HELLENIC REPUBLIC

MINISTRY OF ECONOMY AND FINANCE

THE 2006 UPDATE OF THE HELLENIC STABILITY AND GROWTH PROGRAM 2006 - 2009

December 2006

This update of Greece's Stability and Growth Program has been submitted to the European Commission in accordance with Article 4 of the European Council Regulation 1466/97.

The program can be found on the Ministry's web site: http://www.mnec.gr

1 ECONOMIC POLICY FRAMEWORK

The Greek government has been implementing a reform program aimed at enhancing productivity growth together with promoting equity and social cohesion. To this end, it has moved away from active demand management based on expansionary, debt-financed fiscal policy towards policies that facilitate supply side development, investment in productive capacity and job creation. This program is based on two pillars. The first pillar entails substantial fiscal consolidation and improvement in the quality of public finances. The conviction is that fiscal prudence can be pro-growth in the medium- and long-term. In addition, a redistribution policy is followed in the form of targeted expenditure aimed at enhancing equity and social cohesion. Second, a consistent program of structural reform is being implemented aimed at improving the business environment and enhancing the efficiency of production activity in Greece.

The role of the private sector through the improvement of the business environment is a pivotal element in this policy mix. Emphasis is also placed on enhancing the outward orientation of the Greek economy through facilitating Foreign Direct Investment, expanding the trade ties with the rest of the world, and greater openness.

The above policies are already bearing fruit. In the course of 2 years, the general government deficit has been reduced by 5.2 percentage points of GDP mainly based on curtailing expenditure. The expected outturn of the 2006 State Budget is a deficit of 2.6% of GDP, thus bringing to an end the excessive deficit, in full compliance with the Council notice of 17 February 2005.

At the same time, economic growth has been safeguarded, with a real GDP growth rate of 3.7% in 2005 and an average growth rate of 4.2% during the first three quarters of 2006. This growth record, which remains one of the highest among eurozone countries, was achieved despite wide-spread expectations for a significant post –Olympic slowdown, record high international oil prices and during a period of relatively low growth for Europe. It is important to note that the qualitative aspects of growth are changing also. The contribution of investment to growth is increasing, while exports are playing a more significant role as well.

The Greek government remains committed to continuing on the path of fiscal consolidation and structural reform. As far as the former is concerned, further consolidation based on permanent measures will be pursued, towards the medium-term objective (MTO) of a budget in balance or surplus. We expect that our MTO will be achieved at the latest by 2012, while public debt will remain on a declining trend on the back of high growth, increasing primary surpluses, declining stock-flow adjustment and privatization revenue. The implementation of our reform program is also expected to lead to an improvement in productivity growth, rising participation and employment rates and declining unemployment rates.

The rest of the Program is organised as follows. Section 2 presents recent economic developments, as well as projections for the 2007-2009 period. The overall economic policy strategy and targets for the general government balance and debt, as well as the underlying framework for economic and fiscal policy prospects are presented in Section 3. In Section 4, a sensitivity analysis is conducted and comparisons are presented between the current update of the SGP and the previous one. In Section 5, developments on public finances are presented, both on the expenditure and the revenue side. In Section 6 the issue of long-run sustainability of public finances is briefly taken up.

2 ECONOMIC OUTLOOK

2.1 World Economy – Technical Assumptions

Regarding the international economic environment, we have adopted the most recent common external assumptions of the European Commission (autumn 2006). The basic technical assumptions underlying this Program are contained in the following Table.

Table 1: Technical assumptions

	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Short-term interest rate (annual average)	2.2	3.1	3.7	3.6	3.6
Long-term interest rate (annual average)	3.4	3.8	4.1	4.2	4.2
USD/€ exchange rate (annual average)	1.24	1.25	1.27	1.27	1.27
World excluding EU-25, GDP growth	5.6	5.7	5.2	5.2	5.2
EU-25 GDP growth	1.7	2.8	2.4	2.4	2.4
World import volumes, excluding EU	7.3	9.6	8.1	7.5	7.5
Oil prices, (Brent, USD/barrel)	54.1	65.6	66.3	68.0	68.0

2.2 Cyclical Developments and Current Prospects

2.2.1 The Greek Economy in 2005

Despite widespread expectations for a significant deceleration of growth, based on the withdrawal of Olympics-related stimulus, as well as the sharp rise in oil prices (which increased by 43.9% in euro terms), the Greek economy sustained a robust growth rate of 3.7% in 2005. This was more than double the average growth rate in the eurozone. Both domestic demand and the external balance had a positive contribution to growth in GDP, by 2.6 and 1.1 percentage points respectively.

As far as the domestic demand components are concerned, private consumption continued to grow strongly by 3.7% (in constant prices). The main driving forces were increases in real wages by 2.9% and in gross household disposable income by 3.4%. Public consumption growth, despite a significant deceleration, remained high at 3.1%. On the other hand, cuts in the Public Investment Program by 21% in current prices (mostly due to non-repeated expenditure from the 2004 Olympic Games), as well as a decline in dwelling investment, were the main reasons for a decrease in total investment by 1.4%, in constant prices.

