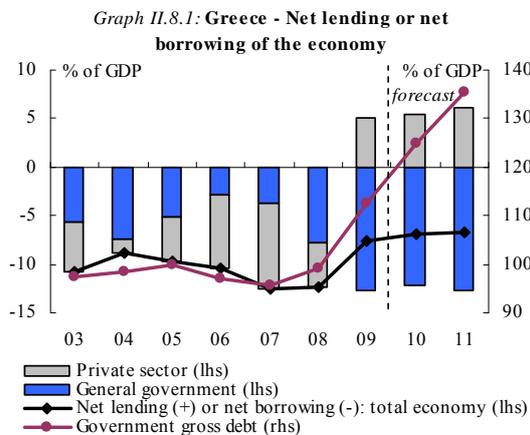


## 8. GREECE

### Economic downturn challenges public finances

#### Economic adjustment and policy response

Having experienced a decade of strong economic growth of 4% on average, the Greek economy entered a recessionary phase in 2009. The accumulation of growing and long-term persistent domestic and external imbalances was accelerated by the unfolding of the ongoing crisis, weighing on the sustainability of the real convergence process in the long run. Both consumer and business confidence were strongly hit, weakening economic activity in 2008 and weighing on medium-term prospects. Although it reacted later than in other countries, GDP growth decelerated strongly in 2008, growing at only 2% compared with 4½% in 2007. The downturn is already taking a heavy toll on public finances. Tax revenue started to weaken in late 2008, while government debt financing became more challenging and more expensive, putting further pressure on the fragile budget.



Given the lack of room for manoeuvre, no expansionary fiscal policy response to the crisis was adopted within the EERP. However, a number of temporary measures were implemented in late 2008 and 2009, aimed at supporting vulnerable social groups and the sectors most hit by the crisis. In addition, although the direct impact of the financial crisis on the banking sector has been relatively contained, mainly thanks to the limited exposure of the Greek banks to high risk financial investments, a series of measures was implemented to safeguard the stability of the sector.

#### Flat growth in 2010 – mild recovery in 2011

The outlook is for real GDP to remain almost flat in 2010, before recovering mildly in 2011. Credit expansion, although still positive, should remain sluggish on the back of tighter credit conditions and high household indebtedness. Moreover, falling employment growth, declining wages and lower non-labour income growth should weigh on disposable income over the medium-term, putting a brake on real demand. In view of the highly uncertain environment, the households saving rate might increase, leading to further pressure on consumption growth. As a result, private consumption is projected to contract by 1¼% in 2010, while returning to positive growth rates by the end of the forecast horizon.

Negative prospects and tightening credit conditions are also expected to worsen profit expectations and discourage investment. Gross fixed capital formation continued to fall markedly in 2009, on the back of both housing and equipment investment retrenchment. In spite of the government's attempt to accelerate the execution of public investment and projects through Public Private Partnerships (PPP) in 2009, only a few of these projects have as yet started. Public investment activity however, is expected to resume in 2010 and to continue to rise in 2011. Investment should decline further in 2010 before showing some positive signs by the end of 2011, reflecting the continuing downsizing of the housing sector and the contraction in corporate investment.

The contraction in domestic demand is expected to continue in 2010, mirrored also by shrinking imports, which are projected to continue falling by around 3% in real terms. Total exports, in turn, should recover mildly in 2010, after the significant fall recorded in 2009, largely because of more favourable world demand prospects. Exports of goods should rise by almost 2½% in 2010 and increase further in 2011, while exports of services - in particular world trade sensitive merchant shipping and tourist receipts - should return to positive territory. All in all, the contribution of net exports to GDP growth should be positive both in 2010 and to a lesser extent in 2011, mainly due to the ongoing fall in imports, which goes well beyond that implied by historical elasticities.

The contraction of economic activity is weighing heavily on employment which is set to fall by some 2% over the forecast horizon. This will push the unemployment rate up to around 10¼% and 11% in 2010 and 2011, respectively.

