

## POST-OLYMPICS LANDING WELL HANDLED

As an effect of the Olympic Games, GDP growth fell to 3.7% in 2005, after 4.7% in 2004. However, the post-Olympics adjustment in investment is now coming to an end. Growth in consumer spending is expected to remain strong and the upswing in tourism should continue. The only blot is that the reining in of public expenditure will have a negative impact on growth. In the final analysis, the increase in GDP will reach 3.8% in 2006. It will drop back to 3.5% in 2007, due to the monetary tightening now underway in the EMU and the slowdown in household credit, which is currently rising at an excessively high pace.

### Demand will remain the driving force of growth

The Greek economy continued to grow solidly in 2005. It achieved 3.7%, compared with 1.4% for the euro zone on average. A one-point rise in the VAT rate in April 2005 did not dampen a smart increase in private consumer spending, underpinning the tenacious growth: private spending was at +3.8% in 2005, after +4.4% in 2004.

Household expenditure will continue to be sustained in 2006 by accommodating monetary conditions. While it is true that with the ECB's gradual tightening of monetary policy (the refi rate lifted to 2.75% in June, then to 3% at the end of the year), the short-term rates will stop being negative in real terms around the end of 2006. However, the scope of the tightening will not be enough to break the strength of borrowing. There is therefore no reason to doubt that the strong expansion of loans to the private sector<sup>1</sup> will continue. Nonetheless, it should drop off a little, due to the rise in the cost of credit, and also, quite likely, stricter lending conditions by banks.

Expenditure will be supported by gains in purchasing power, which will remain substantial, given the national wage agreement signed at the start of April by the unions and the government. The wage agreement allows for a rise of more than 11% in wages in the private sector over the 2006-2007<sup>2</sup> period. Overall, consumer spending is likely to slow down a little, but will still post growth in volume terms near 3% in 2006 and 2007.

### Export supported by tourism

As concerns external demand, Greece will continue to capitalise on the Olympic Games effect, which gave new impetus to tourism (which represents more than 15% of GDP and nearly 20% of jobs). In 2005, the tourism industry began to reap the benefits of the positive fallout of the Olympics (modernised infrastructure, brand image, etc.). The number of visitors grew by more than 10%. With the strong continuation of the tourism industry, along with shipping, exports of services should grow appreciably in 2006.

### Investment set to rise

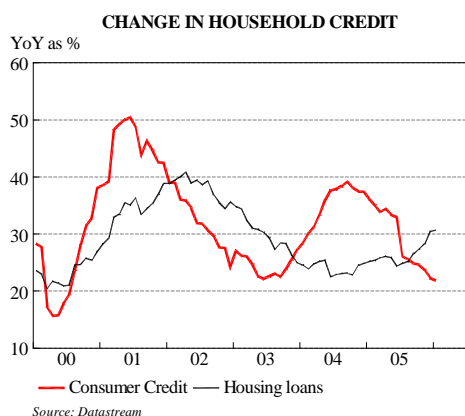
The slowdown in growth in 2005 was greatly affected by the reduction in public investment, in particular, which was reduced by nearly 20% after the Olympic Games. This adjustment is now behind us and we expect to see capital expenditure join in the growth in the Greek economy. The leading reason is – as stated – that both domestic and foreign demand are expected to remain sturdy. Secondly, several other factors will have a positive influence:

- the slashing of corporate income tax levels, from 35% in 2004 to 32% in 2005, 29% in 2006, and 25% in 2007;
- the new private investment incentive law;
- the increase in the absorption of European structural funds;
- the implementation of the structural reforms passed in 2005, which also create a more favourable environment for corporations and for investment.

The increase in investment could amount to 4% or 5% in 2006 and 2007.

### The influence of reductions in public expenditure

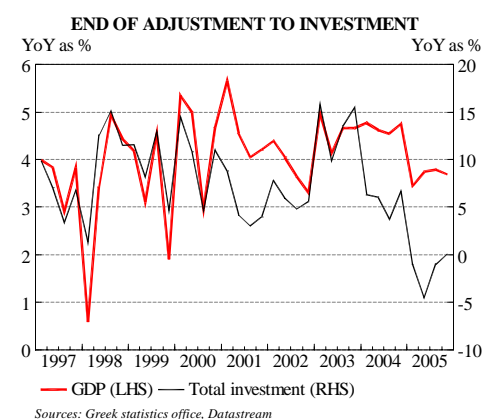
The reductions in public spending will have a negative effect on growth for the next few years. In 2005, the budgetary consolidation was facilitated by the disappearance of the charges associated with the Olympic Games, which reduced the deficit by more than 1 point of GDP. Additionally, current expenditure was contained and revenues increased by a rise in indirect taxation (principally the VAT).



INTEREST RATES ON NEW LOANS TO HOUSEHOLDS \*

	2003	2004	2005	Feb-06
Fixed consump.	9.28	10.62	9.84	8.86
Variable consump.	10.57	9.55	8.47	8.06
Fixed housing	6.52	6.09	5.91	5.63
Variable housing	4.51	4.30	4.06	3.89

\* Loans are mostly variable-rate



<sup>1</sup> Credit to the private sector was up by 16.3% year-on-year as at January 2006: up 7.6% yoy for corporations and up 27.3% for households (mortgage loans: up 30.7%, consumer credit: +21.8%).

<sup>3</sup> In three phases: 2.9% on 1 January 2006, then 2.9% on 1 September 2006, and lastly 5.1% on 1 May 2007.

