8. GREECE

Rebalancing growth amidst ongoing fiscal consolidation

Note: This text and the forecast was finalised in early May, ahead of the fourth quarterly review of the Economic Adjustment Programme. It has not been updated to reflect the findings of that review.

Correcting twin fiscal and external deficits weighs on economic activity…

Following the establishment of the three-year Economic Adjustment Programme in May 2010, Greece adopted comprehensive fiscal consolidation measures. These are expected to continue to have a dampening impact on domestic demand, contributing to the correction of the twin fiscal and external deficits. In the short term, fiscal tightening will have a strong contraction impact on economic activity, on the back of cuts in public wages, an increasing tax burden and ensuing declining disposable income and public spending. However, credible fiscal adjustment efforts and determined implementation of structural reforms should boost confidence and improve sentiment.

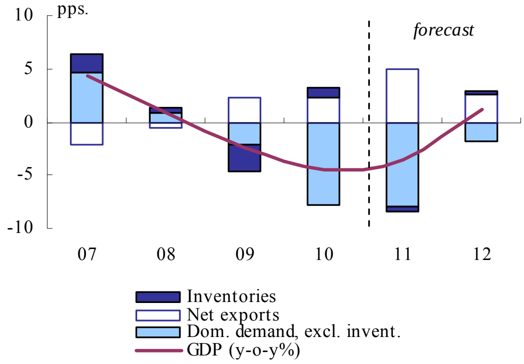
The recent downward revision of annual real GDP data for 2010 (by almost -0.3 pp. to -4.5%) will have an adverse impact on real GDP dynamics in 2011. Domestic demand remains weak, driven by income losses, the adjustment in the labour market and credit conditions. Underlying inflation, wage settlements and unit labour costs are moderating, leading to improved competitiveness. The progressive rebalancing of the economy, supportive external demand and growth-friendly reforms are expected to move the economy back to its potential growth for 2013 onwards. The inflexion point of activity is estimated to be in the last quarter of 2010.

Fiscal consolidation is dampening domestic demand further…

For a third consecutive year, economic activity is set to decline. Real GDP is expected to further fall by 3.5% in 2011 – mainly due to heavy carry-over effects coming from 2010 – while growth is expected to turn positive only in the last quarters of the year or later, with the recovery gaining momentum in after 2012.

The contraction of economic activity, reflected in further weakening labour demand, is still weighing heavily on employment, which is set to fall throughout 2011. Reduced employment opportunities in the private sector, along with the recruitment freeze and cuts in short-term contracts in the public sector, will push the unemployment rate up to above 15% through 2012. The situation in the labour market combined with declining wages should weigh on disposable income over the medium-term, dampening real demand. As a result also of continuing tax uncertainty, private consumption is projected to contract further within the forecast horizon.

Graph II.8.1: **Greece - GDP growth and contributions**



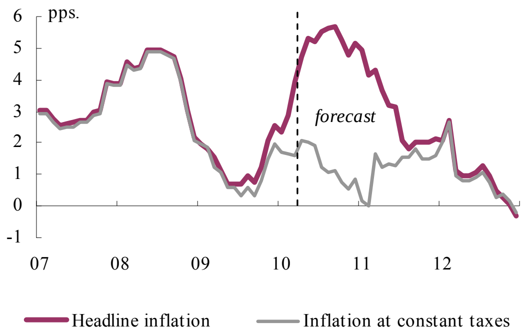
Tight liquidity and rising non-performing loans are putting strains on the banking system. In line with the slowdown of economic activity and continuing deposit outflow, the annual growth rate of credit to private sector is now slightly negative. Market pressures and high spreads have been keeping up the cost of financing and limiting private sector access to it.

Investment has been falling in recent quarters, in both housing and equipment. Public investment activity is expected to remain particularly depressed in 2011, as a result of continued fiscal consolidation efforts. Several initiatives taken in the public domain – including the acceleration in the absorption rate of the EU Structural Funds resources and the new investment law – are improving market sentiment slightly and would assist a recovery in investment as of 2012.