Greek exports of goods increased by 8.2% (constant prices) in 2005, the highest rate recorded in a decade. Prices of exported goods (excluding fuels) which remained largely stable, as well as the improvement in productivity, contributed positively to this development. The contribution of exports to GDP growth was 0.7 percentage points. Following a significant increase by 40% in 2004, shipping revenues growth in 2005 returned to the trend levels of the period 1996–2003. As a result, the growth rate of "exports of goods and services" ended up at 3%, versus 11.5% in 2004. On the other hand, "imports of goods and services" decreased in constant prices by 1.2% (after an increase of 7.4% on average in the 1996–2004 period) despite the increased value of oil imports. The trade balance for goods and services contributed 1.1 percentage points to the GDP growth rate, in sharp contrast with the recorded negative contribution of 0.8 percentage points during the 1996–2004 period.

Although the trade deficit net of fuels (according to customs statistics) decreased by 5.6% in 2005, the significant increase in oil prices during 2005 resulted in a net oil imports growth of 46% versus an annual growth rate of 6.5% in the 2002–2004 period. As a result, net imports reached 3.5% of GDP, compared with 2.6% in 2004.

Total employment in 2005 increased by 1.3% and the unemployment rate declined from 10.5% in 2004 to 9.9% in 2005 according to Labor Force Survey (LFS) data. The actual figure for unemployed people was reduced by 28,300 persons, while total employment increased by 55,900 persons. In addition, the number of unemployed aged 18-24 years and the long-term unemployed decreased by 15,600 and 18,700 persons respectively. The employment rate (persons aged 15-64 years) exceeded 60% for the first time.

Although high oil prices pushed inflation up to 3.5%, versus 2.9% in 2004, core inflation remained on a downward trend, down from 3.3% in 2004 to 3.1% in 2005. Despite the remaining inflation differential with the average of the eurozone or EU-15, the price level in Greece stands at 87.7% of the EU-25 average and to 84.7% of the EU-15 average.

In the area of public finances, the general government deficit outturn was 5.2% in 2005 down from 7.8% of GDP in 2004 and the general government debt fell from 108.5% to 107.5% of GDP.

2.2.2 The Greek Economy in 2006

Economic developments in 2006 have been characterised by strong recovery in investment, record growth in exports of goods, above-expectations overall growth performance and significant reduction of the fiscal deficit, reaching levels below the threshold value of 3% of GDP.

The positive macroeconomic developments of 2005 continued during 2006. Almost all short-term indicators of domestic demand and the external sector, following the upward trend of sentiment indicators, showed a significant acceleration, accompanied by a deceleration of core inflation and a decrease of the unemployment rate.

In the January-September period, economic growth accelerated to 4.2% on an annual basis. We estimate real GDP growth for 2006 as a whole at 4%. The acceleration of domestic demand is attributed to the strong rebound in investment activity, robust consumption spending and the performance of exports of goods. Private consumption expenditure is estimated to increase by 3.8% in 2006. During the January-October period the volume of retail sales increased by 7.5% versus 3.6% in 2005. Total investment is expected to increase by 9.1%. Based on the index of "licences for new buildings", residential investment is estimated to increase by 18% in 2006, while the Public Investment

Programme shows an increase in nominal terms of 15.5% in the January-October period, versus a decline of 31.6% in the corresponding period of 2005.

Exports of goods, in nominal terms, increased by 20.2% in the January-September period, an acceleration of 6.3 percentage points compared to the corresponding period of 2005. Excluding fuels, exports of goods increased by 13.4%, versus 11.1% in 2005. On the contrary, during the same nine-month period, exports of services increased by only 3.2% in nominal terms, mainly due to low "transport and other revenues", although tourism receipts showed an acceleration of 1.2 percentage points versus the corresponding period of 2005, realising a growth of 6.8%. The acceleration of domestic demand in the first nine months of 2006, as well as the prevalence of high oil prices, resulted in an increase of goods imports by 15.6% in nominal terms, while payments for services increased by 9.3%. Based on the above developments, the current account deficit (on a national accounts basis) is estimated to reach 10.8% of GDP. The underlying driving force of domestic demand was mainly investment activity, with investment growing by 9.5% between January and September 2006.

Despite the significant increase in oil prices, inflation followed a downward trend in 2006. CPI increased by 3.2% on average in the January-November period, versus 3.5% in 2005. Core inflation has decelerated to 2.6% down from 3.1% in 2005.

