aftermath of exogenous shocks.

In the model the economic agents form their expectations rationally. Still, a characteristic element of the model is that its structure allows for strong fiscal effects when tax or public spending vary. This is an important comparative advantage of GIMF, in relation to other Neo-Keynesian DSGE that are used in international institutions and central banks, where fiscal policy is almost neutral.

[38] The GIMF model belongs to the latest generation of DSGE models, aimed at analysing policy. It is the product of an evolutionary process that started in IMF more than 20 years ago with the Multimod series of models. The first multi-country DSGE – GEM – was presented in 2004, when Economic Counsellor of the fund was Ken Rogoff. GIMF is GEM's successor.

The GIMF version that has been developed in IOBE comprises of two structurally similar models for Greece and the Euro area, which are linked mainly through foreign trade variables, but differ in terms of the values that their main parameters take in the model calibration. The calibration that was performed based on Greek national accounts and a number of applied studies on the Greek economy, satisfactorily represents the main characteristics of the Greek economy in a steady state for the base year.[39] For the Euro area economy we used the values of the parameters form the dynamic general equilibrium model of ECB [Coenen et al. (2007) and Christoffel et al. (2008)].

The model assumes imperfect competition in the product and labour markets, which is modelled with mark-ups over the marginal cost (competitive price) of goods and services and with wages mark-up over the marginal product of labour (reservation wage). The strengthening of competition corresponds to decrease in the mark-ups or equivalently with increase in the product and labour diversification.

4d. Scenario description and results

Initially, a scenario of stable long-run macroeconomic equilibrium is established, where the mark-ups of Greece in non-tradable goods and services and in the labour market are higher than the corresponding mark-ups of the Euro area, keeping their values fixed at the level of the calibration's base year. More specifically, the mark-up in the Greek non-tradable sector is fixed at 1.6 and the labour market mark-up is 1.5. The corresponding Euro area mark-ups stand at 1.35 in both non-tradable and labour markets. This scenario is named 'pre-structural reforms reference scenario'.

After that, the model is run in an environment where the mark-up of non-tradable and labour markets is gradually reduced so that within a five-year period it declines by 15% and 10% respectively from its initial values, approaches the levels in the Euro area.[40] The reduction reflects the effect on the mark-up from the structural reforms in the non-tradable and labour markets, which in this model are assumed to be implemented gradually. Still, it should become clear that the present study does not specify the structural reforms that will lead to the particular mark-up reduction. It reasonably assumes that the implementation of all the reforms that are envisaged in the Memorandum achieves this goal. Lastly, the simulations are performed under the assumption of complete knowledge of the future shocks, which implies a perfect foresight forward solution (i.e. that the economic agents fully discount these shocks during the dynamic solution of the model).

[39] For the calibration we used the means of the 2000-2007 period of the national accounts data, while certain parameters were set *a priori* at reasonable levels.
[40] This is achieved by endogenising the mark-up through autoregressive forms that describe its evolution.

Table 5 presents the long-term impact on certain key macroeconomic indicators from the simultaneous implementation of the two structural shocks and from the implementation of individual shocks in the mark-up of product and labour markets.

The results show an exceptionally strong positive long-run impact on key macroeconomic aggregates from the simultaneous implementation of the reforms in non-tradable and labour markets. GDP, consumption, investment and real wage in the new equilibrium are significantly higher compared to the steady state in the simulation with pre-reform mark-ups. In particular, GDP in the new steady state is higher by 17% in comparison with its level in the pre-reforms scenario. The impact on employment (in hours) is weaker (3.4%) mainly because of the increase in the real wage. In addition, large and continuous growth appears in both capital stock and private investment. In the new steady state, capital stock is higher by approximately 16.5% compared to its base year value. The real devaluation contributes to export boost. The fiscal deficit (central government and primary) as percentage of GDP, together with the current account balance, go through a significant short-run improvement before returning to their long-run steady state. Public debt as percentage of GDP accumulates in the long term the gains from the short-term reduction of the fiscal deficit.

Table 5

The long-run impact of structural reform on key macroeconomic aggregates (percentage deviation from the pre-reform simulation)

	Non-tradable sector	Labour market	Non-tradable and labour market
GDP	13,5	3,2	17,0
Private Consumption	15,5	3,7	19,6
Private Investment	12,4	2,8	15,6
Real Wage	12,8	-0,6	12,2
Employment	1,5	3,4	4,8
Exports	8,4	2,0	10,5
Imports	6,4	1,7	8,3
Labour share	0,0	1,3	1,3

Real wage increases significantly in the new steady state, which comes from the increase in productivity and the fall in prices. The non-tradable inflation, relative to the inflation at the consumer level, declines in the short-run, after which it returns to its reference value.

The transition from the initial pre-reform steady state to the new equilibrium is presented in Figures 2 to 4. The differences in the transition paths between the stand-alone reforms in the two markets is presented in Figures 5 and 6. In the case of reforms only in the labour market, consumption falls below the reference case for three periods (Figure 6), which results in total product

marginally below the baseline for one period. This impact is due to real wage dynamics, which during the whole simulation period remains slightly below the baseline, as well as due to increase in real interest from the fall in inflation. The real wage dynamics are due to the fact that as the trade unions lose bargaining power, the nominal wage falls, while prices fall by a smaller margin as a result of the presence of adjustment costs. In contrast, investment in both simulations follow stable growth path, which comes from expectations for higher output. It should be noted, however, that in both simulations, consumption lags behind the growth of output, leaving room for capital stock accumulation.

If we add the results of the two stand-alone simulations we get close to the results from the simulation of the simultaneous implementation of the two shocks. Based on this, some could state that the timing and the order of implementation of the two sets of structural reforms are not significant, since the final result is almost the same. Nevertheless, the results show that simultaneous implementation is preferable. The reason is that the impact from implementing the reforms in the non-tradable goods and services sector exceeds the short-run costs from implementing the reforms only in the labour market. In particular, problematic is the real wage decline observed in the labour market shock under the stand-alone implementation. The policy implication that stems from the results of this study is that it is preferable for the reforms to start with the product and services markets, which have immediate positive impact creating a more optimistic sentiment, while the more painful (in the short term) labour market reforms can come second. This implication was also made by Blanchard and Giavazzi (2003), who studied the impact of real wage reduction in a theoretical model.

It should be noted that the strengthening of competition in the market for non-tradable goods and services raises the share of labour in output in the long run. The share of labour in value added is inversely proportional to the value of the mark-up in the labour market. The dynamics of the shares of labour and capital in value added as a result of the shocks in non-tradable and labour markets is presented in Figure 12. In the long run, labour's share is higher by 1.3% after the shock, compared with its share in the baseline simulation.

In order to examine the dependence of the results on the assumption of the initial calibration, we performed sensitivity analysis, varying specific key parameters of the model (see Appendix A). In particular, the same procedure of simultaneous implementation of the two shocks in the labour and product markets was repeated twice. In the first simulation, we changed the inverse of the elasticity of substitution in the consumption function from 5 to 0.99. In the second simulation, we modified the elasticity of labour supply with respect to the real wage from 0.36 to 0.6. The results presented in Table 1A of the appendix differ from those in Table 1, which is expected, but the qualitative implications of the results are not altered. This test showed that the impact of the

structural reforms on the macro aggregates of the Greek economy is strong and the results are robust to changes in the parameters.

An attempt was made to assess the impact on the Greek economy's aggregates in case that the reforms in the non-tradable goods and services sector are not implemented strictly and effectively and the mark-up does not fall to the desired level of 1.35. The results of this attempt are presented in Appendix B. In particular, two simulations were performed. In the first, the mark-up in the non-tradable sector falls gradually to 1.4 and in the second to 1.5 from the initial level of 1.6. The impact of these interventions is, of course, significantly weaker from the complete and effective implementation of the measures (Table 1). The quantitative results are presented in Table 1.B in Appendix B. This test confirms the stance that the implementation of the reforms should take place with great diligence and effectiveness so that the benefits are as large as possible.

4e. Summary and final remarks

The structural reforms contained in the Memorandum in relation to boosting competition in the market for non-tradable goods and services and in the labour market are unambiguously beneficial. The simulations show that these reforms have very strong long-term beneficial impact on key macro aggregates of the Greek economy. Overall, the results are reasonable and consistent with the results from studies of the same type performed for other countries. In addition, the results are relatively stable with respect to modifications in the key parameters of the models. The implementation of the reforms should take place immediately and in parallel with the policy of fiscal consolidation, in order to minimise the short-run negative impact from the latter. The Memorandum contains a complete policy proposal and for this reason it should be implemented fully (with all available means), diligently and effectively, so as to achieve the anticipated impact and to meet the targets. The fact that Greece is lagging behind in comparison with its partners from the Euro area in the structural reforms area is fortunate, since there are gains that can accrue in the few critical years that follow. Closing the structural gap and catching-up with the EU averages confer significant benefits for the Greek economy in terms of output and employment. In addition, this transition will contain a redistributive element, strengthening the share of labour in output.

The impact of the structural reforms on the macro aggregates of the Greek economy will have to be integrated, *a priori* at least, in the design of the macroeconomic scenarios by the experts of IMF and EC. Higher nominal GDP growth rate from that assumed in these scenarios, for instance, will provide a much more optimistic picture for the Greek economy's prospects in both the domestic and the global markets. Inevitably, this will lead to review of some of the policy measures.

Annex A

Table 1.A.

Sensitivity analysis – Percentage deviation from the pre-reform scenario

	Baseline simulation	1/γ =0.99 (5.0)	η= 0.6 (0.36)
GDP	17.0	16.8	18.6
Private Consumption	19.6	19.2	21.4
Private Investment	15.6	14.9	16.8
Real Wage	12.2	11.9	11.8
Employment	4.8	4.9	6.4
Exports	10.5	10.3	11.6
Imports	8.3	8.0	8.9
Labour share	1.3	1.3	1.3

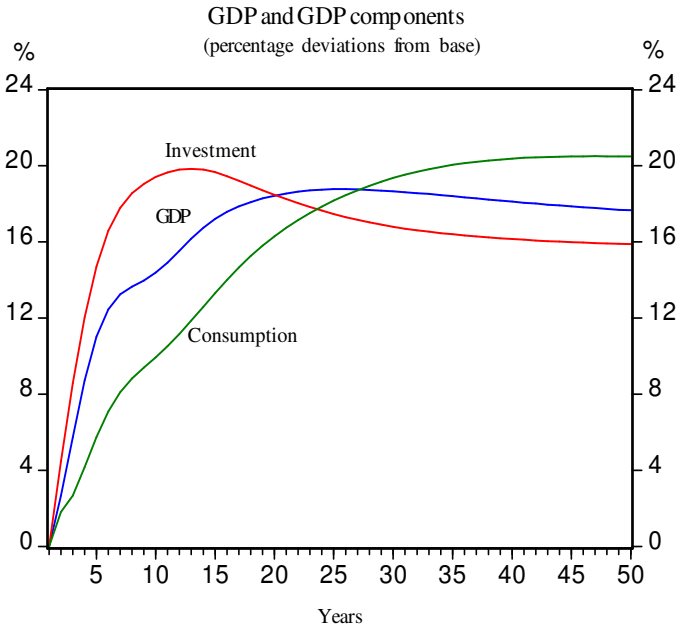
Annex B

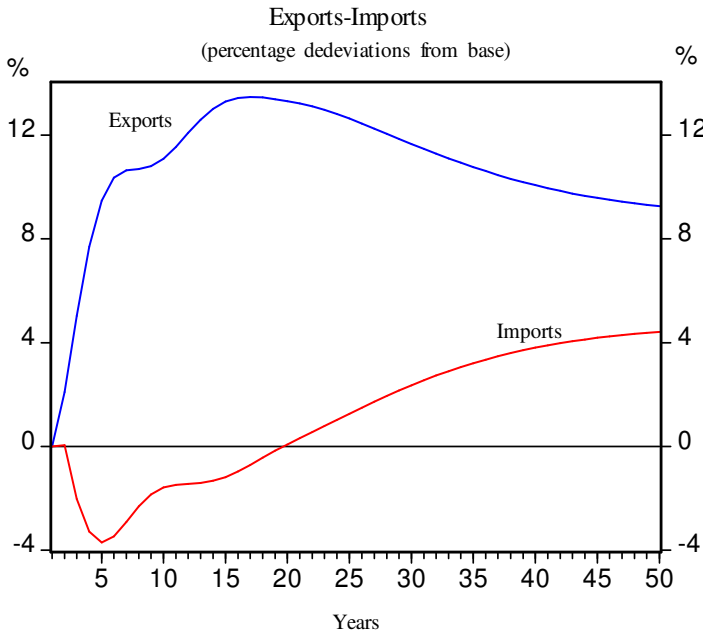
Table 1.B.

Long-term impact of different mark-up values in the non-tradables sector (Percentage deviation from the pre-reform scenario)

	Baseline simulation's mark-up: 1.35	Scenario 1 mark-up: 1.40	Scenario 2 mark-up: 1.50
GDP	13.5	11.1	4.8
Private Consumption	15.5	12.7	5.5
Private Investment	12.4	10.2	4.4
Real Wage	12.8	10.5	4.5
Employment	1.5	1.3	0.6
Exports	8.4	7.1	3.1
Imports	6.4	5.2	2.5
Labour share	1.3	1.1	0.5

Figure 7


GDP and GDP components
(percentage deviations from base)
%
Investment
GDP
Consumption
Years


Exports-Imports
(percentage dedeviations from base)
%
Exports
Imports
Years

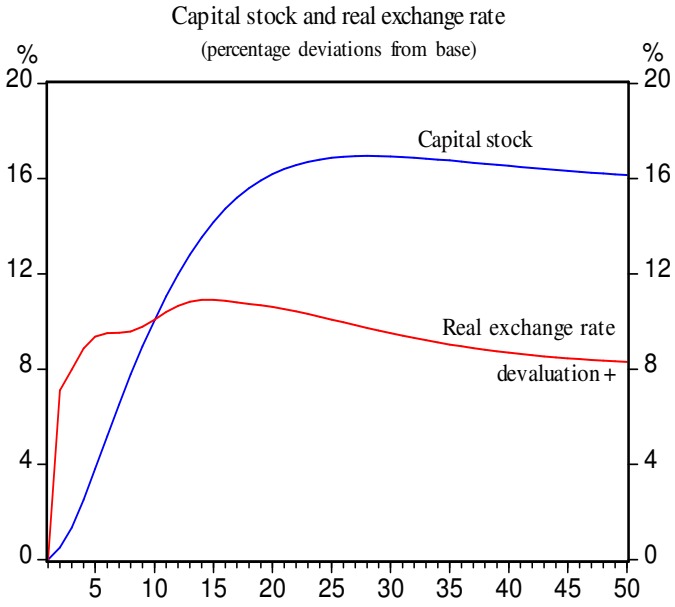
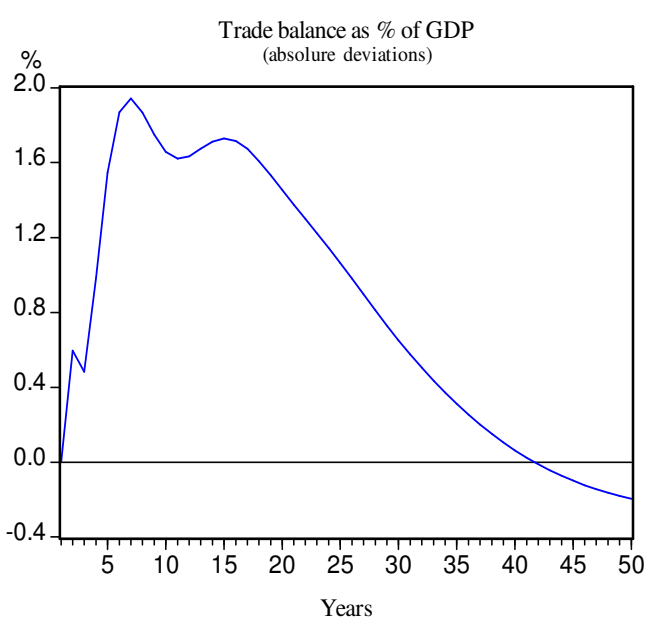

Capital stock and real exchange rate
(percentage deviations from base)
%
Capital stock
Real exchange rate
devaluation +

Figure 8



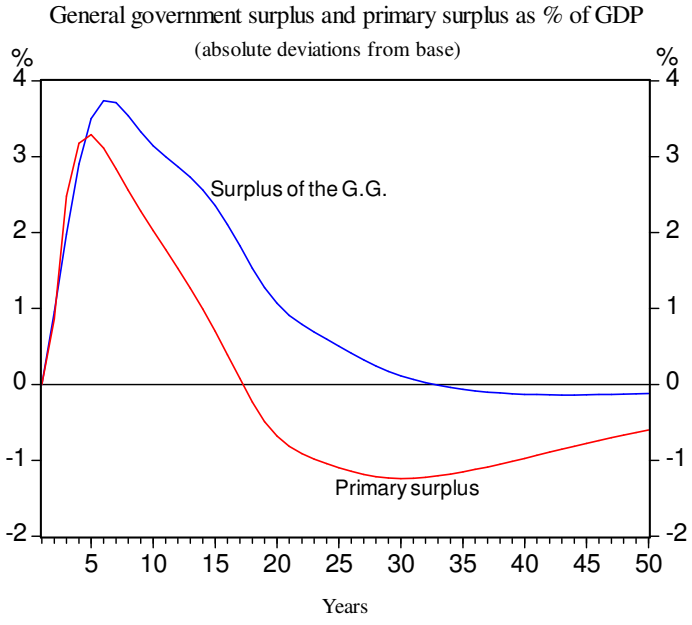
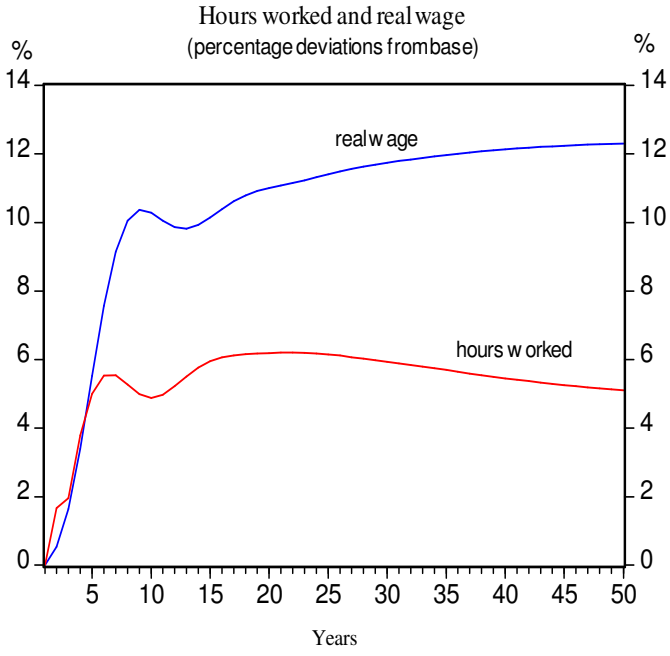


Figure 9



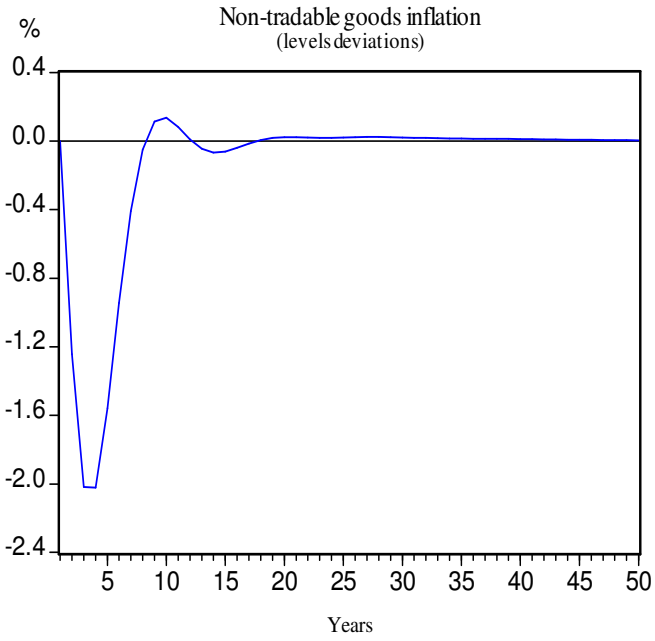
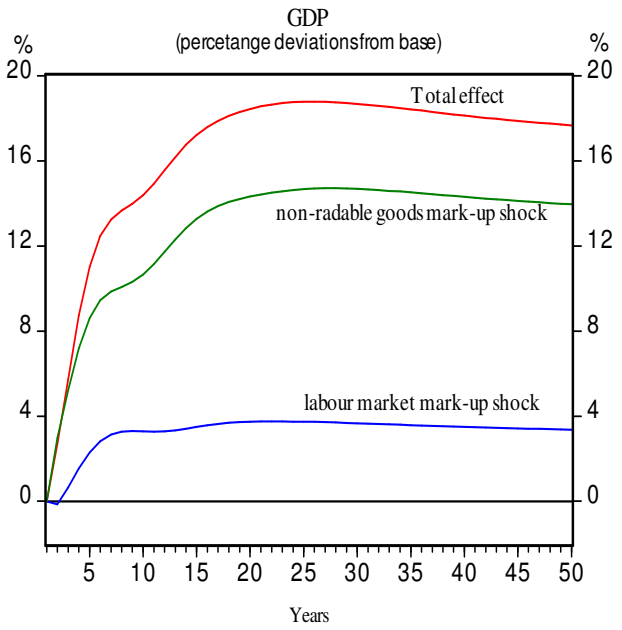


Figure 10



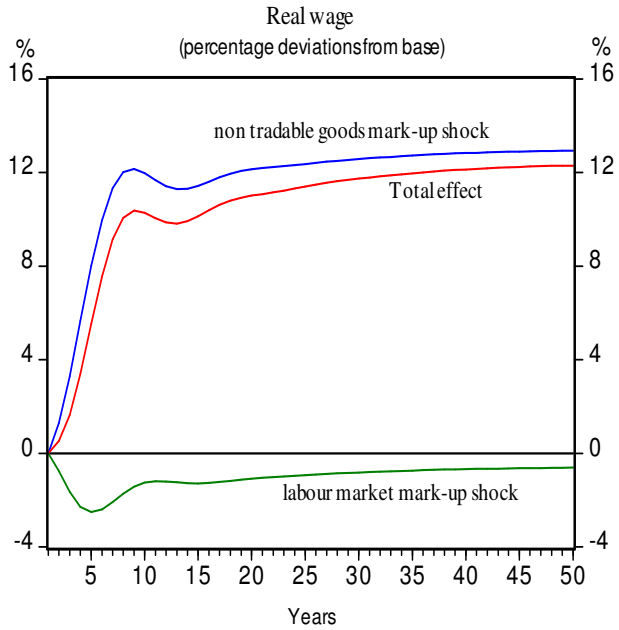
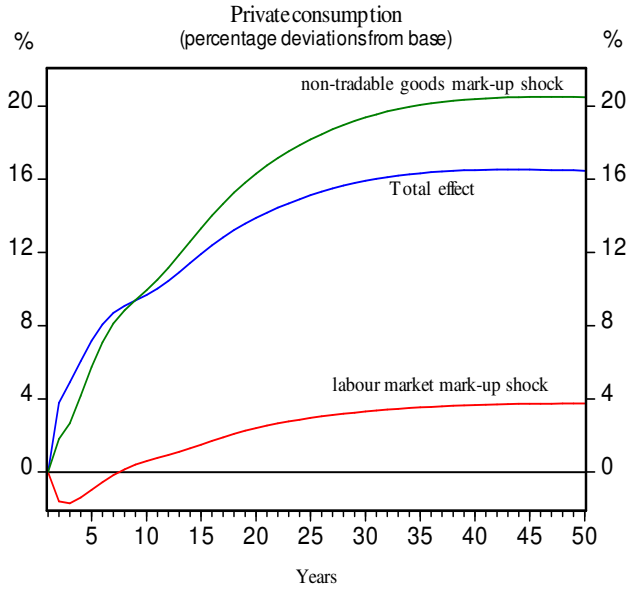


Figure 11



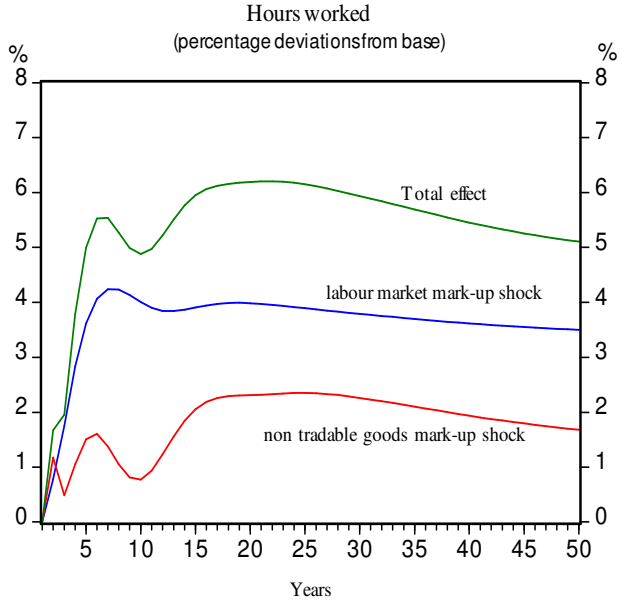
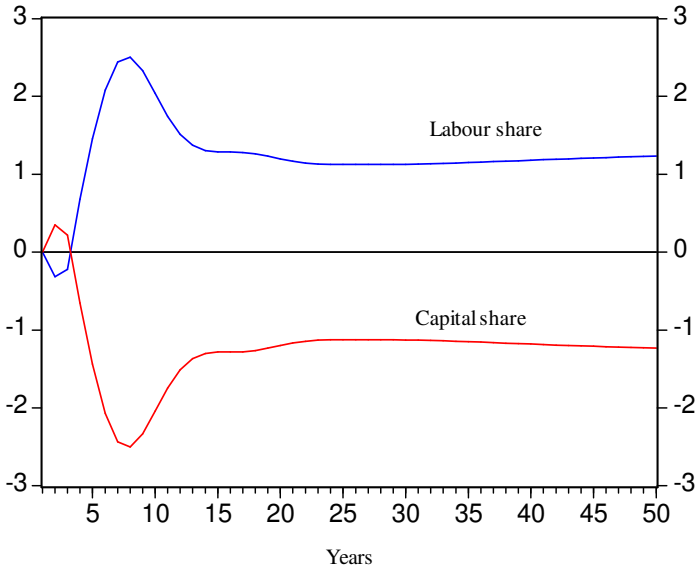


Figure 12

Capital and labour shares
(absolute deviations)



5. Key Findings and Conclusions

The current IOBE report on the Greek economy is devoted to the presentation, analysis, assessment and appraisal of the Memorandum of Economic and Financial Policies.

