Eurobank EFG Economic Research

Greece: Macro Monitor

A Quarterly Review of the Greek Economy

May 2009

Gikas Hardouvelis
Chief Economist
Director of Research
GHardouvelis@eurobank.gr

Platon Monokroussos
Head of Financial Markets Research
PMonokrousos@eurobank.gr

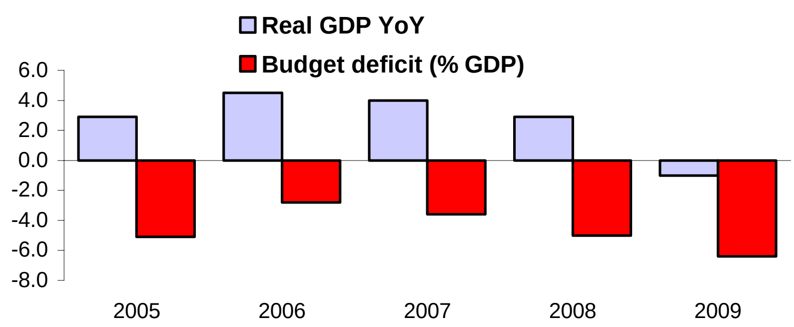
Costas Vorlow
Senior Economist
CVorlow@eurobank.gr

Fiscal risks mount as economy heads for recession

- **Domestic economic activity is expected to decelerate further this year,** weighed down by tighter credit conditions and a significant deterioration in global growth dynamics. **We now forecast real GDP growth to contract by 1.0% YoY in 2009,** mainly as a result of lower investment spending and rapidly decelerating, *though still marginally positive*, consumer-spending growth.
- On a less negative note, certain country-specific **cyclical and structural drivers** may, to a certain extent, act as **buffers to global contagion**, allowing the Greek economy to maintain a significant growth differential relative to more developed euro area peers. Among other factors these may include: **i.** support to household disposable incomes from real wage gains and lower domestic inflation **ii.** less susceptibility to the international-trade channel relative to other, more industrialized countries **iii.** a more rigorous implementation of the New Investment Law e.g. via an acceleration of PPP projects and an increase in the absorption rates of EU structural funds and **iv.** a further significant deceleration in the growth of imports of goods and services this year, which should help mitigate the negative impact of lower exports growth on domestic GDP
- **National headline CPI is likely to retreat to sub-1% YoY levels in May-July,** before edging higher thereafter, as oil price-related base influences come into effect. For the year as a whole, we forecast average inflation of just 1.1% YoY vs.4.4% YoY in 2008.
- The 3.7%-of-GDP *(revised)* **official target for the general government budget deficit** this year **appears overly-optimistic** and we now forecast a deficit outcome **in excess of 6.0%-of-GDP**. This mainly reflects our significantly-worse-than-officially-expected forecast for real GDP growth this year and concerns over the adequacy of a multitude special revenue-generating & expenditure-controlling measures to generate the expected results.

Read also in this issue:

- A special focus on the recent **developments and outlook of the Greek tourism** sector



Source: Realisations & Eurobank EFG forecasts

Greece: key macro indicators - Eurobank EFG forecasts

y/y grwoth	**2007**	**2008**	**2009f**
GDP (constant prices)	4.0	2.9	-1.0
Private Consumption	*3.0*	*2.2*	*0.5*
Public consumption	*7.7*	*3.2*	*2.5*
Total Investment	*9.6*	*-5.3*	*-7.5*
Exports g&s	*3.1*	*2.2*	*-8.5*
Imports g&s	*6.7*	*-4.4*	*-5.6*
National CPI (average)	3.0	4.2	1.1
Budget balance (% GDP)	-3.6	-5.0	-6.4
Public debt (% GDP)	94.8	97.6	105.0
C/A balance (% GDP)	-14.2	-14.4	-12.6
Unemployment rate	8.3	7.7	9.3

Source: Official statistics & Eurobank EFG projections - As of 8 May, 2009

Research Team:
Gikas Hardouvelis, *Chief Economist and Director of* Research
Platon Monokroussos, *Head of Market Research*
Paraskevi Petropoulou, Economist
Galatia Phoka, Emerging Markets Economist

EFG Eurobank Ergasias, 8 Othonos Str. GR 105 57, Athens, Tel:(30210) 3718 906, 3718 999, Fax:(30210) 3337 190, Reuters Page: EMBA
Internet Address: http://www.eurobank.gr

Macroeconomic Overview

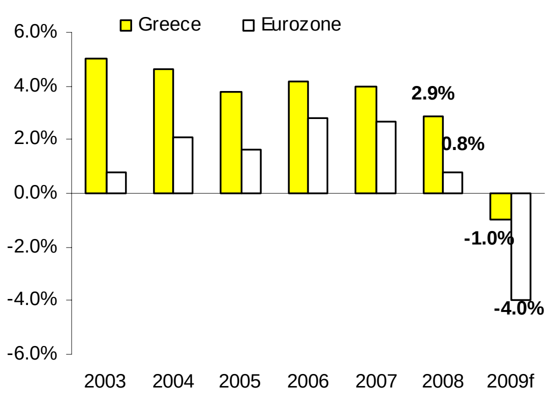
Domestic economic growth decelerates

According to the latest national accounts statistics, Greek real **GDP growth** decelerated to 2.4% YoY in Q4 2008, from 2.7% YoY in the prior quarter, bringing the corresponding full-year reading down to 2.9% from 4.0% in 2007. **Gross fixed capital formation** contracted by a sizeable 11.5% YoY in 2008 after rising by 4.9% YoY a year earlier, while, thanks to a sharp rise in **inventories**, total investment declined by a relatively milder 5.3% YoY, following growth of 9.6% YoY in the 2007. These negative trends, mainly reflect a sharp decline in **housing investment** *(-29.1% YoY)* and, to a lesser extent, lower **investments in machinery & equipment** *(-9.6% YoY)* from a year earlier[1]. On a less negative note, **private consumption** remained the main driver of domestic economic activity, recording positive growth for the greater part of 2008, though decelerating sharply towards the end of the year on nose-diving **consumer confidence** and worsening **domestic credit** conditions. Cumulatively, private consumption rose by 2.2% YoY, after recording annual growth of 3.0% YoY in 2007, while **final consumption** expenditure grew by 2.4%, reflecting a 3.2% YoY rise in public spending. Yet, the overall contribution of domestic demand to GDP growth turned negative last year to the tune of ¾ of a percentage point of GDP, following a positive contribution of 4½ points in 2007. As such, the positive 2008 GDP outcome was chiefly the result of a concurrent improvement in the overall **external sector**, itself being mainly attributed to a sharp deceleration in the growth of **imports** of goods and services *(-4.4% YoY in 2008 vs. +6.7% YoY in 2007).*

Worsened indicators of consumer vigor

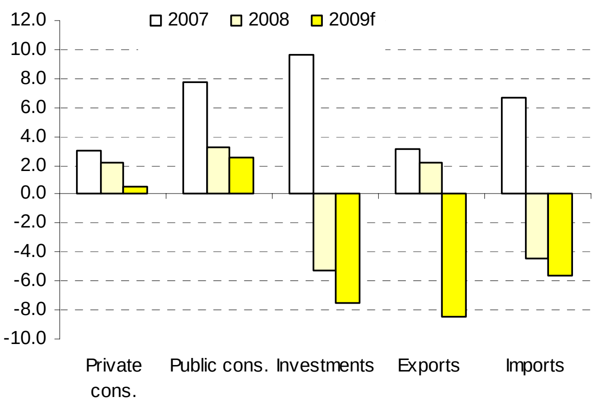
Retail sales excluding fuels and lubricants in volume terms posted negative growth *(-1.4% YoY)* in 2008 for the first time in several years, with the decline being particularly pronounced in the November-December period and, again, in January 2009 *(-5.8% YoY, according to the latest available data).* Extensive industrial action by trade unions ahead of the passage in parliament of a new law for reforming the social security system negatively affected retail sales in early 2008. And, in spite of a gradual recovery during the summer months, tighter domestic credit conditions, deteriorating consumer confidence and extensive riots in main metropolitan areas around the country negatively affected sales during the Christmas shopping season. In a similar vain, **registrations of new passenger cars** dropped 6.8% YoY in 2008 following growth of 3.8% YoY a year earlier, reflecting a sharp reduction in bank financing for the purchases of consumer durables and a rapid deterioration in consumer sentiment, primarily during the last quarter of 2008. Domestic car registrations declined by a further 37.8% YoY in Q1 2009, forcing the government to take special measures to support domestic sales, including the temporary abolition of a special car registration tax.

Real GDP growth



Source: National statistics, EC, Eurobank EFG

Growth of GDP components



Source: National statistics, EC, Eurobank EFG

With regard to expectations of domestic consumers and retailers, the EC **retail trade confidence indicator** for Greece hit a 10-year low in March, reflecting worsened conditions in the domestic retail market, while the **consumer confidence index** remained in the same month close to record lows,

[1] In 2008, final consumption amounted to around 88% of nominal GDP, while the corresponding weights of housing investment, other construction investment and investment spending on metal products and machinery were 5.4%, 5.4% and 4.4%, respectively.

tracking the nose-diving of relevant consumer-vigor indicators in the euro area.