Strong economic growth has contributed to lower levels of the unemployment rate. In the 1st half of 2006, the unemployment rate declined to 9.2%, down from 10.0% in 2005. Based on recent LFS data, employment increased by 73,100 persons in the first half of 2006 in comparison to the corresponding period of 2005, whereas the number of the unemployed decreased by 34,400. The long-term unemployment rate fell to 5.1% and the youth unemployment rate (15-24 years) fell to 24.9%. During the 3rd quarter of 2006, registered unemployed persons decreased by 30,400 persons against the same period in 2005, as recorded by the Manpower Employment Organisation (OAED). This is a reduction of 6.7%. In 2006, total employment is estimated to increase by 1.7% and the unemployment rate to decrease to the level of 9.2%. These figures show that the 'employment content of growth' has improved significantly during the last two years. The fact that the elasticity of employment with respect to GDP increased from 0.297 to 0.354 is a further indication of a structural shift in the Greek labour market.

Fiscal policy in 2006 mainly relied upon further reforming the tax administration, fighting tax evasion and containing government expenditure. This policy has contributed to the implementation of the 2006 budget with the utmost rigour. Based on available monthly data for revenue and expenditure, the central government deficit is estimated to reach 4.4% of GDP in 2006, while the general government deficit is estimated to meet the target of 2.6% of GDP, that was set in the 2006 Budget.

2.3 Medium-term scenario

The baseline scenario is based on the assumption that the overall picture of the external environment will remain favorable, despite some uncertainties. Real output is projected to continue to grow at around 4% over the next three years. Private investment is expected to be one of the main contributors of GDP growth, estimated to increase by an average rate of 8.2% in constant prices, while the corresponding growth rate of investment in equipment will be 8.1%. Investment activity is supported by a number of factors: the reduced tax burden on enterprises, the new investment incentives law, the public-private partnerships framework, the positive externalities emanating from the large infrastructure investments of the last decade, and the implementation of structural reforms.

Regarding the other components of GDP, private consumption is projected to remain strong due to robust growth in real disposable income and favorable credit conditions. Export growth is estimated to remain strong, reflecting relatively buoyant international demand, competitiveness gains and the expansion to new export markets, especially in the Balkan countries, where Greek exports have been growing annually by 2% for the last 10 years.

Strong domestic demand, the increase in personal income and especially the high rates of growth of investment, which involves spending on imported equipment, will result in an estimated increase in the volume of "imports of goods and services" of 7.2%.

Table 2: Macroeconomic prospects

	ESA Code	Year 2005	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
		Level bn euro	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	117.4	3.7	4.0	3.9	4.0	4.1
2. Nominal GDP	B1*g	181.1	7.5	7.8	7.2	7.1	7.0
Components of real GDP							
3. Private consumption expenditure	P.3	80.9	3.7	3.8	3.7	3.7	3.7
4.Government consumption expenditure	P.3	16.9	3.1	2.1	1.1	0.7	0.7
5. Gross fixed capital formation	P.51	30.5	-1.4	9.1	7.7	7.7	7.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0.4	0.3	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	26.2	3.0	5.1	6.5	7.3	7.6
8. Imports of goods and services	P.7	37.5	-1.2	6.5	7.0	7.3	7.4
Contribution to real GDP growth							
9. Final domestic demand			2.62	5.23	4.81	4.78	4.86
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		-0.03	-0.30	-0.07	-0.01	-0.01
11. External balance of goods and services	B.11		1.07	-0.94	-0.83	-0.77	-0.76

Inflation is expected to continue on its downward trend. The average annual rate of increase of the private consumption deflator is projected at 2.8%. Although the output gap remains positive for the whole period, the nominal unit labour cost growth rate is projected to decline gradually from 4.2% in 2006 to 2.6% in 2009. This projection is based on the assumption that real compensation of employees per head will increase in line with labour productivity growth.

Table 3: Price developments

	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
		rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		3.7	3.7	3.2	3.0	2.8
2. Private consumption deflator		3.7	3.4	3.0	2.8	2.6
3. HICP		3.5	3.3	3.3	2.8	2.6
4. Public consumption deflator		3.0	3.4	3.5	3.5	3.5
5. Investment deflator		2.6	3.9	3.1	2.2	2.0
6. Export price deflator (goods and services)		4.2	4.2	2.6	2.5	2.3
7. Import price deflator (goods and services)		2.7	5.3	1.9	1.4	1.0

Employment for the years 2007-2009 is projected to increase as a consequence of strong economic growth. The forecast for the average annual rate of increase in total employment is 1.8%, while the unemployment rate is expected to decrease gradually reaching 6.5% in 2009 down from 9.2% in 2006.

Table 4: Labour market developments

	ESA Code	Year 2005	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons (000)		4148,2	1.3	1.7	1.8	1.8	1.8
2. Employment, hours worked (mio)		7918.9	1.3	1.7	1.8	1.8	1.8
3. Unemployment rate (%)			10.4	9.2	8.2	7.4	6.5
4. Labour productivity, persons			2.3	2.2	2.1	2.2	2.3
5. Labour productivity, hours worked			2.3	2.2	2.1	2.2	2.3
6. Compensation of employees (billion euro)	D.1	61.7	7.7	8.7	8.6	7.7	7.5

Finally, net borrowing vis-à-vis the rest of world is projected to decrease slightly, down from 8.9% of GDP in 2006 to 7.3% in 2009.

