8. GREECE

Deep but inevitable adjustment

Necessary adjustment calls for policy response [72]

The recent downward revision of the GDP data for the first three quarters of 2009, coupled with worse-than-expected fourth quarter, implied a real GDP contraction of 2% in 2009. This deeper-than-expected recession in 2009 will have an impact on real GDP dynamics in 2010, with the carry-over effect at the beginning of the year at almost -1%. Moreover, economic activity is set to lose further steam, due to a number of factors, in particular worsening business and consumer confidence, the developments in financial markets and the implementation of an appropriately restrictive fiscal policy.

Following years of expansionary fiscal policies that resulted in the build-up of fiscal (high general government deficit and gross debt stock, increasing interest payments) and macroeconomic (high current-account deficit and external debt, outflow of income) imbalances, Greece adopted a number of fiscal consolidation measures, which are expected to have an unfavourable impact on real GDP growth in 2010. Successful and credible fiscal adjustment efforts however, should boost confidence and improve sentiment. Credibility gains will compensate the vast economic cost of adjustment and lead to the beginning of a recovery process in the second half of 2011.

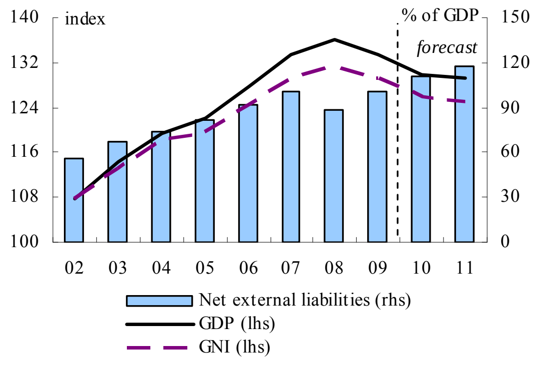
Recession deepens as contraction in domestic demand continues

Economic outlook is for real GDP to contract further in 2010, before starting to recover mildly in the second half of 2011. For the year as a whole, economic activity is set to contract by -3% in 2010. In the short run, fiscal tightening will have a strong contractionary impact on economic activity, on the back of cuts in public wages, increasing tax burden and thus, dragging disposable income down and declining public spending. Market pressure in the form of high spreads on sovereign debt, while likely to reduce as fiscal consolidation proceeds, will continue to hold back economic activity by keeping up the cost and limiting private sector access to financing. With high country risk premia discouraging lending, credit expansion is likely to remain subdued on the back of tighter credit conditions and high household indebtedness.

Falling employment and wage growth, as well as lower non-labour income growth are expected to also weigh on disposable income in 2010, putting a brake on real demand. In view of the highly uncertain environment, the household savings rate might increase, leading to further pressure on private consumption which, as a result, is set to contract by 3.5% in 2010 and decrease further over the forecast horizon.

The immediate outlook for the business sector remains poor; investment is set to decline further in 2010 before showing some positive signs by the end of 2011. In spite of the gradual recovery in external demand, which is expected to support export-oriented sectors, such as chemicals and metals, shipping and tourism, weak domestic demand and financing conditions will continue to weigh heavily on business investment decisions during 2010. Construction sector is set to experience a further downsizing in 2010, as demand remains extremely weak. Public investment activity in turn, although expected to stack in 2010, is likely to start recovering by 2011.

Graph II.8.1: **Greece - Net external liabilities, GDP and GNI**



The weakening domestic demand is forecast to curb imports further, which are projected to continue falling by around 10% in real terms in 2010, inducing also a sizable reduction in the trade deficit. Total exports in turn, benefiting from the gradual recovery of the world trade and more

(72) As for the rest of the Member States, the cut-off date of this forecast is 20 April 2010. As such, the forecast does not factor in the adjustment package prepared in the context of the euro area-IMF financial support.

favourable world demand prospects, coupled also with a relative decline in unit labour cost, are set to rise by almost 2¾% in 2010 and increase further in 2011. All in all, the contribution of net exports to GDP growth is forecast to be positive both in 2010 and to a lesser extent in 2011, mainly due to the ongoing fall in imports.

The contraction of economic activity, reflected in weakening labour demand from the retail, wholesale and construction sectors, is weighing heavily on employment which is set to fall by almost 3% over the forecast horizon. Shorting employment opportunities in the private sector, along with the recruitment freeze and short-term contracts cuts in the public sector are likely to push the unemployment rate up in 2010-11.