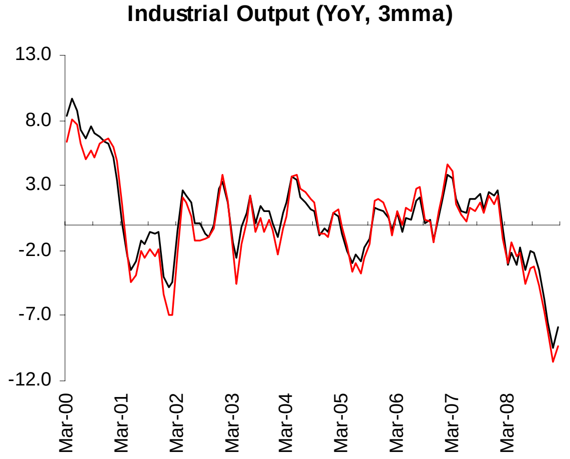
Industrial output contracts

In the industrial sector, total output contracted by 3.7% YoY in 2008, weighed down by weak **manufacturing** *(-4.2% YoY)* and lower production in the **mining** and **power** sectors *(-4.3% YoY and -1.4% YoY, respectively)*. The deceleration in the growth of **industrial** production continued in the first two months of 2009, with output declining by 4.6% YoY in February, following a 10.2% YoY drop in the prior month. Domestic industrial output in the first half of 2008 was negatively affected by soaring input costs, a two-week transport strike by truckers in May and a spoiled seed-oil scandal that temporarily shut down manufacturing of by-products like margarine and other processed food. Production rebounded in Q3, reflecting relative optimism with regard to domestic and external demand developments, leading to a sharp inventory build up and a decline in production during the latter part of the year as the deepening of the global financial crisis inflicted a collapse in new orders. The sharp decline in industrial output in January-February 2009 suggests an ongoing process of concurrent **inventory destocking**, which is likely to continue depressing production for several more months. Sharply weaker demand for domestically produced export goods by main trading partners and the domestic demand slowdown point to a weak trajectory of domestic industrial production for the greater part of the current year. Reflecting these developments, the index of **business expectations in manufacturing** declined in March to levels not seen since the early 80s.

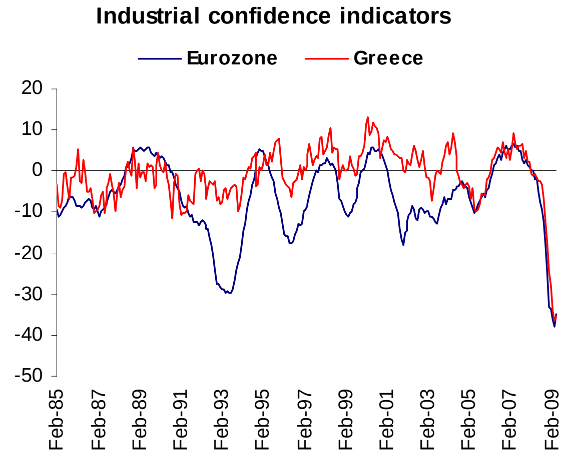
Housing investment in a sharp downturn

Strong **construction** investment as a result of vibrant **residential building activity** and the implementation of big infrastructural projects has been a powerful driver of domestic demand growth in 2001-2007. [2] Yet, housing investment declined sharply last year, reflecting a sizeable rise in the **inventory of unsold houses** and tightened credit conditions in late 2008. Accordingly, the sharp decline in **new building permits** recorded last year continued in January 2009, with the number of new permits declining by a further 22.5% YoY.[3] Reflecting these unfavorable trends, the index of business expectations in the domestic construction sector stood in March at it lowest level since the period immediately following the completion of the 2004 Olympic Games.

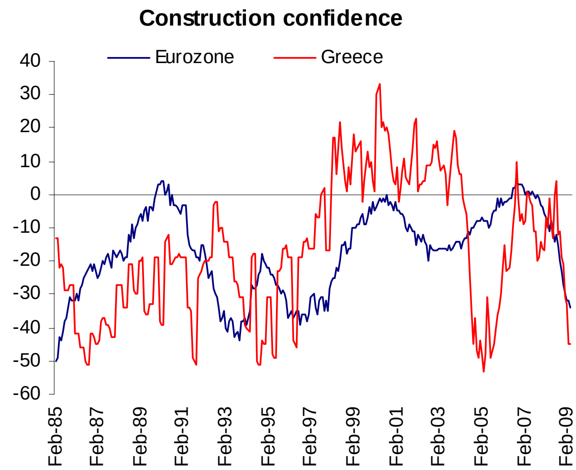
[2] Total construction investment (both public & private) currently accounts for slightly over 10%-of-GDP.
[3] Building permits declined by 15.4% YoY & -17.1% YoY in volume i.e., m^3 terms in 2008



Source: National statistics



Source: EC



Source: EC

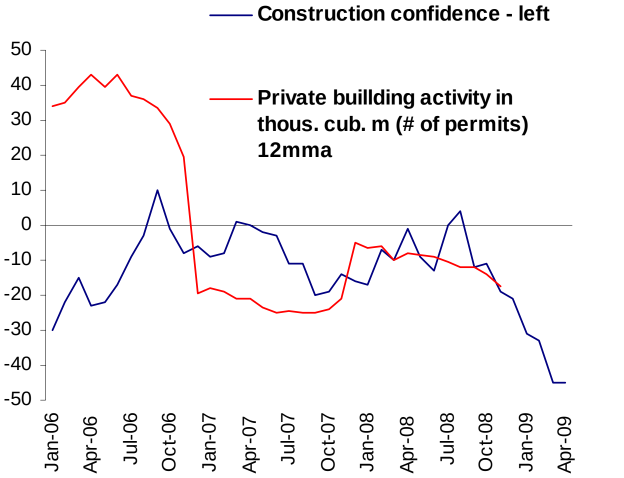
Furthermore, a recent monthly construction-sector survey showed that the difference between the weighted percentages of positive and negative replies regarding current activity relative to the previous quarter stood at -21 in February, its lowest level in 4½ years. The corresponding figure for planned future activity was also a dismal -44.

Government announces assistance measures for prospective homeowners

In a bid to help prop up activity in the domestic construction sector, the government announced in late April a series of **assistance measures for prospective homebuyers**, ranging from state guarantees on new mortgage loans to increased tax relief on interest payments on such loans. The new measures will allow bank loans to cover up to 100 percent of a property's commercial value, up from the 75 percent allowed under current banking practices. These measures along with the continuing influx of EU structural funds and the implementation of projects aiming to reap the benefits of the new investment law and the framework for public-private partnerships are likely to alleviate continuing downward pressures in domestic construction activity in the period ahead. Yet, construction investment is again expected to record negative growth this year on the back contracting domestic demand and tightened lending conditions. With regard to price developments in the residential sector, the most recent official data shows that the first half of 2008 witnessed a continuation of the deceleration trend in the general level of prices that began in early 2006. Yet, home prices remained at relatively satisfactory levels during that period, as building costs continued to rise at above-inflation rates and constructors were not faced with urgent liquidity problems. Specifically, according to Bank of Greece data covering a number of residential areas outside Athens, the average growth of home prices was 2.3% YoY in H1 2008 compared to 3.8% YoY last year. In Athens, residential prices recorded average growth of 3.5% in 2007, while the general cost index for the construction of new residential building rose in H1 2008 by 4.5%, following growth of 4.4% in the prior year. More recently, anecdotal evidence suggest that the long awaited downward adjustment is home prices has already started to take effect since Q4 2008, with year on year declines being recorded in many areas around the country.

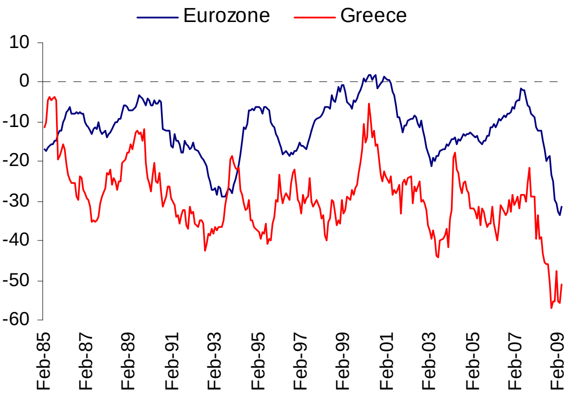
Labor market conditions deteriorate

In the domestic labor market, after reaching a multi-year low of 7.2% in the second quarter of 2008, the **unemployment rate** has embarked upon a rising trajectory, hitting 9.4% in January 2009 *(latest available data)*. This compares with an average unemployment rate of 8.3% in EU-16. More worrying - *and reflecting persisting structural rigidities in the domestic labor market* - the most recent official data *(Jan. 09)* showed unemployment in the 15-24 age group stood at 25%, among the highest in the euro area, with unemployment affecting women *(13.3%)* more significantly than men *(6.7%)*. Weakening domestic demand and worsening external conditions are likely to put more upward pressure in the labor market in the coming months. In response to worsening domestic employment prospects the Greek government announced in early April a €2.5bn assistance program, which includes subsidies to existing jobs and additional public-sector hiring, aiming to support the young and those working in tourism, construction and small businesses. According to government estimates, the measures will benefit some 500k people, while ca 70% of the package will be financed out of EU funds.



Source: National statistics

Consumer confidence



Source: EC

These measures are likely to help mitigate the impact of economic deceleration but are unlikely to prevent the jobless rate from staying firmly above the 9.0% market throughout the remainder of the year.

GDP growth forecast revised downwards

For the current year, we now expect real GDP growth to contract by 1.0% YoY, compared to our earlier forecast for 0.5% YoY growth. National account data for Q1 2009 are not yet available, but we predict the general dynamics of GDP components witnessed in late 2008 to have broadly continued in the first quarter of this year. Namely, contracting growth in fixed investments, primarily as a result of worsened conditions in the residential construction sector and rapidly decelerating, though still marginally positive, year-on-year growth of private consumption. Specifically, we expect domestic demand to contact by around 0.9% YoY in 2009 after recording positive growth of 2.2% YoY last year. In the external sector, the global economic recession and the persistent of a positive inflation differential vis-à-vis main trading partners are expected to depress goods exports this year. Similarly, the growth of services exports – *primarily from tourism and shipping* - is likely to retreat sharply from its strong pace in recent years. With respect to the outlook of Greek tourism sector, industry bodies such as the Greek Chamber of Hotels and the Hellenic Association of Tourist and Travel Agencies have already come out with pessimist forecasts regarding holiday bookings from major tourist markets, with anecdotal evidence pointing to a 20% or bigger year-on-year decline. Tourism revenues amounted to slightly less than 5% of Greek GDP in 2008, while the total contribution of the sector to the domestic economy is estimated to be as high as three times that amount. Separately, revenues from shipping amounted to ca 8%-of-GDP last year, with anecdotal evidence currently pointing to a significant contraction in 2009 revenues.