Table 5: Sectoral balances

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Net lending/ borrowing vis-à-vis the rest of the world	B.9	-7.7	-8.9	-7.9	-7.6	-7.3
of which: - Balance on goods and services		-7.2	-8.0	-8.1	-8.0	-7.8
- Balance of primary incomes and transfers		-1.9	-2.8	-1.4	-1.2	-1.0
- Capital accounts		1.5	1.9	1.7	1.6	1.5
2. Net lending/ borrowing of the private sector	B.9/ EDP B.9	-2.5	-6.3	-5.5	-5.8	-6.1
3. Netlending/ borrowing of general government	B.9	-5.2	-2.6	-2.4	-1.8	-1.2
4. Statistical discrepancy						

3 GENERAL GOVERNMENT BALANCE AND DEBT

3.1 Policy Strategy

Fiscal consolidation has been a top priority for the Greek government. This effort has resulted in a reduction in the general government deficit from a high of 7.8% of GDP in 2004 to 2.6% of GDP this year. Thus, the excessive deficit is set to be corrected this year through the achievement of a general government deficit below 3% of GDP in full compliance with the Council notice of 17 February 2005.[1]

The government is committed to pursue further consolidation towards the medium term objective of a budget that is balanced or in surplus by 2012 at the latest, with annual reductions in the structural deficit of at least 0.5 percentage points of GDP.

3.2 Current general government developments and the Medium Term Objective

The 2006 Budget submitted to Parliament in November 2005, set a target for the 2006 general government deficit of 2.6% of GDP. This target is being achieved despite the upward revision of the general government deficit for 2005 by € 1273 mio, up from 4.5% of GDP to 5.2% of GDP, mainly due to a downward revision of the surpluses of Social Security Funds (SSF) and other entities. The underlying magnitude of the deficit reduction from the previous year is 2.6 percentage points (p.p.) of GDP, whereas the central government deficit improves by 1.9 p.p. of GDP, out of which only 0.4 p.p. of GDP stem from temporary measures. The overall deficit reduction achieved between 2004 when the Excessive Deficit Procedure on Greece was initiated, and 2006 amounts to 5.2 p.p. of GDP.

In detail, total revenue has been raised from 40.5% of GDP in 2005 to 42.2% of GDP in 2006. There has been a significant increase in indirect tax revenue, as the structural measures to combat tax evasion have paid off in terms of higher VAT revenue, along with higher excise taxes on fuel and tobacco products. In parallel, the reform of the tax system with the gradual reduction of corporate tax rates has left ordinary revenues more or less stable, with only a marginal decrease from 24.7% of GDP in 2005 to 24.5% of GDP in 2006.

In order to safeguard the implementation of the 2006 budget and secure a sound basis for next year's budget, the government has proceeded with the implementation of additional revenue enhancing measures of a permanent nature, namely:

- The increase in the rate of income tax pre-payment for enterprises and banks (law 3453 / 2006, from 55% to 65% for enterprises and from 60% to 80% for banks), which is expected to yield additional revenue of € 450 million this year. This revenue increase will permanently raise the level of revenue in forthcoming years.

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[1] This correction is achieved by enhancing also considerably the transparency of fiscal accounts. Eurostat, in its October 2006 EDP release as well as in a letter to the National Statistical Service of Greece, withdrew all reservations on Greek budget data.

- The increase of the excise tax on fuel in order to achieve compliance with the minimum levels detailed in Council Directive 2003/96/EC. The increase in 2006 is approximately 6%, and it is expected to yield € 115 mio this year and €300 mio next year, as an additional excise rate increase for 2007 has also been legislated. Further increases have been legislated for 2008 and 2009.
- The increase of the minimum excise tax on cigarettes from 65% of the Most Preferred Price Category to 75%. This was expected to result in a 20 – 30 cents increase in the price of the cigarettes in the super low and low price category. However, cigarette companies have also raised prices of other categories. As a result of these price developments, additional revenue of € 80 mio and € 175 mio are expected for this year and 2007 respectively.
- The increase in the tax duty imposed on mobile connection bills, which is expected to yield € 19 mio this year and € 71 mio next year.

On the side of total expenditure, there is a reduction from 45.7% of GDP in 2005 to 44.8% of GDP in 2006. In detail, there is a reduction of 0.38 percentage points of GDP and of 0.5 p.p. of GDP in primary expenditure and interest payments respectively in 2006, while expenditure for salaries and pensions is lower than anticipated in the 2006 Budget by € 180 mio. A slight overrun is expected in terms of the operational expenditure, mainly due to higher subsidies to universities, the higher cost of local government elections, and higher than projected national contributions to the EU.

