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COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to the definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Greece, submitted on 30 January 2009, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan").
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of

¹ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

² Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows: "The Council considers that the consolidation envisaged is subject to risks as the underlying macroeconomic scenario is favourable and the revenue-enhancing measures are not fully spelled out after 2008. Also, the reliance on results from the fight against tax evasion is significant and only partly backed up with reforms in tax collection. In addition, the planned cutbacks in some expenditure items (as a share of GDP) are not substantiated by specific measures and partly offset by plans to increase social payments. Ensuring a strong fiscal consolidation path would help address the imbalances of the Greek economy, notably persistent inflation, competitiveness losses and a large external deficit". In the light of in particular the level of debt which remains among the highest in the euro area, the Council invited Greece to "carry-out the envisaged adjustment towards the MTO, reduce the debt-to-GDP ratio accordingly, and use any budgetary over-performance to speed up the consolidation process to reach the MTO within the programme period", "to pursue the ongoing reforms of tax administration and continue improving the budgetary process by increasing its transparency, spelling out the budgetary strategy within a longer time perspective and effectively implementing mechanisms to monitor, control and improve the efficiency of primary expenditure" and "to improve the long-term sustainability of public finances by achieving the MTO, continuing the on-going reforms in the healthcare system and reforming the pension system; updated long-term projections for age-related expenditure should be produced as soon as possible".

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On the updated stability programme of Greece, 2008-2011

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 coordination of economic policies³, and in particular Article 5(3) (for SP) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [10 March 2009] the Council examined the updated stability programme of Greece, which covers the period 2008 to 2011⁴.
- (2) Greece has experienced strong economic growth at 4% per year over the current decade. In parallel, domestic and external macroeconomic imbalances have widened considerably, which has led to very high public and foreign debt. In the light of the impact of the ongoing global economic and financial crisis on the Greek economy, the implied re-pricing of risks puts further pressure on the debt burden. According to the Commission services' January 2009 interim forecast, GDP growth slowed down in 2008, to 2.9% in real terms and is expected to decelerate strongly in 2009, but remain positive. With the general government deficit having remained above the 3% of GDP threshold since 2007⁵, and one of the highest public debt in the EU, Greece has no

³ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

⁴ On 6 February 2009 the Greek authorities submitted an addendum to the programme, providing clarifications on changes on the budgeted tax enhancing measures and the planned budgetary process reform. The addendum does not introduce any change in the fiscal strategy outlined in the stability programme, while both the macroeconomic scenario and the budgetary projections remained unchanged.

⁵ According to data notified by the Greek authorities in October 2008 and validated by Eurostat, the general government deficit reached 3.5% of GDP in 2007, thus exceeding the 3% of GDP reference

room for fiscal impulse, so as not to jeopardise further the long-term sustainability of public finances and the competitiveness position of the country. As a result, no fiscal stimulus package is envisaged. The Greek authorities have put forward in the 2009 budget law some measures, aiming at safeguarding social cohesion, including benefits to low-income households. Greece is facing the challenge to achieve substantial fiscal consolidation, while improving the quality of public finances and correcting the factors behind the large domestic and external imbalances of the economy.

- (3) The macroeconomic scenario underlying the programme envisages that real GDP growth will fall from 3% in 2008 to 1.1% in 2009 before picking up again to 1¾% on average over the rest of the programme period. Assessed against currently available information⁶, the macroeconomic scenario is based on favourable growth assumptions for 2009 and thereafter. In particular, private consumption and to a lesser extent investment growth, are projected in the programme to remain robust, on the back of favourable employment growth and an optimistic assessment of the impact of recent initiatives to support investment and enhance the absorption of EU Structural Funds. Moreover, the decline in Greece's trading partners' economic activity and the weakening international trade prospects entail considerable downside risks to the macroeconomic scenario of the programme, reflecting mainly the vulnerability of the shipping and tourism sectors to the current crisis. The programme's projections for inflation appear to be realistic, while the evolution of the external imbalances in the medium term is somewhat favourable.
- (4) For 2008, the general government deficit is estimated at 3.7% of GDP in the update (including 0.4% of GDP deficit-decreasing one-off measures), which is ¼ of a percentage point higher than the projection in the Commission services' January 2009 interim forecast. This compares with a target of 1.6% of GDP set in the previous update. This deviation of 2 percentage points reflects both revenue shortfalls and expenditure overruns. In particular, revenue is estimated at about 1 percentage point of GDP lower than budgeted, mainly stemming from the lower-than-expected yield of the revenue-enhancing measures implemented in 2008. Expenditure overruns amount to around another 1 percentage point of GDP, resulting mainly from primary current expenditure slippages and, in particular, higher-than-expected public consumption and wages.
- (5) According to the update, the deficit target for 2009 is set at 3.7% of GDP (including 0.5% of GDP deficit-decreasing one-off measures), in line with the Commission services' interim forecast. Compared with the budgetary target set in the 2009 budget law, approved by the Parliament on 21 December 2008, it represents an upward revision by 1¾ percentage points of GDP. The new budgetary target takes into account the worse-than-expected budgetary outturn in 2008. It also reflects a more prudent projection for total revenue, which is revised downwards by 1 percentage point of GDP, while public expenditure is revised up by 0.4 percentage point of GDP. Nevertheless, the revenue ratio is still projected to grow by almost 1 percentage point of GDP in 2009, on the back of the tax revenue-enhancing package adopted in