Main downside risks to our 2009 GDP projections include: **i.** a less favorable growth trajectory in major trading-partner economies, which could negatively affect the two most dynamic Greek export sectors, namely tourism & shipping and **ii.** a bigger-than-expected deceleration in domestic consumption and investment spending, as a result of deteriorated sentiment, worsened domestic lending conditions and the additional fiscal tightening the country needs to implement this year in order to help bring is fiscal accounts towards a more sustainable path. With regard to the latter, note that in late March Greece was officially placed, along with five other European Union countries, under EU fiscal supervision i.e., the so-called Excessive Deficit Procedure (EDP), for failing to contain its 2008 general government budget deficit to no more than 3.0%-of-GDP. *Last year's deficit is now estimated to have reached 5.0%-of-GDP compared with an initial deficit target of just 1.6%-of-GDP*. Accordingly, the country was given a six-month deadline for the adoption corrective measures to help reduce, on a sustainable basis, its fiscal deficit below the 3%-of-GDP reference threshold by 2010. In view of these developments, the Greek government announced in mid March a series of one-off tax hikes on individuals earning more than €60,000/year along with a wage freeze for civil servants earning more than €1,700/month[4]. In our view, these initiatives will not be adequate to significantly reduce the general government budget gap and the government will need to take additional measures this year to help contain its budget deficit close to levels dimmed compatible with the Maastricht Treaty[5]. Indeed, according to local media reports, the government is set to announce a new package of fiscal restraining – *and, by implication, growth painful* – measures right after the EU elections in early June. Besides the significant worsening of external conditions since last autumn and the potential impact of further fiscal tightening due to EDP limitations, the significant build up of domestic inventories instrumented in 2008 is another factor that could potentially depress domestic production throughout this year[6]

Buffers to global contagion

On a less negative note, certain country-specific cyclical and structural drivers may, to a certain extent, act as buffers to global contagion, allowing the Greek economy to maintain a significant growth differential relative to more developed euro area peers. Such favorable factors are likely to include: **i.** support to profit margins and household disposable incomes from the rapid deceleration in input costs and domestic inflation pressures *(Eurobank EFG now expects domestic consumer inflation to decline to 1.1% YoY or lower this year, from 4.2% YoY in 2008)* **ii.** real wage gains and increased transfers to the weakest segments of the population, which will continue to support private consumption spending *(~80% of GDP*

[4] The one-off tax contributions will be calculated on declared 2007 incomes and the government expects to raise some €274mn from that measures.

[5] Eurostat estimates the budgetary impact of these measures to be 0.5%-of-GDP, with only half of it being of permanent nature.

[6] Inventories grew by €3.57bn in 2008, after rising by €225mn in 2007 and an average increase of €21mn in the prior seven years.

in 2008). According to Bank of Greece *(BoG)* forecasts, average economy-wide salaries will grow by 2.0-2.5% in real terms in 2009, even accounting for the observed reductions in working hours. This should facilitate real growth of 1.0-1.5%YoY in wage earners´ incomes. In conjecture with the above projections, note that the two-year collective wage agreement in the private-sector currently in effect calls for a 5.9% YoY rise in minimum wages this year. Separately, Greece´s revised stability & growth program foresees further strong increases in both the overall public wage bill and social transfers in 2009. These developments along with falling inflation and lower oil prices are expected to support disposable incomes and consumption spending in 2009. Yet, considerable uncertainty surrounds the above projections, especially taking into consideration local press reports citing evidence of renegotiations of existing wage contacts and agreements for lower pay and working hours in sectors of the domestic economy more directly affected by the global economic crisis **iii.** the current structure of the Greek economy implies less susceptibility to the international-trade channel relative to other, more industrialized, EU peers. Greece's exports of goods currently account for around 9% of domestic GDP, with total exports of goods & services accounting for 23%-of-GDP **iv** a more rigorous implementation of the New Investment Law e.g. via an acceleration of PPP projects *(€1.5 bn already signed, €0.5 bn in the 2009 pipeline to be signed)* and an increase in the absorption rates of EU structural funds could help to partly counterbalance the expected contraction in private investment this year. EU authorities have already signaled their willingness to increase down payments for the co-financing of projected under the 4th CSF program **v.** the domestic banking system appears to be in a much better position to weather the global credit crisis relative to most EU peers with regard to both its capital adequacy and the industry-wide loans-to-deposits ratio *(currently, close to 100%)*. These along with a €28bn package provided by the government to support the domestic banking system should prevent an abrupt freeze of domestic credit due to liquidity & solvency reasons and **vii.** a further significant deceleration in the growth of imports of goods and services this year should help mitigate the negative impact of lower exports growth on domestic GDP.

From a medium-term perspective, domestic economic prospects remain clouded by uncertainty regarding the severity and duration of the global credit crisis. As a result, we now view the balance of risks as being skewed towards a lower-than-previously-anticipated GDP growth trajectory in the years ahead. Strong productivity gains thanks to heavy investment in infrastructure in recent years, a further expansion of the Greek shipping fleet and the implementation of several large-scale energy interconnection projects in the natural gas, electricity and oil sectors are likely to continue supporting domestic growth as well as the export orientation of the economy. On a less positive note, the external sector will likely remain a drag on economic growth, restraining the economy's debt-servicing capacity and posing risks to the medium-term economic outlook. Such risks may become particularly pronounced in the period ahead, given a distinctively more difficult external environment and the fading out of exceptional factors that supported growth in recent years, including the sharp decline of domestic interest rates post-EMU entry and the hosting of the 2004 Olympic Games.

With regard to accumulated macro imbalances, the sharp widening in the current account deficit in recent years is probably the most representative aggregate measure of the cumulative loss of competitiveness the country has suffered since adopting the euro *(real exchange-rate appreciation since 2001: 16% in terms of CPI, 35% in terms of ULC)*. The persistence of a 1.0-1.5ppts inflation differential vis-à-vis the euro area *(destination for ca 45-50% of Greek exports)* and structural rigidities in key sectors of the domestic economy are the main culprits of Greece's accumulated competitiveness loses. From a more inter-temporal perspective, Greece´s large external imbalance is the outcome of a rapid growth in domestic investment and relatively stable growth in national saving, which have boosted Greece's savings-investments imbalance from around 10.5%-of-GDP in 2001 to over 15%-of-GDP in late 2008. Domestic saving rates have been lagging behind the corresponding EU average, reflecting higher public-sector deficits and a rising private-sector propensity towards consumption. In fact, the household sector has accounted for most of the increase in the saving-investment gap since 2001, owing to declining household savings and a strong pick-up in housing demand. Although Euro zone membership effectively secures the adequate financing of the country's external deficit and debt - the latter is currently estimated at around 150%-of-GDP - the wide current account gap poses a threat to the medium-term growth prospects of the economy. Given that now more than 70% of the current account deficit is financed by external borrowing, the servicing of the accumulated gross external debt absorbs considerable domestic resources.

All in all, there is not doubt that the world economic recession will negatively affect domestic growth dynamics in the months & quarters ahead. This view is supported by the recent worsening in a range of real activity & sentiment indicators, the underperformance of the domestic equity market and the widening of the Greek government bond yield spreads vis-à-vis the German benchmarks. On a more positive note, certain country-specific cyclical and structural drivers may, to a certain extent, act as buffers to global contagion, allowing the Greek economy to maintain a positive and significant growth differential relative to more developed euro area peers *(Eurobank EFG now forecasts real GDP growth of around -4.0% in the euro are this year).*

Key indicators of domestic economic activity

	Last	2008	2007
Consumer-vigor indicators			
Private consumption in constant prices (% YoY)	+0.9 (Q4 08)	2.2	3.0
Retail sales excl. fuels & lubricants volume (% YoY)	-5.9 (Jan. 09)	-1.4	2.2
New car registrations (% YoY)	-37.8 (Q1 09)	-6.8	3.8
Consumer confidence (e.o.p. index level)	-55.8 (Mar. 09)	-55.5	-28.8
Retail trade expectations (e.o.p. index level)	-37.7 (Mar. 09)	-20	33.8
Industrial-activity indicators			
Industrial production (% YoY)	-4.6 (Feb. 09)	-3.7	2.2
manufacturing output (% YoY)	-6.5 (Feb. 09)	-4.2	1.8
Capacity utilization in industry (e.o.p rate)	70.5 (Feb. 09)	73.8	77.2
Industrial confidence (e.o.p. index level)	-36.6 (Mar. 09)	-24.4	2.1
Manufacturing PMI (e.o.p. index level)	38.9 (Feb. 09)	41	53.7
Construction sector & other investment-activity indicators			
Cross capital formation in constant prices (% YoY)	0.5 (Q4 09)	-5.3	9.6
Housing investment in constant prices (% YoY)	n.a.	-27.2	-3.4
Other construction in constant prices (% YoY)	n.a.	11.6	22.7
Private building permits volume (% YoY)	-33.4 (Jan. 09)	-17.1	-5.0
Construction confidence (e.o.p. index level)	-45 (Mar. 09)	-21	-16