Furthermore, on the general government data, there has been an improvement in the surpluses of SSF and other public entities by 0.78 p.p. of GDP in 2006, as extraordinary events led to lower results in 2005. Data for SSF show that their surpluses were on average equal to around € 2100 mio for the 2002-2004 period, excluding capital transfers to social security funds. In 2005 this amount decreased to €1646 mio, mainly because of the significantly increased number of employees exiting the labor force and starting to receive pensions, resulting in a decrease in the surplus of the Welfare Fund of Public Employees by € 120 mio. Also, IKA (Wage Earner's Social Insurance Fund) had higher than projected expenditure, due to the settlement (in 2005) of pre-existing debts to other insurance funds within the general government sector, as well as increased expenses for pharmaceuticals and medical care. These expenditures increased IKA's deficit by € 270 mio, but as they are non-recurring they are not expected to continue affecting IKA's budget. In addition, the surplus of the Fund of Insurance Companies decreased by € 106 mio as a result of the acquisition of bonds and other securities.

The carry-over effect (excluding capital transfers to social security funds) for 2006, results in a SSF surplus of € 3105 mio, compared to € 3650 mio as reported in the April 2006 EDP. This amount includes € 1157 mio of deposits made by the auxiliary pension funds of several banks into the newly established ETAT (auxiliary pension fund for the employees in the banking sector).

Table 6: General Government Budgetary Prospects

	ESA Code	Year 2005	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
		Level bn euro	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-9.5	-5.2	-2.6	-2.4	-1.8	-1.2
2. Central government	S.1311	-11.6	-6.4	-4.5	-4.3	-3.7	-2.8
3. State government	S.1312						
4. Local government	S.1313	0.01	0.1	0.1	0.1	0.1	0.1
5. Social security funds	S.1314	2.1	1.1	1.8	1.8	1.8	1.5
General government (S13)							
6.Total revenue	TR	73.3	40.5	42.2	42.1	42.5	42.9
7.Total expenditure	TE	82.8	45.7	44.8	44.5	44.3	44.1
8. Net lending/borrowing	EDP B.9	-9.5	-5.2	-2.6	-2.4	-1.8	-1.2
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	8.8	4.9	4.6	4.4	4.2	4.1
pm: 9a. FISIM		0.035	0.0	0.0	0.0	0.0	0.0
10. Primary balance		-0.7	-0.4	2.0	2.0	2.4	2.9
Selected components of revenue							
11. Total taxes(11=11a+11b+11c)		40.0	22.1	22.3	22.5	22.6	22.9
11a. Taxes on production and imports	D.2	22.8	12.6	13.1	13.4	13.6	13.8
11b. Current taxes on income, wealth, etc	D.5	16.8	9.3	9.0	8.9	8.8	8.9
11c. Capital taxes	D.91	0.4	0.2	0.2	0.2	0.2	0.2
12. Social contributions	D.61	26.1	14.4	14.5	14.7	14.9	15.2
13. Property income	D.4	1.7	1.0	1.1	1.1	1.0	1.0
14. Other (14=15-(11+12+13))		5.5	3.0	4.3	3.8	4.0	3.8
15=6. Total revenue	TR	73.3	40.5	42.2	42.1	42.5	42.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)			36.5	36.7	37.1	37.5	38.0
Selected components of expenditure							
16. Collective consumption	P.32	17.9	9.9	9.8	9.7	9.4	9.2
17. Total social transfers	D.62 + D.63	43.2	23.8	23.6	23.7	23.9	24.1
17a. Social transfers in kind	P.31 =D.63	11.7	6.4	6.2	6.0	5.8	5.6
17b. Social transfers other than in kind	D.62	31.5	17.4	17.4	17.7	18.1	18.5
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	8.8	4.9	4.6	4.4	4.2	4.1
19. Subsidies	D.3	0.3	0.1	0.1	0.1	0.0	0.0
20. Gross fixed capital formation	P.51	6.3	3.5	3.5	3.5	3.5	3.4
21. Other (21=22-(16+17+18+19+20))		6.3	3.5	3.2	3.1	3.3	3.3
22=7. Total expenditure	TE	82.8	45.7	44.8	44.5	44.3	44.1
Pm: compensation of employees	D.1	21.9	12.1	12.0	11.9	11.8	11.7

Regarding the 2007 budget targets, a general government deficit of 2.4% of GDP for next year is projected. Compared to the 2006 budget expected outturn, the adjustment net of one-offs, is equal to 0.6 p.p. of GDP. A 0.2 p.p.of GDP improvement in ordinary budget revenue is expected. This improvement is carried over from 2006, due to measures already taken this year. Continued success in tackling tax evasion will also contribute to the improvement in revenue.

On the expenditure side, improvement is expected from interest payments, primary expenditure and ESA95 adjustments. Moreover, the government's effort to restrain expenditure in 2007 is being enhanced by new legislation regarding fiscal audits and controls. So far, controls only referred to the legality and regularity of public spending as described in the Budget. According to the new legislation, a General Directorate for Fiscal Audits is established along with internal auditing agencies within Ministries, local authorities and public entities in general with a budget exceeding € 3 mio.