value, In view of the notified breach of the Treaty reference value, the Commission prepared on 18 February 2009 a report under Article 104.3 of the Treaty.

⁶ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

September 2008 and included in the 2009 budget law. To ensure meeting the revised targets, the update envisages a number of measures, on top of those included in the 2009 budget law, aiming at constraining primary public expenditure and rationalizing the public expenditure management. These new measures, which should be adopted in the course of 2009, are not clearly detailed in the programme. The overall stance of fiscal policy will be broadly neutral in 2009.

- (6) The budgetary strategy outlined in the programme aims at reducing the structural deficit from 4.5% of GDP in 2008 to 4.3% in 2009 and 2.2% by 2011, while the medium term objective (MTO) of a balanced budget in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures) is not projected to be attained within the programme horizon. After targeting 3.7% of GDP in 2009, the headline deficit will decline over the programme period to 3.2% of GDP in 2010 and 2.6% by 2011. Similarly, the primary balance will reach a surplus of 1.7% of GDP by 2011, which compares with 0.8% in 2009. In structural terms, this would amount to an improvement of $\frac{3}{4}$ percentage points of GDP on average. Budgetary consolidation in 2010 and 2011 is mainly based on an ambitious expenditure retrenchment, which is however, not fully backed with concrete measures. Government gross debt, estimated at 94.6% of GDP in 2008, is projected to exceed 96% of GDP in 2009 and 2010, before returning to 94 $\frac{3}{4}$ % in 2011. Apart from the rise in the deficit and the decline in GDP growth, a significant stock-flow adjustment contributes to the rise in the debt ratio in 2009.
- (7) The budgetary outcomes are subject to significant downside risks. In particular, the underlying macroeconomic scenario is based on favourable growth assumptions. Risks in 2009 are also linked to possible slippages in the implementation of the revised 2009 budgetary target, especially when taking into account track record of recurrent expenditure overruns and revenue shortfalls. From 2010 onwards, risks stem from the lack of information on the measures to support the envisaged consolidation, particularly on the expenditure side. Moreover, the envisaged cuts in some expenditure categories appear ambitious. Risks associated with the projected evolution of the debt-to-GDP ratio also appear to be on the upside, stemming from the risks attached to the deficit projections. These risks may be compounded by uncertainty about the stock-flow adjustments in which, as in the past, the programme does not provide information on components. In addition, possible debt increasing financial transactions within the framework of the financial sector support package may put further upward pressure to the debt-to-GDP ratio. However, with no reference to this financial package, the programme does not take into account its potential impact on the debt developments.
- (8) Long-term projections of pension expenditure according to the commonly agreed method are under preparation; the long-term budgetary impact of ageing is likely to be well above the EU average. The budgetary position in 2008 as estimated in the programme, which is worse than the starting position of the previous update, would compound the long-term budgetary impact of an ageing population. Moreover, the current level of gross debt is well above the Treaty reference value. Reducing it requires achieving high primary surpluses for a long period of time. Maintaining high primary surpluses over the medium term and further reforming the pension system aiming at containing the likely significant increase in age-related expenditures would contribute to reducing the high risks to the long-term sustainability of public finances. The above-mentioned risks from financial sector stabilisation schemes put in place by Greece could have a potential negative impact on the long-term sustainability of public

finances, primarily via their impact on government debt, although some of the cost of the government support could be recouped in the future.