The balance of risks for the baseline scenario remains on the downside especially in 2011 as the estimated confidence gains may be less buoyant or delayed. In addition, the liquidity tightness may have a more profound impact on economic activity through the bank-lending channel, especially in the case of risks associated with the timely and rigorous implementation of the stability programme materialising. On the positive side, if the fall in domestic output is not proportionate to the decline in demand, the increase in net exports may compensate more for the fall in domestic demand, leading to a higher contribution of net exports to GDP growth than assumed. The latter would largely depend on labour-market developments, wage and unit-labour cost adjustment in particular. The announced cuts in public sector remuneration are expected to play an important signalling role that would support private-sector wage moderation.

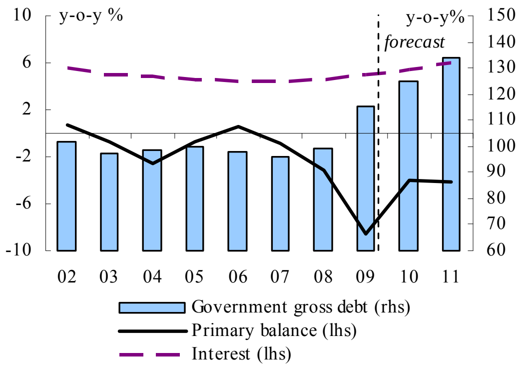
Recovery prospects depend on the correction of domestic and external imbalances...

The significant progress made by Greece in terms of real convergence over the last decade is now considerably challenged. Bringing the Greek economy back to a sustained convergence path involves the prompt correction of the factors underlying domestic and external imbalances.

Developments in the external sector are expected to lead to a partial correction of the external deficit in 2010. Nevertheless, improvement over the medium term is likely to be much more moderate, given the structural weaknesses of the external performance of the economy and past years' accumulated competitiveness losses. Notably, the external imbalance, although improving, may still amount to more than 8% of GDP by 2011. In a recessionary context in both real and nominal terms, external constraints are becoming more severe, leading to the inevitable adjustment.

Widening competitiveness losses over the recent years are also reflected in the sizeable appreciation of the real effective exchange rate (REER) based on unit labour costs. The rapid rise of wage costs and mark-ups in excess of productivity growth, as well as the persistence of the inflation differential with the euro area, has contributed to a wage-price spiral and resulted in high real-wage growth, well above productivity growth. The disconnection between wages and labour-market and productivity developments, including the still weak response of wages growth to the downturn, are set to come to an end in the short term, with positive impact on country's competitive position. Appropriate wage developments, in line with the moderation of public wages, would help to regain part of the lost competitiveness. While inflationary pressures continuing to build up in the following months, fuelled by the adverse base effects of energy prices, the VAT-rates increase and the increase in excise duties on alcohol, tobacco and fuel, core inflation will be reined by the negative output gap and constrained wage growth.

Graph II.8.2: **Greece - General government debt, primary balance and interest**



...and the fiscal consolidation results

Expansionary fiscal policies until recently, contributed to aggravating the external imbalances and to protracted losses in competitiveness. High government deficits have led to one of the highest public debt ratios in the EU, which remains on a steep upward path. While in Greece, as in other EU countries, the most recent deterioration in public finances must be seen in the context of the global economic crisis, fiscal imbalances have been high and persistent for many years, suggesting exceptional structural roots. The ongoing crisis, however, has already made these imbalances unsustainable in the medium-term, with obvious implications for the financing of the large external and public deficits. This not only renders the financing of any additional debt issuance more expensive, but also adds to the cost of refinancing the existing stock of public debt.

In 2009, the Greek public finances have worsened much beyond what could have been expected to result from the downturn and the financial-sector support measures. According to the notification of April 2010, the government deficit has reached 13.6% of GDP in 2009.[73] The January 2010 update of the stability programme set a nominal fiscal adjustment of 4 pps. of GDP, on the back of a detailed set of fiscal consolidation measures. The Council Decision and the Recommendation of 16 February[74] provide a detailed list of fiscal and structural measures to be implemented by 2012. To ensure meeting the budgetary target, the Greek authorities have adopted additional fiscal measures of 0.4 pp. of GDP in February and of 2 pps. of GDP in March.[75] Further substantial measures will be included in the adjustment programme under the euro area - IMF financial-support package. Under the no-policy-change assumption and on the back of the discontinuation of one-off measures in 2010, the headline deficit is projected to remain at around 10% of GDP in 2011. This, combined with the economic downturn, would lead to a sizable increase in the debt ratio over the forecast horizon.

(73) Eurostat (news release 55/2010 of 22 April 2010) is expressing a reservation on the quality of the data reported by Greece, due to uncertainties on the surplus of social security funds for 2009, on the classification of some public entities and on the recording of off-market swaps. Following completion of the investigations that Eurostat is undertaking on these issues in cooperation with the Greek Statistical Authorities, this could lead to a revision for the year 2009 of the order of 0.3 to 0.5 pps. of GDP for the deficit and 5 to 7 pps. of GDP for the debt.

(74) On 16 February 2010, the Council adopted a Decision under Article 126(9) TFEU giving notice to Greece to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit and a Recommendation under Article 121(4) TFEU with a view to ending the inconsistency with the broad guidelines of the economic policies in Greece and removing the risk of jeopardising the proper functioning of EMU.

(75) On 9 March 2010 the Commission adopted a Communication (COM(2010)91) assessing the decisions taken so far by the Greek authorities in order to achieve the 2010 budgetary target. The Communication concluded that Greece was implementing the Council Decision of 16 February 2010 and the measures outlined in its stability programme. If fully, effectively and timely implemented, the additional fiscal measures of March 2010 appear sufficient to achieve the 2010 budgetary targets.

Table II.8.1:

Main features of country forecast - GREECE

	2008		Annual percentage change						
	bn EUR Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	240.2	100.0	2.9	4.5	4.5	2.0	**-2.0**	**-3.0**	**-0.5**
Private consumption	173.3	72.1	2.9	5.3	3.3	2.3	**-1.8**	**-3.5**	**-2.4**
Public consumption	41.4	17.2	2.7	-0.1	8.4	0.6	**9.6**	**-7.0**	**-3.1**
Gross fixed capital formation	46.3	19.3	4.0	9.8	4.6	-7.4	**-13.1**	**-5.5**	**-0.8**
of which : equipment	21.9	9.1	9.4	4.7	20.9	6.3	**-19.0**	**-5.0**	**-1.7**
Exports (goods and services)	55.5	23.1	6.4	5.3	5.8	4.0	**-18.1**	**2.6**	**4.1**
Imports (goods and services)	80.0	33.3	5.6	9.0	7.1	0.2	**-14.1**	**-10.5**	**-3.4**
GNI (GDP deflator)	232.4	96.7	2.7	4.0	3.7	1.6	**-1.5**	**-3.0**	**-0.6**
Contribution to GDP growth : Domestic demand			3.2	5.8	4.8	0.2	**-2.5**	**-4.8**	**-2.4**
Inventories			-0.1	0.4	0.8	1.0	**-0.1**	**-1.9**	**0.1**
Net exports			-0.3	-1.7	-1.1	0.8	**0.7**	**3.8**	**1.8**
Employment			1.0	2.0	1.4	0.1	**-1.2**	**-1.9**	**-0.8**
Unemployment rate (a)			9.9	8.9	8.3	7.7	**9.5**	**11.8**	**13.2**
Compensation of employees/head			8.2	3.1	6.6	5.9	**5.5**	**-0.8**	**0.4**
Unit labour costs whole economy			6.2	0.7	3.5	3.9	**6.3**	**0.3**	**0.1**
Real unit labour costs			-0.3	-2.3	0.5	0.3	**5.0**	**-2.6**	**-1.6**
Savings rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			6.5	3.1	3.0	3.5	**1.0**	**2.9**	**1.7**
Harmonised index of consumer prices			-	3.3	3.0	4.2	**1.3**	**3.1**	**2.1**
Terms of trade of goods			0.0	0.4	0.9	-2.2	**-2.9**	**-2.1**	**-0.5**
Trade balance (c)			-14.8	-17.1	-17.7	-16.6	**-14.0**	**-12.0**	**-10.9**
Current account balance (c)			-5.9	-12.8	-14.7	-13.8	**-13.1**	**-10.3**	**-8.6**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-10.5	-12.5	-12.4	**-12.3**	**-9.4**	**-7.6**
General government balance (c)			-6.6	-3.6	-5.1	-7.7	**-13.6**	**-9.3**	**-9.9**
Cyclically-adjusted budget balance (c)			-6.3	-4.7	-7.0	-9.6	**-14.1**	**-8.2**	**-8.2**
Structural budget balance (c)			-	-5.2	-6.8	-8.7	**-13.0**	**-8.5**	**-8.2**
General government gross debt (c)			97.1	97.8	95.7	99.2	**115.1**	**124.9**	**133.9**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.