In parallel with the restraint in government consumption and operating expenditure, the government is pursuing its social agenda ensuring that consolidation does not come at the expense of social welfare. To this end, there is an increase in payments aimed at improving the living standards of low income earners. This expenditure amounts to about € 1200 mio (0.57% of GDP), incorporating increases in farmers' pensions (OGA, Farmers' Insurance Fund), in EKAS (Pensioners' Social Solidarity Allowance), and a refund of the contribution on behalf of the Solidarity Account of SSF (LAFKA).

Regarding the SSF surplus, this is projected to amount in 2007 to € 3400 mio (excluding capital transfers to social security funds). This includes an estimate of € 900 mio deposits by banks into ETAT.

Lastly, the medium term objective of fiscal policy is to reach a budget in balance or surplus by 2012 at the latest, with annual reductions in the structural deficit of at least 0.5 p.p. of GDP. The focus is on accelerating the pace of structural adjustment, mainly on the expenditure side.

3.3 Structural Balance – Fiscal Stance

We estimate potential growth at 4.0% on average for the 2006 - 2009 period. Based on that estimate, the cyclically-adjusted deficit in 2006 will reach 3.4% of GDP, down from 8.4% and 5.6% in 2004 and 2005 respectively. In the years ahead, the cyclically-adjusted deficit falls gradually reaching 1.6% in 2009. The improvement in the cyclically-adjusted balance is quite substantial: 2.2 p.p. of GDP in 2006, 0.7 p.p. in 2007, 0.5 p.p. in 2008, and 0.6 p.p. in 2009.

Table 7: Cyclical Developments

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Real GDP growth (%)		3.7	4.0	3.9	4.0	4.1
2. Net lending of general government	EDP B.9	-5.2	-2.6	-2.4	-1.8	-1.2
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP D.41 +FISIM	4.9	4.6	4.4	4.2	4.1
4. Potential GDP growth (%) (1)		4.2	4.0	4.0	4.0	4.0
5. Output gap		1.2	1.2	1.1	1.1	1.2
6. Cyclical budgetary component		0.4	0.8	0.3	0.4	0.4
7. Cyclically adjusted balance (2-6)		-5.6	-3.4	-2.7	-2.2	-1.6
8. Cyclically adjusted primary balance (7-3)		-0.7	1.2	1.7	2.0	2.5

3.4 Debt levels and developments

The significant fiscal consolidation is bearing fruit in terms of lowering the debt ratio at a sufficiently rapid rate. Since 2005 the debt to GDP ratio is moving downwards steadily, from an average of 111.6% of GDP over the 2000-2004 period to 104.1% of GDP in 2006, while it is projected to fall further to 91.3% of GDP by 2009. Increasing primary surpluses, diminishing stock-flow adjustments, privatisations, and strong nominal GDP growth are all important contributing factors in these positive developments.

Table 8: General Government Debt Developments

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Gross debt		107.5	104.1	100.1	95.9	91.3
2. Change in gross debt ratio		-1.0	-3.4	-4.0	-4.2	-4.6
Contributions to changes in gross debt						
3. Primary balance		-0.4	2.0	2.0	2.4	2.9
4. Interest expenditure (incl. FISIM)		4.9	4.6	4.4	4.2	4.1
5. Stock-flow adjustment		1.4	1.7	0.6	0.6	0.5
of which: - Differences between cash and accruals						
- Net accumulation of financial assets *of which: - privatisation proceeds*						
- Valuation effects and other						
p.m. implicit interest rate on debt		4.7	4.5	4.4	4.4	4.5
Other relevant variables						
6. Liquid financial assets						
7. Net financial debt (7=1-6)						

The reduction in the debt ratio over the program period is also facilitated by an integrated and prudent strategy aiming at improving the efficiency of public debt management. This strategy has a clear priority to minimise over the long term, both, the cost and the risk of borrowing within the environment of the euro-area common monetary policy and liberalised financial markets. Several factors influence the cost of servicing the government debt. Such factors are the size and composition of the debt portfolio, the term structure of interest rates, inflation, and the borrowing requirements of the government. Several factors have led to a substantial reduction in the weighted average cost of servicing the government debt: the debt management strategy, pursuing a transparent issuance policy, the decline in interest rates and the restructuring in debt duration.

4 SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

4.1 An Alternative Scenario: Sensitivity of budgetary projections

In this section, we provide a sensitivity analysis of budgetary projections for the 2007-2009 period. A more ‘pessimistic’ growth scenario for the Greek economy is presented and its projections are compared to those of the ‘baseline’ scenario.

In this alternative scenario, it is assumed that some of the existing downside risks are realized. These risks are related to the outlook for world trade and GDP, oil price developments, or the impact of worldwide monetary tightening on growth. Should these risks materialize, they might impair economic growth performance in the Greek economy.