Source: National statistics

	Last	2008	2007
National accounts statistics - *volume*			
Exports of goods & services (% YoY)	-1.6 (Q4 08)	2.2	3.1
Imports of goods & services (% YoY)	-5.2 (Q4 08)	-4.4	6.7
Balance-of-Payments statistics *(nominal - terms)*			
Tourism revenues (% YoY)	-24.1 (Feb 09)	3.0	-0.3
Transportation revenues (% YoY)	-24.3 (Feb 09)	13.3	18.3
Customs-based statistics *(nominal - terms)*			
Goods exports (% YoY)	-14.8 (Feb. 09)	1.1	4.3
Goods exports excl oil (% YoY)	-17.6 (Feb. 09)	2.7	5.4
Goods exports to EU (% YoY)	-16.7 (Feb. 09)	-0.1	24.5
Goods exports to non-EU countries (% YoY)	-11.2 (Feb. 09)	3.4	-19.8
Goods imports (% YoY)	-30.0 (Feb 09)	9.0	9.7
Goods imports excl oil (% YoY)	-17.4 (Feb. 09)	4.0	16.1
Goods imports from EU (% YoY)	-19.1 (Feb. 09)	3.5	15.9
Goods imports from non-EU countries (% YoY)	-52.8 (Feb. 09)	20.3	2.9

Source: National statistics

YoY %	Last	2008	2007
Domestic MFI credit to domestic enterprises & households *(oustanding balances)*			
Private sector (% YoY)	10.8 (Mar. 09)	16.4	21.5
Enterprises (% YoY)	12.2 (Mar. 09)	19.8	20.6
Households (% YoY)	9.2 (Mar. 09)	12.8	22.4
Housing loans (% YoY)	8.7 (Mar. 09)	11.4	21.9
Consumer credit (% YoY)	10.9 (Mar. 09)	16.0	22.4
Private-sector credit outstanding (% GDP)			
Total domestic enterprices & households	103 (Mar 09)	103	94
Domestic households	48 (Mar 09)	48	50

Source: National statistics

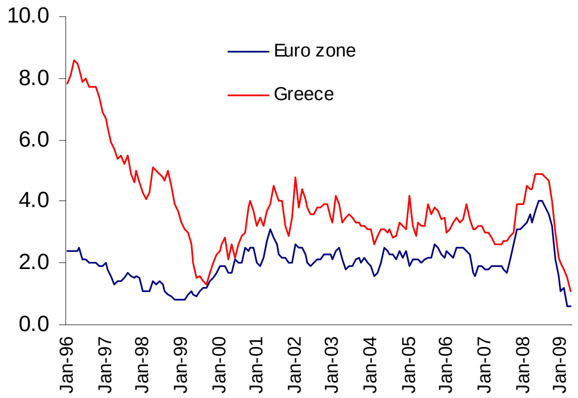
Inflation pressures retreat rapidly

The rally in world energy and commodity prices, high wage growth and second-round effects from past increases in input costs put sharp upward pressures on domestic inflation in the first half of last year, with the **national CPI** hitting a seven-year high of 4.9% YoY in June-July 2008[7]. Those effects more-than-counterweighed the disinflationary impact from the stronger trade-weighed euro and moderating domestic demand over that period, while an upward trend was also record with regard to core inflation *(+3.8% YoY in May 2008 vs. 2.6% in January).* The sharp consecutive drops in oil prices and the prices of other basic commodities, mainly as a result of rapidly declining global demand and a significant worsening of world economic prospects post the Lehman Brothers debacle exerted significant downside pressures on domestic prices, facilitating a steep decline in domestic CPI in Q4 08 and again during the first four months of the current year *(domestic CPI hit a multi-year low of 1.0%YoY April 2009).* In average annual terms, Greek inflation rose by 4.2%YoY in 2008, from 3.0%YoY in the prior year, while the national **CPI index excluding the volatile fresh fruit, vegetable and fuel costs** posted a smaller rise relative to the headline index, averaging 3.4% YoY last year vs. 3.2% YoY in 2007.

Sub-1.0% YoY headline CPI readings likely in the following months

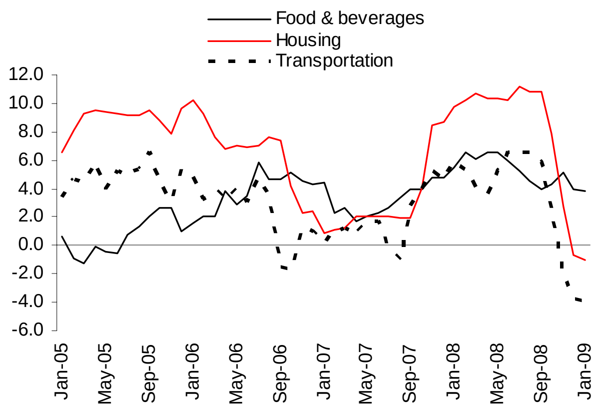
Global deflationary forces, retreating domestic demand pressures, lower economy-wide unit labor cost growth and favorable base effects are likely to facilitate further year-on-year declines in **Greek headline inflation** in the coming few months. The latter is expected to retreat to sub-1% YoY levels in May-July, before edging higher thereafter, as oil price-related base influences come into effect. For the current year, we expect annual headline inflation to average around 1.1%YoY, while the retreat in the domestic **core inflation** is expected to be more contained with the corresponding year-on-year average projected to ease to 2.7%YoY. This compares favorably with a European Commission forecast for average harmonized inflation of 1.8%YoY in Greece and 0.4%YoY in the euro area this year. The expected persistence of a positive – *though lower relatively to recent years* – **inflation differential** vis-à-vis the euro area will be mainly the result relatively stronger domestic demand conditions and fasted unit labor cost (ULC) growth in Greece. It may also be driven by less-than-satisfactory competitiveness conditions in key sectors of domestic economic activity, putting upward pressure in the general level of prices. These forecasts are surrounded by an unusually high degree of uncertainty though, given significant uncertainty surrounding the expect of domestic demand slowdown, the duration and intensity of global deflation forces and any new fiscal measures the Greek government may take this year to contain mounting fiscal deficits *(hikes in excise taxes on fuels? VAT hikes? Other measures that could affect domestic prices?).*

Harmonised CPI (YoY, %)



Source: Eurostat

Selective Greek CPI sub-indices (YoY, %)



Source: National statistics

Wage pressures abate

With regard to domestic wage developments, the latest Bank of Greece data shows that the growth of economy-wide **unit labor costs** *(ULC)* in Greece accelerated to 5.4% YoY in 2008, from 4.0% YoY in

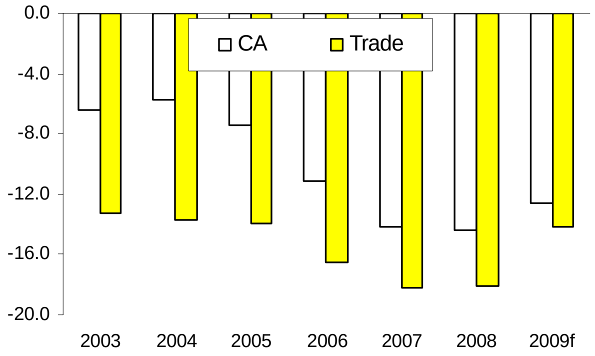
[7] The international price of Brent was running at a year-on-year rate of -48.9% last December but the average rose by around 24.8%YoY in 2008 vs. a year earlier. In the domestic market, the retail price of fuels included in the national CPI basket rose by an average annual rate of 14.7%YoY in 2008 and were down around 20% December-to-December.

the prior year[8]. The corresponding rate of growth in the domestic business sector *(which includes all public and private-sector enterprises)* was 4.7% YoY, compared to 4.8% YoY in 2007. For the current year, the BoG expects a deceleration in ULC growth *(to 3.3% YoY economy-wide and to 2.6% YoY in the domestic business sector),* mainly as a result of lower growth in average pre-tax earnings. In the public sector, the 2009 budget projection was for a 6.3% YoY rise in the public-sector wage bill *(compared to 9.1% YoY in 2008)*, with the rise in the overall bill for wages and pensions budgeted at 7.9% YoY Vs. 10.2% YoY in the prior year. These projections were based on the assumption that the total number of new public-sector hires would experience broadly zero growth this year after rising by 0.7% YoY in 2008. Yet, the rise in public sector wages in 2009 will actually be lower than that envisioned in this year's budget plan since the government decided in mid-March - *in view of Greece's prospective entry under EU´s Excessive Deficit Procedure (EDP)* - to freeze wages for civil servants earning €1,700/month or more, with a similar freeze also implemented for pensioners. These measures along with a provision that the number of new public-sector hires will be lower than the number of new retirees point to a rise of only 2.6%YoY in the total bill for wages and pensions i.e., ca 0.3%-of-GDP lower relative to budget projections. In the private non-bank sector, the 2-year collective was agreement that was signed in 2008 provides for average annual growth in minimum wages of 5.7% this year. Yet, in a sectoral level, anecdotal evidence suggest that the adverse economic environment is causing reductions in average working time and overtime employment and, in some cases, even cuts in wages. In view of the these developments, the BoG now forecasts growth of 2.0-2.5%YoY in average real salaries for the economy as a whole comparing to a rise of 2.5% YoY in 2008. This is likely to function as a source of support to domestic consumption this year, but the latter is likely to exhibit much lower growth relatively to last year, weighed down by higher unemployment and faltering consumer confidence.