The main risks to this baseline scenario are quite balanced. On the positive side, the resurgence of both consumer and business confidence and the gradual improvement of liquidity and capitalisation of Greek banks may help to sustain credit expansion at modest levels, which could underpin private consumption and ease the adjustment of the housing sector. In addition, 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. On the negative side, a sharper fall in external demand would weigh more on economic activity. Moreover, within a context of tighter credit conditions, external financing could prove less benign and so the servicing of Greece's fast-rising external debt might crowd out domestic spending.

#### **Sustained recovery implies correcting domestic and external imbalances...**

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

The developments in the external sector are expected to lead to a significant correction of the external deficit in 2010. Nevertheless, the expected improvement over the medium term is likely to be much more moderate, given the structural weaknesses of the external performance of the economy. Notably, the current account deficit, although improving, may still account for almost 8% of GDP by 2011. In a context of weak growth in both real and nominal terms, external constraints are becoming more severe and should eventually lead to a serious adjustment.

Mounting competitiveness losses over the last decade are 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. While nominal compensation per employee is set to increase by about 2¼% in 2009, HICP inflation is projected to remain close to 1% in 2009, resulting in high real wage growth, well above productivity growth. The disconnection between wages and labour-market conditions and productivity developments, including the weak response of wages growth to the current downturn, are set to continue in the medium-term, thus undermining further the competitive position of the economy. The promotion of productivity, together with appropriate wage developments, would help to regain lost competitiveness. Although current inflation rates are low, they are projected to quickly return to an upward trend over the forecast period. Core inflation should also rise more rapidly than the euro area average, also reflecting the poor functioning of domestic markets, especially services.

#### **...and adjusting public finances.**

The persistent deterioration of external imbalances reflects both rising investment and falling savings. The private and public sectors have alternated over time as the driving force of this deterioration, with the share of general government de-savings having markedly increased in the most recent years. The ongoing crisis, however, has the potential to make these imbalances unsustainable in the medium-term, with obvious implications for the financing of the large external and public deficits.

As public revenue depends strongly on indirect taxation and customs, weak consumption and decreasing imports translate swiftly into lower tax receipts and significant revenue shortfalls. In addition, the economic downturn is burdening social protection expenditure, leading to a further fiscal deterioration. With the general government deficit well above 3% of GDP on average over the current decade, and the accumulation of large debt-increasing below-the-line operations, public debt is quickly returning to levels well above 100% of GDP, which will raise the cost of financing government debt. This would not only render the financing of any additional issuance more expensive, but would also increase the cost of refinancing the existing stock of public debt.

The 2008 general government deficit notified by the Greek authorities in October 2009 stands at 7¾% of GDP, higher by 2¾% percentage points of

GDP than the previous notification made in April 2009. Eurostat expressed a reservation on the figures reported by Greece on 21 October 2009 and did not validate the data<sup>(85)</sup>. Any upward revision in the 2008 deficit figure would mainly be due to higher public expenditure, which had not been recorded in the previous notifications according to the Greek authorities. The notified expenditure figure includes a one-off capital expenditure of around 1¼ p.p. of GDP, related to past years' general government liabilities to the private sector, mainly public hospitals' arrears to the suppliers of paramedical and pharmaceutical procurement.

For 2009, the official public deficit estimate stands at 12½% of GDP, compared with the budgetary target of 3.7% of GDP included in the January 2009 update of the stability programme. On the expenditure side, a number of one-off expenditures mainly related to arrears to hospitals' suppliers amounting to around 1½ percentage points of GDP have been included. Taking into account relevant information provided by the Greek authorities, and the budget implementation cash-data over the first

nine months, the general government deficit in 2009 is expected to reach 12¾% of GDP. The Commission services' projection also includes the impact of measures announced in the 2009 budget law, the January 2009 update of the stability program and in the fiscal package of March 2009. However, the measures presented in June 2009 but not implemented in the course of the year, have not been taken into account in the projection for 2009.