Table 9: Comparison between the baseline and the alternative scenarios

	Baseline scenario			*Alternative scenario*		
	2007	*2008*	*2009*	*2007*	*2008*	*2009*
GDP growth rate	3.9	4.0	4.1	3.5	3.5	3.5
GDP deflator change	3.2	3.0	2.8	3.1	2.9	2.6
Unemployment rate	8.2	7.4	6.5	8.4	7.8	7.3
General government deficit, % of GDP	2.4	1.8	1.2	2.4	1.9	1.4
General government debt, % of GDP	100.1	95.9	91.3	100.6	97.0	93.3

The alternative scenario projects a slower annual GDP growth rate of 3.5%. Growth rates for all components of GDP will be lower than in the baseline scenario and thus inflation rate is projected to be lower every year by around 0.1 p.p. on average. Employment growth rates also remain below the reference value of the baseline scenario, while unemployment rates are higher. As far as public finances are concerned, a slower growth of government current revenues is projected by about 0.4% to 0.6 % each year. Moreover, the alternative scenario assumes cuts on capital and consumption expenditures items, in order for the general government deficit to be below the reference value with a safety margin. The debt to GDP ratio follows a downward path in the alternative scenario, although the levels are higher than in the baseline scenario.

4.2 Comparison with the previous update

We present in Table 10 deviations of the current SGP from those in the 2005 SGP update, which covered the years 2005-2008.

The real GDP growth rate of 2006 is estimated at 4%, higher than the corresponding 2005 SGP projection by 0.2 p.p. GDP growth projections for the period 2007-2008, included in the present SGP, are quite similar to those of the previous update.

For the general government deficit of 2006 as a percentage of GDP, the 2005 SGP projection is exactly the same with the estimated outturn. For the period 2007-2008, the existing differences between the two programs are marginal. The differences between the 2005 and 2006 SGP with respect to debt developments point to an accelerated pace of debt reduction.

Table 10: Divergence from previous SGP update

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Real GDP growth (%) Previous update		3.6	3.8	3.8	4.0	
Current update		3.7	4.0	3.9	4.0	4.1
Difference		0.1	0.2	0.1	0.0	
General government net lending (% of GDP) Previous update	EDP B.9	-4.3	-2.6	-2.3	-1.7	
Current update		-5.2	-2.6	-2.4	-1.8	-1.2
Difference		-0.9	0.0	-0.1	-0.1	
General government gross debt (% of GDP) Previous update		107.9	104.8	101.1	96.8	
Current update		107.5	104.1	100.1	95.9	91.3
Difference		-0.4	-0.7	-1.0	-0.9	

5 QUALITY OF PUBLIC FINANCES

5.1 Developments on the expenditure side

The Greek government, building further on its efforts to rationalize the expenditure of public administration and safeguard the budget implementation for the years ahead, has enacted new legislation (3402/06), as mentioned above, that put in place procedures to improve the arrangements for the control and management of public expenditure. A General Directorate of Fiscal Audits has been established with a mission to audit all public entities of the general government. With the assistance of an integrated system of internal auditing agencies, the audits will cover the Ministries, local government and all other public entities. The Directorate will be expected to propose corrective measures whenever necessary to keep total spending in line with the original Budget estimates.

The ordinary budget primary expenditure exhibits signs of slowdown, rising by 5.1% in 2006 compared to an increase of 8% in 2005. This curbing of expenditures is the outcome of prudence in policy interventions. In detail, the salaries and pensions are to increase by 6.6% in 2006. The expenditures on salaries include a carry-over effect of the much needed personnel hiring, primarily in hospitals, education and security forces. Despite that, savings amounting to € 180 mio are expected compared to what was originally budgeted. An unexpectedly higher rate of retirement is leading to a slight overrun by € 77 mio in the expenditure on pensions.

The expenditure on social security and health care is projected to grow by 2.9% in 2006 compared to a rise of 16.3% in 2005. Operating expenditure is expected to increase by 7.8%, partly due to the increased cost of the elections for the local authorities and the increased grants to higher education. Interest payments record a decrease by 2.5% compared to 2005, which amounts to € 70 mio savings over the original Budget estimate.

Against a background of strong economic growth and enhanced efforts to restrain public consumption, the Greek government has highlighted as key priority areas for the years to come the improvement of living standards of low income earners and the acceleration of economic growth. Economic equity and social cohesion are essential elements for the sustainability of economic growth over the long term. Based on this, pensions and salaries expenditure are projected to grow by 6.4% in 2007. The increase amounts to €1244 mio, as mentioned before, and incorporates, among others, increases in OGA (Farmers' pensions) by € 600 mio, in EKAS (Pensioners' Social Solidarity Allowances) by € 190 mio and the LAFKA (Social Solidarity Account of SSF) outlays amounting to € 110 mio. The operating expenditure will increase only by 2.1%, in contrast with a rate of 7.8% in 2006, bringing the total amount to € 8.732 mio or 20% of the ordinary budget primary expenditure.