External sector developments remain a cause of concern

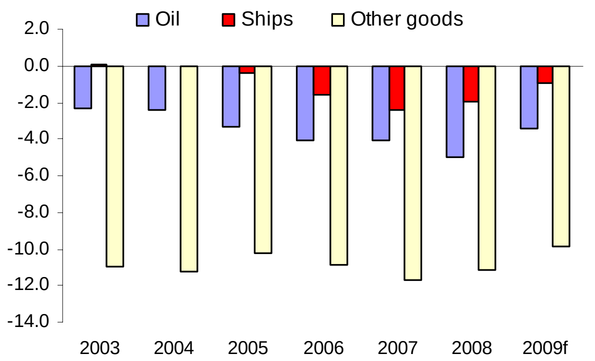
Bank of Greece's settlement data for 2008 revealed a further deterioration in the **current account** balance, which saw it deficit rising by 8.2% YoY to €35bn or 14.4%-of-GDP, from 14.2%-of-GDP in 2007[9].

Current account & trade balances (% GDP)



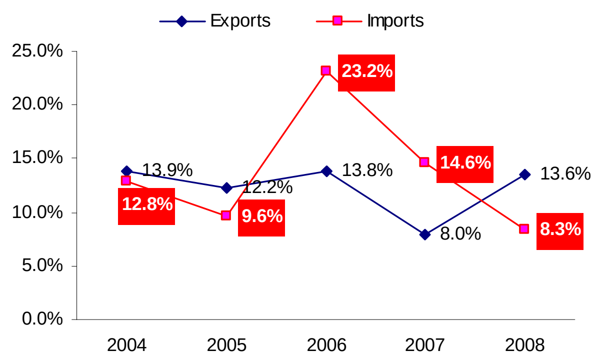
Source: BoG & Eurobank EFG foerecasts

Trade-balance components (% GDP)



Sources: BoG, Eurobank EFG forecasts

Goods exports & imports (YoY, %)



Source: BoG

The deterioration was mainly the result of a higher **oil imports bill** as well as higher payments for interest and dividends. It was also due to a wider deficit in the

---

8 The sharp rise in domestic labor costs last year reflects a concurrent acceleration in nominal pre-tax average earnings (6.6% YoY in 2008 vs. 5.2% YoY in 2007).

9 The deficit of the overall balance of the current account and capital transfers *(which, reflects the overall external financing needs of the economy)* reached 12.7%-of-GDP in 2008, from 12.3%-of-GDP in the prior year

trade balance excluding fuels and ships. The latter was despite higher exports growth *(both year-on-year and with respect to the growth of imports)* and generally reflects continuing competitiveness losses and the inability of the country's production base to adequately meet domestic and external demand needs[10]. These negative developments were only partly counterweighed by higher surpluses in the balances of services and current transfers. The higher surplus in the services balance last year was chiefly due to higher net receipts from transportation services. Net travel receipts rose by 2.1% YoY last year, amounting to 3.7%-of-GDP and covering slightly more than 20% of the trade deficit. The main balk of tourist inflows continued to come from the EU-27, with Germany and U.K. remaining the two most important export markets for Greek tourism. The shares of these two countries with respect to the total number of foreign tourists visiting Greece declined relative to a year earlier but the shortfall was partly filled by a higher number of visitors from Russia and other CEE countries. Transportation revenues *(mainly from shipping services)* continued to grow strongly last year, though decelerating notably in Q4 due to the sharp decline in international freights. For the year 2008 as a whole, net transportation revenue amounted to around 4.1%-of-GDP *(highest for the last 5 years),* but its average annual growth eased to 7.7%YoY, from 25% YoY in 2007.

With respect to developments in the **international market for freights**, the Baltic Dry Index *(BDI)* recorded hefty gains in the first half of 2008, thanks to strong demand for raw materials and basic commodities from emerging economies *(primarily from China).* Yet, the deepening of the global financial crisis after the collapse of U.S. investment bank Lehman Brothers *(Sept. 2008)* and the ensuing halt in global trade prompted a sharp decline in dry cargo freights in H2 2008, bringing the annual average change in the BDI index for the whole year to -10%. Yet, the index rebounded sharply in the first months of the year and stood some 180% higher year-to-8 May 2009. Despite this recovery, the outlook of dry cargo freights remains rather uncertain for the remainder of the year with the expected rise in the capacity of global fleet and the global economic slowdown presenting negative factors. With respect to recent developments in the market of tankers, the sharp rise in world oil prices throughout the first half of 2008 constrained transport demand, though the relatively small growth in the total capacity of the world tankers fleet over that period contributed to the positive growth in freights over that period. Consequently, the sharp retrenchment in world oil prices during H2 2008 led to a decline in the demand for oil transportation services late last year. Reflecting these developments, the benchmark Baltic Dirty Tanker Index (BDTI) declined sharply towards the end of 2008, but recorded an average annual rise of 34% for the year as a whole. The corresponding index stood some 60% lower year-to-8 May 2009. For the year as a whole, a decline is expected in tanker freights as a result of lower global demand for oil and an expected rise in the capacity of world tanker fleet.

Elsewhere in the Greek balance-of-payments, the overall deficit in **the balance of incomes** widened by 20% YoY in 2008, driven by higher net payments for interest and dividends as a result of a further rise in the proportion of public debt held by foreigners. Note that total *(i.e., both private and public)* external debt stood at around 149%-of-GDP at the end of last year compared to ca 130%-of-GDP at the end of 2007. Finally, the surplus in the balance of current transfers rose by 7.4%YoY, reflecting higher EU transfers to the general government as well as lower government payments to the EU budget, while the overall balance of current and capital transfers recorded a net surplus of €6.8bn or 2.8%-of-GDP. Net total transfers from the EU budget rose in 2008, reaching €6bn *(ca 2.5%-of-GDP),* reflecting an acceleration of structural funds inflows heading into the 31.1.2008 deadline for implementation of the 3rd Community Support Framework (CSFIII) for Greece[11]. From the funding side, the overall balance of portfolio, FDI and ''other'' investment recorded a net inflow of €30.2bn, which compares with an inflow of €27.4bn in 2007. Specifically, last year recorded net portfolio inflows of €16.4bn along with net inflows of €12.1bn under ''other'' investments and €1.7bn of FDI. The purchase of a 23% stake in the Hellenic Telecommunications Organization *(OTE)* by Deutsche Telecom accounted for the greater part of FDI inflows to Greece in 2008. Reflecting these developments, foreign exchange reserves stood at €2.5bnat the end of 2008, while the country's *(negative)* net investment position was

[10] Exports of goods excluding fuels and ships grew by 15.2% YoY last year while imports of goods excluding fuels and ships grew by. 5.8% YoY

[11] From the beginning of the implementations of CSFIII till the end of December 2008 some €21.2bn had been received from the EU structural funds i.e., some 94% of the total funding available for Greece under the corresponding program

€183.9bn *(75.7%-of-GDP)*, compared to 214.5bn *(94%-of-GDP)* in the prior year.

In 2009, Greece's balance-of-payments dynamics will be influenced by the confluence of slower growth in major trading-partner economies and the negative effects for persisting structural weaknesses in key sectors of domestic economic activity. Goods exports will ne negatively affected by slower *- or even negative, as we project-* domestic demand growth as well as the recession in the euro area and in the CEE region, which represents the destination of an increasing share of Greek exports in recent years. Yet, given the overall structure of the Greek balance of payments, the trade deficit is likely decline in 2009 as a result of sharply lower imports growth from a year earlier. Specifically, payments for fuel imports are likely to be lower this year as a result of lower world oil prices and reduced domestic energy demand due to the economic slowdown. A sharp concurrent drop will also likely be experienced in the payments for the purchase of ships. With regard to the expected evolution of the balance of services, this will also be negatively affected by lower revenues from shipping and tourism. On the capital account, besides the expected inflows leading to a completion of CSFIII, an acceleration of EU payments for the co-financing of structural programs under CSFIV *(2007-2013)* is expected this year. With regard to the former, note that the recently agreed *European Economic Recovery Plan* grants member-countries a 6-months extension for the absorption of funds available under CSFIII[12][13].

Data for the first two months of 2009 showed a 21.1% YoY improvement *i.e., decline* in the current account deficit mainly on the back of a smaller trade gap excluding oil and ships *(exports and imports down by 19.7%YoY and by 24% YoY, respectively)* and, to a lesser extent, a lower net oil import bill. Customs-based statistics for the first two months of the year appear to generally confirm these trends, though these data re not directly comparable with settlement statistics. Overall, for the year 2009 as a whole, our forecast is for a current account deficit of 12.6%-of-GDP.

All in all, the sharp widening in the current account deficit in recent years is probably the most representative aggregate measure of the cumulative loss of competitiveness the country has suffered since its adoption of the euro.[14] The persistence of a positive and significant inflation differential vis-à-vis the euro area *(destination for ca 45-50% of Greek exports)* and structural rigidities in key sectors of the domestic economy represent the main culprits of Greece's accumulated competitiveness loses. From a more inter-temporal perspective, Greece's large external imbalance is the outcome of a rapid growth in domestic investment and relatively stable growth in national saving, which have boosted Greece's savings-investments imbalance from around 10.5%-of-GDP in 2001 to well over 15%-of-GDP currently. Domestic saving rates have been lagging behind the corresponding EU average, reflecting higher public-sector deficits and a rising private-sector propensity towards consumption. In fact, the household sector has accounted for most of the increase in the saving-investment gap since 2001, owing to declining household savings and a strong pick-up in housing demand. Although Euro zone membership effectively secures the adequate financing of the country's external imbalance, the wide current account gap poses a threat to the medium-term growth prospects of the economy. Given that now more than 70% of the current account deficit is financed by external borrowing, the servicing of the accumulated gross external debt continues to absorb considerable domestic resources.