- (9) The medium-term budgetary framework remains weak, characterised by a poor track record. Fiscal developments in Greece reflect insufficient control of public expenditure, while revenue projections have proven to be systematically overoptimistic. Moreover, structural and endemic problems related to the recording of Greek government accounts, have also been detrimental for timely and effective revenue and expenditure control. The programme envisages the continuation of the ongoing budgetary reform and further progress with the implementation of programme budgeting, with a view to improving the public expenditure monitoring and management, increasing transparency and introducing a multi-year planning perspective in the budgetary process. The full implementation of the budgetary process reform, however, is scheduled for 2012.
- (10) In response to the financial crisis, the Greek government has adopted a number of measures to ensure the stability of the financial sector, including the measure of deposit guarantees, up to EUR 100,000. The package of measures consists of a recapitalisation scheme, making available new capital to credit institutions in exchange of preferential shares', a guarantee scheme, covering new debt with a maturity between three months and three years, and a securities scheme, providing government bonds to eligible credit institutions and enhancing their access to liquidity, in particular with the ECB. The overall amount of the package stands at EUR 28bn (around 10% of GDP).
- (11) According to the programme, fiscal policy is geared towards restoring investor confidence and addressing the macroeconomic imbalances. The Greek government, given the lack of room for fiscal manoeuvre, has not adopted a short-term stimulus package in response to the economic slowdown which, in view of the large economic imbalances, would be in line with the EERP. The programme foresees a number of structural measures, including sectoral specific measures in the tourism sector, without direct budgetary impact, such as those aimed at sustaining employment, enhancing business investment including private-public partnerships, boosting lending to SMEs and improving EU funds absorption. The update also includes a series of other structural reform measures, which are part of the longer-term strategy for improving the quality and sustainability of public finances, such as the reform in the public expenditure management and control and the implementation of the recently adopted pension reform. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.
- (12) Greece has adopted a consolidation programme with the aim of limiting the extent of the fiscal deterioration in 2009 and reducing the general government deficit below the 3% of GDP threshold by 2011. On the basis of the change in the (recalculated) structural balance, the overall fiscal stance is broadly neutral in 2009 and restrictive in 2010. More specifically, the programme targets for 2010 a structural adjustment of 1½ percentage points of GDP and a further structural improvement of some ½ in 2011. However, taking into account risks to the budgetary plans, the envisaged consolidation may fall short of the targets and the headline deficit remain above the 3% of GDP reference value. In light of the large domestic and external imbalances of the Greek economy, the pace of the fiscal adjustment is insufficient and not fully backed by concrete permanent measures in 2010 and 2011, especially on the expenditure side.

Finally, taking into account the risks to the debt projections mentioned above, the debt-to-GDP ratio may be increasing over the whole programme period, mainly reflecting insufficient progress in the reduction of the government deficit.

- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data⁷.

The overall conclusion is that the programme envisages reducing the budget deficit over the medium-term, but falls short to address timely and effectively the structural imbalances of the Greek economy and reverse the upward trend of public debt. Although the consolidation strategy beyond 2009 relies on permanent expenditure restraint and increasing tax revenues, the programme does not spell out concrete measures to back fully the planned budgetary adjustment in 2010 and 2011. Moreover, against the background of a sharp deterioration in the global economic environment, the budgetary strategy is also subject to significant downside risks, with the growth assumptions underlying the macroeconomic scenario of the programme being favourable. Consolidation relies to some extent, on the results from the fight against tax evasion, which is only partly supported by reforms in tax administration, while the planned cutbacks in expenditure are partly offset by plans to increase wages and social transfers. Strengthening the fiscal consolidation path, based on permanent measures to control current primary expenditure including public wages, would be paramount to achieve sound and sustainable public finances in Greece. Moreover, the envisaged adjustment in the programme is only partly supported by structural policies to improve the quality of public finances. The structural nature of the factors underlying competitiveness losses and the widening external imbalances urgently requires the implementation of bold structural reforms. In the long term, the level of debt which remains among the highest in the EU, coupled with the projected increase in age-related spending, will also affect negatively the long term sustainability of public finances.