Primary expenditure is projected to fall gradually from 20.9% of GDP in 2006 to 20.3% of GDP in 2009. The debt-to GDP ratio is expected to progressively decline to 91.3% in 2009, down from 107.5% in 2005 and 104.1% in 2006. For 2007, the general government debt is forecast to fall by 4 p.p. of GDP, the primary surplus contributing 2 p.p. points. The primary surplus will further contribute to debt reduction by 2.4 p.p. in 2008 and 2.9 p.p. of GDP in 2009.

5.2 Developments on the revenue side

The government implemented in 2006 revenue-enhancing measures of a permanent nature, which are anticipated to be fully performing in the year ahead, as analyzed above in section 3.2. All these measures are estimated to increase the contribution of excise taxes to total revenue, reaching 13.5% of GDP in 2006, up from 13.1% in 2005. On top of these measures, ordinary budget net revenue is forecast to rise by 9.9% compared to 2005.

Corporate tax policy in 2006 aimed at further facilitating a favorable business environment, in pursuit of the objective of economic growth with more jobs as well as enhancing competitiveness. As part of this effort, the Greek government continued with the gradual reduction of corporate tax rates, from 35% in 2004 to 25% in 2007.

The government is now proceeding with the second phase of tax reform, aiming at a simplified and fair tax system. The tax reform will widen the tax base and enhance equity among tax-payers. These measures include the increase of tax free income from € 11,000 to € 12,000, the gradual reduction of tax rates for the middle-income taxpayers, as well as the continued fight against tax evasion, through intensified audits that utilize the new technologies provided by the General Secretariat of Information Systems.

Direct tax revenue is expected to increase by 4.8% in 2007, while indirect taxes are to rise by 8.8%. Total revenue is expected to amount to € 51,370 mio compared to € 47,830 mio in 2006. Notably, for the 2007-2009 period, the revenue of the ordinary budget is estimated to increase from 24.5% of GDP in 2007 to 25% of GDP in 2009. Regarding the Public Investment Program, the year-on-year growth rate of revenue is projected to be 9.6% in 2007, increasing to 11% in 2008 and reverting back to 9.5% in 2009.

5.3 Quality of Fiscal Statistics

The Greek government remains committed to enhance the transparency and accuracy of fiscal accounts. In June and September 2006, Eurostat carried out methodological visits to clarify the pending issues mentioned in the Eurostat News Releases of 26 September 2005 and 24 April 2006. These issues concerned the recording of a number of transactions: the accounts of social security, receivables and payables for the years 2002-2005, the treatment of accounts of other government bodies as well as transactions with the EU among others. After clarifications provided by the National Statistical Service of Greece (NSSG), Eurostat announced in its News Release of 23 October 2006 that it had withdrawn all reservations on deficit and debt data. Thus, it provided acknowledgment of the significant progress achieved in data compiling and reporting. Going forward, the Greek government has agreed to establish an action plan for a further improvement of statistical methods, enabling an even more timely and reliable compilation of fiscal data.

The NSSG recently conducted a revision of Greek GDP data in accordance with EU Regulation 2223/96, which requires that all Member States revise their accounts at least every five years by updating the base year utilized. The last major revision of the Greek GDP data took place in 1994. It involved the application of ESA79 to the base year 1988 and led to an increase in GDP of more than 20%. In between the two major revisions there was only one revision, which did not use any new surveys. This means that up to this point national accounts have been using the data of the 1981 Census of Population. The recent update in the base year was enhanced by incorporation of the information contained in new surveys that measure value added in the services sector, and the most recent decennial Census of Population, among others. As a result of these new statistical surveys and the relevant methodology that has been adopted we are now in the position to measure economic activity in the services sector better, in particular in areas such as wholesale and retail trade, transportation, construction, and tourism among others. We note that the GDP magnitudes contained in this SGP update are still based on unrevised figures.

6 LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

According to existing projections for the impact of population ageing on the long-term sustainability of public finances (currently being updated), demographic developments lead to a significant increase of pension expenditure as a ratio to GDP by 2050. There is a lower impact on health expenditure, while no impact is projected for the long-term care system for the elderly, the educational system or unemployment benefits.

In the framework of the above analysis, and the government's option to ensure the maximum possible consensus for the reform of the social security system, a national dialogue on this issue was launched in spring of 2006. In addition, an "Experts Committee" has been established in order to review the social security system, chaired by the Chairman of the Economic and Social Committee (ESC). This Committee is responsible for monitoring and evaluating the adequacy and accuracy of studies describing the magnitude of the problems that the social security system faces. It is expected that the Committee will have completed its mandate by fall of 2007, so that all information, scenarios and proposals are presented to the wider public in a timely fashion.

The **rationalisation of healthcare expenditure** is also an important priority. Relevant measures and policies are detailed in this year's Progress Report on the National Reform Programme for the 2005-2008 period.