Money & credit developments reflect global financial crisis

The annual growth of the Greek component of Eurozone's M3 money aggregate, which excludes currency in circulation, decelerated during the last quarter of 2008 and, again, in January-February 2009 as a result of the economic slowdown and tightened domestic credit conditions. The Greek M3 growth rate stood at 10.9%YoY in February 2009 down form 14.4%YoY in Q4 2008. This compares favorably with the evolution of the corresponding average in the euro area over the same period *(Feb. 09: 5.5%YoY; Q4 08: 7.8%YoY)*, reflecting the effect of the sharp rise in the depo rates offered by domestic monetary financial institutions in their quest for deposits as well as the continuing shift of money market funds into M3 instruments such as time deposits with maturities of

---

[12] The European Economic Recovery Plan calls for discretionary fiscal measures taken mostly at the national level *(Expected stimulus in 2009-2010: 1½%-of-GDP)*

[13] The final deadline for the entire implementation of the CSFIII programme was 31.12.2008 but Greece was given a 1-year extension for the implementation of infrastructure projects in the areas that affected by the Summer 2007 wildfires

[14] The real exchange-rate appreciation since 2001 has been around16% in terms of CPI and 35% in terms of ULCs.

up to 2 years. Interest-rates on household deposits with tenors of up to one year rose significantly in 2008, though they remained broadly stable for overnight deposits. Domestic deposit rates generally tracked the evolution of interbank rates during the first three quarters of last year, but remained unaffected by their declines in Q4, reflecting tightened liquidity conditions and constrained access to international money markets by Greek financial institutions in late 2008. According to BoG data, the average interest rate offered on time deposits with agreed maturity of up to one year, *which comprise the greater portion of domestic household deposits,* rose by 84bps last year to 5.36% in December 2008, while the interest rate applied to overnight deposits remained broadly unchanged *(Dec 08: 1.24%)*[15]. Domestic interest rates on both of these deposit categories declined in the first quarter of the current year as a result of easing money market pressures following aggressive liquidity injections by the ECB and other major central banks. Domestic repo rates declined significantly in 2008 and, again, during Q1 2009. With regard credit developments, the most recent data reveal an ongoing deceleration in the growth of lending to domestic households by domestic Monetary Financial Institutions *(MFI).* Total outstanding balances of MFI loans to domestic households was growing at an annual rate of 9.2% YoY in March, less than half the rate recorded in the same month a year earlier and the corresponding average of the prior 5-year period. The corresponding growth in the outstanding balances of housing loans and consumer credit were 8.7% YoY and 10.9% YoY, respectively in the March, while the annual growth of domestic MFI lending to domestic households is expected to decelerate further throughout this year and average around 4-5% YoY in 2009.

15 In the euro area, interest rates on time deposits with agreed maturity of up to one year decline by a relatively smaller pace both in 2008 and in the first two months of this year, leading to a further widening in their spreads with Greece's domestic rates. For the 1-year tenor, the corresponding deferential was around 160bps, with Greek banks continuing to face relatively larger financing costs relative to their competitors in the Euro area.

Budget deficit to remain ''excessive'' both this year and the next

The new update of Greece's Stability and Growth Programme *(SGP 2008-2011)* submitted to EU authorities in January, envisions a general government budget deficit of 3.7%-of-GDP in 2009, both under a baseline scenario of 1.1% real GDP growth and an alternative scenario under which economic growth decelerates to 0.5%. For the years 2010 and 2011, the program foresees fiscal deficits of 3.2%-of-GDP and 2.6%-of-GDP, respectively under both the assumed baseline and alternative scenarios. This implies a 2.6ppts-of-GDP cumulative improvement in the corresponding cyclically-adjusted balance net of one-offs. Specifically, the so called *structural deficit* is seen improving from a deficit of 4.8%-of-GDP in 2008 to 4.2%-of-GDP this year and to 2.8%-of-GDP in 2010 and 2.2%-of-GDP in 2011.

Fiscal-slippage risks on the rise

In its assessment of Greece's new SGP conducted in early March, the EU Council adopted a relevant recommendation by the EU Commission and opinioned that **i.** the budgetary outcomes for the current year and the next two are subject to significant downside risks *i.e., the realized fiscal deficits risk coming in well above the Greek government´s projections*. Such risks stem from an assumed macro scenario that is based on favorable growth assumptions as well as possible fiscal slippages in the implementation of the revised 2009 budget target. Note that the 2009 budget plan that was approved by the Greek parliament in late December foresaw a budget gap of 2.0%-of-GDP **ii.** the €28bn domestic financial sector stabilization scheme put in place by Greece could have a potential negative impact on the country´s public finances that is not properly reflected in the submitted fiscal projections and **iii.** the medium-term budgetary framework remains weak, characterized by a poor track record as result of insufficient control of public expenditure and revenue projections that prove systematically optimistic.

Greece placed under EU budgetary surveillance for 2nd time since its Euro zone entry…

The EU Commission opinioned in late March that an excessive deficit exists in Greece. Moreover, the Commission proposed, and consequently the Eurogroup endorsed, a six-months deadline for the adoption, by Greece and other five EU countries, of corrective measures to help reduce their fiscal deficits below the 3%-of-GDP reference threshold, on a sustainable basis. This was the second time since its

Eurozone entry in January 2001 that the country was placed under official EU supervision i.e., the so called Excessive Deficit Procedure (EDP). This reflects the fact that since 2001, Greece managed to contain its general government budget deficit below 3%-of-GDP only once *(in 2006)* despite strong domestic growth and a generally favorable international environment.

…Necessitating further corrective measures

In a bid to help deal with deteriorating public finances, the Greek government announced in mid March a series of one-off tax hikes on individuals earning more than €60,000/year along with a wage freeze for civil servants earning more than €1,700/month[16]. *Eurostat estimates the impact of the special fiscal measures introduced earlier this year to have an overall budgetary impact of 0.5%-of-GDP, with only one-half of it being of a permanent basis.* In our view, these initiatives will not be adequate to significantly reduce the general government budget gap and, reportedly, the government currently considers a new range of revenue-boosting measures, which, among other items, may include: **i.** a further hike in the special consumption tax on hitting oil and motor fuels *(by 3-4 cents/litter)* so as to bring it further in line with the corresponding EU average **ii.** a higher excise tax on tobacco products **iii.** higher taxes on mobile telephone **iv.** a special levy for the legalization of semi-open spaces in residences **v.** an increase in the personal-income tax rate applied to the highest income bracket to 45%, from 40% currently and **vi.** higher inheritance real-estate taxes. According to local media reports, a second package of fiscal measures will likely be announced shortly after the EU parliamentary elections in June, with certain estimates about the budgetary impact of such measures ranging from around €3bn to €5bn *i.e., 1.25%-2.1%-of-GDP.* It is still uncertain what kind of additional measures local authorities will finally decide to implement, if any. Yet, given the magnitude of the expected deterioration in the country's fiscal position, it is doubtful whether these would be enough the help contain the 2009 budget deficit close to levels envisioned by the GSP *i.e., close to 3.7%-of-GDP.*

2008 budget outcome much worse than expected earlier

With respect to the execution of the 2008 budget, the final outcome was significantly worse than both an initially projected general government deficit of 1.6%-of-GDP and a consequently revised deficit forecast of 2.5%-of-GDP *(2009 Budget Plan).* Greece's revised stability SGP estimated that the 2008 deficit reached 3.7%-of-GDP, while according the most recent data *(April 2009)* submitted to Eurostat by Greek authorities, last year's budget gap actually came at 5.0%-of-GDP. As can be surmised by the latest available data, the difference between the final 2008 deficit outcome and the budgeted figure is mainly due to revenue shortfalls and, to a lesser extent, certain expenditure overruns. The main reasons behind the corresponding shortfall in ordinary budget revenue include: **a)** lower than projected tax revenues due to the slowdown in domestic economic activity, primarily during the last quarter of the year **b)** certain organization problems and delays, which resulted to lower than projected tax revenues resulting from the application of a new unified framework for property taxation **c)** the fact that the new scheme of settling outstanding tax liabilities to the state did not yield the expected results, among other reasons because of liquidity constraints caused by the financial crisis and relatively tight deadlines *(which, have been already extended into 2009)* **d)** a sharp contraction in VAT tax receipts in the last two months of 2008 as a result of the deepening of the global financial crisis and the December riots that negatively affected retail sales in main metropolitan areas **e)** higher than projected tax refunds in order to help enhance liquidity in the market and **f)** from the expenditure side, the realized overruns were mainly the result of certain social solidarity benefits and higher than projected transfers to Social Security Funds.

A further deficit overshooting is likely this year

With regard to the fiscal prospect for 2009, the revised stability and growth program foresees a ca €2.5bn shortfall in revenues relative to the budget projections, mainly as a result of lower-than-earlier-anticipated tax receipts. On a less negative note, the government expects the implementation of the 2009 budget to be supported by revenue items such as the 2008 property tax on households *(accruing, as mentioned, in 2009),* part of the tax settlement and tax arrears receipts being transferred in 2009, revenue from a new tax package legislated in September and certain special revenue-enhancing special reassures introduced earlier this year. Privatization receipts of at least €1bn and a closer monitoring and evaluation of the performance of tax offices are also expected to contribute to the expected results. From the expenditure side, the government expects budget outlays in 2009 to be higher by

[16] The one-off tax contributions will be calculated on declared 2007 incomes

€900mn relative to the corresponding estimate of the 2009 budget as a result of increased financing needs of social security funds and the required adjustment in the system of remuneration of healthcare personnel in order to conform to EU Directives. The government promises to implement a series of measures aiming to contain primary spending this year which, among other items, will include a closer monitoring of primary expenditure, limits to new hiring and the implementation of prudent wage policies with pay increases covering inflation. From a more inter-temporal perspective, one of the key government priorities, as specified in the new SGP, is the change in the preparation, implementation and monitoring of the state budget, through the adoption of a Programme Budgeting, which will aim to establishment of a three-year fiscal framework *(the full implementation of the programme budgeting is scheduled for 2012).*

Upward revision to our forecast for the 2009 budget-deficit outcome

Be that as it may, the government now officially targets a general government budget deficit of 3.7%-of-GDP this year[17]. In our view, this target is ambitious in several respects and, *under the assumption of unchanged policies* we now expect a deficit outcome in excess of 6.0%-of-GDP[18]. The main reasons for this include our significantly-worse-than-officially-expected forecast for real GDP growth this year, which is likely to depress budgetary revenues and put upward pressure on primary expenditure in the form of higher unemployment benefits and increased social transfers to those in need. Our more pessimistic forecast for the 2009 general government deficit outcome also reflects lingering worries over the adequacy of a multitude of recently introduced revenue-generating and expenditure-controlling measures to generate the expected results. With regard to our downwardly revised forecast of -1.0% real GDP growth this year we note that this compares with forecasts of 1.1% and 0.5% *(baseline and worst-case, respectively)* envisioned in the new stability & growth program, a -0.9% projections included in the Commission's Spring 2009 forecasts report and growth of 0.0% or lower now expected by the Bank of Greece. The table below shows our estimates for the 2008 budget deficit outcome along our revised forecast for 2009 (data in %-of-GDP-terms).

TABLE: 2009 budget (%-of-GDP term)

	2009 Budget	Eurobak EFG Forecasts
1. Ordinary Budget		
a. Gross ordinary revenue	24.7%	23.0%
a1. Tax reinbursements	1.3%	1.4%
a2. Special revenue	0.5%	1.0%
a3. Net revenue (a-a1+a2)	23.9%	22.7%
b. Expenditure	25.4%	27.7%
b1. interest	4.6%	5.1%
b2. Primary expenditure (b-b1)	20.7%	22.5%
2. Ordinary budget (1a3-b)	-1.4%	-5.1%
3. Public Investment Budget		
a. Revenue	1.4%	1.5%
b. Expenditure	3.4%	3.6%
4. PIB balance (3a-3b)	-2.0%	-2.1%
5. Central gvnt bal. (2+4)	-3.4%	-7.2%
6. Public surplus&adj.	1.4%	0.7%
7. General gvnt bal. (5+6)	**-2.0%**	**-6.4%**

Our revised projection for the evolution of ordinary budget revenue this year is based on a rather brave assumption regarding the elasticity of ordinary budget revenue with respect to nominal GDP growth *(ca 2.5 vs. an average of slightly higher than 1.0 in recent years).* It also incorporates the estimated impact of the special revenue-generating measures introduced earlier this year. Our forecasts also incorporate: **a.)** growth of primary expenditure in line with the 2009 budget target *(+9.1% YoY) - an admittedly optimistic assumption, especially in view of the latest data for the budget execution in Q1 2009 (primary expenditure up 19.1%YoY)* **b.)** a €500mn overshoot in interest rate costs relative to the budget target. This is expected as a result of i. the sharp widening in Greek bond spread during the first quarter of the year and ii. higher-than-initially-projected issuance of government paper this year to meet increase spending needs. *In late April, the head of Greece´s Public Debt Management Agency (PDMA) said that the sovereign will likely borrow more than the €43.7bn initially planned for this year. Market estimates are now for total government bond issuance of around €55bn, some €43.3bn of which has already been raised.* **c.)** a broadly flat reading for the overall balance of social security surpluses and other adjustments *(i.e., the so-called white whole of the budget)* relative to last year. In 2008, this item recorded a much lower than projected surplus *(ca €1.8bn vs. €4.7bn expected).* For the current year, the 2009 budget forecasts a 24% YoY in the aforementioned surplus.

[17] 2008 Update of the Hellenic Stability & Growth Programme 2008-2010

[18] In its new macroeconomic projections for the euro area, the European Commission expects the Greek general government budget deficit to rise to 5.1%-of-GDP and to 5.7%-of-GDP in 2009 and 2010, respectively. In line with these forecasts, the Commission also expects the general government gross debt to increase to 103.4%-of-GDP in 2009 and to 108%-of-GDP next year, from 97.6%-of-GDP last year

Overall, we consider the above assumptions as relatively mild and, under the scenario of no further fiscal measures, we regard the balance of risks as being skewed towards an even higher budget deficit outcome this year. Under these circumstances, our forecast for Greece's gross public debt-to-GDP this year rises to around 105%-of-GDP, from 97.6%-of-GDP previously and against the most recent EU Commission forecast of 103.4%-of-GDP. Yet, as we noted earlier, the government reportedly considers a new package of corrective fiscal measures to be introduced after the EU elections. Our preliminary calculation on the likely budgetary impact of such measures - *based on relevant figures currently circulated in the local press* - still point to an overall deficit outcome in excess of 5%-of-GDP this year.

European Commission forecasts

y/y growth	**2009**	**2010**
Real GDP	-0.9	0.0
Private Cons.	*0.4*	*0.5*
Public cons.	*1.9*	*1.9*
GFCF	*-5.6*	*0.7*
Exports g&s	*-7.3*	*0.8*
Imports g&s	*-6.0*	*0.9*
HCPI period avrg	1.8	2.3
Budget bal. (% GDP)	-5.1	-5.7
Public debt (% GDP)	103.4	108.0
C/A balance (% GDP)	-11.5	-11.9
Unempl. rate	9.1	9.7

Source: EC Economic Forecast, Spring 2009

Focus: Greek tourism industry
Recent developments & prospects

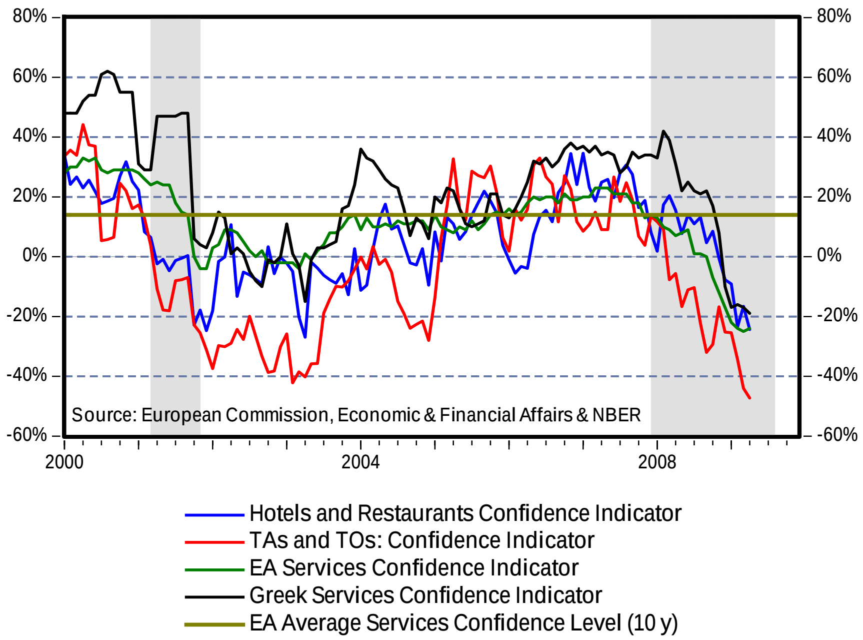
- **There is little doubt that the Greek tourism industry is heading for its worst post-war era recession**
- **Yet, some recent survey data suggest that the demand for tourism services may be stabilizing, albeit at very depressed levels relative to the past periods**
- **Moreover, survey data regarding current and future price levels suggest an effort by the industry to defend profit margins, at least in the hotels and restaurants sector**

The severity of the economic downturn[1] is vividly reflected in the recent weak reading in a range of consumer and business confidence indicators. Greece's tourism sector is expected to experience a severe downturn this year, as demand for tourism and leisure services is sharply lower worldwide and, especially, in Greece's major exports markets *(US, UK, Germany, Italy and other Euroarea countries).* The following brief takes a closer look on the recent performance of a number of confidence indicators for the Greek services sector, namely the sub-groupings that refer to "hotels and restaurants" and the "travel agencies, tour operator and tourist assistance" activities.

1. Business Confidence in the sector remains at depressed levels

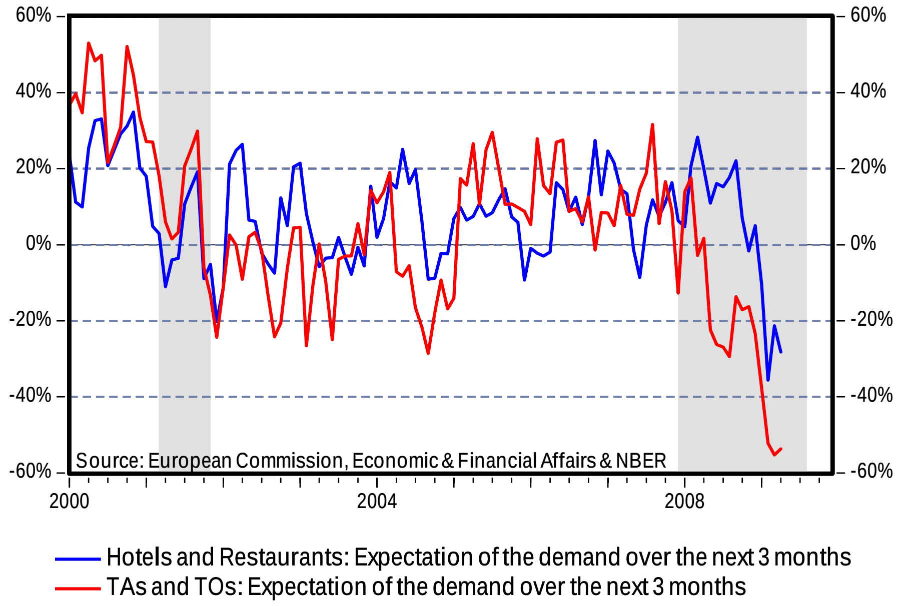
As figure 1 suggests, sentiment in the sector has already witnessing a significant downturn. Readings *(survey balances)* in the "hotels and restaurants" have turned solidly negative since December 2008, whereas pessimism is currently the prevalent sentiment among tour operators, travel agencies and the tourist assistance companies *(henceforth TAs & TOs).*

Figure 1
Sentiment in the tourism industry turns south *(grey areas indicate recessions)*



In fact, TAs & TOs remain more pessimistic about industry prospects when compared to both the Greek hotels and restaurants owners and their European peers in the services sector as a whole. Furthermore, the available history of relevant confidence indicators shows that TAs & TOs confidence is currently at record lows. These entrepreneurs appear to possess a "better information set" relative to hotel and restaurant owners, having "sensed" the downturn in demand earlier than the rest of the entrepreneurs in the sector. As such, Figure 1 vividly underscores a bleaker outlook for the Travel & Tourism sector in Greece for the coming months.

