

# THE GREEK PUBLIC FINANCE SCANDAL

*The Greek authorities have consistently hidden the extent of their budget deficit since 2000. The risk of the government defaulting on its debt would appear to be limited but, despite the removal of the Olympic Games burden, belt tightening is inevitable and will worsen the economic slowdown in 2005.*

## Greece embellished its public accounts

When it came to power in March, the conservative party launched an audit of the country's finances –in collaboration with Eurostat– to remove any doubt over the figures published by the previous socialist government. Even before the final results were known, the 2003 deficit had been revised from 1.7% to 3.2% of GDP (in May), prompting the Ecofin Council to open an excessive deficit procedure on July 5th. In addition, the 2004 forecast was raised to 4% GDP in the summer due to the cost of hosting the Olympic Games.

Unfortunately, the revisions did not end there. The scale of the problem started to sink in at the informal Ecofin Council meeting on September 10th and 11th, when the Greek finance minister provided his counterparts with the results of the audit, confirmed by Eurostat on September 23rd. The latest figures available show that the Greek budget deficit consistently exceeded 3% of GDP between 2000 and 2003: 4.1% rather than 2.0% in 2000, 3.7% rather than 1.4% in 2001 and 2002, and 4.6% rather than 1.7% in 2003.

According to Eurostat, the extent of the discrepancy is due to:

- a downward revision to tax revenues (mainly VAT) in 2003;
- a downward revision to payments received from EU institutions in 2003;
- under-recording military expenditure between 2000 and 2003;
- an overestimate of the social security fund surplus between 2001 and 2003;
- under-recording of interest between 2000 and 2003.

Public debt figures were also revised considerably (see Table). The difference is mainly attributable to:

- underestimated outstanding, primarily in relation to bonds with capitalised interest;
- an overestimate of consolidating assets of social security.

## The default risk is extremely low...

The Greek public accounting scandal will probably have a limited impact in the short term. The announcement of revisions and the size of these has not affected the euro and has had a negligible influence on the spread between Greek and German 10-year bond yields. This has increased by just three euro cents, stretching from an average of 17bp before the Eurostat announcement to 20bp after. This tends to prove that the market assesses the risks to the eurozone as a whole and not individual member states when considering government debt securities<sup>1</sup>. In other words, the market is expecting Greece to remain part of the eurozone and European solidarity to save the day in the event of a default. Although the pre-2000 figures on which Greece's entry to the EMU was assessed were not included in the audit and could also bring an unpleasant surprise<sup>2</sup>, it seems highly unlikely that EMU membership would be in doubt. A suspension of European funds – as requested by Germany in particular – is also unlikely even though such a consequence is specifically mentioned in the regulations. However, the threat exists and will be used to ensure that the Greek government takes the necessary steps to bring the deficit back below 3% of GDP.

## ...but a medium-term risk to growth as fiscal austerity takes effect

In reality, the risk is not so much from the government defaulting on its debt as the extent of imminent belt tightening and the effect this has on growth. At the end of September, the Greek government presented an ambitious draft budget aimed at lowering the budget deficit from 5.3% of GDP this year (by its own forecasts) to 2.8% next year. Its task will be made easier by the fact that there is almost nothing left to pay on the Olympic Games, automatically knocking one GDP point off the deficit. The deficit reduction plan then assumes a 7.4% increase in total revenues (versus +8.5% in 2004) on the back of continued strong growth – government estimate of 3.9% – and the hike in some indirect taxes. Some possibilities include: higher alcohol and tobacco duty, raising VAT from 8% to 18% on some luxury goods, and increasing the cost of vehicle tax discs.

## SUBSTANTIAL EMBELLISHMENT OF THE PUBLIC ACCOUNTS

As % of GDP	00	01	02	03	04*
Deficit	2.0	1.4	1.4	1.7	1.2
<i>Deficit</i>	<i>4.1</i>	<i>3.7</i>	<i>3.7</i>	<i>4.6</i>	<i>5.3</i>
Debt	106.2	106.9	104.7	102.4	97.7
<i>Debt</i>	<i>114.0</i>	<i>114.7</i>	<i>112.5</i>	<i>109.9</i>	<i>112.1</i>

In black: figures before revisions (March 2004)

In red: figures after revisions (Sept. 2004)

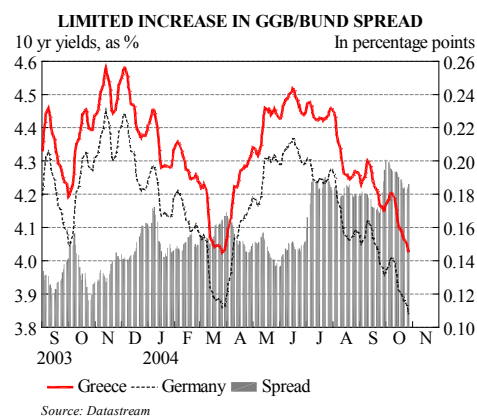
Sources: Eurostat, \* government forecasts

Sovereign debt rating (long-term)

S&P A+ (negative credit watch since September 13th)

Fitch A+ (negative credit watch since September 29th)

Moody's A1 unchanged



<sup>1</sup> Such a situation has already arisen when S&P downgraded Italy's debt rating in July.