In view of the above assessment, Greece is invited to:

- (i) strengthen substantially the fiscal consolidation path already in 2009, especially if economic conditions turn out to be better than expected in the programme, through well-specified permanent measures curbing current expenditure, including a prudent public sector wage policy, thereby contributing to necessary reduction in the debt-to-GDP ratio;
- (ii) ensure that fiscal consolidation measures are also geared towards enhancing the quality of public finances, within the framework of a comprehensive reform programme, in the light of the necessary adjustment of the economy, with a view to recovering competitiveness losses and addressing the existing external imbalances;
- (iii) implement swiftly the policies to reform the tax administration and improve the functioning of the budgetary process by increasing its transparency, spelling out the budgetary strategy within a longer time perspective and set up mechanisms to monitor, control and improve the efficiency of primary current expenditure;

⁷ In particular, general government expenditure by function and information on debt developments and the components of stock-flow adjustment (differences between cash and accruals, net accumulation of financial assets, valuation effects and other), liquid financial assets and net financial debts are not provided.

- (iv) in view of the mounting level of debt and the projected increase in age-related expenditure, improve the long-term sustainability of public finances, by continuing the on-going reforms in the healthcare and pension system.

Greece is also invited to improve compliance with the data requirements of the code of conduct.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	SP Jan 2009	4.0	3.0	1.1	1.6	2.3
	COM Jan 2009	4.0	2.9	0.2	0.7	n.a.
	SP Dec 2007	4.1	4.0	4.0	4.0	n.a.
HICP inflation (%)	SP Jan 2009	3.0	4.3	2.6	2.5	2.4
	COM Jan 2009	3.0	4.3	2.5	2.7	n.a.
	SP Dec 2007	2.9	2.8	2.7	2.6	n.a.
Output gap ¹ (% of potential GDP)	SP Jan 2009	2.2	1.9	0.3	-0.8	-1.0
	COM Jan 2009 ²	3.0	2.8	0.5	-1.2	n.a.
	SP Dec 2007	1.3	1.2	1.2	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	SP Jan 2009	-12.1	-12.8	-11.4	-10.8	-10.0
	COM Jan 2009	-12.1	-11.7	-11.2	-11.6	n.a.
	SP Dec 2007	-12.8	-12.7	-12.5	-12.2	n.a.
General government revenue (% of GDP)	SP Jan 2009	39.9	40.0	41.0	41.1	41.2
	COM Jan 2009	40.0	39.9	40.8	40.0	n.a.
	SP Dec 2007	39.9	41.1	41.7	42.3	n.a.
General government expenditure (% of GDP)	SP Jan 2009	43.4	43.7	44.7	44.3	43.8
	COM Jan 2009	43.4	43.4	44.5	44.2	n.a.
	SP Dec 2007	42.6	42.7	42.5	42.3	n.a.
General government balance (% of GDP)	SP Jan 2009	-3.5	-3.7	-3.7	-3.2	-2.6
	COM Jan 2009	-3.5	-3.4	-3.7	-4.2	n.a.
	SP Dec 2007	-2.7	-1.6	-0.8	0.0	n.a.
Primary balance (% of GDP)	SP Jan 2009	0.6	0.3	0.8	1.2	1.7
	COM Jan 2009	0.6	0.6	0.6	0.0	n.a.
	SP Dec 2007	1.2	2.4	3.1	3.8	n.a.
Cyclically-adjusted balance ¹ (% of GDP)	SP Jan 2009	-4.4	-4.5	-3.8	-2.8	-2.2
	COM Jan 2009	-4.8	-4.7	-3.9	-3.7	n.a.
	SP Dec 2007	-3.4	-2.4	-2.3	n.a.	n.a.
Structural balance ³ (% of GDP)	SP Jan 2009	-4.4	-4.5	-4.3	-2.8	-2.2
	COM Jan 2009	-4.6	-5.0	-4.7	-3.7	n.a.
	SP Dec 2007	-3.1	-2.4	-2.3	n.a.	n.a.
Government gross debt (% of GDP)	SP Jan 2009	94.8	94.6	96.3	96.1	94.7
	COM Jan 2009	94.8	94.0	96.2	98.4	n.a.
	SP Dec 2007	93.4	91.0	87.3	82.9	n.a.

Notes:

¹ Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 3.2%, 2.7%, 2.8% and 2.5% respectively in the period 2008-2011.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2008 and 0.5% in 2009 (all deficit-reducing) according to the most recent programme and 0.4% of GDP in 2008 and 0.8% in 2009 (all deficit-reducing) in the Commission services' January interim forecast.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations