COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Greece, 2003-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

The first stability programme of Greece covering the period 2000-2004 was submitted in December 2000 and assessed by the Council on 12 February 2001[2]. Greece submitted the 2003 update to its stability programme, covering the period 2003-2006, on 1 December 2003. The Commission services have carried out a technical evaluation of this updated stability programme taking into account the information provided in accordance with the Code of Conduct[3], the Autumn 2003 forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication from the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The updated programme largely complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes. This update does not provide the breakdown of the budget balances of the sub-sectors of the general government, as it was the case in the previous programmes. There is also no analysis of the long-term sustainability of public finances.
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> In 2003, the Greek economy has continued to be buoyant despite the less supportive international context. Real GDP growth reached 4.0% after 3.8% in 2002, mainly sustained by a very robust internal demand. Public investment supported by the 3rd Community Support Framework and investment related with the preparation of the 2004 Olympic Games boosted activity, while private investment and consumption continued to increase at a robust rate supported notably by favourable credit conditions. Consequently, employment is estimated to have accelerated in 2003, but the unemployment rate, although declining, still hovers at around 9.5%. Consumer prices have been slowly decelerating, but due to demand pressure, their average increase should still reach 3.5%. Despite buoyant and better than expected real output growth, the government deficit is estimated at 1.4% of GDP in 2003, up from 1.2% of GDP in 2002 and against 0.9% of GDP projected in the previous programme. In cyclically-adjusted terms based on Commission calculations

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[1] OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/spg/main_en.htm

[2] OJ C 77, 9.3.2001

[3] Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

[4] COM(2002) 668 final, 27.11.2002.

according to the commonly agreed methodology, the government deficit deteriorated by 0.4 percentage points, at 1.7% of GDP in 2003.

According to the 2003 update of the stability programme, the economic activity should accelerate further in 2004, real GDP reaching 4.2% and mildly slow down as from 2005 due to faltering boost from the Olympic Games-related investment. Real GDP growth is thus projected to reach 4% in 2005 and 3.8% in 2006. The 2003 update considers that the deceleration in investments, in the period 2005 and 2006, should be relatively limited, as financial flows, in particular those stemming from the 3rd Community Support Framework until 2006, should be directed towards sectors and geographical areas other than those related with the Olympic Games and support investment.

These assumptions seem to hinge on the optimistic side. The Commission Autumn 2003 forecasts project a sharper deceleration in gross capital formation in 2005, to a still rather high pace, as a result of the ending of the Olympic Games-related activities. Private consumption, however, is expected to continue increasing at robust rates. Commission calculations on the basis of real GDP projections provided by the update show that the positive output gap increases throughout the period to 2006. However, projecting such a steady and buoyant real growth in the medium term seems somewhat optimistic and risks are skewed to the downside. Moreover, in a context of such robust demand, pressures on costs and prices can be stronger than expected in the update, putting even more at risk the control of some government expenditure items, such as the wage bill, and endangering the external competitiveness of the economy.

Against such a background of strong economic dynamics, the budgetary adjustment efforts projected in the programme are modest and back-loaded to 2005 and 2006. The update targets a general government deficit of 1.2% of GDP in 2004 as against an expected deficit of 1.4% of GDP in 2003. For 2005 and 2006, the projections are for headline deficits of 0.5% of GDP and balance in 2006. Commission calculations based on the programme growth assumptions and budgetary targets show that the cyclically-adjusted government balance would not improve at all in 2004. It would improve by 0.5% of GDP in 2005 and 0.3% of GDP in 2006. At the end of the programme horizon, the cyclically-adjusted deficit would reach 0.9% of GDP, still far from a close-to-balance position. All in all, in the light of the current and projected growth conditions and the implied inflationary risks, the fiscal stance in the update is inappropriate.

There are several risks associated with the budgetary projections of the update. According to the 2003 update, the slippage in 2003 would proceed mainly from overruns in State expenditure related to the acceleration of the preparation of the Olympic Games and compensation for weather damages. However, the deviation also results from less-than-expected fiscal revenues and more importantly, from higher-than-projected social transfers and public wages. The general government deficit in 2003 is likely to be higher than 1.4% of GDP. Such a worse fiscal situation is likely to affect the outcome for 2004. The overall budgetary cost of the 2002 tax reform and of the 2003 social package was estimated by the Greek authorities at 2.2-2.4% of GDP (of which 0.8%-1.0% of GDP split over 2003 and 2004 for the tax package and 1.4% of GDP for the social measures almost fully in 2004). Such costs can hardly be consistent with a decline of only one percentage point of GDP in the primary surplus of the State budget in the two years, as assumed by the update.

Moreover, the impact of these measures may have been underestimated in the budgetary projections of the programme.. Finally, expenditures related to the Olympic Games will accelerate in the first half of 2004. According to the Commission Autumn 2003 forecasts, the government deficit for 2004 will be clearly above the programme's target.

The budgetary strategy of the 2003 update is based on maintaining high primary surpluses consistent with a reduction in the expenditure ratio and an accelerating decline in the debt ratio. The budgetary adjustment is expected to gain momentum in 2005 and 2006 with the primary surplus increasing by 0.6 percentage points to 5.3% of GDP in 2006. This would be mostly the result of lower current primary spending, in particular government consumption. However, for these years no concrete budgetary policy actions are spelled out. It must be noted in this respect that the Code of Fiscal Stability, which was announced in the 2002 update and was welcomed by the Council in its opinion of January 2003, has not been adopted as yet. Such a code was supposed to outline a regulatory framework for improving control over primary expenditure.

The medium-term budgetary adjustment projected by the updated programme, needs to be assessed taking particular account of the still very high level of the government debt. The government debt ratio is projected to decline by over 14 percentage points of GDP over the entire period 2003-2006 to 90.5% of GDP in 2006. As a comparison, the 2002 update projected a reduction of more than 17 percentage points of GDP for the same period. The largest part of the reduction is expected to occur after 2004. The debt ratio reduction is expected to result from increasing contribution from the primary surplus and diminishing stock-flow adjustments. The projections for the primary surplus (4.7% in 2003 and 2004, increasing to 5.3% by 2006) seem ambitious in the light of the risks to the proposed budgetary adjustment highlighted above. Moreover, past experience shows that financial transactions (which are not recorded in the deficit), tend to weigh heavily on debt accumulation. In its Opinion on the 2002 update stability programme and the previous programmes, the Council had already urged the Greek authorities to implement stronger and more robust medium-term budgetary adjustment taking into consideration the still very high level of the government debt, as well as its insufficient decline in recent years. Such an effort was also necessitated by the future budgetary costs of ageing population.

Greece has not presented an analysis of long-term sustainability of public finances in its updated stability programme despite previous assessment clearly pointed out the risk of long-term unbalances. The Commission considers that, on the basis of the current policies, there are risks of severe budgetary imbalances emerging in Greece. Pension expenditure is projected to increase to a level that would be well above other EU countries. The Greek budgetary strategy outlined in the programme – which is mainly based on the reduction of the deficit towards close to balance – is not sufficient to improve the sustainability of public finances and more ambitious targets for the budget balance should be pursued. Moreover, the budgetary challenges posed by the ageing population should be tackled through a comprehensive strategy that includes further reform of the pension system.

The economic policies as reflected in the 2003 update are not fully consistent with the recommendations in the broad economic policy guidelines, especially those with budgetary implications. In particular, the projected decline in the debt ratio is subject to risk and there is no clear evidence of effective control of government current primary expenditure, in particular of its inelastic components, like the wage bill and social transfers.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated stability programme of Greece and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Greece, 2003-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [10 February 2004], the Council examined the 2003 update of the stability programme of Greece which covers the period 2003 to 2006. The updated programme complies largely with the data requirements of the revised “code of conduct” on the content and format of stability and convergence programmes.

The budgetary stance underlying the update is based on maintaining high primary surpluses over the programme period, consistent with a reduction in the expenditure ratio and an accelerating decline in the debt ratio. At the same time, a significant programme of public investment is expected to be implemented.

The 2003 update projects real GDP growth to accelerate from an estimated 4.0% in 2003 to 4.2% in 2004 and decelerate somewhat afterwards, averaging 4% in the period 2004-2006 from an expected average rate of growth of 3.8% in the 2002 update of the stability programme. Employment growth is projected to decelerate from 1.7% in 2004 to 1.2% on average in 2005-2006. Inflation is expected to decline gradually, the private consumption deflator decelerating to 2.6% by 2006 from 3.5% in 2004. On the basis of currently available information, the macroeconomic scenario in the update seems optimistic and risks are skewed to the downside. In particular, the evolution of potential growth over the medium term reflects favourable assumptions about the contribution of capital formation. Moreover, in a context of such robust demand, pressures on costs and prices can be stronger than expected in the update, putting even more at risk the control of some government expenditure items, such as the wage bill, and endangering the external competitiveness of the economy.

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[5] OJ L 209, 2.8.1997.

The update targets a general government deficit of 1.2% of GDP in 2004 as against an expected deficit of 1.4% of GDP in 2003. In cyclically-adjusted terms, based on Commission calculations according to the commonly agreed methodology, there is no improvement in 2004 as the cyclically-adjusted deficit remains at 1.7% of GDP. For 2005 and 2006, the projections are for headline deficits of 0.5% of GDP and balance in 2006. In cyclically-adjusted terms, the corresponding deficits amount to 1.2% and 0.9% of GDP respectively. In the light of the high debt ratio, the overall proposed adjustment is quite limited while a more balanced "policy mix" would call for a stricter stance of fiscal policy and an effective use of the opportunity provided by favourable growth prospects.

Although the budgetary targets in the programme seem to provide a sufficient margin against breaching the 3% deficit threshold with normal macroeconomic fluctuations throughout the programme period, there are risks linked to the macroeconomic scenario, the likely underestimated deficit in 2003 and the lack of information on envisaged measures to contain primary expenditures. Anyhow, the Stability and Growth Pact medium-term objective of a budgetary position of close-to-balance or in surplus will not be achieved over the programme period.

The government debt ratio is projected to gradually decline from 101.7% of GDP in 2003 to 90.5% of GDP in 2006. Developments in the debt ratio are likely to be less favourable than projected, given the risks to the deficit outcome mentioned above and possible negative developments in below-the-line operations, the latter having been a persistent source of debt accumulation in recent years.

On the basis of current policies, there is a serious risk of severe budgetary imbalances emerging in Greece in the future due to an ageing population, taking also into account the high debt ratio. Thus, the budgetary challenges posed by ageing population should be tackled through a comprehensive strategy that includes further reform of the pension system.

The economic policies as reflected in the 2003 update are not fully consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. In particular, the projected decline in the debt ratio is subject to risk and there is no clear evidence of effective control of government current primary expenditure, in particular of its inelastic components, like the wage bill and social transfers.