Inflation pressures are fading in response to demand pressures

Inflationary pressures have built up in the course of 2010, fuelled by VAT-rate rises in the programme and the increase in excise duties on alcohol, tobacco and fuel. Annual inflation in 2010 exceeded 4½% on average. A number of structural reforms targeting the existing inflexibilities in domestic markets would positively affect both inflation and inflation expectations. Looking forward, both headline and core inflation should decline, as base effects and tax effects fade out, and slack in the economy and wage moderation start feeding through.

Graph II.8.2: **Greece - Inflation and inflation at constant taxes**



The labour market is adjusting. There is evidence of strong downward pressure on labour costs, in particular non-basic pay, as the cuts in public sector wages spill over to the private sector and firms endeavour to recover competitiveness, and to absorb indirect taxes in their margins and costs. Employment contracted in 2010 and is projected to decline further by some 2½% in 2011, with the unemployment rate peaking at above 15%. On the other hand, a symmetric faster rebound of employment in the recovery phase is possible, especially if ongoing labour market reforms are implemented as planned, and the economy is successful in swiftly reallocating resources from the non-traded sectors to tradeables. Wage growth is projected to remain very subdued in line with the national collective agreement of July 2010 (for minimum wages, but which also plays a guiding role for other wages as well).

Structural reforms to improve supply prospects

The adjustment programme for Greece contains a very wide agenda of structural reforms. The aim of these reforms is to improve the supply-side conditions of the economy and increase internal competition and external competitiveness. Their implementation will facilitate the return of the economy to potential growth, while strengthening this potential. In the course of 2010, Greece adopted two batches of labour market reforms. By July, Parliament had already voted on legislative changes related to overtime pay rates, severance costs, and sub-minima wages for groups at risk, such as young and long-term unemployed. The Government and the social partners also agreed that the minimum wage would be frozen until summer 2012, and then expected to increase in line with expected euro-area inflation. The new labour law of December reforms the mediation and arbitration system and goes in the direction of moving the wage bargaining system towards the firm level, where the firms' growth strategies are decided. The establishment of special firm-level collective agreements could be a promising step towards making the wage-setting system better adapted to reflect the firms' economic conditions.

...while the recovery is entirely driven by the external sector

The contraction in domestic demand, which is expected to be sustained over the forecast horizon, is also mirrored by shrinking imports. Total exports, which started to recover already in 2010, will be further enhanced in 2011-12 by labour cost developments and favourable external demand factors as suggested by high-frequency indicators: new industrial orders for the non-domestic market are more dynamic than orders for the domestic market and the gap has been widening since mid-2010.

Exports of goods should rise by around 6% on average in 2011-12, while exports of services – in particular world trade sensitive merchant shipping and tourist receipts – should recover at a faster pace in the wake of a sustained adjustment in prices. All in all, the contribution of net exports to GDP growth should be highly positive in 2011 and 2012, due to both the accelerating pick-up in exports and the ongoing contraction in imports. The current-account deficit is expected to decline to around 8% of GDP in 2011 and to move closer to 6% of GDP in 2012. Expected competitiveness gains and the benefits from ongoing structural reforms may result in an even faster adjustment of the current-account balance.

The risks to this baseline scenario are broadly balanced. On the positive side, the contribution of net exports and investment to GDP growth may turn out to be stronger than projected, should the impact of ongoing and planned structural reforms materialise more swiftly. In particular, the rapid implementation of measures aimed at enhancing investment opportunities and attract FDI may speed up the recovery. On the negative side, given the usual uncertainty on the inflexion of the cycle, one cannot at the time of the writing exclude the possibility that the economy will take longer than expected to return to positive territory.

Ongoing fiscal consolidation to be further strengthened in 2011

The 2010 general government deficit published and validated by Eurostat stands at 10½% of GDP, 2¾ pps. of GDP higher than the ceiling established in May 2010 during the setting up of the adjustment programme. The fiscal slippage recorded in 2010 stems from the worse-than-expected revenue performance, which were only partly compensated for by lower expenditure, the sector reclassification of public enterprises and their inclusion in general government, and the significantly worse-than-estimated fiscal position of social security and local authorities. At the same time, the general government consolidated gross debt in 2010 was almost 143% of GDP, up from 127% of GDP in 2009.