Figure 2
Expectation of demand over the coming 3 months *(grey areas indicate recessions)*

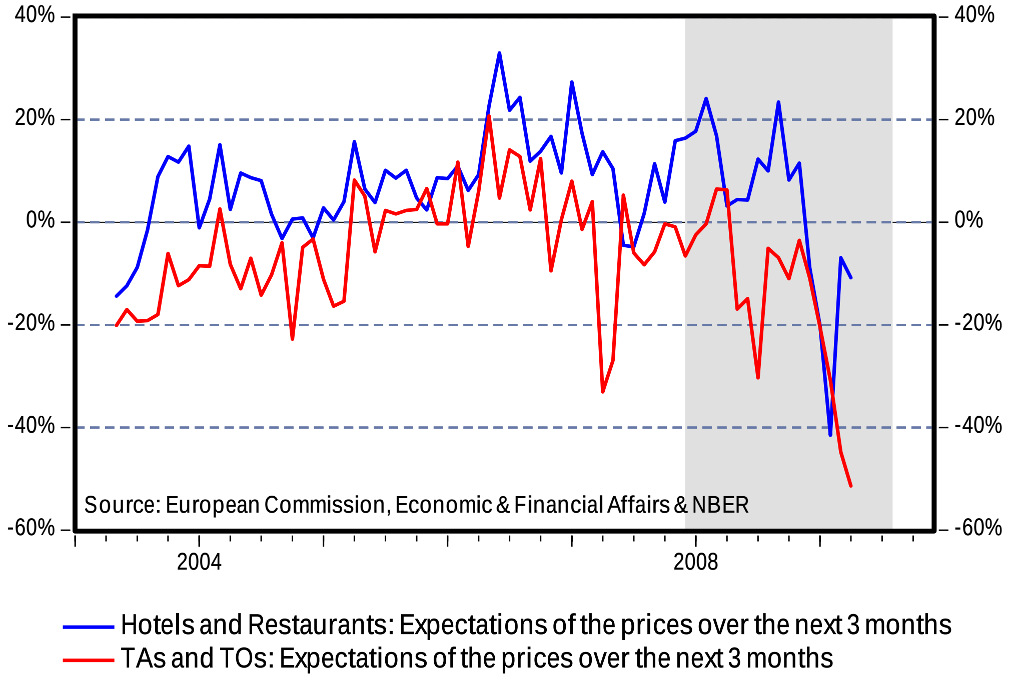


Focusing on 3-month-ahead expectations, the most recent survey readings *(April 2009)* suggest that the pace of demand declines may be loosing momentum. In Figure 2, the demand outlook appears to be stabilizing, albeit at very depressed levels. Both hotels and restaurants owners as well as TAs & TOs appear to start feeling "less pessimistic" about future demand. Yet, it remains to be seen whether the data reflect a turnaround in demand patterns following the spring season or whether the future conceals even more unpleasant surprises for the sector as a whole. Figures 1 and 2 reveal that confidence data are rather choppy, even in recovery phases so the evidence of stabilization in the demand outlook, as suggested by Figure 2 at least, should be evaluated with caution.

2. Mixed expectations about price levels

Lately there has been a lot of debate with regard to the pricing of tourism services in Greece, as price levels have traditionally been viewed as the Achilles' heel of the country's competitiveness in general. Within the current deflationary environment, it makes sense to pursue price competitiveness as long as standards do not suffer, especially when competitors offer hefty discounts to potential customers. As such, domestic entrepreneurs will need to strike a balance between diminished profit margins, cost cutting and quality of services offered. Figure 3 shows a dichotomy in views between hotel & restaurant owners and TAs & TOs. It appears that the former are more optimistic on prices than the latter. This optimism may reflect a good spring break season that may have been mainly fuelled by stronger than expected demand due to improved consumer confidence both in Greece and abroad. Econometric analysis in the form of "Granger Causality Tests", suggests strongly that hoteliers' price level expectations have a leading property over those of TAs & TOs. Hence, the latter have a "better" view on the tourism sector's performance as a whole and, especially, with respect to future demand, whereas hotel and restaurant owners usually possess a "better" outlook for the evolution of prices in the sector. This suggests a price-setting ability, even within a severely recessionary environment. While the above should be received with caution[2] Figure 3 suggests that the hotels and restaurants sector may be able to maintain prices at levels that may defend profit margins and the financial healthiness of the sector, at least in the short term. It remains to be seen how much demand destruction will be suffered by the current economic downturn and to what degree this will be reflected in prices. Examination of available sectoral data for the Spanish and Cypriot tourism sectors reveal a rather mixed picture regarding price levels, while the aggregate EU/EA survey data point to further deflation in the services sector.

Figure 3
Expectation of prices over the coming 3 months *(grey areas indicate recessions)*

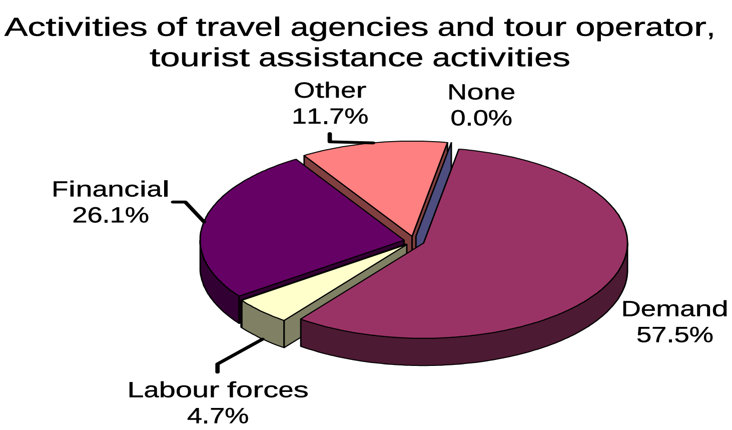


3. Factors weighing business

Finally, TAs & TOs as well as hotels and restaurants owners recognize demand weakness as the most important factor currently weighing on business *(Figure 4)*. Roughly one out of four TAs and TOs recognize as the 2^{nd} most important limiting factor the financial one, possibly reflecting the weakness of consumer credit in Greece's main tourism markets, including the US and UK. Yet, financial and financing problems do not appear to be as severe for entrepreneurs in the hotel sector, as only one out of twenty cites such factors to be limiting their business. Moreover, one out of three report that there is no limiting factor currently affecting their business activities.

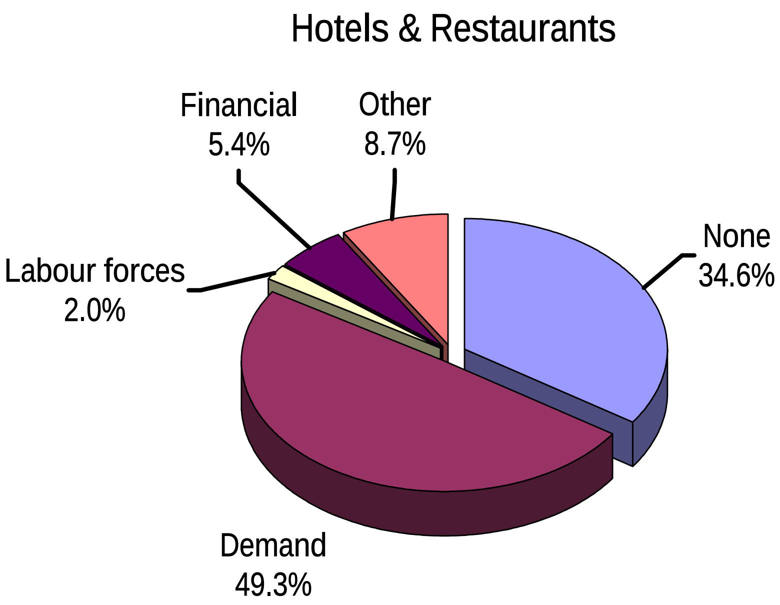
Figure 4
Factors weighing on Business

(a)



(Continued next page)

Figure 4
Factors weighing on Business (continued from previous page)
(b)



4. Conclusions

To summarize, Greek business confidence survey data reveal a lot of pessimism among the ranks of the tourism industry entrepreneurs. Both the industry's expectations and the fundamentals of the global economy suggest that demand for tourism services will most likely be very depressed. Growing numbers of hotel and restaurant owners, however, expect improved levels of prices despite the global deflationary environment. It is still too early to ascertain whether there will be robust demand for tourism services in Greece, strong enough to justify the current expectations of relatively higher price levels.

Endnotes

[1] On May 4th, the European Commission revised its forecast for the Euroarea (EA), expecting a contraction twice as deep as the one it had forecasted for 2009 a quarter ago. In the EA, growth is expected to drop by 4% and be flat in 2010. Unemployment is seen rising almost to double digits (9.9%) outlining the dire image of the "*deepest and most wide-spread recession of the post-war era*", to use the EU Monetary Affairs Commissioner's wording.

[2] There are not sufficiently enough data to extend the analysis over a large period of time, examining the impact of several recessions on the survey's readings.