As things turned out, though, the authorities did not manage to achieve their initial objective of a deficit under 4% of GDP. That deficit has reached 4.5% of GDP in 2005, according to figures approved by Eurostat at the end of April, as against 6.9% in 2004.

The Greek authorities have promised their European partners to bring down the deficit to within the 3% threshold in 2006 (2.6%, to be precise). The budget again emphasised containment of expenditure, particularly by restricting the rise in the public service's wages bill<sup>3</sup>. On the revenue side, a value-added tax at 19% was introduced as of 1<sup>st</sup> January on new construction. Meanwhile, the target values comprising the tax basis for the assessment of property sales were revalued. The government also hopes to improve tax collection by emphasising its "war" on fraud and tax evasion. These measures are bearing fruit, as evidence by the 18.6% year-on-year rise in State receipts in the first quarter.

In an effort to reduce the public debt (107.5% of GDP in 2005), the government intends to pursue its privatisation programme, aiming to bring in € 1.65 billion (0.9% of GDP) in 2006. The banking sector is particularly involved with the sale of part of the shares that the State still owns in Emporiki, a partial sale of the Agricultural Bank (ATE) and the offering of the Postal Savings Bank on the market.

### *In the long term, continuation of high growth will depend on the implementation of structural reforms*

In the medium-to-long term, the Greek economy will continue to catch up with the euro zone average. The speed of the progress in this direction could, however, depend on the extent of the structural reforms undertaken.

It is clear that the government accelerated the pace of reforms in 2005:

- a legal environment was defined for setting up public-private partnerships (PPP);
- reforms were implemented in the retail sector (opening hours extended<sup>4</sup>, conditions for sales defined, etc.);
- reforms made to working hours: the cost of overtime was reduced, modulation of weekly working hours (introduction of year-long working-hours accounts, spreading of time over 4 months);
- the status of public enterprises was reformed;
- bank employees' pension funds were reformed<sup>5</sup>.

These reforms were accompanied by repeated incidents of labour unrest in 2005 and the start of 2006 (sailors' strike in February, general strike on 15 March, Athens garbage collectors' strike in the first half of April, etc.). No doubt this year the government will make every effort to implement these reforms, rather than introducing a new round of measures. And meanwhile, the race in the local government elections to be held in the autumn is looking very close.

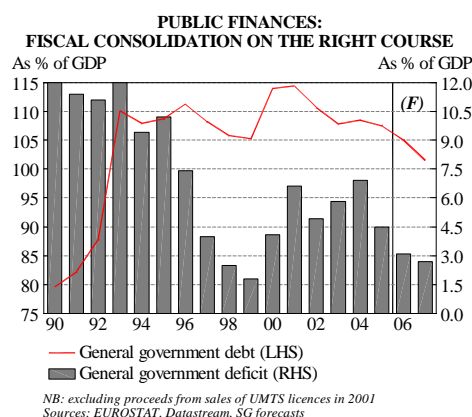
Beyond that time, the authorities may attempt to reform the centralised system of wage negotiations. However, most of all, they will want to come up with the reform to the pension system. According to demographic forecasts, Greece's population will age rapidly from 2010 onwards, so that expenditure on pensions could comprise 25%–30 % of GDP by 2050.

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### GDP GROWTH

	04	05	06	07
Priv. consump.	4.4	3.8	3.5	3.3
Pub. consump.	3.9	3.0	1.5	1.5
Investment	5.7	-1.6	4.7	4.0
Change in inventory*	0	-0.1	0	0
Net exports*	-0.5	1.1	-0.1	-0.1
<b>GDP</b>	<b>4.7</b>	<b>3.7</b>	<b>3.8</b>	<b>3.5</b>

\* contribution to GDP growth



<sup>3</sup> The agreement referred to in note 2 on the previous page gives public enterprises a 7% rise in 2006-2007 (+3% in 2006, +4% in 2007). Given inflation, this is practically a freeze in real wages. Since that deal was made, there have been calls for strikes in the public enterprises.

<sup>4</sup> The banking industry is also affected by the expansion of opening hours.

<sup>5</sup> The law of 30/09/2005 specifying the merger of the funds managed by the banks for their employees with a single government-run fund.

As a %	2003	2004	2005	2006 (f)	2007 (f)
Real GDP	4.6	4.7	3.7	3.8	3.5
Consumer prices	3.5	3.0	3.5	3.1	2.9
Unemployment rate	9.7	10.5	9.9	9.3	8.7
Current acc. bal. (% GDP)	-7.1	-6.2	-8.0	-7.7	-7.5
Pub. sector bal. (% GDP)	-5.8	-6.9	-4.5	-3.1	-2.7

## WORTH WATCHING

**Olympic Airlines on the brink of collapse?** The European Union decided to take Greece to the European Court of Justice for not complying with a previous order calling for it to take back € 161 million in illegal State aid paid to Olympic Airways (which restarted business in 2003 under the name of Olympic Airlines) between 1998 and 2002. This will be no help to the Greek government in its current efforts to find a solution to save the company founded by Aristotle Onassis in 1956. The authorities acknowledge that the company is not viable in its present state, but promise that it will continue to operate at least until September-October. After that date, it is hoped that a public-private company dominated by private investors will be created. However, it is quite likely that the Commission will oppose any proposal to make a contribution of public funds to prop up the company, vital though that may be.