Under a no-policy-change scenario assumption and on the back of the discontinuation of one-off expenditure realised in 2009, the headline deficit should remain above 12% of GDP in 2010 and increase further over the forecast horizon, exceeding 12¾% of GDP by 2011. Both falling revenue-to-GDP and rising expenditure-to-GDP ratios will contribute to this fiscal deterioration.

The economic downturn, coupled with high budget deficits, is expected to push debt higher, from 112½% of GDP in 2009 to over 135% of GDP by 2011, thus weakening the already fragile sustainability of Greek public finances in the long term.

<sup>(85)</sup> Eurostat (news release 149/2009) has expressed a reservation on the data reported by Greece on 21 October 2009, due to significant uncertainties over the figures notified by the Greek statistical authorities.

Table II.8.1:

**Main features of country forecast - GREECE**

	2008		Annual percentage change						
	bn Euro	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010
GDP	239.3	100.0	2.9	4.5	4.5	2.0	-1.1	-0.3	0.7
Private consumption	173.3	72.4	2.9	5.3	3.3	2.3	-2.5	-1.3	0.8
Public consumption	40.4	16.9	2.7	-0.1	8.4	0.6	2.0	-0.1	0.7
Gross fixed capital formation	46.3	19.4	4.0	9.8	4.6	-7.4	-16.2	-3.9	1.3
of which : equipment	21.9	9.1	9.4	4.7	20.9	6.3	-19.0	-4.8	1.1
Exports (goods and services)	55.5	23.2	6.4	5.3	5.8	4.0	-11.8	2.7	3.1
Imports (goods and services)	80.0	33.4	5.6	9.0	7.1	0.2	-20.3	-3.1	1.9
GNI (GDP deflator)	231.5	96.7	2.7	4.0	3.7	1.6	-1.6	-0.7	0.7
Contribution to GDP growth :									
Domestic demand			3.2	5.9	4.8	0.1	-4.9	-1.6	0.9
Stockbuilding			-0.1	0.4	0.8	1.0	-0.6	-0.1	-0.4
Foreign balance			-0.3	-1.7	-1.1	0.8	4.4	1.5	0.1
Employment			1.0	2.0	1.4	0.1	-0.9	-0.8	-0.2
Unemployment rate (a)			9.9	8.9	8.3	7.7	9.0	10.2	11.0
Compensation of employees/head			8.2	3.1	6.6	5.9	2.3	1.4	1.8
Unit labour costs whole economy			6.2	0.7	3.5	3.9	2.5	0.9	0.9
Real unit labour costs			-0.3	-2.3	0.5	0.3	0.8	-0.5	-1.3
Savings rate of households (b)			-	-	-	-	-	-	-
GDP deflator			6.5	3.1	3.0	3.5	1.7	1.4	2.3
Harmonised index of consumer prices			-	3.3	3.0	4.2	1.2	1.4	2.1
Terms of trade of goods			0.0	0.4	0.9	-2.2	6.5	-0.9	-0.3
Trade balance (c)			-14.8	-17.1	-17.7	-16.6	-11.0	-10.3	-10.5
Current account balance (c)			-5.9	-12.8	-14.7	-13.8	-8.8	-7.9	-7.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-10.5	-12.5	-12.4	-7.5	-6.8	-6.7
General government balance (c)			-6.6	-2.9	-3.7	-7.7	-12.7	-12.2	-12.8
Cyclically-adjusted budget balance (c)			-6.3	-3.8	-5.1	-8.9	-12.6	-11.3	-11.6
Structural budget balance (c)			-	-4.3	-4.9	-8.1	-11.3	-11.3	-11.6
General government gross debt (c)			98.1	97.1	95.6	99.2	112.6	124.9	135.4

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