The Memorandum constitutes a radical innovation in the way economic policy is exercised in Greece. It is a strict, but absolutely essential, medium-term programme for the restructuring of the Greek economy, which has already become a law of the state (Law No. 3845/6.5.2010). In the short term, it aims to help the Greek economy avert the risk of bankruptcy, by providing a loan of € 110 billion at an average interest rate of 4.3%, in a period when the international financial markets are firmly closed to the Greek state and Greek banks. A prerequisite for the disbursement of these funds is the implementation of the terms set out in the Memorandum'.

IOBE wishes to encourage and facilitate the implementation of the Memorandum, and the present report is a first attempt in this direction. The Memorandum, which is currently being demonised by a section of the press, labour unions, professional and business groups, as well as by a section of the political establishment, is the lifeline for Greece's salvation. Of course it is no panacea, leaving significant issues unresolved so that their solution can be planned and implemented by the Greek government over the course of the coming decade. These issues are mainly of institutional, structural and social security nature.

The global economic community today has turned its spotlight on Greece. The phrase 'Greek public debt' pops up in almost every analysis.

Can a country whose domestic output represents four to five tenths of one percentage point (0.4%-0.5%) of world GDP pose a global threat? Unbelievable, but true. Today, especially after the Lehman Brothers collapse, the global financial markets are dysfunctional. They act either as distorting lenses that frequently produce false images or as systems that are hypersensitive to risk, sounding the alarm at the slightest hint of danger. However, because nobody knows how long these markets will remain dysfunctional, the best that Greece can do is to reverse its image as soon as possible by radically and immediately improving its performance.

Despite the exaggerations that are said and written about Greece, sometimes in good and sometimes in bad faith, the fact remains that the country is facing its most serious economic crisis since mid 1970s and probably since WWII. This crisis has arisen mainly from its own mistakes and omissions. It is a twin crisis: public finances and competitiveness, and is largely due to the reckless expansion and dysfunction of the state.

The Greek economy is in its present extremely difficult situation as a result of: (a) expansion of the unproductive public sector at the expense of the private sector; (b) circumvention of any notion of competition, appraisal and incentives for improved performance within the

various activities of the public sector; (c) imposition of countless restrictions on entrepreneurship (restricted professions, opening hours, fixed profit margins, complex licensing procedures, outdated rules and regulations, etc.); (d) preservation of a stillborn and socially unjust social security system; and above all (e) complete loss of control of budget expenditure and revenue between 2007 and 2009.

What began in mid-70s as a reasonable democratisation procedure, when social groups excluded during the post-civil-war period were given access to participation in the governance of the country, derailed from its normal course and degenerated into populism, which, although occasionally interrupted by certain bright intervals, resulted in the current dramatic predicament.

However, as economic history teaches us, every great crisis also presents a great opportunity. Some of the countries that suffered major crises were driven into bankruptcy and deprivation, but others managed to achieve regeneration and a repositioning. Critical success factors in crisis management is the rational and timely economic policy response aiming at remedying economic imbalances, at openness, at mobilisation of the productive forces (entrepreneurship and labour), at the immediate abolition of disincentives.

But the most important factor is the undertaking of leadership initiatives on the part of the country's political system. The management of major crises is not unlike a battle for survival. It needs high morale, reliable battle plan, coordinated action, modern weapons, good generals, sufficient ammunition, good alliances and available resources. Greece is in the fortunate position to be facing the greatest crisis in its contemporary history while being under the 'protective umbrella' of the Euro area, to which the International Monetary Fund (IMF) also contributes. The resources that the three institutions – European Commission (EC), European Central Bank (ECB) and IMF – provide so that Greece can meet its medium term borrowing needs constitute, all things considered, the biggest rescue package ever provided in contemporary global economic history.

As already noted, a prerequisite for the disbursement of these funds is compliance with the terms of the Memorandum that was jointly prepared by the Greek government and the three international institutions. The Memorandum sets out targets, actions and policy measures over a three-year period, related to four areas: public finances, social security, structural reforms and the financial system. Both the targets and the means contained in the Memorandum were presented, analysed and assessed in the present report.

The measures contained in the Memorandum are necessary in order to restore the Greek economy and are consistent with the establishment of a new, viable model of development. IOBE, along with other institutions, has for years been advocating this direction.[41]

[41] "IOBE's positions on economic policy" June 2009, "IOBE's positions on an effective state" July 2006.

An important difference is that today these measures and target have become a law of the Hellenic Republic. And because they have a three-year time frame, they comprise a strictly delineated, medium-term economic policy framework.

Many ask whether this framework is sufficient in order for the Greek economy to overcome the current crisis. The financial markets are wondering whether the Greek economy will manage to avoid some form of debt restructuring, given that, even with this economic policy framework, the country's public debt as percentage of GDP will reach 150% in 2013, according to the Memorandum's projections, before starting to fall immediately after.

IOBE is of the view that the diligent implementation of the Memorandum can lead the Greek economy to fiscal consolidation and economy recovery. As already noted, the current report aims at presenting the content of the Memorandum, so as to encourage and facilitate its implementation through specific proposals, and to analyse the presented opportunities and the 'hidden' forces of development which can be released by the implementation of the envisaged measures. For example, the model that was presented for assessing the macroeconomic impact of the reforms in the markets for goods, services and labour provide indications that the abolition of obsolete, almost soviet-type, clientelist restrictions that are currently in place, may increase national output by about 10% over the next five years, providing a strong counterbalance to the essential fiscal consolidation. Employment and real wages are also expected to increase. However, these beneficial developments are not included in the macroeconomic scenarios of the Memorandum and as such can serve as a 'pleasant surprise' for the global markets.

Some might, of course, claim that the economic models are merely table-top exercises. This is largely true, and IOBE in particular, which is not simply a think tank, but a think-and-do tank, believes that even the best plans can fail in practice due to inadequate organisation and management. IOBE also acknowledges that it is not easy to change from one moment to the deeply rooted, deviant attitudes and habits. As already noted, there is a need for leadership skills and initiatives, coordinated action and a realistic and flexible approach, which dictates the abandonment of protectionism and state interventionism as growth levers and the adoption of outward-looking policy of development that is friendly to foreign capital. Greece can attract significant investment in the primary sector, energy, transport, tourism, the financial sector, health care, industry and commerce, provided it adopts this new approach. Arguments about branches, enterprises and banks loosing their Greek character, at a time when the country is facing drastic liquidity restrictions and capital scarcity, are misleading. They simply encourage protectionism and aim at preserving the status quo that led us into the present situation.

The response to the investment of the Chinese company COSCO in the port of Piraeus is a typical example of faulty initial manoeuvres, stemming from the dangerous embrace of the political establishment with the trade unions, which had adverse impact on the image of

Greece as a destination for foreign investment. Thankfully, reason finally prevailed, making it possible for Chinese investments to act as catalysts for the future of many sectors of the Greek economy.

Wide-ranging privatisation programme and the utilisation of idle state property could contribute decisively to the realisation of major private investments, but also, as previously noted, to a reduction of the debt-to-GDP ratio to a level significantly below what is envisaged in the Memorandum's baseline scenario.

The Memorandum touches only the surface, or not at all, of some important policy issues. For example, the programming time frame should be extended to 2020, so that it can be linked to changes in the country's model of development from the side of total supply. Also, issues related to the so-called "knowledge triangle" (education, research, innovation), to the treatment of overregulation through the simplification of legislation and to the fight against corruption, play decisive role for competiveness in the long term.

Regarding the debate about the restructuring of the public debt, it should be said that the creation of primary fiscal surpluses of around 6% of GDP, as envisaged in the Memorandum, will most likely convince the financial markets of the Greek state's solvency, since, as analysed in the chapter on public finances, it would result in rapid deceleration of the debt-to-GDP ratio from 2013 onwards. Thus, the refinancing of the public debt could continue normally after 2012. However, if the financial markets are still dysfunctional or sceptical at that time, then it is quite possible that the financing of Greece from the three international institutions will be extended for a further three years, rather than Greece being forced to resort to some kind of debt restructuring. Of course, the debt restructuring could not have been avoided if it was not for the intervention of the three institutions. Those who still argue in favour of this solution appear to be unaware of the new reality in the Euro area and in particular the establishment of special purpose vehicle with € 750 billion initial capital from the Euro area member countries and IMF, which was already approved at the Council of Europe on 17/06/2010. Recall that the current account of the Euro area is nearly balanced. Essentially, this implies that the borrowing needs of the Euro area member-countries from the South are about equal to the current account surplus of the member countries from the North.

In this respect, it would be an omission not to stress the fact that even though the current crisis causes 'shock and awe' in Greece, it helps with the implementation of necessary restructuring, which also provides valuable lessons for the Euro area. The main lesson is that even though the Greek problem could be the most serious, it is not the only one. A monetary union between very different economies cannot be preserved without a crisis management system. The establishment of the Special Purpose Vehicle, which could be considered as a European Monetary Fund forerunner, should be accredited to the Greek crisis. What is still needed is the establishment of an improved coordination in the overall Euro area eco-

nomic policy. This means, first, a stricter in its implementation, but more flexible Stability and Growth Pact, second, the setting of limits on both the current account deficit and the surplus of the Euro area countries, third, establishment of restrictions on aggressive trading in the markets for financial derivatives. The planning of some of these developments has already started.

Lastly, to the reasonable question whether there are instances of countries that have successfully implemented a fiscal implementation as large as the one envisaged in the Memorandum, the answer is positive. Greece itself is perhaps the best example of a significant fiscal consolidation. In 1993, the general government deficit stood at 14.5% of GDP, while in 1999 the deficit (after the revision) was 3.1% of GDP. The new explosion of the deficit to 13.6% of GDP ten years later, in 2009, mainly as a result of the expansion of the state and the public expenses, explains, as already mentioned the causes of the current fiscal crisis. Incidentally, the time frame in the Memorandum for reducing the general government debt to 3% of GDP is longer than that stipulated in the initial Stability and Growth Programme (SGP) of the Greek government (2014 in the Memorandum versus 2012 in the SGP).

The Scandinavian countries too, and Sweden and Finland in particular, serve as examples of very substantial, yet sustainable, fiscal consolidation in the 1990s. From fiscal deficits of around 17% of GDP at the beginning of the decade, these countries managed to achieve nearly balanced fiscal positions by its end.

In the first five months of 2010, the Greek central government deficit fell by about 38% relative to the corresponding period of the previous year, against a 40% target. This is without a doubt a positive development. The negative element of this development is that this target has been achieved with a significant reduction in expenditure for public investment, while there is a relative shortfall in the revenue target (about 6% increase against 14% target, including Public Investment Programme revenue). Better results on the revenue side will contribute, among other things, to greater social acceptance for the whole endeavour.

According to the national accounting data for the first quarter of 2010, the change in GDP was -2.5% against the Memorandum's forecast of -4% for the entire year, with private consumption increasing by 1.5%. These figures, in conjunction with the recovery observed in the Euro area (year-on-year increase in industrial production in April 2010 by about 8.5%) and the depreciation of the euro, provide indications that the GDP contraction might turn out to be significantly smaller than the Memorandum's projections. If this indeed turns out to be the case, then, in combination with higher inflation, the trend in the debt-to-GDP ratio will be more favourable than the projections in the Memorandum.

The future of the Greek economy continues to face many risks. By adopting the Memorandum, Greece simply took a step towards its salvation. The diligent implementation of the

Memorandum simultaneously in all four areas (fiscal, social security, structural reforms, financial) will ensure the gradual mitigation of these risks. In this respect, the greatest risk is the annulment of the Memorandum on account of its demonisation by a section of the political establishment, the press, the labour unions and various professional and business interests that are affected. But among those that oppose the Memorandum, no one has proposed an alternative solution. This is because simply there is no alternative solution. The annulment of the Memorandum would push Greece to bankruptcy and deprivation of its population's most vulnerable segments.

These are historic times. The political leadership of the country, or at least that part of it which is willing to do so, should assume its historic role, open new paths and leave the mistakes of the past behind. Greece today has healthy, albeit dispersed, forces which recognise that radical changes must be made to economic structures, social values and attitudes. These forces, if allowed to express with dynamism and creativity, may become the catalyst for great changes.

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2. ECONOMIC ENVIRONMENT

2.1 The Global Economy's Trends and Prospects

The Global Economic Environment

The **global** economy is gradually recovering from the financial crisis and the recession, but the speed of recovery differs significantly between the economic regions. The measures to support the financial systems and the fiscal expansion reduced the strength of the recession from mid-2009. As a result, the global economy is expected to grow by 4.2% in 2010 and 4.3% in 2011, after a recession of 0.6% in 2009, while the largest growth rates are expected in the emerging economies.[42] Faster recovery is anticipated in Asia, while in the emerging countries of Eastern Europe the revival will be milder. As noted in key reports of IMF, OECD and EC, common factor for reversal of the economic indicators is the rejuvenation of **international trade** flows, which after falling by 11% in 2009, are expected to increase by 10.6% in 2010 and 8.4% in 2011. This development will strengthen mainly the economies with large export share. Also, the evidence shows that the speed of recovery of each economy from the recession does not depend on its size, but on the absence or presence of structural problems that have accumulated from the past. Thus, the countries with large structural problems, as well as large public debt, are expected to have lower growth rates, which will delay their return to pre-crisis income levels.

Economic Regions

In its last report for 2010, IMF forecasts that the global economic growth will be larger than previously expected, reaching close to 4.2%, while similar growth is expected in 2011. Meanwhile, the recovery process will not have uniform speed across the economic regions. The output growth rate in the developed countries (G7, Euro area, the Asian newly industrialised countries) is expected to reach 2.3%, slightly higher from the 2.1% forecast of the previous report.[43] In the Euro area, in particular, the growth rate is expected to reach 1%. From the developed countries only Spain and Greece are expected to remain in recession in 2010, as all the rest are anticipated to record a GDP increase, while in some cases (USA, Japan, Canada) the return to growth will be significant. In addition, only in Greece the recession is expected to continue in 2011. The emerging economies will experience strong growth (6.3%), after the 2009 slowdown (2.4%), while China and India are expected to grow at 10% and 8.8% respectively, reverting to the pre-financial crisis growth rate. It is worth mentioning that in IMF's latest projections the Asian markets grow fast in the coming five years.

[42] World Economic Outlook, April 2010, IMF

[43] WEO Update, January 2010, IMF

The European Commission also revised upwards its estimates for the global economy for the current year in its spring report.[44] According to the new report, the growth of global GDP (except the EU) will be close to 4.8%, 0.8 percentage points more than expected in the previous report published in November.[45] Larger recovery due to the revival of the global economy is expected for EU too, close to 1% in 2010 and 1.7% in 2011.

Despite the fact that growth expectations have been revised upwards, the fiscal difficulties of many countries has caused heightened concern about the stability of public finances and financial markets, for the time being to a lesser level than what was observed during the outburst of the financial crisis. The rapid increase of budget deficits and, in consequence, public debt in many developed economies has caused turbulence in the sovereign bond markets, especially in the European Union. In this adverse fiscal environment, the proposals of the European Commission so as to achieve stable growth in all European countries include:

- Taming of the public finances to levels that will not thwart economic development.
- Restructuring of the banking system, with liquidity ease and rationalisation of the lending criteria (it is estimated that with the return of the global economy on a stable growth path, the negotiations for the Basil III agreement will accelerate their pace so as to avoid state-led bank bail-outs in the future).
- Market normalisation in the services sector, improvement in the labour and capital markets, with improved adjustment of skills and knowledge by the employees and the enterprises, as well as focus on innovation activities, consistent with the Europe 2020 agenda.

Regarding the most significant economies, **USA** is expected to recover quickly from the recession, as after the 2.4% fall of GDP in 2009, it is expected to grow by 3% in 2010 and 2011. The large reversal of the indicators seems to come mainly from state support programmes – it is estimated that these programmes reduced the GDP fall in 2009 by one percentage point. Despite its growth, however, private consumption remains subdued, while employment has not followed suit with the GDP increase. The current account balance experienced positive developments with medium intensity, due to the international trade revival in late 2009, following the rapid fall in international transactions since late 2008. On the other hand, the successive state injections have inflated the budget deficit of the US government, which at the end of 2010 is expected to reach 10.6% of GDP (more than three times its 2008 level).

The gradual reduction of the liquidity injections is expected to reduce the growth rate in 2011 to 2.6%, while unemployment after its peak in 2010 at 9.5% is expected to fall to 8,3% in 2011. The grad-

[44] Economic Forecast Spring 2010
[45] Economic Forecast Autumn 2009

ual withdrawal of the support programmes, under the weight of the rising deficits, will not eliminate the weaknesses in the real estate market, which have not completely vanished, nor will it tackle the subdued financing of small enterprises. The risk of increase in the medium-term and long-term interest rates cannot be ignored, which would increase the US debt to levels above 100% of GDP until 2020, with deficits reaching -8%, when prior to 2008 they did not exceed -4%.

In **Canada** the growth rate of the economy is expected to reach 3% in 2010 and 3.3% in 2011, reflecting the strengthening of the Canadian dollar. As mentioned earlier, the counties that came into the financial crisis without structural problems found it easier to achieve quick and stable recovery. The economy of Canada belongs to this category. Still, its debt needs to return to a downward trend, boosting labour productivity in the meantime.

The output of Asian economies, after the sudden fall in the end of 2008, is expected to experience strong recovery in 2010. The only exception is Japan. The recovery in the remaining countries was fuelled by both the international trade boost and domestic factors. This development strengthens the argument that the stabilisation of the global economy should rely more on boosting the internal economies and primarily the domestic demand of the emerging economies (China, India and others). As noted in IMF's latest report, the growth in Asia was fuelled by four main factors: fast normalisation of international trade, recovery of industrial production and exports, increase of capital inflow and mainly domestic demand increase, as the low debt level (except Japan) allowed for generous liquidity injections. The growth of the Asian economies is expected to reach 7% in 2010 and 2011, with significant, however, differences between the countries.

In **Japan** the income growth is estimated at 2% in 2010, which will slightly increase in 2011, supported mainly by increase of exports, following the reduction of the current account surplus as percentage of GDP from 4.5% in 2007 to 3% in 2009. The growth of GDP is clearly satisfactory, given that the extent of contraction in 2009 reached 5.2%. Despite this, the country is lagging behind, as domestic consumption remains anaemic mainly due to deflation and subdued labour market, while high public debt does not allow significant demand stimuli. Meanwhile, the yen is expected to appreciate, which will affect the exports' contribution to GDP, but the latest developments regarding the review of the fixed exchange rate regime of the Chinese currency to the dollar and its expected appreciation, might normalise the exports in the wider region.

The transformation of the economy of **China** from command to mixed seems to be accelerating, as private investment is increasing rapidly. This development is strengthening the Chinese economy, as private consumption and investment are expected to increase. The GDP growth rate in 2010 and 2011 is expected to reach around 10%, while the boost in pri-

vate initiative is expected to create positive impact for the wider Asian area.

Meanwhile, **India** is experiencing spectacular growth at 8.8% in 2010 and 8.3% n 2011, due, among other reasons, to private demand boost. The business climate is improving, the profitability of the enterprises is blossoming, while the labour market is developing, which creates a further consumption boost. The high inflation rate (13.2%) remains an obstacle, which limits competitiveness, resulting in negative current account balance. Apart from that, it should be noted that India does not have the infrastructure to support high levels of development, which leads the country to seek imports of goods and raw materials. For these reasons, imports in the next few years are expected to increase, as the domestic production is not in the position to cover the increase in demand that comes with the rise in the living standards observed in the past few years.

The recession's extent in the **states of ex USSR** reached -6.6% in 2009, confirming the forecasts of the international organisations. The latest developments are more positive, as the growth rate is expected to reach 4% in 2010 and 3.6% in 2011. A number of factors have contributed to the reversal of the indicators: increase in energy commodity prices (crude oil, natural gas, etc.), normalisation of international trade, recovery of the Russian economy which is a major influence to most of these countries, but also the IMF support programmes to the countries with significant structural problems. The increase in the energy commodity prices plays significant role in these economies' recovery, as the export economies are expected to grow at 4.1%, while the growth of the import economies is expected to stand at 3.3%.

For the **Russian** economy in particular - the largest economy in the region - the recovery is expected to reach 4% this year and 3.5% in 2011. The recovery would have been more extensive, if the "toxic" loans in its banking system did not hold back private consumption through the reduced liquidity in the market. The high inflation rate remains a large problem for the countries in the region overall and Russia in particular, where despite the downward trend in the coming two years, it will remain close to 7%.

In conclusion, the majority of the economies are expected to experience stronger recovery, compared with the projections from the beginning of the year, a trend that is reflected also in the economic climate indicators of the "World Economic Survey", conducted by the German institute IFO.

More specifically, the world economic climate indicator continues to improve during the second quarter of the year, reaching 104.1, twice its value in the first quarter of 2009 when the financial crisis was at its peak. The value of the indicator is stabilising above its long-run average (96.9 for the 1991-2009 period). It should be noted, however, that the improvement is related to estimates of the current situation and not of prospects, which implies that even though the global economy

has founds its way out of the deep crisis, the expectations for the future need more time to recover.

The Economic Climate Index (Table 2.3) improves in all three economic regions. In **Western Europe** the index marginally increases, reflecting in a way the difficulty for the European countries to recover decisively from the crisis due to their fiscal mismanagement, while the performance of **N. America** and **Asia** is significantly better. The expectations for the coming six months are optimistic in all regions. Still, a small reduction of the positive expectations is observed in comparison with the first quarter of the year.

Table 2.1

Global Environment – International Monetary Fund (real annual % change)

	2009	2010	2011
USA	-2.4	3.1 *(2.7)**	2.6
Japan	-5.2	1.9 *(1.7)*	2.0
Developing Asia	6.6	8.7 *(8.4)*	8.7
China	8.7	10.0 *(10.0)*	9.9
ASEAN-5	1.7	5.4 *(4.7)*	5.6
Euro area	-4.1	1.0 *(1.0)*	1.5
Commonwealth of Independent States (CIS)	-6.6	4.0 *(3.8)*	3.6
of which Russia	-7.9	4.0 *(3.6)*	3.3
Middle East and North Africa	2.4	4.5 *(4.5)*	4.8
Sub-Saharan Africa	2.1	4.7 (*4.3)*	5.9
World	-0.6	4.2 *(3.9)*	4.3

Developing Asia: Vietnam, India, Indonesia, China, Malaysia, Thailand, Philippines.
ASEAN5: Vietnam, Indonesia, Malaysia, Thailand, Philippines.
Middle East and North Africa: Egypt, Algeria, Morocco, UAE, Jordan, Iraq, Iran, Qatar, Kuwait, Lebanon, Libya, Mauritania, Bahrain, Oman, Saudi Arabia, Sudan, Syria, Djibouti, Tunisia.
Sub-Saharan Africa: Angola, Ethiopia, Cote d'Ivoire, Gabon, Equatorial Guinea, Cameroon, Congo, Mauritius, Botswana, Namibia, Nigeria, South Africa, Uganda, Capo Verde, Seychelles, Swaziland, Tanzania, Chad and others .
* the estimates from the previous report of IMD (World Economic Outlook Update, January 2010) are presented in brackets.
Source: IMF, World Economic Outlook, April 2010.