The 2011 budget law foresees the implementation of fiscal consolidation measures – including those agreed in May – of some 5¾% of GDP. Around half of these measures are intended to enhance revenue, and most of them are permanent. The rest comes from spending cuts and includes retrenchment of unproductive and untargeted spending, a reduction in short-term contracts in the public sector, better targeting of universal household subsidies, and better management and use of state assets, particularly in the collection of arrears.

The implementation of fiscal policy in 2011 remains challenging. While the Government has confirmed its commitment to meet the deficit target, fully recouping the slippage of 2010, it has not yet announced any additional measures. Based on current trends and the budgetary execution so far, additional measures will be needed to ensure that the 2011 deficit ceiling is respected. The upward revision of the 2011 budget deficit forecast stems mainly from the tax revenue performance in the first quarter of 2011, the downward revision for the yield of some fiscal measures in the state budget, and a base effect from the worse-than-expected 2010 fiscal outcome.

Table II.8.1:
Main features of country forecast - GREECE

	2009			Annual percentage change						
	bn EUR	Curr. prices	% GDP	92-06	2007	2008	2009	2010	2011	2012
GDP		235,1	100,0	3,0	4,3	1,0	-2,0	**-4,5**	**-3,5**	**1,1**
Private consumption		174,0	74,0	3,1	2,8	3,2	-2,2	**-4,5**	**-6,4**	**-2,2**
Public consumption		48,4	20,6	3,1	8,2	1,5	10,3	**-6,5**	**-2,6**	**0,1**
Gross fixed capital formation		40,2	17,1	4,3	5,5	-7,5	-11,2	**-16,5**	**-16,6**	**-1,9**
of which : equipment		18,0	7,6	8,6	22,3	6,6	-11,8	**-23,5**	**-16,0**	**1,2**
Exports (goods and services)		44,3	18,8	6,3	5,8	4,0	-20,1	**3,8**	**10,7**	**6,9**
Imports (goods and services)		69,5	29,6	5,8	9,9	4,0	-18,6	**-4,8**	**-8,4**	**-3,1**
GNI (GDP deflator)		228,6	97,3	2,9	3,4	0,7	-1,5	**-4,5**	**-3,7**	**1,1**
Contribution to GDP growth :	Domestic demand			3,5	4,6	1,0	-1,8	**-7,7**	**-8,0**	**-1,8**
	Inventories			-0,1	1,6	0,5	-2,3	**0,9**	**-0,5**	**0,3**
	Net exports			-0,4	-2,0	-0,5	2,0	**2,3**	**5,0**	**2,6**
Employment				1,2	1,7	0,2	-0,7	**-2,1**	**-2,6**	**0,1**
Unemployment rate (a)				9,9	8,3	7,7	9,5	**12,6**	**15,2**	**15,3**
Compensation of employees/head				7,9	6,1	7,0	3,6	**-3,5**	**-1,0**	**0,1**
Unit labour costs whole economy				6,0	3,6	6,2	5,0	**-1,1**	**-0,1**	**-0,9**
Real unit labour costs				-0,2	0,5	2,8	3,7	**-3,5**	**-0,4**	**-1,3**
Savings rate of households (b)				-	4,4	-0,3	4,2	**-0,2**	**3,2**	**5,0**
GDP deflator				6,3	3,1	3,3	1,3	**2,6**	**0,3**	**0,4**
Harmonised index of consumer prices				-	3,0	4,2	1,3	**4,7**	**2,4**	**0,5**
Terms of trade of goods				0,0	0,8	-3,3	1,0	**4,0**	**-3,6**	**-0,9**
Trade balance (c)				-15,2	-19,5	-20,4	-16,3	**-14,2**	**-13,0**	**-12,3**
Current-account balance (c)				-6,3	-15,6	-16,3	-14,0	**-11,8**	**-8,3**	**-6,1**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-13,3	-14,9	-12,9	**-10,1**	**-6,4**	**-4,0**
General government balance (c)				-6,5	-6,4	-9,8	-15,4	**-10,5**	**-9,5**	**-9,3**
Cyclically-adjusted budget balance (c)				-6,6	-7,5	-10,4	-14,9	**-8,2**	**-6,1**	**-6,6**
Structural budget balance (c)				-	-7,3	-9,5	-14,0	**-8,6**	**-7,4**	**-7,9**
General government gross debt (c)				97,7	105,4	110,7	127,1	**142,8**	**157,7**	**166,1**

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