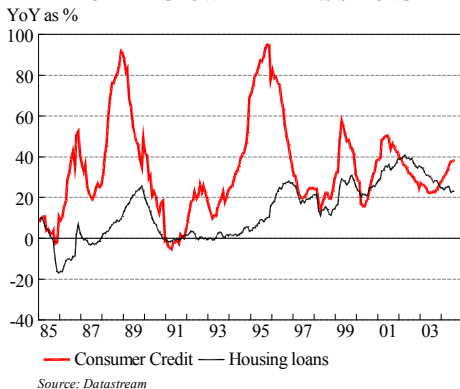
<sup>2</sup> According to the latest information available, the authorities feel that the reintegration of military expenditure will have little impact on the public-sector balance in 1997 and 1998, whereas the 1999 deficit will be revised upwards from 1.8% to 2.4%-2.5%.

## GDP GROWTH

	02	03	04	05
Private spending	2.0	4.2	3.6	3.0
Public spending	3.8	-2.5	1.5	1.3
Investment	4.5	13.2	4.5	3.0
Change in inventories*	0.2	-0.1	0.1	-0.1
Net exports*	-0.7	-1.3	-0.3	-0.1
<b>GDP</b>	<b>3.6</b>	<b>4.5</b>	<b>3.7</b>	<b>2.9</b>

\*contribution

## CREDIT GROWTH REMAINS STRONG



<sup>3</sup> Civil service wages rose 9.5% in 2004 compared to an inflation expected at approximately 3%. All sectors combined, wage growth will probably come out at 6%-6.5%.

<sup>4</sup> The upturn in consumer credit growth since the middle of last year follows the Greek central bank's decision to remove the individual borrowing ceilings.

The government is also relying on the income from the repatriation of capital illegally held abroad. A law to this effect was passed in July 2004, similar to the Italian model in 2002. Above all, though, spending will be capped: primary expenditure (excluding interest charges on debt) is set to increase by 5.3%, compared with 14.6% in 2004. For example, military spending will be cut by EUR 400m (around a fifth of a GDP point), the public sector wage bill will be limited by an almost complete halt to recruitment, while pay increases (and pension increases) will be more in line with inflation<sup>3</sup>. Measures will also be taken to reduce debt with, in particular, a privatisation programme worth EUR 1.5bn: the leading contenders will be Olympic Airlines and the Greek Postal Savings Bank (Tahydromiko Tamieftirio).

Despite all this ambition, we think the Greek deficit will again exceed 3% of GDP in 2005 – our forecast is 3.8%. First of all, because growth is floating back down after the Olympic Games and will struggle to make it above 3%, in contrast to the government's projection of nearly one point higher. Also, because the authorities do not appear to have renounced the tax cuts for the poorest households and, in particular, businesses. Under the terms of a three-year plan to reduce corporate tax from 35% to 25%, large enterprises should see their tax rate fall from 35% to 32% in 2005 and smaller enterprises, which already pay less tax, from 25% to 24%. This will make it even more difficult to meet the revenue targets included in the 2005 budget.

Overall, the economy will probably be able to support the restrictive impact of the adjustment to public finances. The measures introduced are merely likely to slow the economy a little more than was already expected after the end of the Olympic Games. The components that will weigh most heavily on GDP growth will obviously be public spending and construction investment. However, private consumption will also slow, as:

- when the public-sector deficit and public debt widen, agents increase their savings and reduce spending ahead of expected tax hikes (Ricardian equivalence);
- disposable income will grow less quickly (in real terms, it will probably increase by over 4% this year) due to weaker growth in nominal wages.

Nevertheless, household expenditure is again set to be the main growth driver and will probably rise by around 3% after a 3.6% increase this year. This will be primarily due to strong credit growth. Obviously, mortgage lending could continue to slow as the property market confirms its weaker trend (house prices have been slowing since the beginning of 2004), but consumer credit should register further sustained growth<sup>4</sup> as borrowing conditions remain generous (short-term interest rates will be negative in real terms for a good part of 2005). In addition, Greek household debt is still below the European average despite rising significantly in recent years.

However, if the Greek authorities were forced to take more drastic measures (sharp VAT hike, for example), consumer spending would be affected and Greece could suffer the same fate as Portugal in 2002/03: after registering a record deficit of more than 4% of GDP in 2001, Portugal had to present an ambitious fiscal austerity plan in mid-2002 to return within the terms of the growth and stability pact (VAT increase, accelerated recovery of tax arrears, introduction of motorway toll booths, asset sales, civil service pay freezes, etc.), plunging the economy into recession.

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## WORTH WATCHING

**Next deadline.** At the Ecofin Council meeting on October 21, the eurozone economic and finance ministers solemnly declared that revisions of the type made to the Greek public accounts will not be tolerated in future. For now, though, they have not decided on any punishment but have given the Greek authorities until the next meeting in November to present revised figures for the years before 2000, as well as a description of the intended measures that will bring the country back into line.

As %	2001	2002	2003	2004(f)	2005(f)
GDP, by volume	4.3	3.6	4.5	3.7	2.9
Consumer prices (CPI)	3.7	3.9	3.4	2.9	3.2
Unemployment rate	10.5	10.2	9.5	9.0	8.7
Curr. acc. bal. (as % of GDP)	-8.0	-7.3	-6.4	-6.2	-6.0
Public balance (as % of GDP)	-3.7	-3.7	-4.6	-5.5	-3.8

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