Table 2.2

IFO – Economic Climate Index for global economy (Index, 2005=100)

Quarter / Year	II/08	III/08	IV/08	I/09	II/09	III/09	IV/09	I/10	II/10
Economic Climate	82.4	74.2	60.6	50.7	65.2	79.6	91.4	99.5	104.1
Current Situation	99.1	87.9	69.2	46.7	39.3	43.0	54.2	67.3	80.4
Expectations	66.7	61.4	52.6	54.4	89.5	114.0	126.3	129.8	126.3

Source: IFO, World Economic Survey, WES 02/2010

Table 2.3

IFO – Economic Climate Index per economic region (2005=100)

Quarter / Year	II/08	III/08	IV/08	I/09	II/09	III/09	IV/09	I/10	II/10
North America	57.7	59.4	51.0	46.0	66.9	78.7	85.4	90.4	95.4
Western Europe	88.3	73.4	59.6	52.6	64.5	76.4	89.3	98.3	99.3
Asia	83.3	71.9	57.9	47.4	69.3	89.5	101.8	108.8	113.2

Source: IFO, World Economic Survey, WES 02/2010

The Economies of the EU and the Euro Area

The growth of the EU economies, after the 4% contraction that was experienced in 2009, is expected to remain weak in the 2010-2011 period (1.3% this year and 1.9% in 2011) compared to the rest of the world. In the EU-27, the countries that are expected to experience recession in 2010 are Spain, Cyprus, Ireland and Greece, while in 2011 the only country with expected output reduction is Greece (-1.1%), due to the impact from the fiscal consolidation effort on economic activity. The countries with intense fiscal problems (Spain, Portugal, Ireland) are expected to experience subdued growth or recession, while Germany and France, the strong, export-oriented countries of the Euro area, present a rather mediocre recovery compared with other developed countries.

Regarding GDP's main components, private and public consumption will remain very low in 2010 and 2011, while investment will experience positive growth from 2011 (2.5% in the EU, 1.8% in the Euro area). Irrespectively from the speed of recovery, the support measures that were adopted in many countries seem to have prevented contraction in most places in Europe, leading their economies back on a growth path. The large deficits and public debt in quite a few European countries, as already mentioned, are the other side of the coin in this effort and simultaneously the largest obstacle for quick recovery. Countries that do not suffer from these two fiscal problems (e.g. Germany) have better growth prospects. In the remaining countries a "tight" fiscal plan is considered essential in order to free their economies from growth obstacles. In those countries, the generation of primary surpluses for debt reduction in the medium term will certainly help their economies to return on a stable growth path in the years to follow.

In the light of the adverse fiscal developments, the idea of creating an institution for overseeing a common fiscal policy in the Euro area has come strong on the agenda. The purpose of such an initiative is to avoid the generation of similar misbalances in the future and to strengthen the productivity and the competitiveness of the European economies. According to the official figures, the budget deficits in EU and the Euro area are expected to fall in 2011 by -6.5% and -6.1% respectively, after an increase in the current year. In contrast, public debt will continue to expand in both regions, reaching 83.8% in EU and 88.5% in the Euro area in 2011.

The process of recovery cannot be much different from previous experience, as the European Commission states in its latest report. Past experience indicates that the European economies should focus on the external environment, strengthening their export orientation. Increase of export, in the current relatively favourable conditions for international transactions, will provide the European economies with new investment and employment boost, with a subsequent positive impact on income.

Europe's emerging economies are expected to grow at faster rate compared with EU-27. Their growth rate is expected

to reach 2.9% in 2010 and 3.4% in 2011. However, these economies experience high inflation rates.

The sluggish consumption growth rate (public and private) and the investment reduction in 2010 are expected to weaken further Europe's labour market. In particular, **employment** in EU and the Euro area is estimated to fall by about 1% in 2010, while in 2011 it is expected to increase marginally. As a result, unemployment will increase in both regions (9.8% in EU-27, 10.3% in the Euro area). This increase, despite the positive shift in GDP, is due to the fact that the labour market tends to lag behind the changes in GDP. It is believed that certain structural changes in the labour market at company and sector level (construction and other) are needed in many European economies in order to eliminate existing rigidities.

Inflation is expected to increase in 2010 by 1.8% in the EU and 1.5% in the Euro area. This trend is expected to continue in 2011. In 2009, as a result of the subdued economic activity, rapid inflation reduction was observed in quite a few countries, even reaching negative levels in some cases.

In addition, rising energy and commodity prices are expected to generate inflationary pressure in 2010 and 2011. The inflation rise would have been even higher if the labour cost contributed to it, as in previous years, but the latest data indicate a rather subdued labour cost increase. As a result, inflation is going to follow a minor upward trend in the medium term.

Table 2.4

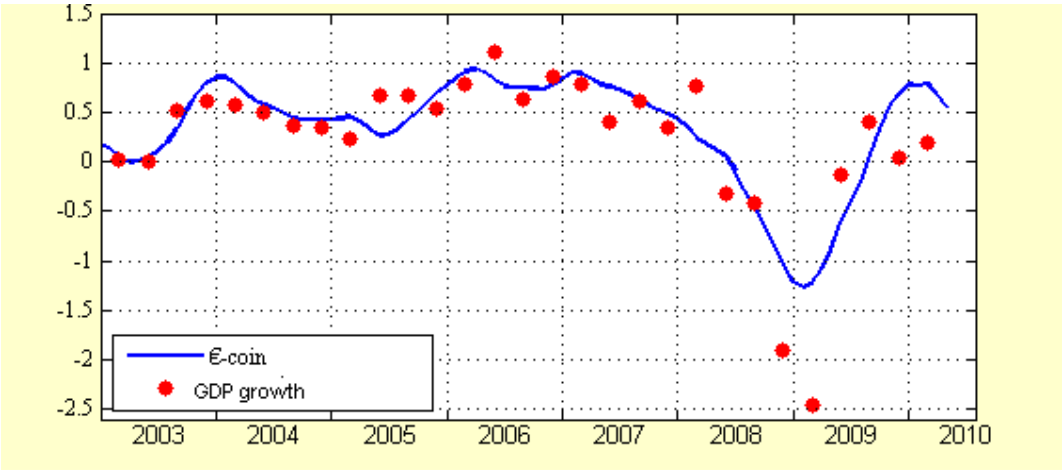
Key Macroeconomic Aggregates, EU-27, Euro area (annual % change)

	EU-27			**Euro area**		
	2009	2010	2011	2009	2010	2011
GDP	-4.2	1.0	1.7	-4.1	0.9	1.5
Private Consumption	-1.7	0.1	1.3	-1.1	0.0	1.1
Public Consumption	2.2	1.0	0.1	2.3	0.9	0.3
Investment	-11.5	-2.2	2.5	-10.8	-2.6	1.8
Employment	-2.0	-0.9	0.3	-2.1	-1.0	0.1
Unemployment	8.9	9.8	9.7	9.4	10.3	10.4
Inflation	1.0	1.8	1.7	0.3	1.5	1.7
Exports	-13.0	4.9	5.0	-12.3	5.0	5.2
General Gov. Balance (% of GDP)	-6.8	-7.2	-6.5	-6.3	-6.6	-6.1
General Gov. Debt (% of GDP)	73.6	79.6	83.8	78.7	84.7	88.5
Current Account Balance	-1.4	-1.4	-1.3	-0.8	-0.6	-0.5

Source: Economic Forecast Spring 2010, European Commission, May 2010

Figure 2.1

€-COIN Index (CEPR**)**



Source: CEPR (www.cepr.org)

Table 2.5

European Commission – Economic sentiment indicator EU-27 & Euro area (1990-2009=100)

Month	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09	Jan-10	Feb-09	Mar-10	Apr-10	May-10*
EU-27	80.5	85.4	87.0	90.0	91.5	95.0	97.2	97.6	99.8	101.9	100.0
Euro area	80.8	84.8	86.7	89.6	91.9	94.1	96.0	95.9	97.9	100.6	98.4

*Starting from May 2010, the data of the economic sentiment surveys for the enterprises is classified according to the new NACE Rev.2 of the European Commission
Source: European Commission (DG ECFIN), May 2010

The uncertainty surrounding the immediate future of the global economy, despite its return to growth and the concern about the impact of the significant deterioration of public finances have influenced business and consumer expectations, as measured by the indicator of economic activity calculated by CEPR[46] and the economic sentiment indicators of the European Commission (DG ECFIN). The indicators either remain exchanged or fell slightly in the first 5 months of 2010.

More specifically, the CEPR indicator for the Euro area declined in May. Its value remained, however, positive, signalling the continuation of positive GDP growth in the Euro area in the second quarter of 2010, relative to the immediately preceding quarter.

The European Commission's economic sentiment indicators for the Euro area and EU-27, which in Greece are compiled by IOBE, slightly declined. The modification in its estimation methodology might conceal the exact extent of the change, nevertheless there is definitely a decreasing trend. The indicator reached 100 and 98.4 points in EU-27 and the Euro area respectively, remaining, however, sufficiently

[46] The Center of Economic Policy Research (CEPR) in cooperation with the Bank of Italy each month calculates the €-COIN leading indicator of economic activity for the Euro Area. The indicator provides a forecast of GDP growth and is constructed from a range of different data, such as the course of industrial production and of prices, as well as labour market and financial data.

higher from the values recorded recently. As for the individual sectors, the economic sentiment indicator in industry rose in May, while in contrast in the remaining sectors the indicator decreased. Lastly, consumer confidence fell in both regions, remaining, however, close to the levels recorded in the past six months.

2.2 The Economic Environment in Greece

Economic Sentiment

The **Economic Sentiment Indicator for Greece** in the last few months remained significantly below its long-term average for the period 2001-2009, standing at 67 points. This level is substantially lower than the level recorded in the first two months of the year (74 points), but is slightly higher than the level recorded in the same period of the previous year (63 points).[47] Despite the mild year-on-year improvement, the economic sentiment is steadily deterioration in Greece since the general elections in October. It is evident that the gradual revelation of the true fiscal circumstances of the economy and the adoption of measures to alleviate them has influenced negatively the economic sentiment, intensifying the insecurity of enterprises and consumers, who seem to discount the adverse prospects of the Greek economy.

The continuous deterioration of the economic sentiment during the last 7 months extends to almost all sectors, while the consumer confidence has reached historical lows. The widespread insecurity of the Greek consumers and their fears about the labour market developments are reflected in their intensely pessimistic expectations. More specifically, the period March – May 2010, business expectations remained lower compared with the same period of the previous year, but also in comparison with the first two months of the current year. This observation holds for all sectors except Industry, which seems to endure to some extent. The consumer expectation index has continuously declined since November, registering successive record-low levels.

Contrary to Greece, in the EU the economic sentiment has improved in comparison with the previous year. Even though many European countries experience acute fiscal imbalances, the economic sentiment index in most of them is improving. More specifically, in the three months March – May, the index in the EU-27 averaged 107 points, 10 points higher relative to the first two months of the year and 36 points higher compared to the same period in the previous year. In May the economic sentiment in EU-27 slightly deteriorated, but this might be due to technical reasons (break in the series). In greater detail:

The **Consumer Confidence Index** has steadily declined since November, while during the March-May period it registered a historically low level at -62 (from -49 during the first two months of the year), which is worse than the corresponding

[47] Since May 2010, due to the adoption of the new classification NACE 2, there is a break in the economic sentiment series, which implies that the results of the overall index should be interpreted with caution.

level the year before by 10 points. The average values for the index in the EU and the Euro area were significantly higher at -14 and -17 respectively. The Greek consumers were the most pessimistic Europeans during that period.

Wage cuts in March and May, deterioration of the purchasing power from repeated increases in indirect taxation, rising uncertainty in the labour market and overall extensive bad psychology, weigh down on the already heavy economic climate. As a result, the expectations deteriorates even more, reaching their lowest level in May after the finalisation of the fiscal measures within the framework of the EU-IMF support agreement. The consumer expectations of the financial situation of their households over the coming 12 months worsened significantly.

Table 2.6

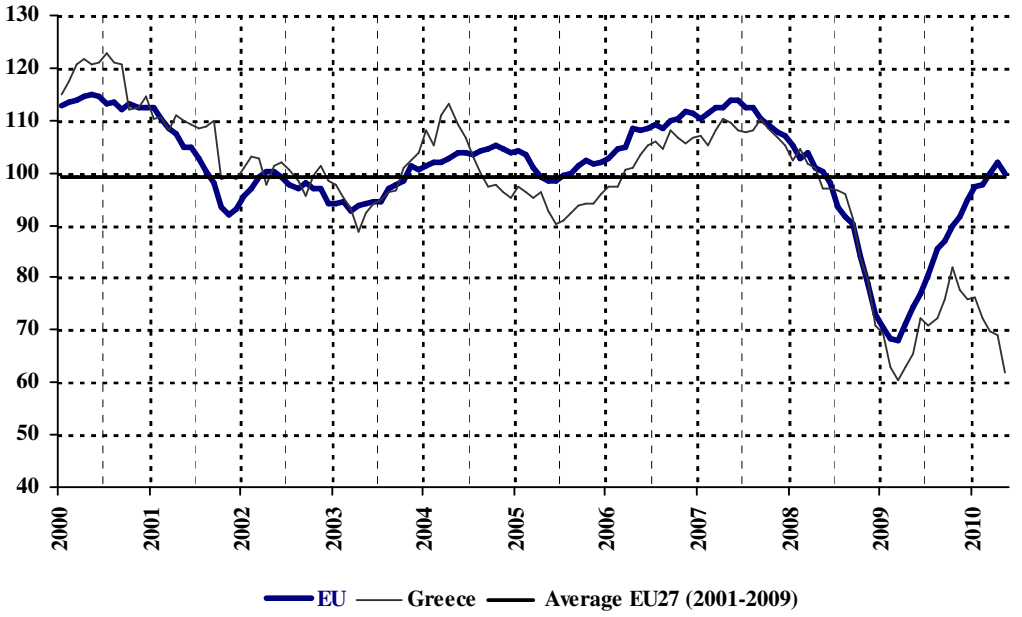
Economic Sentiment, Short-Term Indices

	Economic Sentiment Indicator[1]		**Business Confidence Indicators[2] *(Greece)***				**Consumer Confidence Indicator[1] *(Greece)***
	EU-27	*Greece*	*Industry*	*Constructions*	*Retail Trade*	*Services*	
2001	**101.0**	**107.6**	**101.9**	**114.0**	**92.2**	**105.8**	**-26**
2002	**94.9**	**98.9**	**101.2**	**114.0**	**93.3**	**82.8**	**-28**
2003	**93.2**	**93.2**	**97.9**	**115.0**	**102.0**	**85.5**	**-39**
2004	**102.5**	**102.9**	**99.1**	**81.5**	**104.8**	**94.6**	**-26**
2005	**99.4**	**89.3**	**92.6**	**63.0**	**96.8**	**93.6**	**-34**
2006	**108.4**	**103.1**	**101.5**	**91.1**	**110.8**	**103.7**	**-33**
2007	**110.8**	**108.0**	**102.8**	**92.5**	**120.8**	**106.6**	**-29**
2008	**90.7**	**89.0**	**91.9**	**95.2**	**102.5**	**97.8**	**-46**
2009	**79.9**	**70.6**	**72.1**	**65.5**	**80.4**	**70.1**	**-46**
Jan-09	70.3	69.4	68.2	65.0	65.3	62.6	-48
Feb-09	68.2	63.1	62.8	68.3	61.9	64.5	-55
Mar-09	68.0	60.4	63.8	59.1	60.2	66.0	-56
Apr-09	71.1	63.0	68.9	63.0	64.5	66.7	-51
May-09	74.3	65.3	71.0	52.8	80.7	73.2	-50
Jun-09	77.1	72.3	76.0	69.0	90.4	75.3	-45
Jul-09	80.5	70.7	73.8	67.4	91.4	73.7	-49
Aug-09	85.4	72.3	75.5	61.4	88.5	75.8	-45
Sep-09	87.0	75.7	80.4	67.6	91.4	68.4	-39
Oct-09	90.0	81.8	79.4	71.6	99.0	72.4	-27
Nov-09	91.5	77.7	74.8	72.4	91.1	71.8	-38
Dec–09	95.0	75.9	71.0	68.1	81.0	70.6	-44
Jan–10	97.2	76.1	75.8	64.1	75.3	67.2	-47
Feb-10	97.6	72.4	72.6	48.5	71.6	63.1	-51
Mar-10	99.8	69.6	75.3	39.6	54.5	61.7	-58
Apr-10	101.9	69.1	80.6	44.6	64.0	64.1	-61
May-10	100.0	61.9	74.9	44.0	64.3	56.8	-67

Source: [1] European Commission, DG ECFIN, [2] IOBE

Figure 2.2

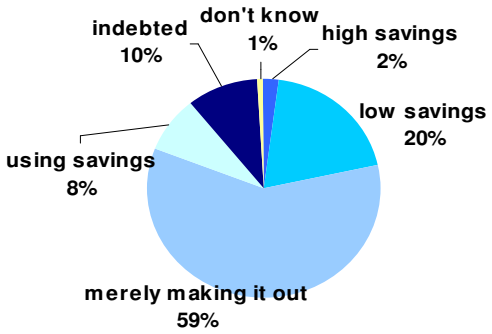
Economic Sentiment Indicator, EU-27 and Greece (seasonally adjusted data, 1990-2009=100)



Source: European Commission, DG ECFIN

Figure 2.3

Consumers' evaluation of their household's financial situation
(March – May 2010 average)



Source: IOBE

The most pessimistic expectations were recorded in May: three out of four respondents were expecting their financial situation to worsen in the coming 12 months. Similar were also the expectations about the economic situation overall for the same period: 79% of the consumers in May (from 69% in April) were expecting slight or significant deterioration. Historically low levels were also registered in the propensity to save. Meanwhile, the expectations about unemployment registered historically high values, with nine out of ten consumers expecting further

deterioration. This shows that the consumers are concerned about the current developments and the upcoming changes and worried about the need to adjust to a new reality that might differ substantially from what they are used to, which would make it different to sustain their existing consumption patterns.

The proportion of consumers reporting that they were 'in debt' was 10%, while 8% reported that they were dipping into their savings. Meanwhile, the percentage of those that were saving small or large amount fell to 22% from 26% in the first two months (and 28% the year before). Almost three out of five consumers (from 52% the year before and 56% in the beginning of the year) report that they were "just making ends meet".

In **Industry,** the Confidence Indicator in the last three months (March – May) stood at 77 on average, up by 3 points compared to the first two months of the year and by 9 points compared to the same period of the previous year. Industry seems to be the only sector that resisted the fall, standing at levels slightly higher than those of the previous year. In April this index registered its highest value since October 2008. Despite the improvement in the overall index, quite a few of the business activity indices remained negative. The expectations regarding the course of production in the coming 3-4 months formed an exception, as their balance was positive (+8 on average from -5 for the same period of the previous year). In contrast, the estimates of order levels and demand remained low, with more than half of the enterprises considering them to be low for the time of the year.

Significant reduction relative to the same period of the previous year was registered in the finished product inventories, with 64% of the enterprises assessing them to be normal for this time of the year. Despite the registered improvement in comparison with the first two months of the year and the same period of the previous year, the employment expectations remained grim with the relevant indicator standing at -19, which implies a continuation of job losses in industry. Meanwhile, the utilisation rate of the production factors remained at about the same levels compared with the previous year (69-70%), while the number of months of assured production were slightly reduced at 3.9 (against 4.3 for the same period of the previous year).

The Confidence Indicator in **Retail Trade** in the period March – May 2010 stood at an average of 61, from 73 in the first two months, loosing 7 points relative to the same period of the previous year. The indicator had been falling steadily from November until March, while in the following two months it slightly improved. As a result, while in March most activity indicators continued to deteriorate substantially, in April and May the large accumulated fall was partially corrected. The enterprises estimated their sales as weak, as three out of five enterprises assessed them as lower relative to the previous quarter.

The projections of the sales over the coming three months were also quite pessi-

mistic, with the relevant balance at an average of -41, when the same period of the previous year it stood at -9. The enterprises were expecting the orders placed with suppliers to fall further, as their inventories were still bloated. The employment expectation deteriorated significantly, as the creation of new jobs has diminished. Lastly, the enterprises expecting a reduction in prices were slightly more than those expecting an increase, while the same period in the previous year the deflationary pressures were significantly more intense.

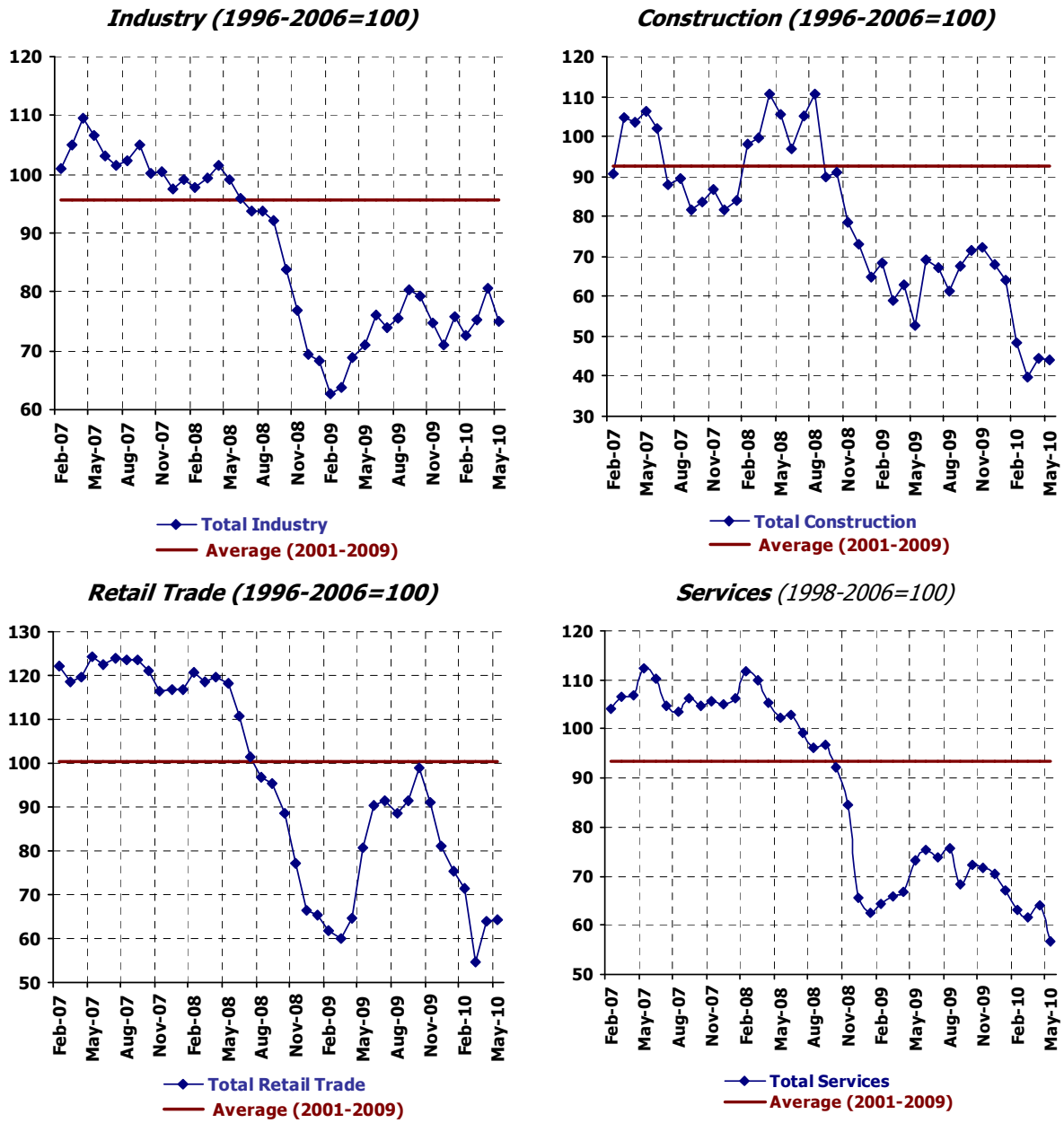
The business confidence in the **Construction** sector, where prospect remain intensely grim, has suffered a major blow. The Confidence Indicator stood on average at 43 in the period March – May (from 56 during the first two months of the year), performing significantly worse compared with the same period last year (58 points), when the sector was already in recession. The very grim expectations of the businesses on their current work schedule and employment fell further, with the corresponding balances standing at -75 and -44.

The negative balance of the enterprises' estimates on their current work schedule is more than twice as low (-47), compared with the same period in the previous year, while the number of months of assured activity has fallen to 12.8 on average (from 16.1 in the same period of the previous year). The sector relies more on projects that have already started and have been delayed. The price expectations were deflationary, while characteristically only 9% of the enterprises reported that they were not facing any obstacles to their construction activities, with 41% assessing as the main obstacle to their operation low demand, 39% lack of financing and the remaining the freeze in the public investment programme.

In **Services**, the Confidence Indicator stood at 61 on average in the period March – May 2010, from 61 in the first two months of the year, losing 8 points compared with the same period in 2009. In May, the confidence indicator recorded historically low values. Most of the activity indices deteriorated: the assessment of the enterprises on their current activity was almost twice as negative in relation to the same period in 2009, while their expectations of the future demand have steadily remained negative. About 43% of the enterprises report that their current demand was lower compared with the same period in the previous year. The employment expectations remained negative, despite their improvement since the beginning of the year. The price expectations were deflationary with heightened intensity in April and May. Moreover, only ¼ of the companies reported that their business activity was being conducted without obstacles, with insufficient demand cited as the main obstacle by 37% of the companies, followed by factors associated with the adverse economic situation (21%) and insufficient working capital (15%).

Figure 2.4

Business Confidence Indicators[1]



[1] In the calculation of the Business Confidence Indicators a period-base is used, instead of a year-base. In such a way, the Confidence Indicators of Industry, Construction and Retail Trade are calculated under a common period-base (1996-2006=100) and the Services indicator under the period-base 1998-2006=100, as there are no available data before 1998. The period-base method allows for more precise interpretation of the fluctuations of expectations in a long-term period, while at the same time it allows the construction of comparable sector indices.
Source: IOBE

3. PERFORMANCE AND PROSPECTS

3.1 Macroeconomic developments

Developments in the first quarter of 2010

The course of the Greek economy in the first quarter of 2010 was mainly affected by the domestic fiscal crisis, whose impact was blunted somewhat from improvement in the economy's external sector as the global economic crisis subsided. In the first quarter of 2010 GDP fell by 2.5% in comparison with the same quarter in the previous year and by 1% compared to the preceding quarter. The Greek GDP continues to fall for a fifth consecutive quarter, with its contraction rate stabilising at 2.5% (annualised, in comparison with the previous year average). Still, as the second, more extensive, set of policy measures was adopted in early March, the GDP course for the first quarter incorporates mainly the impact from the fiscal problems of the country during that period.[48]

The intense uncertainty regarding the situation with the public finances and the prescribed policy measures from the beginning of the current year seem to have exercised negative impact on GDP's basic components. The sharp fall in fixed capital formation and the significant reduction in public consumption, which led to the decline in GDP, clearly reflected the pressures from the adverse fiscal developments. On the other hand, the *prima facie* unexplainable increase in private consumption slowed down the GDP contraction. Additional support, for one more quarter, came from the external sector, as the exports declined by much smaller amount and proportion, compared to the imports.

In greater detail, total final consumption slightly fell during the first quarter of 2010 by 0.7%, compared with 0.4% growth in the same quarter of 2009. This decrease was due exclusively to the large fall in public consumption by 9.0%, as private consumption increased by 1.5%. However, we should also take into account the eruption in public consumption by 9.7% during the same quarter in 2009, together with the impact on officially recorded private consumption from tax incentives for issuing purchase receipts.

Gross investment expenditure fell by 18.4 in the first quarter of 2010, significantly faster compared with the same period in 2009 (-4%) and 2008 (1.9%). Slower was the contraction of fixed capital formation (-14.6%), reflecting the continuous, yet small, inventory increase. Residential construction and metal products/machinery registered a fall of around 16.7% and 10.0% respectively, while the largest drop was recorded by non-residential construction (-29.3%). Transport equipment was the only category of fixed capital formation that experienced growth during the first quarter of the year (8.4%).

Regarding the external sector of the economy, exports declined by 0.5%, which is a

[48] As usually happens the last few years, the revision of the provisional GDP data leads to worse estimates post factum. Thus, it is quite possible that the GDP fall in the first quarter is greater than from what the current figures suggest.

significantly smaller contraction compared to the same period in 2009 (-17.9%). The small export reduction stemmed from a fall in the export of goods by 3.9%, as the export of services increased by 1.9%. Significantly larger was the contraction of imports during the same period, reaching 6.6%. The increase of the imports of services by 10.7% was more than compensated by the contraction of the – proportionately larger – import of goods (-11.1%). Overall, the deficit in the trade balance decreased by 15.8%, falling to 11.3% of GDP from 13.1% a year ago, limiting further its negative contribution to domestic output.

Total gross value added fell by 3.2% in comparison with the same quarter of 2009. Agriculture, forestry and fishing, together with financial activities, real estate and leasing were the only sectors that experienced value added growth, by 1.7% and 0.2% respectively. On the other hand, significant value added reduction was recorded in construction (-24.6%), industry (-5.3%) and other services (-2.9%).

The prolonged economic activity contraction and the worsening expectation on its course due to the adverse fiscal circumstances had a negative impact on the labour market. Unemployment stood at 11.7% on average during the first quarter of the year, while in February it surpassed 12%, reaching 12.1%. In such a way, it increased by 2.4 percentage points from the first quarter of 2009 and by 1.4 percentage points from the preceding quarter. The reduction in employment (-1.3% on an annual base) contributed to the deterioration of unemployment. Despite weakening total demand, inflation continued to grow in early 2010, experiencing a sharp increase due to the rise in indirect taxation as part of the fiscal consolidation effort. Prior to that, inflation acceleration had begun in the fourth quarter of 2009 due to rising prices globally, as evident in, for example, the increase in the industry import prices by 8.8% and the large year-on-year difference in pre-tax fuel prices.

Summing up the course of key macroeconomic indicators during the first quarter of 2010, the main factor that shaped their course was the domestic fiscal crisis. The ongoing adverse investment sentiment in the private sector was joined by a slump in public investment even before the official start of the fiscal consolidation programme in March. The fiscal consolidation effort was reflected in the public consumption cut, in contrast to the previous year's large expansion. The private consumption invigoration and the foreign trade revival prevented further contraction. Still, the former development most likely comes from reduction in the black economy rather than from a real demand boost.

Table 3.1

Key macroeconomic indicators – Quarterly National Accounts (constant 2000 prices)

Year/ Quarter	GDP		Final Consumption		Investment		Exports		Imports	
	mil. €	Quarter % change (n/n-4)	mil. €	Quarter % change (n/n-4)	mil. €	Quarter % change (n/n-4)	mil. €	Quarter % change (n/n-4)	mil. €	Quarter % change (n/n-4)
2001	**142,001**	**4.2%**	**127,980**	**4.1%**	**33,025**	**3.9%**	**33,878**	**0.0%**	**52,882**	**1.2%**
2002	**146,884**	**3.4%**	**134,663**	**5.2%**	**33,441**	**1.3%**	**31,034**	**-8.4%**	**52,219**	**-1.3%**
2003	**155,614**	**5.9%**	**137,952**	**2.4%**	**39,627**	**18.5%**	**31,940**	**2.9%**	**53,768**	**3.0%**
2004	**162,808**	**4.6%**	**142,899**	**3.6%**	**39,109**	**-1.3%**	**37,498**	**17.4%**	**56,579**	**5.2%**
Q1 2005	40,910	2.4%	36,627	4.1%	8,763	-9.5%	9,485	4.9%	13,967	0.3%
Q2 2005	41,229	1.5%	36,867	3.6%	8,803	-12.0%	9,334	0.3%	13,762	-3.4%
Q3 2005	41,748	2.1%	37,287	3.8%	8,718	-10.6%	9,829	3.6%	14,083	-1.2%
Q4 2005	42,571	3.0%	37,676	4.1%	9,737	0.7%	9,760	1.1%	14,581	3.0%
2005*	**166,457**	**2.2%**	**148,458**	**3.9%**	**36,020**	**-7.9%**	**38,408**	**2.4%**	**56,392**	**-0.3%**
Q1 2006	42,543	4.0%	38,123	4.1%	9,448	7.8%	9,923	4.6%	14,960	7.1%
Q2 2006	43,386	5.2%	38,544	4.6%	9,939	12.9%	10,198	9.3%	15,287	11.1%
Q3 2006	43,890	5.1%	38,860	4.2%	10,361	18.9%	10,093	2.7%	15,400	9.4%
Q4 2006	44,165	3.7%	39,270	4.2%	10,516	8.0%	10,237	4.9%	15,849	8.7%
2006*	**173,984**	**4.5%**	**154,798**	**4.3%**	**40,264**	**11.8%**	**40,452**	**5.3%**	**61,496**	**9.1%**
Q1 2007	44,960	5.7%	39,780	4.3%	11,204	18.6%	10,306	3.9%	16,300	9.0%
Q2 2007	45,269	4.3%	40,204	4.3%	10,947	10.1%	10,461	2.6%	16,325	6.8%
Q3 2007	45,650	4.0%	40,536	4.3%	10,613	2.4%	10,999	9.0%	16,498	7.1%
Q4 2007	45,886	3.9%	40,845	4.0%	10,762	2.3%	11,017	7.6%	16,742	5.6%
2007*	**181,765**	**4.5%**	**161,365**	**4.2%**	**43,525**	**8.1%**	**42,783**	**5.8%**	**65,865**	**7.1%**
Q1 2008	46,193	2.7%	40,896	2.8%	10,992	-1.9%	11,141	8.1%	16,827	3.2%
Q2 2008	46,479	2.7%	41,125	2.3%	10,553	-3.6%	11,278	7.8%	16,470	0.9%
Q3 2008	46,539	1.9%	41,229	1.7%	10,538	-0.7%	10,951	-0.4%	16,164	-2.0%
Q4 2008	46,216	0.7%	41,293	1.1%	10,344	-3.9%	11,104	0.8%	16,544	-1.2%
2008*	**185,428**	**2.0%**	**164,543**	**2.0%**	**42,427**	**-2.5%**	**44,474**	**4.0%**	**66,005**	**0.2%**
Q1 2009	45,747	-1.0%	41,213	0.8%	10,554	-4.0%	9,145	-17.9%	15,150	-10.0%
Q2 2009	45,609	-1.9%	41,126	0.0%	9,772	-7.4%	9,133	-19.0%	14,430	-12.4%
Q3 2009	45,393	-2.5%	41,363	0.3%	8,742	-17.0%	8,781	-19.8%	13,548	-16.2%
Q4 2009	45,040	-2.5%	41,422	0.3%	7,670	-25.9%	9,378	-15.5%	13,560	-18.0%
2009*	**181,789**	**-2.0%**	**165,124**	**0.4%**	**36,738**	**-13.4%**	**36,437**	**-18.1%**	**56,688**	**-14.1%**
Q1 2010	44,588	-2.5%	40,939	-0.7%	8,607	-18.4%	9,097	-0.5%	14,155	-6.6%

* provisional data

Source: ELSTAT, Quarterly National Accounts, June 2010

Medium-term outlook

The unprecedented fiscal developments, as reflected in the large spread between the Greek and the German bond rates, have dominated the economic developments since early 2010 not only in Greece, but in the European Union as a whole, as most member countries are experiencing fiscal difficulties. Despite the two fiscal measure packages that had been announced by early March and the decisions of the European Union institutions (of 16 February and 25 March) for adopting a support mechanism for the Greek economy (further deliberated on 11 April), the Greek state was not in the position to secure the required capital in favourable

terms from the international markets. As a result, it had to resort to the support mechanism.

The medium- and long-term impact of the policy measures of the EC & IMF support mechanism were presented in the first chapter of this report. Irrespective of the medium- and long-term positive results that these measures may bring, there is still uncertainty firstly regarding the capability of Greece to implement the agreed programme of reforms and secondly regarding their impact on the Greek economy. Added to this are the immediate pressures from the restrictive fiscal policy, which is one of the three pillars of the agreement,[49] on economic activity and real income.

Despite the fact that production activity and business sentiment are overall grim and worsening in comparison to late 2009 and early 2010, there are some positive signals.

In greater detail, on the supply side of the economy, industrial production falls during the first four months of this year, but with a speed that is much slower compared to the previous year. Tourism turnover increased marginally from the lowest levels for the past five years that were registered in 2009. However, construction decreased substantially with speed comparable to the average rate of decline for 2009, despite the large fall the previous year by 20%. Meanwhile, turnover both in wholesale and in retail trade increased substantially in the first quarter of 2010. This result, however, should be interpreted with caution, as the tax incentive measures for collecting purchase receipts, in combination with the introduction of objective criteria for evaluating taxable income, have limited the undocumented transactions.

On the demand side, the indications for a weakening of the Greek economy have been stronger. Investment expenditure continued to decline - lacking last year's boost from public expenditure, it reached its lowest level for first quarter since 2003. The decline in investment expenditure was largely due to budget cuts and delays in the public investment programme, as in key branches of the private sector, such as industry, our investment surveys indicated that investment intentions have significantly rebounded from late 2009 after deteriorating in the previous year. Unemployment increased to the levels it registered exactly 10 years ago (first and second quarter of 2000). This development, together with the reduction in employment will have a negative impact on final consumption expenditure, beyond the already recorded slump in public consumption. The small increase in private consumption during the first quarter was the other side of the coin of the increase in the trade turnover and as such it might be due to the tax incentives, rather than to a real increase in demand. Nevertheless, the increase in industrial orders in March and April, as a result of the global economy's revival, is a positive signal.

Similar are the trends that appear from the business surveys conducted by IOBE. The economic climate indicator retained its negative trend, despite its temporary sta-

[49] Together with the structural reforms and the measures in the financial sector.

bilisation in April. The large fall in May, when the indicator reached levels slightly above its historically low value of March 2009, incorporated the first reactions to the Greek government's decision to resort to the support mechanism.[50] The continuous slump of consumer confidence to new historically low levels for third month in a row is a good representation of the assessment of the current situation and the prospects for the coming months.

The fiscal consolidation effort and the concern over its success, the impact of the fiscal consolidation measures on other economic variables and the structural reforms will be the key determinants of the developments in the Greek economy in the medium- and long-term. The third package of measures that was announced in early May with the activation of the support mechanism is expected to deepen the fall in **public consumption** that was recorded in the first quarter. Its implementation is not yet completed, while further fiscal measures are planned to be implemented until the end of the year. As a result, after the sharp increase in 2009, public consumption is expected to return to the 2008 levels or even to levels lower than that.

The unexpected resilience of the **household consumption** in the first quarter, irrespectively of its various interpretations, is expected to vanish by the end of the year. Additional pressure will act on it during the year from: a) new wage reductions in the public sector that were announced in May, larger than those announced in March, and reductions in pensions; b) large increase in inflation due mainly to consecutive indirect tax increases and enlargement of the basic VAT rate in the autumn; c) growth of unemployment; d) decline in credit expansion to households (negative rate in April). Overall, final consumption expenditure is expected to fall significantly during the remaining months of 2010.

The sharp fluctuation in **investment expenditure**, and especially in public investment, that was predicted in the previous IOBE report, is confirmed by the preliminary data from the national accounts and the budget execution. The Public Investment Programme (PIP) for 2010, after a cut in March to the 2009 levels (€ 9.6 billion), was further reduced in May by € 500 million. The PIP payments in the first five months of the year fell by 29.6% in comparison with the same period in 2009. Despite the slowdown of the decrease in PIP payments in comparison with the first two months (-58.2%), the rescheduling of the vote on the new investment law for the third quarter of 2010 (in the Stability and Growth Programme it was scheduled for the middle of the year) is an additional bulwark for the flow of investment from the public to the private sector, putting in doubt PIP's implementation.

Private investment is also expected to follow a downward trend this year. Contraction of domestic demand, accumulation of outstanding liabilities of the state to its suppliers and public works construction

[50] The change in the sector classification to NACE Rev 2. in May led to modification of the sectoral indicators, included in the overall indicator, which makes its direct comparison with previously recorded levels problematic.

companies, and rapid deceleration of the business credit expansion (reaching 3.9% in April from 24.1% in the third quarter of 2008) are the key factors that are expected to cause private investment to fall for a second year in a row. Since last September, the enterprises in industry have experienced credit contraction, which in April spread to the trade sector. A significant delay in the implementation of the National Strategic Reference Framework (NSRF), which has almost completely halted, and the heightened uncertainty about the course of the Greek economy, which increases the investors' scepticism and leads to delays / abandonment of investment projects, have been added this year to the above key factors. The revival of the global economy, which is already reflected in the increase of the Greek export of services, is the only factor that acts as a positive stimulus for private investment. Most probably, this trend will continue and expand to other sectors, as since March the industry orders from abroad have grown, reaching 20.3% in April (mainly from the Euro area with +30.0%). Nevertheless, part of the increased demand has being met with available inventory, as the capacity utilisation rate has remained low (at 67.6% in May).

The smaller deficit of the **external sector** of the economy in early 2010 limited its negative impact on GDP. Greek **exports** benefited significantly from the weakening of the euro/dollar exchange rate, in addition to the revival of global demand. The small reduction in exports in the first quarter, which stemmed exclusively from reduction in the exports of goods, will most likely weaken in the coming quarters, without a spectacular reversal of the first quarter trends.

The reduction in the negative impact of the external sector on GDP by 15.8% is mostly due to contraction of **imports**. Their propensity to increase due to significantly higher prices of goods, mainly coming from outside the Euro area, such as oil and gas, due to the appreciation of the dollar, was overcompensated by the rapid fall in domestic demand. The factors behind this fall (wage cuts in the public sector, taxation increase and unemployment growth) have intensified in the second quarter as a result of the new package of fiscal measures and the adverse economic climate in general. Their impact is expected to be felt stronger in the coming months with the complete implementation of the measures that have been already adopted and the new measures programmed for the rest of 2010, until the benefits from the reform effort begin to materialise.

The above trends in the main components of GDP are expected to lead to deepening recession of the Greek economy, in the few coming quarters at least. After all, the fall in the first quarter was significantly larger compared to 2009, reaching 2.5% against 1.0%. All recent estimates of international and domestic organisations point to this direction. Nevertheless, there is a wide deviation in the estimates for the extent of GDP fall this year. In its 2009 Governor's Annual Report, just before the Greek government resorted to the support mechanism, the Bank of Greece stresses the heightened uncertainty of its previous estimate for GDP reduction by 2%. In its

spring estimates, published shortly after the completion of the deal for the support mechanism, the European Commission expected contraction of the Greek economy not larger than 3% during the current year and not larger than 0.5% the following year.[51] In contrast, IMF in its report regarding the programme for liquidity injection of Greece, predicted GDP contraction by 4.0% this year and 2.6% in 2011.[52] IOBE, taking into account the trends in the key indicators for the first three to five months, the economic environment after the recourse to the support mechanism, the content and the implementation progress of the support agreement, estimates that the drop in GDP this year will stand at about **3.2%**.

Unavoidably, the economic recession and the effort of curtailment and rationalisation of the expenditure in the public sector that extends to restructuring of its employment, preserve and boost the negative trends that have dominated in the **labour market** since 2009. The increase in unemployment has been accelerating since early 2009. In the first quarter of 2010, the year-on-year increase in unemployment, did not fall below the year-on-year increase in the fourth quarter of 2009 (2.4 percentage points).

Employment continued to fall without accelerating, reaching 1.3% in the first quarter of this year. Largest is the slump of employment in manufacturing (-8.9%), construction (-7,6%) and wholesale-retail trade (-6.2%). In contrast, the employment in the public sector remained unchanged, at least until the end of the first quarter. Employment was about the same in public administration (+0.1%), higher in education (+1.4%) and much higher in health and social care (+6.3%), activities mainly conducted by the state. For the coming few months, seasonal factors are expected to alleviate unemployment and employment reduction, but by lesser extent compared to the past few years. This forecast is supported by the data from IOBE's latest business surveys, in which the employment expectations in services, trade and construction (but not in industry) are less pessimistic. Nevertheless, new boost of unemployment is expected from the end of the third quarter, which is expected to lead to an annual unemployment rate at around **12,0%** (for greater detail, see section 3.4).

[51] European Economic Forecast- Spring 2010, European Commission, May 2010.
[52] Greece, Staff Report on Request for Stand-by Arrangement, IMF, May 2010.

Table 3.2

Domestic Expenditure and Gross Domestic Product – European Commission forecast
(constant 2000 prices)

	2008	2009	2010	2011
Annual Percentage Changes				
Gross Domestic Product	2.0	-2.0	-3.0	-0.5
Private Consumption	2.3	-1.8	-3.5	-2.4
Public Consumption	0.6	9.6	-7.0	-3.1
Gross Fixed Capital Formation	-7.4	-13.1	-5.5	-0.8
Equipment	6.3	-19.0	-5.0	-1.7
Final Demand	1.5	-5.2	-4.7	-1.2
Exports of Goods and Services	4.0	-18.1	2.6	4.1
Imports of Goods and Services	0.2	-14.1	-10.5	-3.4
Gross National Income	1.6	-1.5	-3.0	-0.6
Employment	0.1	-1.2	-1.9	-0.8
Compensation of Employees / Head	5.9	5.5	-0.8	0.4
Real Unit Cost of Labour	3.9	6.3	0.3	0.1
GDP Deflator	3.5	1.0	2.9	1.7
Harmonised Index of Consumer Prices	4.2	1.3	3.1	2.1
Contribution to real GDP change				
Domestic Demand	0.2	-2.5	-4.8	-2.4
Net Exports	0.8	0.7	3.8	1.8
House Inventories	1.0	-0.1	-1.9	0.1
As percentage of GDP				
Trade Balance	-16.6	-14.0	-12.0	-10.9
General Government Balance	-7.7	-13.6	-9.4	-7.6
Current Account Balance	-13.8	-13.1	-10.3	-8.6
General Government Debt	99.2	115.1	124.9	133.9
Percentage				
Unemployment (% of civilian labour force)	7.7	9.5	11.8	13.2

Source: European Economic Forecast , Spring 2010, European Commission, May 2010

After the sharp acceleration of **inflation** in the past three months, when it almost doubled (5.4% in May from 2.8% in February), the consumer price index will continue to grow in the coming months (at a slower rate), since part of the measures adopted in May to increase indirect taxes will come into force on 1 July. Inflation will appear high also because of the low CPI levels during the period May-July of 2009, while from the autumn the broadening of the basic VAT tax rate to more goods will create inflationary pressures. Gradual reduction of public sector wages and pensions, whose implementation is not yet completed, reduction in real wages due to higher taxes, further cut in public consumption and in the medium term structural interventions in the restricted professions and markets will act in the opposite direction. The overall result of these opposing forces points at much higher inflation during the current year (**4.5%)** compared with the year before (1.2%).

Table 3.3

Comparison of Forecasts on Selected Economic Indicators for the Period 2009 – 2011

(constant 2000 prices, annual % change or level)

	MFIN*			EC			OECD			IMF		
	2009	*2010*	*2011*	*2009*	*2010*	*2011*	*2009*	*2010*	*2011*	*2009*	*2010*	*2011*
GDP	-2.0	-4.0	-2.6	-2.0	-3.0	-0.5	-2.0	-3.7	-2.5	-2.0	-4.0	-2.6
Final Demand	:	:	:	-5.2	-4.7	-1.2	-2.5	-6.1	-5.3	:	:	:
Private Consumption	-1.8	-4.0	-3.7	-1.8	-3.5	-2.4	-1.8	-3.7	-3.6	-1.8	-4.0	-3.7
Harmonised Index of Consumer Prices (%)	1.3	1.9	-0.4	1.3	3.1	2.1	1.3	3.0	0.3	1.3	1.9	-0.4
Gross Fixed Capital Formation	-13.9	-11.4	-11.8	-13.1	-5.5	-0.8	-13.9	-12.5	-11.5	-13.9	-11.4	-11.8
Unemployment (%)	9.4	11.8	14.6	9.5	11.8	13.2	9.5	12.1	14.3	9.4	11.8	14.6
General Government Balance (% GDP)	-13.6	-8.1	-7.6	-13.6	-9.4	-7.6	-13.5	-8.1	-7.1	-13.6	-8.1	-7.6
Current Account Balance (% GDP)	-11.2	-8.4	-7.1	-13.1**	-10.3**	-8.6**	-11.2	-8.9	-6.7	-11.2	-8.4	-7.1
Gross Public Debt (% GDP)	115	133	145	115.1	124.9	133.9	:	:	:	115	133.3	145.1

* The forecasts are the same with those of IMF, as their source is the joint statement of the support mechanism.
** Based on the national accounts.
Source: Note on the Economic Policy Programme related to the Eurogroup and the IMF the support mechanism, Ministry of Finance, May 2010, European Economic Forecast Spring 2010, European Commission, May 2010, OECD Economic Outlook No. 87, May 2010, Greece, Staff Report on Request for Stand-by Arrangement, IMF, May 2010.

In a longer term horizon, the rapid fiscal developments and the deteriorating trends of key macroeconomic aggregates and indicators prior to the recourse to the support mechanism revealed the ever intensifying need for immediate and radical multifaceted reforms. The delay in tackling the large number of economic problems and issues caused them to grow to huge proportions. Even though the current conditions are quite averse and it is far from certain that we can avoid even worse developments, the support agreement does provide a framework for the resolution of the current problems. Reforms and initiatives that have been widely discussed for quite a few years, but were never put to implementation, have finally been incorporated into a concrete time plan. Even though the short-term impact of these measures on GDP and other economic indicators will be strongly negative, in the medium term they will begin to yield positive results, such as lower inflation, higher employment, revival of investment initiatives and in general an economic activity boost.

3.2 Developments and prospects in key sectors of the economy

This section presents the quarterly indices of activity complied by the Hellenic Statistical Authority (ELSTAT), which track the course of production in Industry and the turnover of businesses in the sectors of Construction, Commerce and Services. At the same time, it presents the corresponding branch indices compiled by IOBE on the basis of the business surveys it has been conducting in Greece since 1981. The joint analysis of these indices and the trends that emerge provide a broader pic-

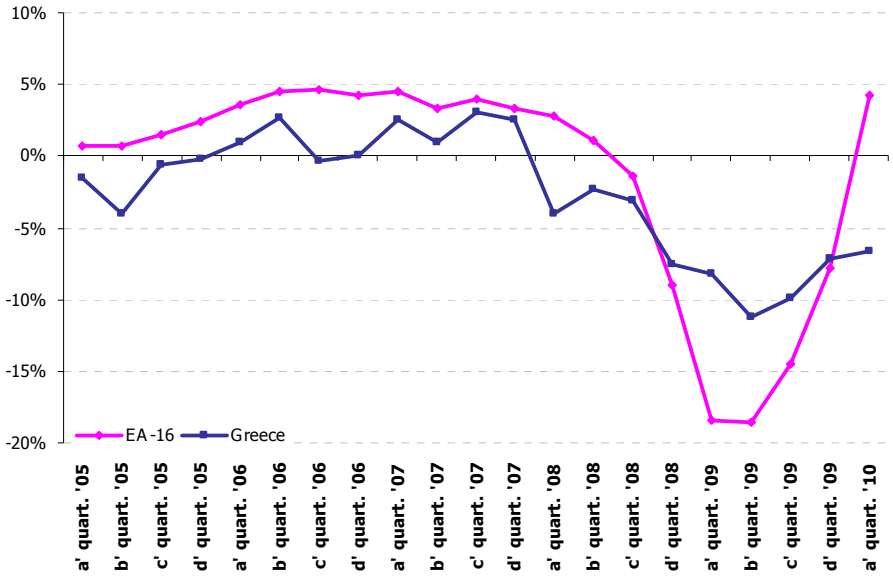
ture of the supply side of the economy and contribute to the assessment of the strength of domestic demand.

Industry

Industrial production dropped by 5.3% in the first four months of 2010 compared to the same period the year before, when it declined at a double rate (-10%). In contrast the industrial production in the Euro area as a whole increased during the same period by 5.8%, against a fall of -19% the year before. The extent of recession of the domestic industrial production is also evident in the fact that only the economy of Cyprus followed a similar trend as Greece. This particular development, which clearly was the result of the adverse fiscal developments, was reflected at branch level primarily in the reduction of electricity and natural gas supply by 11% in 2010 against 1.6% the year before. In Manufacturing, production continued to fall, but at lower rate compared to the first quarter of 2009 (-3.6% against -13.8%). Similar was the trend in Mining-Quarrying, where the index fell by 6.9% in early 2010 against 10.7% the year before. In contrast, Water Supply increased by 1.5% against a drop of 0.8% in the corresponding quarter of 2009.

In greater detail, the **Manufacturing** branches of Basic Metals and Chemicals recovered significantly during the first four months of the year, achieving growth rate of 8.8% and 3.2% respectively, against a drop of 23.3% and 17.2% in the same period the year before. Pharmaceutical Products also registered production increase, though smaller than the year before (7.9% against 12.4%). In contrast, Food manufacturing fell (-2.4%), but at a lower rate compared with the first four months of 2009 (-6.2%), while in Coke & Refinery Products the index dropped, reversing the upward trend observed the year before (-4% against 7,6%). In the rest of the main branches, the large fall observed in the period January – April of 2009 slowed down significantly in the first four months of this year. Indicatively, the fall in Plastics stood at -1.6% against -16% the year before, in Electrical Equipment at -2% against -21.8%, in Non-Metallic Minerals at -5.9% from -29.5% and in Manufacture of Metal Goods at -7.5% from -24.6%. In Textiles, even though the downward trend slowed down in relation to the year before, the decline was still significant (-17.8% against -30.8%), while the crisis in Clothing is particularly intense, as during the past two years the production index fell by 38% (-22.5% in the first quarter of 2010 against -20.4% the year before).

Figure 3.1
Production Index in Manufacturing
% change w.r.t the same quarter of the previous year (2005=100)



Source: Eurostat

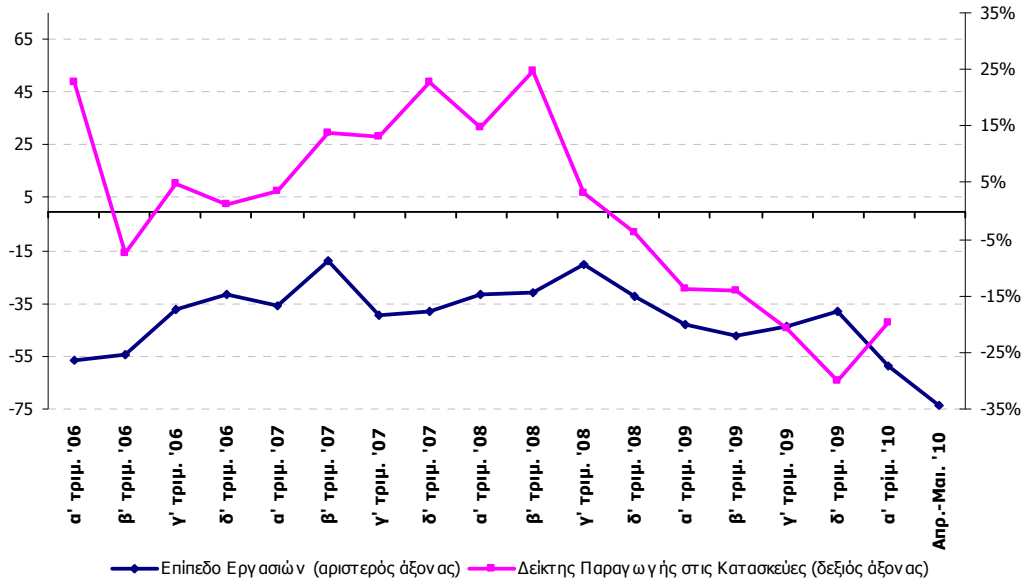
The decline of production in **Mining-Quarrying** came from a significant drop of production in Mining of Coal & Lignite by 15.2% against an increase of 3.6% in the first four months of 2009, which dominated the increase registered in the remaining sub-branches. More specifically, the production index increased in Other Mining and Quarrying by 1.4% against its large drop the year before (-31.8%) and in Mining of Metallic Ores (18.3% against -28.6%), while in Extraction of Crude Petroleum & Natural Gas the production index doubled in comparison to the year before.

Slowdown of the downward trend is observed in the various goods categories, with the exception of Intermediate Goods, which registered increase by 1.1% (against -23% the year before). The reduction ranged from -3.9% in Consumer Durables (-24.5% the year before) to -14.2% in Capital Goods (29.2% the year before). In Consumer Non-Durables, the index fell by 4.6% against 6.2% drop in 2009, while in Energy production declined significantly (-8.2%), against an increase of 3% the same period the year before.

Construction

The general index of production in Construction fell by 19.7% in the first quarter of 2010 against the same period of the previous year, against a drop of 13.8% the year before. As a result it stood at levels similar to those it had in the first quarter of 2005. Regarding the production indices of the branches that comprise the sector, in Building Construction production fell by 16.2%, against a drop of 22.1% in the first quarter of 2009, while the reduction in the output of Civil Engineering works was three times as high (-21.9%) compared to the year before.

Figure 3.2
Construction Production Index (annual changes) and Business Level



Source: ELSTAT – IOBE

Total building activity (private and public) was limited to 12,690 permits, registering a small decline (2.8%) in comparison to the first quarter of 2009, when the reduction reached 8.1%. In terms of building volume, the reduction was much larger, reaching 20.9% against a drop of 14.9% the year before. At regional level, reduction in terms of permits was recorded in seven out of the 13 regions. Larger was the drop in Crete (-18.1%), East Macedonia-Thrace (-12.3%), Central Macedonia (-10.2%) and West Macedonia (-8.6%). In contrast, significant increase was register in Peloponnese and the South Aegean region (15.5% and 10% respectively).

On the other hand, the transactions with residences with the mediation of credit institutions during the first quarter of 2010 increased by 38.5%, in addition to the increase registered in the fourth quarter of 2009 (14.4%). This particular development reversed the downward trend that has dominated the real estate market since the beginning of 2008, absorbing in the mean time part of the excess supply of residences. The de-escalation of the interest rate on new mortgage loans to 3.7% in March is expected to contribute further in this direction, even though the mortgage credit expansion rate continued to decline.[53]

Retail Trade

The **Volume Index in Retail Trade** (turnover at constant prices, with automotive fuels and lubricants)[54] increased by 5.8% in the first quarter of 2010, against a 14.3% drop the year before. In comparison with the fourth quarter of 2009, however, the index fell by 5.2%.

[53] The production index in construction is presented in terms of annual percentage change, while the level of activity index refers to the difference in the weighted average of the percentage of responses of higher / lower than normal level of activity.

[54] According to the new statistical classification of economic activities NACE Rev.2, the branch 'retail sale of automotive fuels and lubricants' comes under **retail trade** and no longer belongs to the category 'trade, maintenance and repair of motor vehicles and motorcycles'.

In the first quarter of 2010, the index increased in all the main categories of retail trade, except Departmental Stores and Automotive Fuels & Lubricants. The largest increase is recorded in Pharmaceuticals-Cosmetics (15.6%), where the previous year the index was pretty stable. In the Supermarkets, the index increased by 3.8% against a drop of 7.5% the year before. Similarly, in Food-Beverages-Tobacco the index increased by 6.6% against a drop of 1.3% in the first quarter of 2009. Meanwhile, the volume index in Clothing-Footwear increased by 6.2%, which is less by 2.5 percentage points compared to last year's growth rate. Significant increase was also registered in Furniture-Electrical Appliances-Household Goods (4.2%) and Books-Stationary-Other Gift Items (6.9%), following their large drop in the same period the year before (-20% and -26.1% respectively). In contrast, in the Department Stores category the index declined at larger rate compared to the previous year (-6.6% against -4.3%), while in the Automotive Fuels & Lubricants the index fell further (-3.6%) after the large drop the year before (-41.1%).

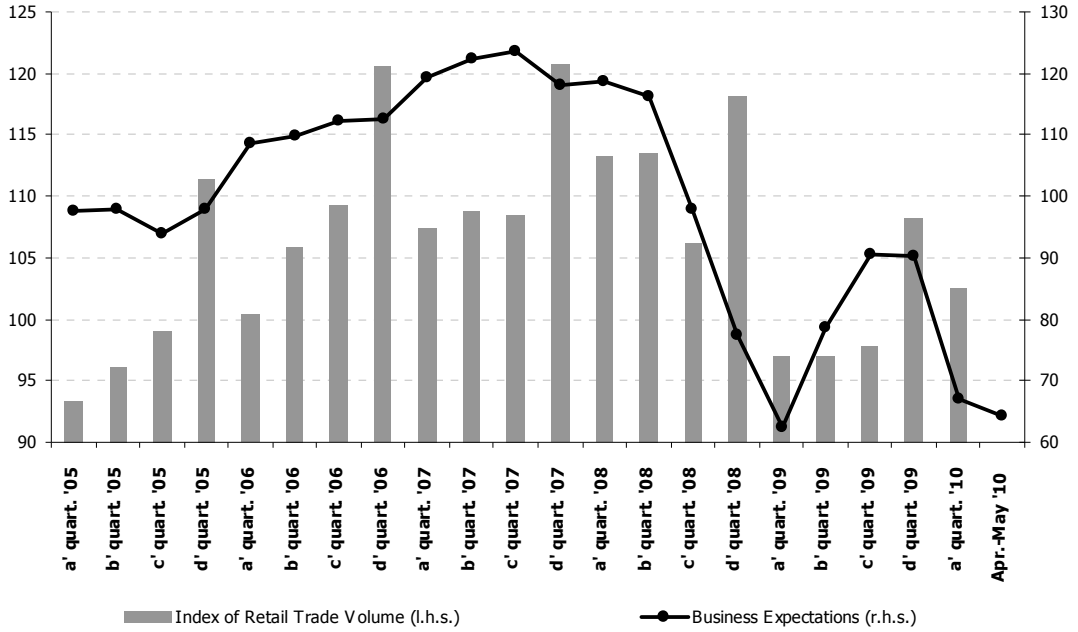
Evidently, the increase in retail trade volumes came from stricter issuance of purchase receipts, rather than a genuine increase in consumption, given the restrictive income policy, the increase in taxes and the heightened economic uncertainty.

The **Turnover Index** for Trade, Maintenance and Repair of Motor Vehicles and Motorcycles (branch 45 according to NACE Rev.2) fell further by 7.5% in the first quarter of 2010. Given its large year-on-year decrease (-30.7%), the index reached its lowest levels on quarterly basis since 2005. The same trend is observed in the sub-branch Trade of Motor Vehicles (branch 451 according to NACE Rev. 2), where the index fell by 8.6% in the first quarter of 2010, against a 35.5% drop the year before.

In the **Business Surveys** carried out by IOBE, the Confidence Indicator for Motor Vehicles declined in May and is now at levels markedly lower compared to the last few years. The fall in the index is related with the increase in the inventory and the stabilisation of the sales estimates at very low levels, as the measures related to the fiscal consolidation have a direct impact on this sector. The switch to cars with lower engine capacity is already a fact.

Figure 3.3

Index of Retail Trade Volume (turnover in constant prices, 2005=100) and Business Expectations Index in Retail Trade (1996-2006=100)



Source: ELSTAT-IOBE

Table 3.4

Annual Change in the Retail Trade Volume Index, January-March

Retail Trade Store Categories	Volume Index (2005=100)				
	2008	**2009**	**2010***	**Annual Change (`09/'08)**	**Annual Change* (`10/'09)**
General Index	113.2	97.0	102.8	-14.3%	5.9%
General Index (excluding car fuels and lubricants)	104.4	94.6	100.2	-9.5%	5.9%
Store Subcategories					
Supermarkets	110.3	102.1	105.9	-7.5%	3.8%
Department Stores	104.6	100.1	93.5	-4.3%	-6.6%
Fuels and Lubricants	169.7	99.4	95.8	-41.1%	-3.6%
Food – Beverages – Tobacco	87.8	87.1	92.8	-1.3%	6.6%
Pharmaceuticals – Cosmetics	107.5	107.5	124.2	0.0%	15.6%
Clothing – Footwear	92.3	100.1	106.3	8.7%	6.2%
Furniture – Electrical Appliances – Household Goods	113.1	90.8	94.7	-20.0%	4.2%
Books – Stationery – Other Gift Items	106.1	78.6	84.0	-26.1%	6.9%

*Provisional data
Source: ELSTAT

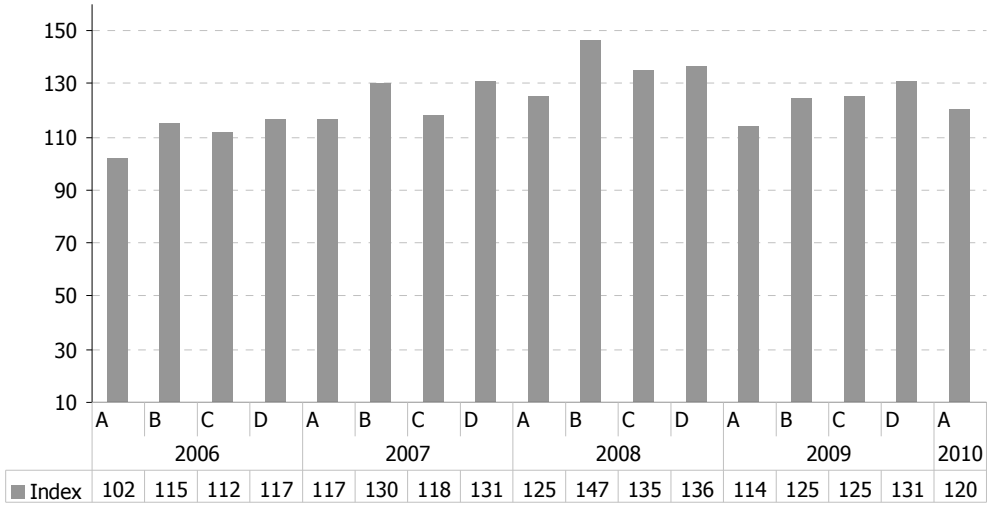
The overall confidence index for Retail Trade in to the first five months of this year stood at levels slightly lower compared to the year before. More significant fall, however, was registered in certain Retail Trade categories, with the sharpest fall recorded in Household Goods (-10.3%), Fabrics-Clothing-Footwear (-7.4%) and Food-Beverages-Tobacco (-5.7%), while in the assessment of the increase in the Motor Vehicles (including spare parts) category we should take into account the very low level of confidence during the same period the year before.

Table 3.5
Sectoral Indices of Business Expectations in Retail Trade (1996-2006=100)

	2008	2009	Δ(%)	Jan 09-May 09	Jan 10-May 10	Δ(%)
Food – Beverages – Tobacco	112.6	87.9	-22.0%	85.0	80.2	-5.7%
Fabrics – Clothing – Footwear	117.0	90.6	-22.6%	83.9	77.7	-7.4%
Household Goods	105.1	67.8	-35.5%	64.5	57.9	-10.3%
Motor Vehicles (including parts)	90.0	76.4	-15.2%	44.9	51.4	14.4%
Department Stores	114.5	106.4	-7.1%	104.4	100.3	-4.0%
Retail Trade Total	102.5	80.4	-21.6%	66.5	65.9	-0.9%

Source: IOBE

Figure 3.4
Turnover Index in Wholesale Trade -Sector 45- (2005=100)



Source: ELSTAT

Wholesale Trade

The **Turnover Index for Wholesale Trade** (branch 45 in NACE Rev.2) [55] increased year-on-year by 5.4% in the first quarter of 2010, against a year-on-year decrease of 9% in the same quarter of 2009. This is the first instance of a year-on-year increase of this index since the fourth quarter of 2008. Quarter-on-quarter, the index fell by 8.2% as a result of the intense seasonality that comes with the seasonal shopping during the Christmas period.

Services

In the Services sector,[56] the turnover index stood at about the same level in the first quarter of 2010 with those for the same quarter the year before, while in 9 out of the 15 branches the index declined. In comparison, in the first quarter of 2008 the index declined in only one of the branches.

[55] The Wholesale Trade index is calculated without VAT and includes the total amounts invoiced by a company during the reference period (quarter).

[56] The indices that IOBE has selected to present are mainly those for which additional data are available from its Business Surveys.

In greater detail:

The largest increase of the turnover index was registered in the **Information Service Activities** (branch 63) by 6%, which however was significantly lower compared with the first quarter of 2009 (31%). This branch has had consistently higher index compared to the rest of the branches in the Services category. The level it registered in the first quarter was the second highest level for the last three years.

The turnover in the branches under **Legal, Accounting and Management Consultancy** services increased by 5.3% in the first quarter of 2010 (against a 9.9% drop in 2009), which is the second largest increase among the 15 categories. The turnover in these activities follows strong seasonality patterns, with the largest value being recorded in the last quarter of the year. As a result, the index fell by 40% quarter-on-quarter, which, however, is the smallest fall the last three years for this particular quarter-on-quarter comparison.

In contrast, the turnover index in Telecommunications (branch 61) [57] declined for an eighth consecutive quarter on an annual basis. The fall registered in early 2010 was almost the same with the decline recorded in the same quarter of the previous year (-6.5%). As a result the index recorded its lowest levels since 2005.

The fall registered in the **Computer Programming, Consultancy and Related Activities** (branch 62) was similar, yet smaller compared to the drop the year before (-6.1% against -15.8%), reaching levels close to those recorded in the third quarter of 2006.

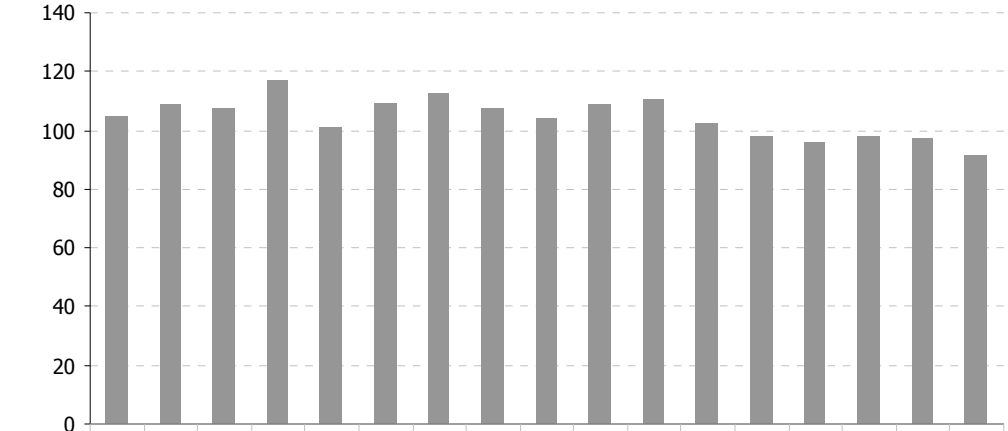
The turnover index in **Advertising and Market Research** (branch 73) fell by 7.3% in the first quarter of 2010. As a result the index recorded its lowest level for the past five years.

Lastly, the turnover index in the **Accommodation and Food Service Activities** (branches 55 and 56) recovered from the lowest level of the past five years that was registered in the first quarter of 2009, increasing by 2.9%. The increase in arrivals of non-residents from abroad in the main airports of the country by 3% in comparison with the same period of the previous year contributed to this development.

The developments that took place in the branches of services had already been identified to a significant degree in the projections of the leading indicators in IOBE's business surveys. During the first five months of the year, the confidence indicator for Services fell by 6% in comparison with 2009. Nevertheless, the indices for the particular branches in their majority followed an upward trend (in relation to the same period of the previous year). This trend was particularly strong in the business services and the financial sector.

[57] The Telecommunications index no longer incorporates the Postal and Courier Activities branch.

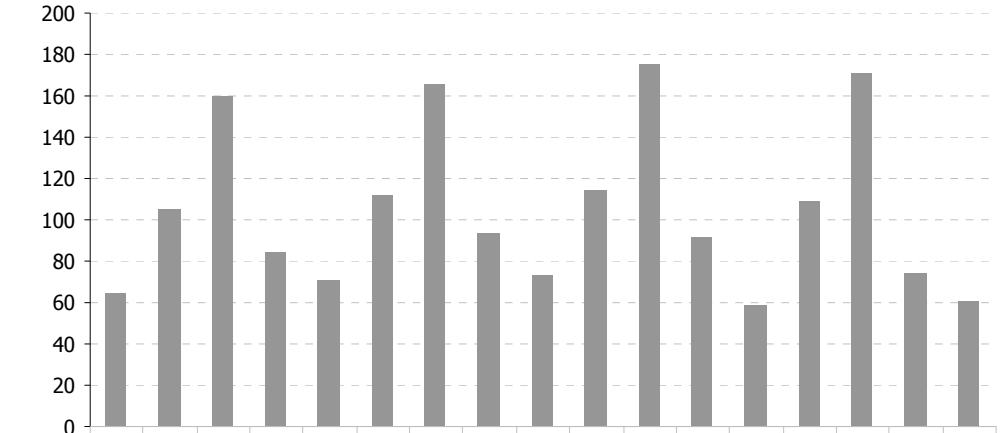
Figure 3.5
Turnover Index in Telecommunications, branch 61 (2005 = 100)



	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A
	2006				2007				2008				2009				2010
Index	105	109	107	117	101	109	113	108	105	109	111	103	98	96	98	97	91

Source: ELSTAT

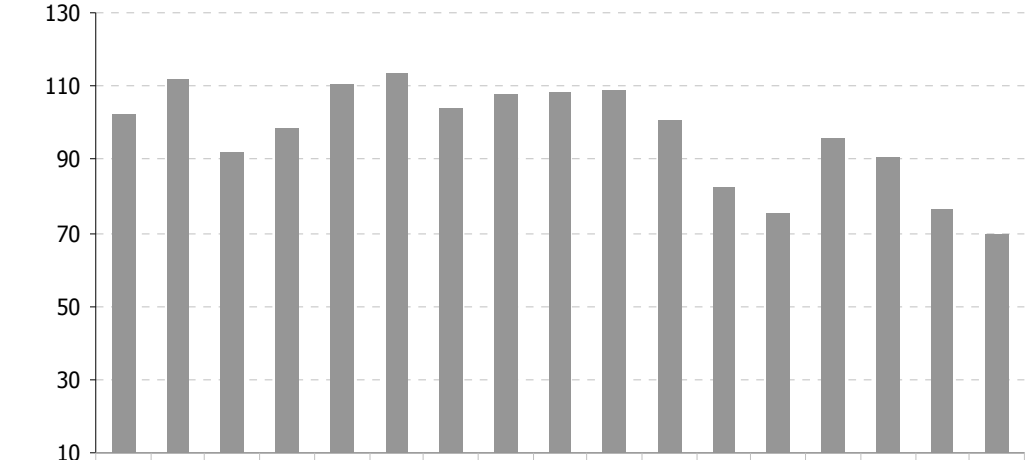
Figure 3.6
Turnover Index in Accommodation, Food and Beverage Service Activities -Sectors 55 & 56- (2005 = 100)



	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A
	2006				2007				2008				2009				2010
Index	64	106	160	85	71	112	166	94	74	115	175	92	59	109	171	75	61

Source: ELSTAT

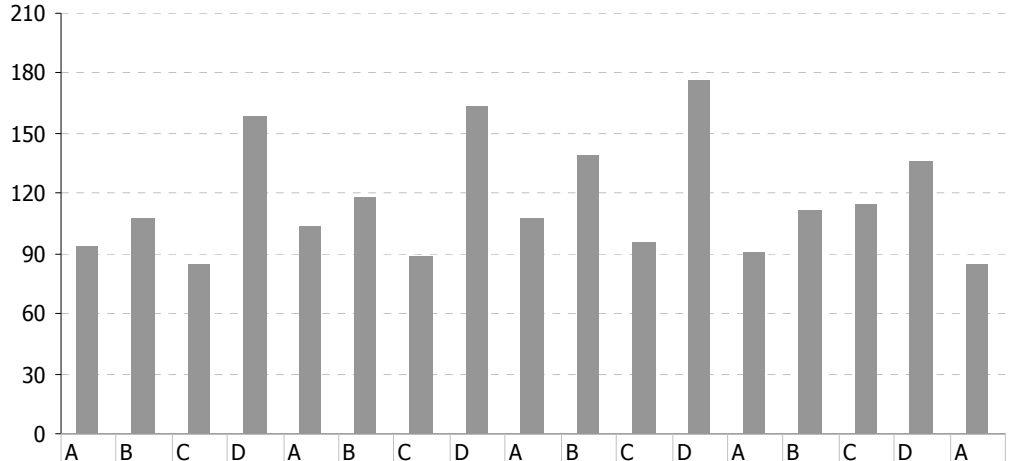
Figure 3.7
Turnover Index in Trade, Maintenance and Repair of Motor Vehicles and Motorcycles -Sector 45- (2005=100)



	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A
	2006				2007				2008				2009				2010
Index	102	112	92	98	111	113	104	108	108	109	101	83	75	96	91	76	70

Source: ELSTAT

Figure 3.8
Turnover Index in Informatics Services -Sector 62- (2005 = 100)



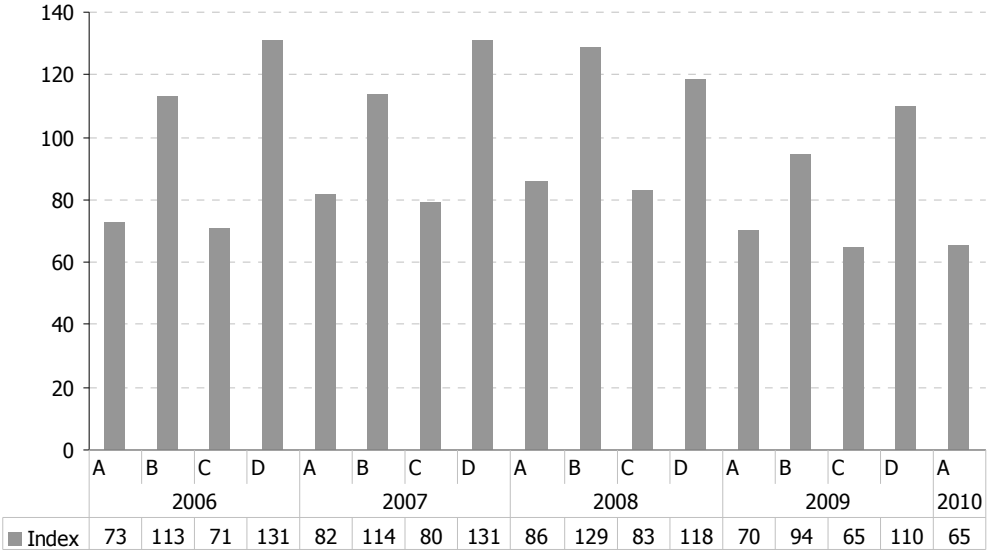
	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A
	2006				2007				2008				2009				2010
Index	94	108	85	159	103	119	89	164	107	139	96	177	90	111	114	136	85

Source: ELSTAT

Figure 3.9
Turnover Index in Legal, Accounting and Management Consultancy Activities, branches 69 & 70.2 (2005 = 100)

Source: ELSTAT

Figure 3.10
Turnover Index in Advertising and Market Research, branch 73 (2005 = 100)



Source: ELSTAT

Table 3.6

Confidence Indicators in Services Sectors (1998-2006=100)

	2008	2009	Δ(%)	Jan 09-May 09	Jan 10-May 10	Δ(%)
Hotels – Restaurants	98.8	79.4	-19.6%	68.5	70.2	2.6%
Travel Agencies – Tour Operators – Tourist Assistance	85.7	71.1	-17.0%	64.0	70.5	10.2%
Other Business Services	87.4	61.1	-30.1%	53.8	65.1	21.0%
Financial Institutions	84.5	72.4	-14.3%	58.5	72.9	24.6%
IT Services	92.9	65.1	-29.9%	64.4	45.2	-29.7%
Total Services	97.8	70.1	-28.3%	66.6	62.6	-6.0%

Source: IOBE

In summary, slowdown of the downward trend was observed in quite a few indicators in the first quarter of 2010. Despite the indications that the global economy is recovering, the deep recession of the Greek economy, in combination with its fiscal problems, will hold back domestic production recovery.

The domestic nature of the crisis is evident in the fact that industrial production accelerated in all countries of the Euro area, apart from Cyprus, which was also reflected in significant recovery in the overall Euro area industrial production index. Nevertheless, in particular branches of domestic industry, and especially in those that have higher share of export, activity is growing, compared with the year before. The increase in new industry orders by 4.9% in April 2010 in comparison with April 2010, which came entirely from increase in the orders from abroad (+20.3%) indicates that activity in these branches will continue to grow over the coming months.

The deterioration of the indices in construction continued in early 2010, deepening the recession that the sector has experienced in the past two years. This development has affected adversely domestic industrial production, as quite a few branches, such as Cement, Metal Products, Electric Equipment and others depend largely on the Construction sector. The excess supply that characterises the real estate market and the current adverse economic environment practically eliminate the possibility of the sector's recovery in the near term. Nevertheless, the increase in residence transactions since the end of last year and the drop in the interest rate of new mortgage loans, can be seen as positive signals.

The increase in the turnover index in retail trade that was registered in the first quarter of 2010 reflected more the increase in issuance of purchase receipts and less a genuine increase in transactions. The fiscal measures, in combination with the income loss experienced by quite a few groups of the population, have had a negative impact on private consumption and are expected to act adversely on retail trade turnover over the coming months, especially in the categories that do not contain staple products. An indication of such a development is the course of the Motor Vehicles sector, where in the first five months of the year sales dropped by 6.5% in comparison with the same period of the previous year, when they had already fallen by 32% in relation to 2008.

3.3 Export Performance of the Greek Economy

The recovery of the global economy in early 2010 had a positive impact on Greek exports of goods, which increased in the first quarter by 1.1% compared to the same quarter of 2009. Nevertheless, after the significant fall in the year before by 15.7%, exports remained at low levels. In contrast, imports continued on the downward trend that they have recorded since 2008. In the first quarter of 2010, imports fell by 13.4% to their lowest level in five years, compared to a reduction of 18.9% in 2009. Likewise, the trade deficit fell to its lowest level in five years, as in early 2010 it declined almost with the same rate as in the first quarter of 2009 (-18.9%

against -20% respectively).[58] This led to a year-on-year increase in the imports-exports coverage ratio by four percentage points to 28%.

Large increases were registered in goods with small share in total exports. Exports of raw materials increased by € 71.8 million (+45.3%), while exports of 'products and transactions not classified elsewhere' increased by €24.6 million (+35.3%). In contrast, the exports of industrial goods, which have the largest share, increased only marginally, while the exports of agricultural products decreased by 3%.

Among the industrial products, the largest increase by 18% was recorded in 'chemical and related products', which increased their share in total exports by 2.4 percentage points in the first quarter of 2009. The increase in this particular category compensated for the reduction in the remaining categories of industrial products. The exports of 'industrial goods classified by raw material' and 'various industrial goods' fell at a similar rate (-3.6%), while the exports of 'vehicles and transport equipment' dropped by more than double this rate (-10%).

Among the agricultural products, which as a group saw their share in total exports drop by 1 percentage point in comparison to 2009, increase in exports was recorded in 'food and live animals' by 2.1%, whose share in total exports reached 20% in the first quarter of 2010. The particular increase, however, was not enough to compensate the reduction in the remaining categories. The exports of 'beverages and tobacco' dropped (-13.3%) three times as much as the year before, while the exports of 'animal and vegetable oils and fats' fell by 24.5%. The latter category of agricultural products experiences a continuous fall since 2006 with a compounded annual growth rate of -28.5%. As a result the value of exports in the first quarter of 2010 is four times lower than the level recorded in 2006. Lastly, the value of fuel exports stood at its lowest level in five years, falling by 14.3% compared to the year before.

In terms of destination, the exports of Greek products to EU-25 in early 2010 increased by 4.4%, compared with a significant fall the year before (-18.2%). The exports to the Balkan countries, which absorb a sizeable proportion of the Greek products, continued their fall, but at a rate slower than the year before, with their value reaching the 2006 levels. The exports to the Euro area remained essentially at the same levels in comparison with the first quarter of 2009, while the exports to the EU members outside the Euro area increased by 6.7%. Meanwhile, the exports to the majority of EU-27 member-states (21 out of 27 countries) increased, albeit marginally in some of the cases.

As for Greece's main partners, the exports to Germany, which is the largest market for Greek products, increased by 9.3%. The increase of the exports to the United Kingdom (27.5%) and France (12.9%) was also sizable, raising their shares to about 5% of total exports. The exports to

[58] The estimates are based on the analysis of the Panhellenic Exporters Association and the Exports Research Centre, using provisional data of the Hellenic Statistical Authority.

Cyprus, the third largest market for Greek exports with 8% share in early 2010, increased by 3.1%. In contrast, the exports to Italy, the second largest market, declined by 11.6%.

Exports to OECD countries, which account for 59% of Greece's total exports, increased by 4.8% in the first quarter of 2010. In the Balkan region, the exports to Romania and Bulgaria, countries which absorb almost 1/10 of Greece's exports decreased by 15.8% and 6.3% respectively. This particular decrease, by about € 35 million, was overcompensated by increase of the exports to Albania (1.4%), Croatia (double compared to the year before) and Bosnia-Herzegovina (51.6%), whose share in exports, despite the large increase only about surpassed 1% in the first quarter of 2010. The exports to Turkey increased significantly, reaching €175.4 million (+51.2%), while its share increased with 1.7 percentage points compared to the first quarter of 2009.

Exports to North America fell significantly (-24.6%), reaching their lowest level in five years. This is mostly due to a reduction of exports to the US market by 31.1%. The exports to the countries of North Africa and the Middle East declined by 6.6% against a 20.8% increase the year before. The exports fell in 11 of the 18 countries in the particular region, with the decline rate ranging from -5% to -58%. Lastly, the exports to China increased by € 13.5 million (+72%), while the exports to India remained at about the same level. The penetration of Greek products in these markets remained low – 0.9% and 0.4% respectively – despite their large population size and high rates of economic growth.

Table 3.7
Exports per category

January – March							
	Value (€ million)		**Percentage change**		**Shares (%)**		
	2009*	**2010***	**09/08***	**10/09***	**2008**	**2009***	**Q12010***
Agricultural Products	**858,9**	**833,6**	**-0.8%**	**-3.0%**	**21.6%**	**25.4%**	**24.4%**
Food and Live Animals	638,6	651,9	0.3%	2.1%	15.9%	18.9%	19.1%
Beverages & Tobacco	136,6	118,5	-2.3%	-13.3%	3.5%	4.0%	3.5%
Animal, Vegetable Oils and Fats	83,7	63,2	-6.7%	-24.5%	2.2%	2.5%	1.8%
Raw Materials	**158,6**	**230,3**	**-14.0%**	**45.3%**	**4.6%**	**4.7%**	**6.7%**
Fuels	**291,4**	**249,6**	**-14.4%**	**-14.3%**	**8.5%**	**8.6%**	**7.3%**
Industrial Products	**2.001,1**	**2.008,6**	**-20.1%**	**0.4%**	**62.5%**	**59.2%**	**58.8%**
Chemicals and Related Products	487,9	575,7	-13.1%	18.0%	14.0%	14.4%	16.9%
Industrial Goods Classified by Raw Material	729,7	702,4	-22.9%	-3.7%	23.6%	21.6%	20.6%
Machinery & Transport Equipment	400,7	360,6	-25.0%	-10.0%	13.3%	11.9%	10.6%
Miscellaneous industrial products	382,8	369,9	-17.5%	-3.4%	11.6%	11.3%	10.8%
Other	**69,3**	**93,9**	**-38.7%**	**35.5%**	**2.8%**	**2.1%**	**2.7%**
Total Exports	**3.379,3**	**3.416,0**	**-15.7%**	**1.1%**	**100%**	**100%**	**100%**

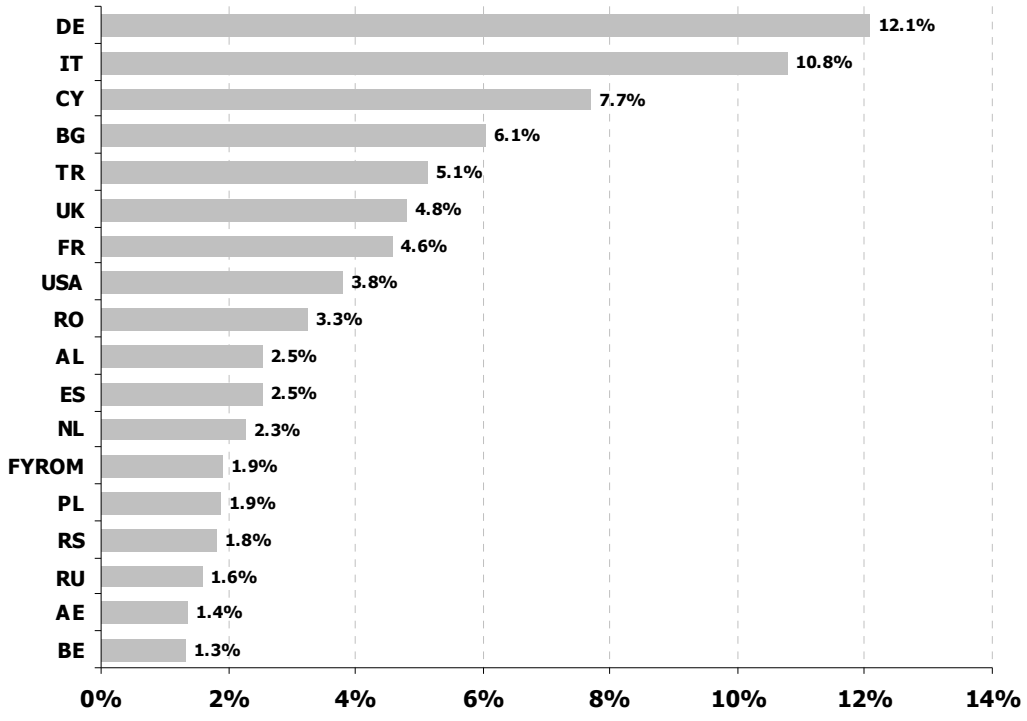
* Provisional data
Source: PEA-ERC-ELSTAT

Table 3.8
Exports per destination in the first quarter of 2010

	Value (€ million)			Share	
	2009*	**2010***	**Δ (%) 10/09**	**2009***	**2010***
OECD (29 countries)	1,932.4	2,025.6	4.8%	57.2%	59.3%
EU-27	2,168.5	2,212.8	2.0%	64.2%	64.8%
Euro Area-16	1,542.1	1,544.6	0.2%	45.6%	45.2%
North America	211.8	159.6	-24.6%	6.3%	4.7%
Other Developed Countries	33.9	34.1	0.6%	1.0%	1.0%
Remaining OECD (excl. S. Korea)	152.1	222.3	46.2%	4.5%	6.5%
Balkans	602.3	569.7	-5.4%	17.8%	16.7%
Commonwealth of Independent States	70.4	78.7	11.8%	2.1%	2.3%
Middle East and North Africa	243.6	227.6	-6.6%	7.2%	6.7%
Other African Countries (excl. N. Africa)	37.9	24.5	-35.4%	1.1%	0.7%
South East Asia	29.4	47.9	62.9%	0.9%	1.4%
South America	15.9	11.2	-29.6%	0.5%	0.3%
Remaining countries	166.4	145.3	-12.7%	4.9%	4.3%

* Provisional data
Source: ELSTAT - ERC

Figure 3.11
Countries with the largest share on Greek exports, first quarter 2010



Source: PEA **Data processing:** IOBE

Overall, the fact that the value added of the majority of Greek products is low makes their penetration in foreign markets more difficult, as they compete with products from other countries that usually have lower production cost. Nevertheless, a significant number of industrial and agricultural goods has managed to attain a

share in the global markets. In early 2010, the gradual improvement in the global economic conditions had a positive impact on Greek exports, including in goods that are not part of what are seen as 'traditional exports', which led to reversal of the downward trend from the previous year.

For 2010 in total, the value of Greek exports is expected to stand at about € 14.5 billion, given that the GDP of Greece's main trading partners is expected to increase, at a small rate at least. The fall in the high exchange rate of the euro, which was a bulwark for the Greek exports in the past few years, is also expected to contribute in a positive way.

3.4 Employment - Unemployment

The economic recession had a serious impact on the domestic labour market in the first quarter of 2010. The unemployment rate reached its highest level in a decade (11.7%) increasing by 2.4 percentage points in relation to the same period of the previous years and by 1.4 percentage points in comparison with the fourth quarter of 2009. The total number of unemployed reached 586,800 – the largest at least since 1998 – increasing by 124,500 (27%) in comparison with the year before and 72,400 (14%) in relation to the preceding quarter. Meanwhile, the unemployment rate in Greece is among the highest in EU-27 (10.1%) and the Euro area (10.5%), in 7th and 4th place respectively.

The number of employed (4,425,600) stood at a similar level to the first quarter of 2006, declining by 1.3% relative to the first quarter of 2009 and by 1.1% in relation to the preceding quarter. On the other hand, the employment participation rate, i.e. the labour force as a percentage of the population increased to 53.9% from 53.5% the year before.

Unemployment among women rose to 15.5% in the first quarter of 2010, against 13% in the same period of the previous year, remaining significantly higher than the unemployment among men (9% from 6.8%). Furthermore, unemployment increased among all age groups. The jobless rate increased most among young people aged 15-29 (+3.8%), which generally have the greatest difficulty in accessing the labour market. The corresponding rate for women of the same age group stood at 27.4%, higher by 4.3 percentage points relative to the first quarter of 2009. The jobless rate for men of the same age grew at a lower rate, reaching 18.1%.

The jobless rate among the 'new unemployed', i.e. those that enter the labour market for the first time without being able to find a job, fell to 23.6% in the first quarter from 29.2% the year before. This indicates that large part of the population delayed their job-seeking effort due to the unfavourable economic conditions. The reverse trend is observed among the long-term unemployed, as in the first quarter of 2010 their share in the total number of unemployed reached 44.6% against 41.3% the year before, representing an increase by 70,800 people. Foreign nationals were facing greater obstacles in accessing the labour market, as the unemployment rate among this group stood at a higher level than the national average (14.5% against 11.7%).

The largest pressure on the labour market was experienced by people with medium and low educational level. The largest unemployment rate (18.1%) was registered among persons who have not attended school at all, followed by the primary school graduates (14%), tertiary technical education graduates (13.4%) and those who have completed secondary education (13.2%). In these particular categories, the increase in the unemployment rate is higher or equal to the national average. The largest increase relative to 2009 (+4.5%) was registered among the persons who have completed only some years of primary school (standing at 11.5%). In contrast, the access to the labour market is easier for university graduates and holders of doctorates or post-graduate diplomas, for whom the unemployment rate stood at 7.1% and 7.4% respectively, experiencing at the same time the lowest rise (1.2 and 1.7 percentage points respectively).

At a regional level, the unemployment moved upward, with the exception of Western Greece, where it fell by 0.8%. The highest unemployment rate of the last six years (20.4%) and the largest rise (+6.1%) among all regions was registered in the Ionian Islands. South Aegean followed with 18.9%, while very high unemployment rate was also observed in Crete (12.9%) and in the regions of Macedonia and Thrace. In Western Macedonia, a region with chronic labour market problems, the unemployment rate stood at levels slightly above those of 2009 (15.1%), while in Eastern Macedonia-Thrace the jobless rate stood at 14.2%, registering the second highest rise (+3.6%) relative to 2009. Likewise, the unemployment rate in Central Macedonia increased with 2.9 percentage points relative to the year before, reaching 12.4%. Indicative of the extent of the recession is the fact that a similar trend was observed in Attica, where the unemployment rate increased by 3.1%, reaching 10.7%. The last two regions, as they contain the urban centres Athens and Thessaloniki within their boundaries, had performed better in the labour markets the past few years. Similar to the national average were the unemployment rates in Central Greece (11.3%) and Thessaly (11.3%), while smaller rates were recorded in Peloponnese (8.8%) and the Northern Aegean region (7.6%).

As for the economic activity sectors, the number of employed in the primary sector (562,400) stood at its highest levels since the forth quarter of 2003, registering an increase by 8.2% relative to 2009. In contrast, secondary sector employment experienced intense pressures, as the number of employed (894,000) stood at its lowest levels since at least 1998, falling by 7.8% relative to the year before. Lastly, in the tertiary sector, the number of employed (2,969,200) stood at its lowest level for the past two years, even though its reduction relative to the first quarter of 2009 (-0.9%) was smaller compared to the year before (-1.4%). As a result, the employment rate stood at 12.7% (against 11.6% the year before) in the primary sector, at 20.2% (against 21.6%) in the secondary sector and at 67.1% in the tertiary sector, about the same as the year before.

Table 3.9
Number of 15 years old and over (in thousands) by employment status

Quarter/Year	Grand Total	Labour Force					
		Total	% of Population	Employed	% of Labour Force	Unemployed	% of Labour Force
1998	8.680,4	4.525,8	52,1	4.017,9	88,8	507,9	11,2
1999	8.764,5	4.586,1	52,3	4.031,4	87,9	554,7	12,1
2000	8.839,8	4.611,9	52,2	4.088,5	88,6	523,5	11,4
2001	8.906,4	4.580,3	51,4	4.086,3	89,2	493,9	10,8
2002	8.964,3	4.656,0	51,9	4.175,8	89,7	480,2	10,3
2003	9.014,9	4.734,4	52,5	4.274,5	90,3	460,0	9,7
2004	9.063,5	4.818,8	53,2	4.313,2	89,5	505,7	10,5
2005	9.108,1	4.846,5	53,2	4.369,0	90,1	477,5	9,9
2006	9.157,4	4.886,4	53,4	4.452,3	91,1	434,5	8,9
2007	9.207,4	4.916,8	53,4	4.509,9	91,7	406,9	8,3
Q1 2008	9.222,7	4.918,2	53,3	4.511,6	91,7	406,5	8,3
Q2 2008	9.230,1	4.939,7	53,5	4.582,5	92,8	357,1	7,2
Q3 2008	9.237.8	4.944,9	53.5	4.589,8	92,8	355,1	7,2
Q4 2008	9.245,8	4.946,3	53,5	4.553,6	92,1	392,7	7,9
2008	**9.234,1**	**4.937,3**	**53,5**	**4.559,4**	**92,4**	**377,9**	**7,6**
Q1 2009	9.252,7	4.948,1	53,5	4.485,8	90,7	462,3	9,3
Q2 2009	9.262,4	4.974,5	53,7	4.531,9	91,1	442,6	8,9
Q3 2009	9.272,3	5.005,3	54,0	4540,1	90,7	465,1	9,3
Q4 2009	9.282,4	4.991,2	53,8	4.476,8	89,7	514,4	10,3
2009	**9.267,5**	**4.979,8**	**53,8**	**4.508,7**	**90,6**	**471,1**	**9,5**
Q1 2010	9.292,2	5.012,4	53,9	4.425,6	88,3	586,8	11,7

Source: ELSTAT, Labour Force Survey

At branch level, employment fell by 6.2% in Wholesale-Retail Trade and Repair of Motor Vehicles and Motorcycles, compared to an increase by 2.7% the year before. The large increase in the secondary sector comes from a fall by 8.9% (47,100 persons) in Manufacturing and by 7.4% (27,300 persons) in Construction. The employment in Professional, Scientific and Technical Activities declined by 4.8% against an increase by 4.5% the year before. In contrast, resilient to the economic recession is the employment in Accommodation and Food Service Activities (increase by 3% against a fall by 2.9% the year before), Transportation and Storage (+3,9% against -0.7%) and Financial and Insurance Activities (+2.5% against -8.3%).

As for the employment status, the share of wage earners in total employment stood at 63.5% in the first quarter of 2010, falling by 2% relative to the year before, while the share of self-employed, including maidservants, stood at 36.5%. Self-employment was the main form of employment in Agriculture (90% of total employment) and Real Estate Activities (85%), while it also has a significant share in Professional, Scientific and Technical Activities (57%), Wholesale-Retail Trade (46%) and Accommodation and Food Service Activities (45%).

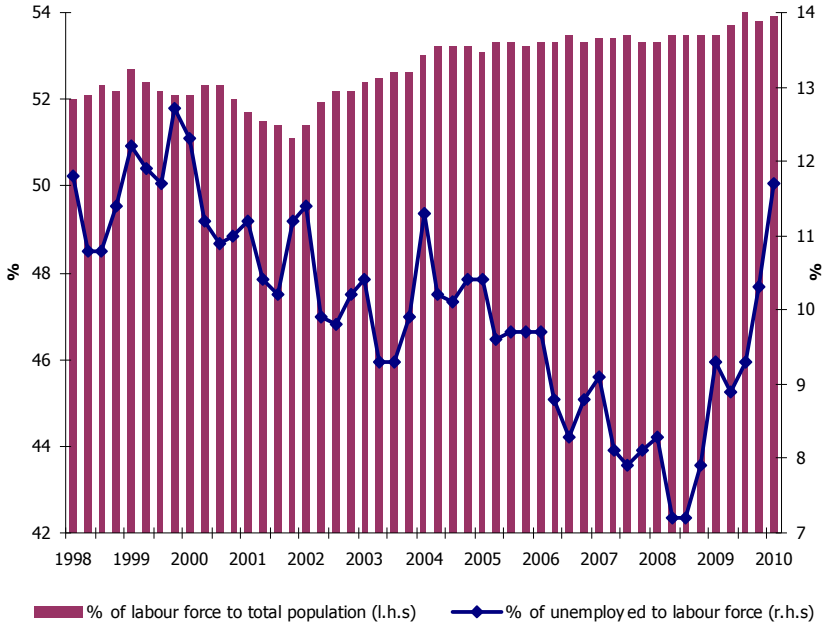
In summary, the rise in unemployment in early 2010 was the result of decline in employment and increase in the labour force, a trend that is expected to continue in 2010. **The unemployment rate is**

expected to stand at about 12%, which corresponds to about 600,000 unemployed, as the recession hits hard at sectors with high number of employees, such as trade, industry and construction. Nevertheless, a constraint to an even sharper rise in unemployment comes from the large share of the public sector and self-employment, for whom the negative impact of the recession is reflected in income reduction rather than job loss. In periods of crisis, self-employment is expected to increase, as the lack of available jobs pushes the unemployed to seek alternative options. An indication of this is observed with the increase of employment in Agriculture in the last two years, which reversed a negative trend from the beginning of the decade.

Additional data on the short-term outlook for employment are provided by the Business Surveys conducted by IOBE. In the period March – May 2010, employment expectations improved relative to the previous two months in Industry and Services. In contrast, the positive employment expectations in Construction slightly declined, while in Retail Trade the decrease was significant, occurring mostly in March. Relative to the same period of the previous year, expectations improved in Industry, fell slightly in Services and registered significant decline in Construction and Retail Trade. The businesses in Trade seemed not to be able to preserve the positive balance of their expectations, which revealed a reversal of the traditional resilience of the sector in times of crisis.

Figure 3.12

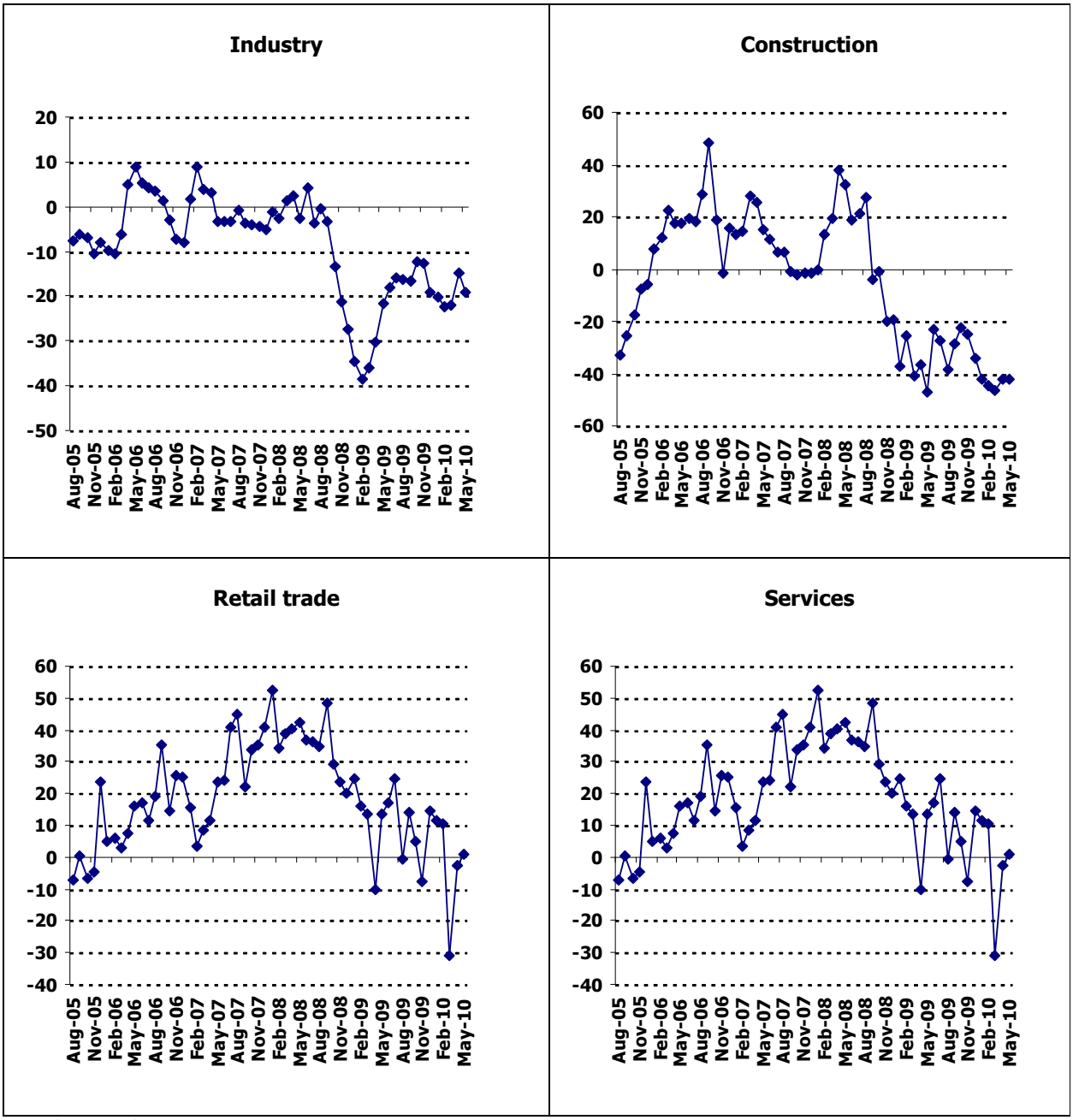
Labour Force (proportion of population of 15 years old and over) and Unemployed (proportion of Labour Force)



Source: ELSTAT, Labour Force Survey

Figure 3.13

Employment expectations (% difference between positive – negative answers)



Source: IOBE

In greater detail:

In **Industry,** employment expectations slightly improved in the period March to May, relative to the first two months of the year, but also relative to the same period of the previous year. The balance of positive – negative answers, however, remained negative, standing at -19 from -21 in January – March, by 10 points higher relative to the corresponding period of the previous year. The share of companies expecting employment to grow in the coming period remained on the whole very low (2% on average), while in contrast 22% of the enterprises were anticipating a decline

in the coming months. The vast majority of the business (75%) were expecting no change in employment.

Employment expectations in **Construction** declined slightly in the period March to May, relative to the first two months of the year. The decline is more pronounced in relation to the same period of the previous year, which is indicative of the very negative circumstances of the sector and the deep crisis that it has been experiencing for the past two years. On average in the period March to May, the employment expectations balance stood at -44 (from -41 the year before), with only 6% of the enterprises expecting employment to grow. Nearly half of the companies in this period were anticipating a further decline in employment. The expectations were significantly worse in Public Works, declining relative to the first two months of the year, while in Private Construction, the balance slightly improved, yet remained negative.

In the **Services** sector, the employment expectations have been improving since February, remaining, however negative. In the period March to May, the balance stood at -19, from -23 in the beginning of the year, slightly lower from the levels in the same period of the previous year. The majority of the enterprises in the sector (63%) were expecting that job creation would remain stable in the coming months, while only 9% (same as in the first two months of the year) were anticipating growth. As for the individual branches, the least negative expectations were recorded in Accommodation and Food Services, while relative to the first two months of the year, employment expectations fell most in Information Technology.

In **Retail Trade**, employment expectation are no longer positive. The sector that in crisis periods remained ahead in job creation registered significant weakening of its ability to revive employment. The index during the period March to May stood on average at -11, significantly worse relative to January to February (+11) and the corresponding period of 2009 (+6). This adverse development comes mainly from the vertical drop in the index in March by 31 points. In April and May, the index returned to growth, remaining, however, slightly negative. As for the individual branches, worse expectations were recorded in Fabrics – Clothing – Footwear, Vehicles-Spare Parts and Household Appliances, while in contrast best expectations were observed in Food – Beverages – Tobacco and Department Stores.

3.5. Consumer Prices

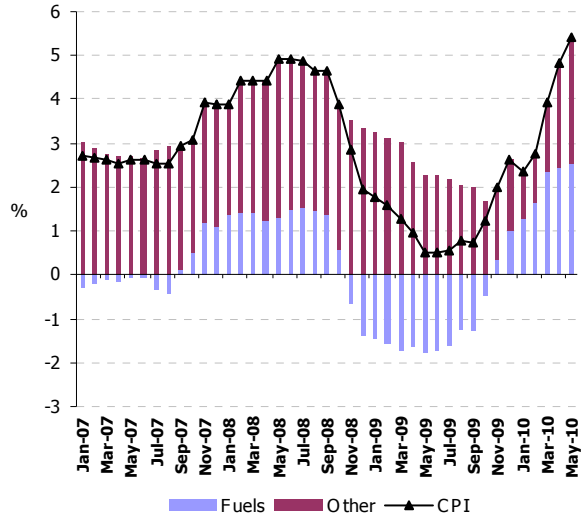
Recent Developments

The rise in the indirect taxation, coming from the fiscal consolidation effort, is the main factor behind the inflation acceleration. The overall Consumer Price Index was running at 3.9% on average for the first five months of 2010 from 1.2% in the same period of the previous year and 4.4% in 2008. In May 2010 the inflation rate peaked at 5.4%, having doubled its rate since January, reaching its highest rate since April 1997. The rise in May came mainly from a new increase in the excise tax on fuels, cigarettes and alcohol. Re-

garding the key categories of goods and services, the increase in CPI for the first five months of 2010 by 2.6%, relative to the year before, was due mainly to the significant increase in the fuel index, which registered compounded average growth rate of 39.4% in the same period against a drop of -23.7% the year before. The impact of this on the overall inflation stood at 1.5 percentage points.

Core inflation the same period was running at 2.3% from 2.9% in 2009. The lower level of core inflation rate during the first five months was exclusively due to lower prices in January and February. In contrast, since March core inflation has been on an upward trend, reaching 3.9% in May. Core inflation is now being driven more by the increase in taxation, rather than by the growth rate of labour cost per unit of output.

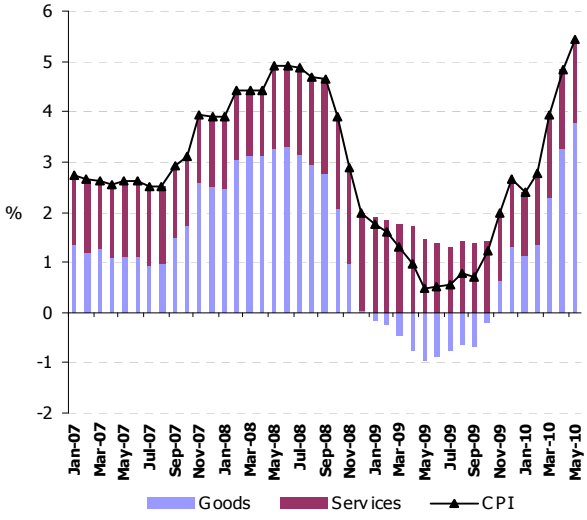
Figure 3.14
Contribution of the change in fuel prices to overall inflation
(annual % change)



Source: Calculations based on ELSTAT data

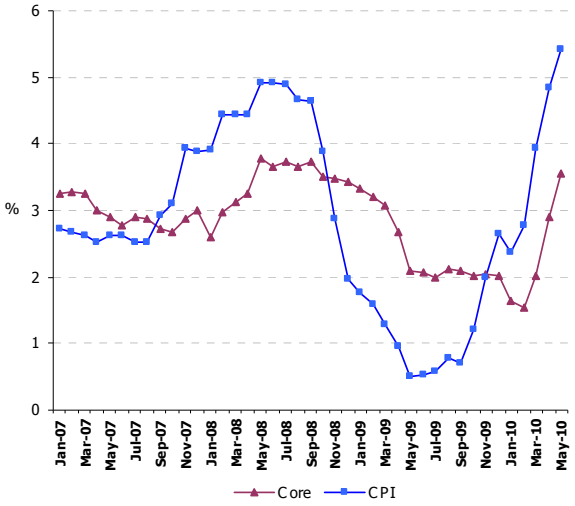
Regarding the main consumption categories, the goods price index increased by 4.1% against a drop of -0.9% the year before, while in services the index was increasing at rates slightly lower than 2009 (3.5 against 4.1 respectively). Thus, the inflation acceleration during the first five months of 2010 came mostly from the increase in the prices of goods, rather than services, reversing the trend recorded in the past two years. As for individual services, highest increase in inflation was recorded in hospital care (+3.1%), medical – dental services (+3%), house rents (+2.6%) and water supply - sewage (+2.4%). Regarding the price index for goods categories, the fruit and vegetable prices decreased by 9.3% the first five months of the year, in contrast with an increase of 8.7% the year before.

Figure 3.15
Inflation
(annual % change)



Source: Calculations based on ELSTAT data

Figure 3.16
Core Inflation
(annual % change)

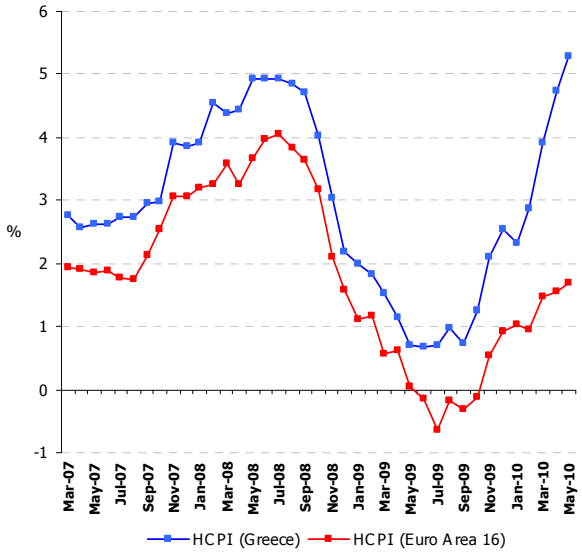


Source: Calculations based on ELSTAT data

The harmonised index followed a similar course with CPI, accelerating to 5.3% in May 2010 from 0.7% in the same month of the previous year. On average for the period January to May, the rate stood at 3.8%, which resulted in Greece ranking 3rd highest among the member states of the European Union, whose average stood at 1.8%. Furthermore, the Greek harmonised inflation rate was the highest in the Euro area (1.3% average). Higher inflation compared to Greece was experienced in Hungary (5.6%) and Romania (4.5%), while some countries reported deflation (Latvia -3.4%, Ireland -2.3% and Lithuania -0.1%).

In all categories, apart from Food and Non-alcoholic Beverages, where prices fell by 1.4%, the price index increased in the first five moths of the year, at a rate ranging from 0.7% to 14.9%. The largest increase, due to the increase in fuel prices, was recorded in Transport, where the same period in the year before prices fell by 4.4%. Next in this ranking is Alcohol – Tobacco, where the inflation rate was twice as high as the year before. The prices in Housing also increased significantly (+6.4%), despite the downward trend in demand in the real estate market that had led to a fall in Housing prices by 3% the same period the year before. Similar change in the trend was observed in Telecommunications, where the increase in taxation led to increase in the prices by 2.7% against deflation of 0.6% the year before. Deceleration of inflation was recorded in Education (3% against 4.7% the year before), in Hotels-Cafes-Restaurants (2.4% against 4%) and Clothing-Footwear (1% against 3.1%).

Figure 3.17
Harmonised Index of Consumer Prices –
Greece & Euro Area (annual % change)



Source: Calculations based on Eurostat and ELSTAT data

Apart from indirect taxation, the increase in the price level in 2010 was also fuelled by increase in industry production costs. Producer prices in domestic industry increased by 7.1% in the first four months, compared to a decrease of 5.8% in 2009. The largest increase was recorded in Coke and Refinery Products (+48.2%), Energy Goods ex-

cept Electricity (+41%), Electrical Equipment (+22.2%) and Energy Goods (+18.7%). Evidently, apart from taxation, the price increase was also influenced by the upward trend in raw material prices, large part of which was imported from abroad. It is indicative that the industry import price index increased by 7.5% in the first four months of 2010, against a fall of 5.3% the year before. The increase in the price of these goods affected production cost, passing on to a certain degree to the final prices of most products.

Medium-term Outlook

The need for fiscal consolidation puts upward pressure on the prices of goods and services through increase in taxation. This particular trend does not seem to be compensated, for the first five months of the year at least, by the fall in domestic demand due to cuts in wages and pensions, unemployment growth and limited credit expansion. Furthermore, additional inflationary pressure in the second half of the year is anticipated to come from increase of the VAT rate to 23% in July, imposition of VAT on services that had been exempted thus far and transfer of some goods and services (about 1/3) to the high VAT bracket until the end of the third quarter of the year. As a result, the CPI inflation rate in 2010 is expected to be around 4.5% against 1.2% in 2009, slightly above the 2008 level (4.2%).

Moreover, as Greece imports a significant number of products and raw materials, its level of inflation is influenced by their price dynamics in the international markets, where the Greek share is too small for it to play any role. The inflationary impact of the price of crude oil, which is expected to range between $70 and $80 per barrel (International Energy Agency) is decisive. Meanwhile, if the depreciation of the euro against the dollar continues, it would make the imports dominated in dollars (such as crude oil) more expensive.

Lastly, the distortions that exist in the operation of particular professions have an adverse influence on the price formation of the domestic goods and services. The limited competition in these markets allows the preservation of significant profit margins. The achievement of better price levels through strengthening of competition is necessary in order to improve both social welfare and the competitiveness of the Greek economy, as inflation in Greece is consistently higher than in most EU countries, quite a few of which are our main trade competitors.

The results of IOBE's monthly business surveys, which serve as leading indicators of price developments on the supply side, provide important information on the anticipated course of prices in the coming period.

While in 2009 deflationary price expectations prevailed due mainly to depressed demand, 2010 started with weakening of the negative, on the balance, expectations in all sectors except Construction. In the period March to May, the expectations for price decrease continued to dominate the inflationary expectations in most branches. In the last few months, the deflationary

expectations weakened in Industry and Retail Trade, while in Services they became slightly stronger. In Construction, these expectations underwent a period of strong variability. In greater detail:

- In **Industry**, the inflationary expectations slightly increased their predominance, as the average for the period March to May stood at +3, against +1 in the first two months of the year. In May, however, the index returned to marginally negative levels. In the corresponding period of 2009, the index stood lower at -12. Seven in ten enterprises in the period March to May were expecting stabilisation of prices in the short term, while 13% held deflationary expectations.

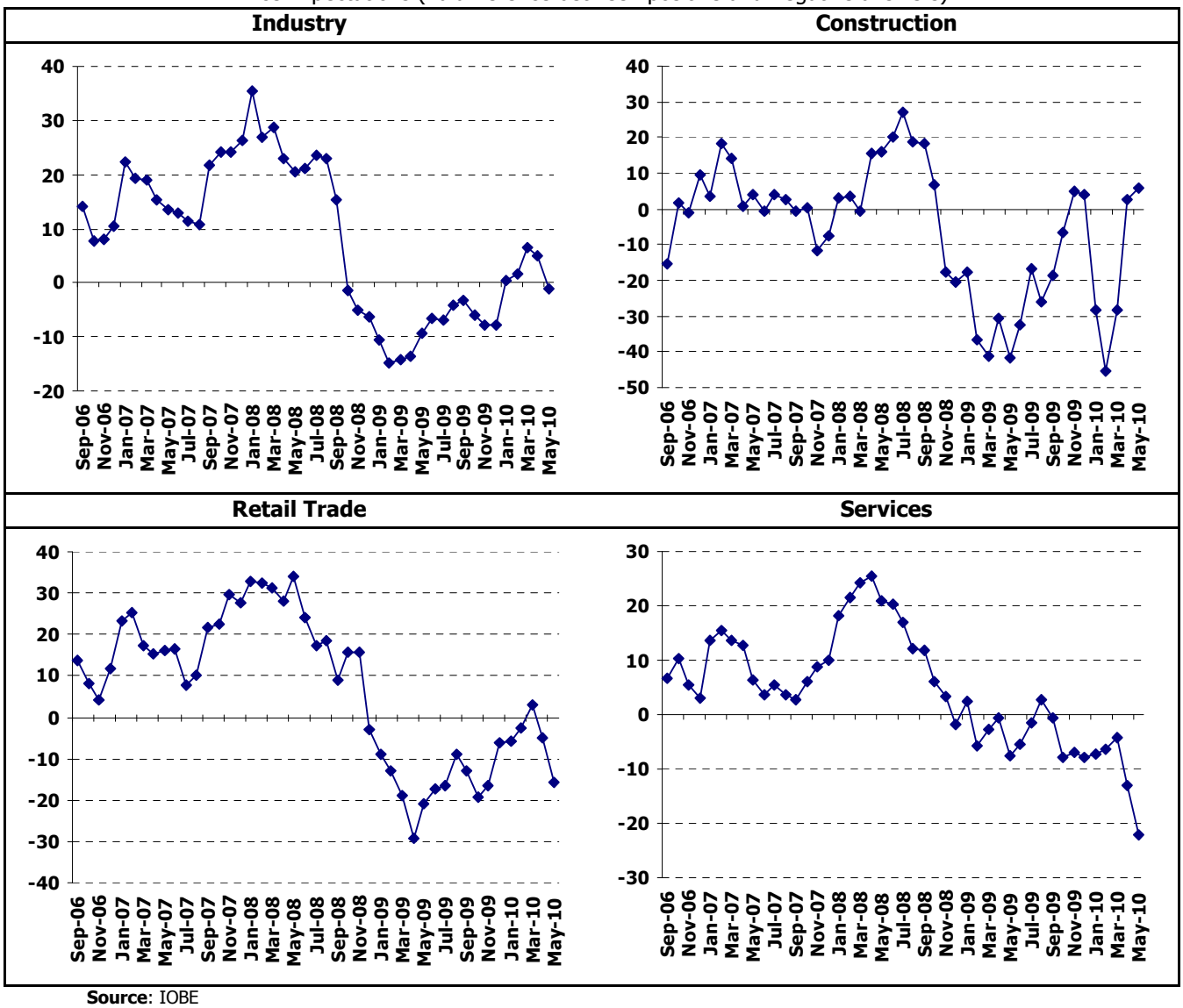
- In **Retail Trade**, the strongly deflationary expectations of the enterprises have eased since December. In the period from January to April the balance of expectations did not vary much, standing close to -3. However, in May the index fell sharply to -16. The share of companies that were expecting price increase in the coming months reached 19% in the period from March to May, while one in four were anticipating a decline. As for the individual branches of the sector, strongly deflationary expectations during this period (and especially in May) were held by enterprises in Fabrics – Clothing – Footwear, Motor Vehicles – Spare Parts and Household Appliances.

- In **Services**, the deflationary expectations eased up between December and March, but in April and May they intensified further. On average for the period March to May, the price expectations index stood at -13 (from -7 in the first two months of the year), significantly lower compared to the same period of the previous year (-4). In the period March to May, one in five enterprises of the sector was expecting price decline in the coming months, while the majority (72%) were expecting price stability. As for the individual branches, the price expectations remained strongly inflationary in Financial Intermediaries, while in the remaining branches the index ranged from -12 to -16.

- Lastly, in **Private Construction** price expectations have experienced intense fluctuation in the past year. The index from strongly negative turned slightly positive in the last quarter of 2009, switching back to strongly negative in the first quarter of the year. In February, the index stood close to its historically low level, while in April and May, the index was again positive, as inflationary expectations dominated at +4. In these two months, the share of companies anticipating price increase shoot up to 23-24%. Still, inflationary expectations are not consistent with the unfavourable conditions in the sector, as most activity indicators have deteriorated lately. In the period March to May, the index stood at -7.

Figure 3.18

Price Expectations (% difference between positive and negative answers)



Source: IOBE

3.6 Balance of Payments

Current Account

In the period January to April 2010, the current account deficit expanded by 25% to stand at € 12.8 billion. In such a way, the deficit returned to its 2008 level, eliminating the gains that were recorded in 2009 due to the financial crisis. The large increase of the deficit, however, reflected more a significant reduction in inflow from EU transfers in the January to April period, rather than an increase in the trade deficit or reduction in the services surplus, which had a relatively small extent. Thus, even in the short term, the deficit is expected to return on a downward path with the current transfer balance returning to normal after the execution of the delayed payment of agricultural subsidies.

The contraction of the **trade deficit** ceased in 2010. The deficit stood slightly higher

than the year before at € 10.7 billion against € 10.3 billion (+3.6%). The import of goods increased by € 378 million due to the large increase in net payments for oil imports (by € 765 million), while the trade balance of goods excluding oil fell by € 393 million. The net payments for the purchase of ships remained almost the same (-1.4%).

The **services surplus,** which acts as a counterbalance to the trade deficit in Greece, continued to decline in 2010, standing at only €1.6 billion. This represents a decrease of 7.8%, while in comparison with 2008 it has declined by € 1 billion. Inflows increased by 6%, while outflows increased by 11.2%. The receipts in tourism continued to decline, experiencing a drop of -7.8%. This is largely due to the global financial crisis, but also probably due to the deterioration of the country's image in the last few months. The payments for tourist services abroad declined by 11%. The small increase in the receipts from transport services (mainly merchant shipping) by 8.7% (+395 million euro),[59] against an increase in payments by 25.8% (+580 million euro) also had a large impact on the services surplus.

The **income account** deficit narrowed by 5.4% (+163 million euro). Receipts from abroad (remuneration, wages, interest, dividend and profits) declined by 20.4% (-319 million euro), while the outgoing payments fell by 10.5% (-482 million euro).

The **current transfers** balance collapsed in the period under examination, falling by €2.26 billion relative to the year before. In particular, the usually positive balance turned to negative (-883 million euro from +1.4 billion euro). This represents a decline of 164% due to a freeze in the payment of agricultural subsidies, but also of funds from EU structural programmes. As such, inflows[60] declined by 74% (2.1 billion euro), while outflows[61] increased by 6.5%, due to higher revenue from VAT in the first four months of the year. It should be noted, however, that immediate improvement of the balance is expected in the near term, following the release of the delayed payment for agricultural subsidies.

Capital Account

The **capital transfers balance** followed a similar trend with the current transfers balance. It dropped by 80.5%, standing at €159 million (-655 million euro), while in previous years the surplus had reached € 2.2 billion. Receipts[62] plummeted by 72%, reflecting the great delay in EU funds absorption (NSRF), while the outflows did not change significantly.

Lastly, the **Current and Capital Account** deficit, which reflects the economy's external borrowing requirements, stood at € 12.7 billion, from € 9.4 billion in 2009, marking an increase by 34.9%.

Financial Account

The **financial account** surplus increased significantly in the first four months of the year, reaching € 12 billion from € 9.9 billion in 2009, which represented an increase by

[59] The amounts in brackets express change relative to 2009, unless otherwise indicated.

[60] The inflows refer to payments from the European Agricultural Guidance and Guarantee Fund (EAGGF) and the European Social Fund (ESF).

[61] The outflows refer mainly to contributions to the Community Budget.

[62] The capital transfer receipts refer to incoming payments from structural and cohesion funds.

21.2%. This was the largest level of the surplus recorded in the last 13 years at least and was due mainly to increased investment in repos and deposits by foreign residents.

At the level of specific accounts, **direct investment** showed a net inflow of € 907 million, which marked an increase by 2.6% (+23 million euro). The inflow of foreign direct investment stood at €1.1 billion in the first four months of the year, marking a decrease by 6.4%, while the outflow of funds for investment abroad stood at € 193 million, lower by 33.9%.

A net outflow of € 2.1 billion was recorded under **portfolio investment**, marking a decline by 125% relative to the year before. The reduction in the holding of bonds and treasury bills of the Greek state and shares of the Greek companies by non-residents, together with the increase in the holdings in foreign portfolios by residents was registered as outflow, while the inflows represented reduction in the holding of foreign bonds and treasury bills by domestic financial institutions and institutional investors.

Large fluctuations were observed in the **'other' investment** category, as the net inflow reached € 13.2 billion from € 1 billion in 2009. The inflows, which refer to placements in deposits and repos, reached € 25 billion, higher by 170%. They were partially compensated from the increase by € 3.7 billion of placements in foreign deposits and repos by domestic investors. Meanwhile, liabilities (public and private) to foreign investors dropped by € 86 million. Lastly, the country's **reserve assets** at the end of April stood at € 4 billion.

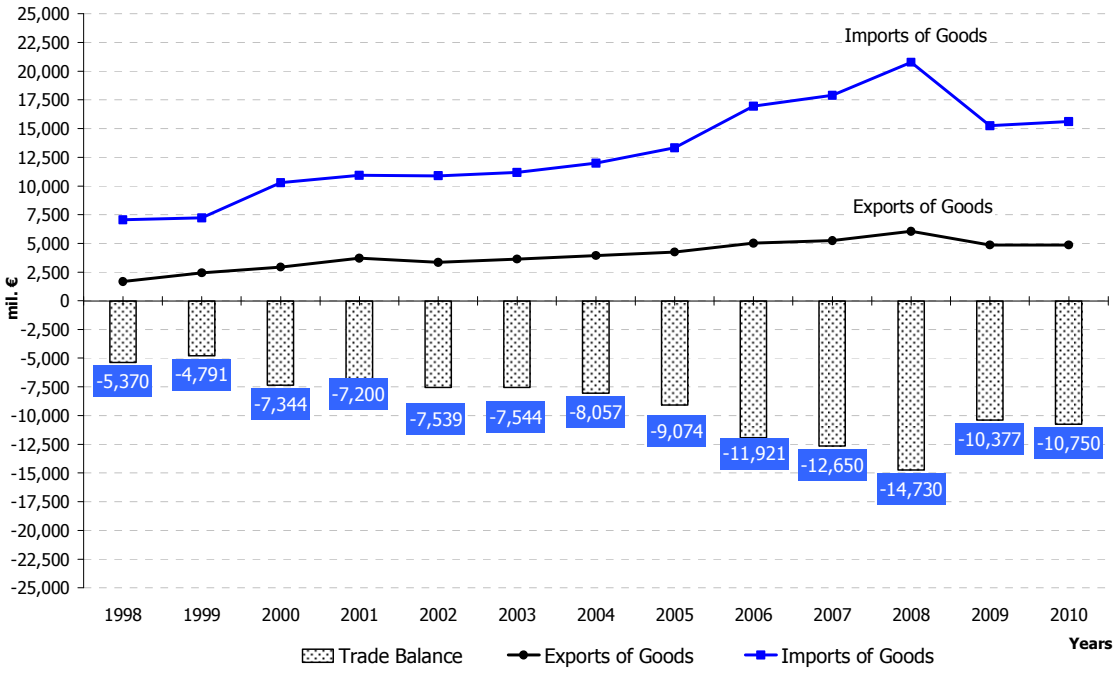
Assessment

The above data should be assessed under the light of the important changes in the global economy. After the financial crisis, which had exceptional intensity and lasted from mid-2008 until late 2009, the global economy is on a recovery path. According to the international institutions, the reversal of the economic climate stems from normalisation of world trade, which improved the trade balances of many countries. The gradual deterioration of the US trade deficit in the past decade, mainly due to low savings, and at the same time the increased holding of US bonds by Asian investors, due to the peg of their currencies to the dollar, proved to be a two-party "game", rather than a genuine realignment of the global economic relations. The European countries did not manage to boost their export presence during this period, mainly as a result of the appreciation of the euro that lasted up to late 2009. Within this framework, the Greek exports did not achieve any significant increase due to the low competitiveness of the Greek products. In contrast, imports had increased significantly, until the crisis shrank the trade flows and reduced the trade deficit. An indication of this trend is presented in figure 3.19, which depicts exports, imports and the trade balance without taking into account oil and fuels, whose value fluctuates largely due to speculation in the respective global commodity markets. Exports followed an almost stable path in the 1998-2010 period, with a small increase in 2008 and a fall in 2009, while imports, after peaking in 2008, have continued to fall. The overall balance increased in 2010.

As noted also in previous reports, the global financial crisis highlighted the longstanding structural problems of the Greek economy. Its lack of openness is reflected in the broadening of the current account deficit, which in combination with the low competitiveness of the domestic products, constitute permanent structural problems of the Greek economy. The rapid developments in the global economy, with the low-cost countries (e.g. China and other Asian countries), dominating the markets for low-cost products (e.g. Textiles), in conjunction with Greece's lag in manufacturing high added value products, has resulted in production and export incapacity of the Greek economy. The full utilisation of NSRF, resulting in a boost of employment, innovation and entrepreneurship, so that the Greek production activity can turn to quality and differentiated products with high added value, can provide the solution to the above problem.

Figure 3.19

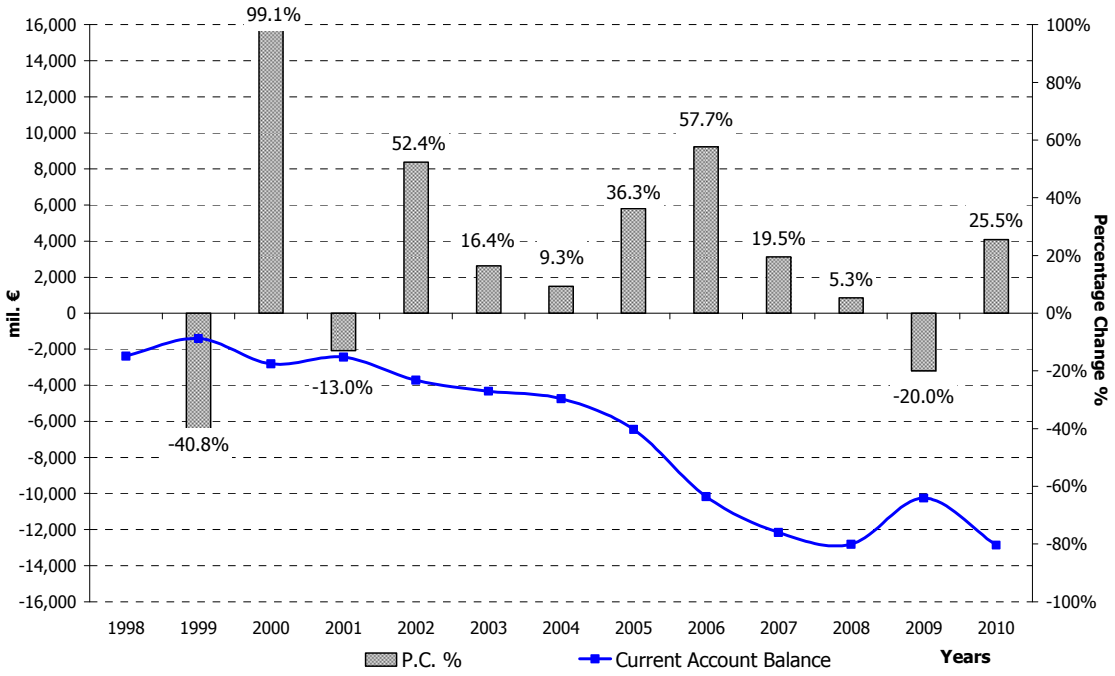
Imports-Exports 1998-2010 (January-April)



Source: Calculations based on Bank of Greece data

Figure 3.20

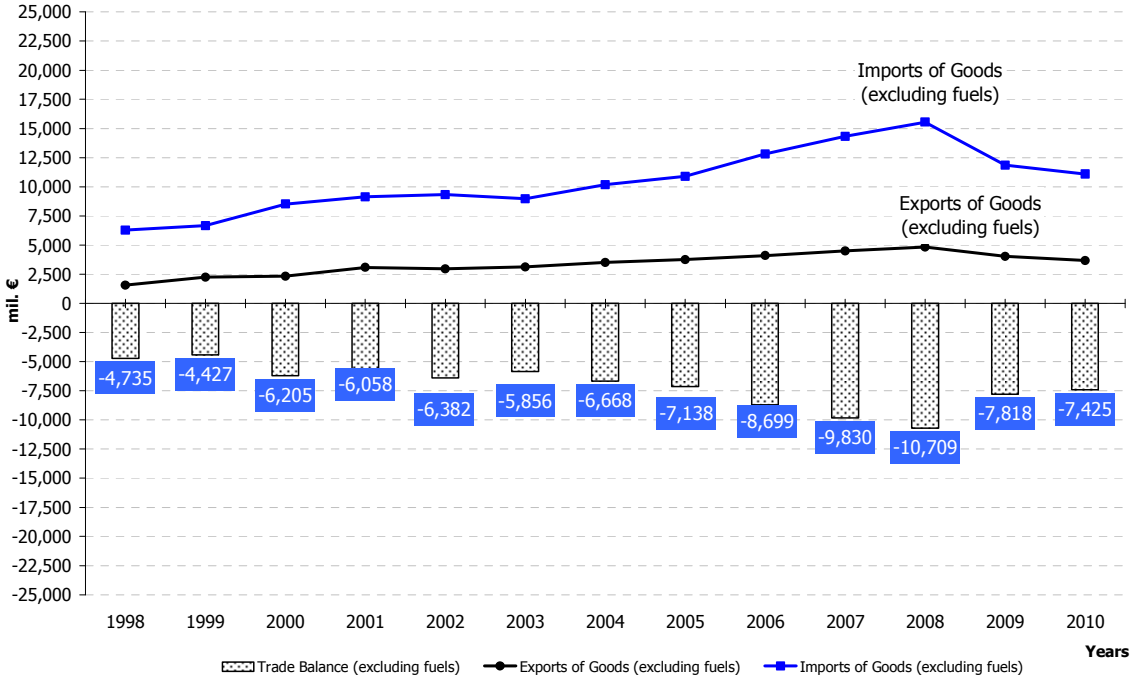
Current Account Balance 1998-2010 (January - April)



Source: Calculations based on Bank of Greece data

Figure 3.21

Imports-Exports (**excluding fuels**) 1998-2010 (January-April)



Source: Calculations based on Bank of Greece data

Table 3.10

Provisional Balance of External Payments (January-April) in mil.€

		January - April			April		
		2008	2009	2010	2008	2009	2010
I	**CURRENT ACCOUNT (I.A+I.B+I.C+I.D)**	**-12,809.6**	**-10,250.7**	**-12,860.9**	**-3,445.1**	**-2,951.7**	**-2,951.8**
I.A	**GOODS (I.A.1-I.A.2)**	**-14,730.8**	**-10,376.6**	**-10,749.5**	**-3,889.6**	**-2,666.4**	**-2,527.9**
	Oil balance	-4,022.3	-2,558.9	-3,324.3	-958.0	-625.8	-627.3
	Trade Balance excluding oil	-10,708.5	-7,817.7	-7,425.2	-2,931.6	-2,040.7	-1,900.6
	Ship's Balance	-1,751.4	-1,241.1	-1,223.6	-566.5	-359.8	-294.6
	Trade Balance excluding oil and ships	-8,957.1	-6,576.6	-6,201.6	-2,365.1	-1,680.9	-1,606.0
I.A.1	**Exports**	**6,048.6**	**4,859.9**	**4,865.0**	**1,485.0**	**1,200.1**	**1,298.8**
	Oil	1,210.9	824.7	1,199.6	364.4	227.7	375.3
	Ships	596.0	346.7	211.5	101.3	77.8	62.3
	Other goods	4,241.7	3,688.5	3,453.9	1,019.3	894.6	861.2
I.A.2	**Imports**	**20,779.4**	**15,236.5**	**15,614.5**	**5,374.6**	**3,866.5**	**3,826.7**
	Oil	5,233.2	3,383.6	4,523.9	1,322.4	853.5	1,002.6
	Ships	2,347.4	1,587.8	1,435.1	667.8	437.6	356.9
	Other goods	13,198.8	10,265.1	9,655.5	3,384.4	2,575.4	2,467.2
I.B	**SERVICES (I.B.1-I.B.2)**	**2,681.7**	**1,757.4**	**1,619.9**	**808.1**	**539.5**	**489.7**
I.B.1	**Receipts**	**8,059.7**	**6,366.1**	**6,746.4**	**2,217.6**	**1,768.2**	**1,829.1**
	Travel	994.5	873.9	806.1	408.3	387.6	327.2
	Transportation	6,023.1	4,550.3	4,945.3	1,547.2	1,144.6	1,269.9
	Other services	1,042.1	941.9	995.0	262.2	236.0	231.9
I.B.2	**Payments**	**5,378.0**	**4,608.7**	**5,126.5**	**1,409.5**	**1,228.7**	**1,339.4**
	Travel	893.9	808.1	718.7	233.8	221.6	173.3
	Transportation	2,948.9	2,244.8	2,824.9	760.6	586.5	744.3
	Other services	1,535.2	1,555.8	1,582.9	415.2	420.6	421.8
I.C	**INCOME (I.C.1-I.C.2)**	**-2,732.1**	**-3,010.9**	**-2,848.2**	**-830.7**	**-823.4**	**-739.1**
I.C.1	**Receipts**	**1,738.3**	**1,566.3**	**1,247.2**	**365.3**	**360.3**	**283.0**
	Compensation of employees	119.0	87.6	67.5	31.9	23.9	15.4
	Investment income	1,619.3	1,478.6	1,179.6	333.4	336.4	267.6
I.C.2	**Payments**	**4,470.3**	**4,577.1**	**4,095.3**	**1,196.1**	**1,183.7**	**1,022.0**
	Compensation of employees	109.2	132.7	126.0	28.9	31.5	31.2
	Investment income	4,361.1	4,444.5	3,969.3	1,167.2	1,152.2	990.8
I.D	**CURRENT TRANSFERS (I.D.1-I.D.2)**	**1,971.6**	**1,379.3**	**-883.0**	**467.1**	**-1.4**	**-174.5**
I.D.1	**Receipts**	**3,439.7**	**2,926.9**	**759.7**	**813.4**	**327.4**	**161.2**
	General Government (mainly transfers from EU)	2,706.8	2,272.8	232.2	636.4	166.8	53.4
	Other sectors	732.8	654.1	527.5	177.0	160.6	107.8
I.D.2	**Payments**	**1,468.1**	**1,547.5**	**1,642.7**	**346.3**	**328.8**	**335.7**
	General Government (mainly transfers to EU)	1,053.9	1,117.6	1,165.5	232.0	208.3	201.0
	Other sectors	414.2	429.9	477.2	114.3	120.5	134.8
II	**CAPITAL TRANSFERS (II.1-II.2)**	**1,794.2**	**814.3**	**159.1**	**377.7**	**334.9**	**10.7**
II.1	**Receipts**	**1,909.1**	**909.6**	**255.3**	**406.7**	**356.5**	**28.7**
	General Government (mainly transfers from EU)	1,776.4	834.2	205.3	380.8	331.8	12.4
	Other sectors	132.7	75.4	50.0	25.8	24.7	16.4
II.2	**Payments**	**114.9**	**95.3**	**96.2**	**29.0**	**21.6**	**18.0**
	General Government (mainly transfers to EU)	8.6	3.3	8.0	1.6	1.0	1.6
	Other sectors	106.4	92.0	88.3	27.4	20.7	16.4
III	**CURRENT ACCOUNT AND CAPITAL TRANSFERS (I+II)**	**-11,015.4**	**-9,436.3**	**-12,701.8**	**-3,067.4**	**-2,616.9**	**-2,941.0**
IV	**FINANCIAL ACCOUNT (IV.A+IV.B+IV.C+IV.D)**	**11,436.7**	**9,923.1**	**12,029.7**	**3,103.4**	**3,031.6**	**2,564.9**
IV.A	**DIRECT INVESTMENT***	**-895.4**	**883.7**	**906.9**	**-369.4**	**858.2**	**-33.9**
	Abroad	-823.0	-291.5	-192.8	-358.3	-77.2	-72.7
	Home	-72.4	1,175.3	1,099.8	-11.2	935.4	38.8
IV.B	**PORTFOLIO INVESTMENT***	**3,786.3**	**7,972.8**	**-2,059.5**	**-5,539.9**	**-7,208.7**	**-6,973.7**
	Assets	-4,208.1	2,069.0	5,361.7	-4,548.9	-4,082.1	1,800.7
	Liabilities	7,994.4	5,903.8	-7,421.2	-990.9	-3,126.6	-8,774.4
IV.C	**OTHER INVESTMENT***	**8,440.7**	**1,038.5**	**13,165.2**	**9,000.7**	**9,388.1**	**9,531.5**
	Assets	-4,873.6	-8,243.7	-11,959.3	396.4	584.0	-3,879.6
	Liabilities	13,314.4	9,282.2	25,124.6	8,604.3	8,804.1	13,411.1
	(Loans of General Government)	-231.4	-1,052.1	-604.6	-192.0	-252.5	-83.3
IV.D	**CHANGE IN RESERVE ASSETS****	**105.0**	**28.0**	**17.0**	**12.0**	**-6.0**	**41.0**
V	**BALANCE ITEM (I+II+III+IV)**	**-421.3**	**-486.7**	**672.1**	**-35.9**	**-414.7**	**376.1**
	ΥΨΟΣ ΣΥΝΑΛΛΑΓΜΑΤΙΚΩΝ ΔΙΑΘΕΣΙΜΩΝ (τέλος περιόδου)***				**2,386.0**	**2,720.0**	**4,042.0**

Source: Bank of Greece

* (+) net inflow (-) net outflow

* * (+) increase (-) reduction

*** * *** Reserve assets, as defined by the ECB, only include monetary gold, the reserve position at the IMF, Special Drawing Rights and the Bank of Greece's claims in foreign currency on residents of countries outside the euro area. Conversely, reserve assets do not include claims in euro on residents of countries outside the euro area, claims in foreign currency and in euro on residents of euro area countries, and the Bank of Greece's participation in the capital and the reserve assets of the ECB.