BANK OF GREECE

ANNUAL REPORT
2004

ATHENS 2005

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2004

PRESENTED TO THE 72nd GENERAL MEETING
OF SHAREHOLDERS ON 25 APRIL 2005
BY GOVERNOR NICHOLAS C. GARGANAS

ATHENS 2005

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M. PAPADONICOLAKI — Government Commissioner

* At the Annual General Meeting of 2005 the following terms of office expire; (a) of Mr. G. Akkas and Mr. Kyriakopoulos, who were elected General Council Members at the Annual General Meeting of 29 April 2002, according to Article 21 of the Bank's Statute, and (b) of Mr. M. Handris, who was elected Deputy Member of the General Council by General Council Decision 13/20 July 2004 (in replacement of Mr. K. Drakopoulos who had resigned), according to Article 22 of the Bank's Statute.

CONTENTS

CHAPTERS PAGE

TABLES

CHARTS

BOXES

I. FINANCIAL RESULTS FOR 2004

The Bank's Profit and Loss Account for 2004 shows total net income of €598.6 million and total operating expenses of €393.0 million, including depreciation and provisions. Net profits thus reached €205.6 million, compared with €218.3 million in 2003.

Out of these net profits, the General Council proposes to the General Meeting of Shareholders, under Article 71 of the Bank's Statute, that an amount of €8 million, corresponding to 12% of the Bank's share capital, be distributed as a first dividend and that an amount of €26.0 million be distributed as an additional dividend. Thus, the total dividend proposed for distribution comes to €34.0 million, compared with €29.8 million in 2003. Accordingly, the total dividend per share comes to €2.85 euro, which is 14% higher than in 2003. From the balance of net profits after the deduction of income tax, an amount of €153.3 million shall be paid to the State, in accordance with Article 71 of the Bank's Statute, compared with €172.4 million in 2003.

Total net income from interest, commission fees and other receipts from domestic and foreign transactions, including transactions with the European Central Bank (ECB) and the other members of the European System of Central Banks (ESCB), increased by €69.2 million or 13.1% compared with 2003 and, as mentioned above, rose to €598.6 million.

Net interest income from claims on the Greek State and domestic or foreign credit institutions increased by €55.1 million or 20.3%, thus totalling €325.9 million in 2004, compared with €270.8 million in 2003. This development is mainly attributable to the decrease, relative to 2003, in interest paid on the balance of the Bank's liabilities arising from transactions with the Eurosystem and to the increase in interest income from investments in euro and foreign currencies with credit institutions abroad.

More specifically, net interest income from the Bank's transactions with the Greek State fell by €53.8 million, compared with a drop of €106.7 million in 2003. This development mainly reflects the €48.5 million decrease in interest income from long-term loans extended by the Bank of Greece to the Greek State, owing to amortisation payments on these loans and to interest rate cuts. In contrast, interest income from the Bank's government security portfolio grew by €5.6 million (decrease of €21.1 million in 2003), primarily as a result of an increase in its portfolio. Interest income from other investments in euro and foreign currencies increased by €10.0 million, since part of the Bank's holdings in US dollars was replaced by holdings in euro-denominated securities and deposits, in the context of the restructuring of the Bank's portfolio. This change had a positive impact on the Bank's income, since returns on euro-denominated assets are higher than on those denominated in US dollars.

Interest income from lending to credit institutions fell by €20.1 million, after rising by €22.2 million in 2003. This decrease is mainly attributable to the smaller than in 2003 supply of liquidity to credit institutions through main refinancing operations, as well as to a reduction in the interest rate on these operations.

Interest paid on the balance of the Bank's liabilities arising from transactions with the Eurosystem fell by €111.4 million to €273.4 million in 2004, from €384.8 million in 2003. This development is mostly due to the decrease in the Bank's net liabilities vis-à-vis the Eurosystem and, to a lesser extent, to the reduction in the interest rate (the minimum bid rate on main refinancing operations).

The Bank's financial operations in 2004 resulted in a net credit balance of €3.9 million, compared with €27.9 million in 2003. This result concerns profits and losses stemming from operations in foreign exchange, securities and gold, as well as non-realised losses from the valuation of the Bank's holdings in foreign exchange and tradeable securities on 31 December 2004. During the financial year of 2004, while the Bank made profits on financial operations (profits on foreign exchange operations amounting to €71.9 million, compared with a loss of €87.4 million in 2003), the net result fell by €24.0 million. This decrease was mainly due to non-realised losses from the valuation of the Bank's foreign exchange portfolio, owing to the appreciation of the euro against the US dollar and other foreign currencies. It should be noted that corresponding losses in 2003 were fully covered by a special reserve, created during previous financial years to cope with potential losses from adverse exchange rate developments.

Commission fees, income from participations and other income increased by €38.1 million, compared with a €56.0 million decrease in 2003. This development was partly due to the rise in income from commissions and other fees collected by the Bank in remuneration for transactions executed for the State, as well as from the management of funds and transaction settlement systems. It is also attributed to the larger amount (€91.4 million, compared with €60.3 million in 2003) carried forward to the financial results of 2004 out of the income corresponding to the estimated value of drachma banknotes that will not be exchanged for euro banknotes by the deadline of 1 March 2012.

The Bank's total operating expenses —excluding depreciation and provisions— grew by €6.2 million to €275.9 million in 2004, compared with an increase of €6.6 million in 2003. More specifically, outlays for personnel remuneration, excluding employers' social security contributions, increased in 2004 by €4.5 million or 3.7% relative to 2003. This increase was due to the grade and pay advancement of the personnel and the pay rises given under the two-year wage agreements at a branch and enterprise level. Administrative and other management expenses decreased by €5.7 million in 2004, after rising by €2.2 million in 2003. This significant reduction was mainly due to lower printing costs owing to reduced banknote production in 2004.

Depreciation increased by €14.9 million, after decreasing by €37.6 million in 2003. This was due to increased depreciation of euro banknote printing costs, owing to the destruction of a larger quantity of worn banknotes.

Finally, higher provisions were made than in 2003 and this affected net profits in 2004. More specifically, (i) an extraordinary provision of €36.1 million was created to cover the Bank's participation in the ECB's losses in 2004, (ii) a provision of €11.4 million (compared with €11.7 million in 2003) was made to cover doubtful claims, in accordance with the Bank's Statute and relevant decisions of the General Council, and (iii) an amount of €35.0 million (€10.0 million in 2003) was set aside to meet the Bank's future liabilities to personnel insurance funds. The latter provision was significantly increased by the inclusion of a special reserve of €558.1 million, formed prior to the Bank's entry into the Eurosystem.

In the course of 2004, the Bank of Greece recruited 50 employees,[1] (45 with post-graduate degrees in such fields as economics, finance, statistics, information technology or librarianship, and 4 in compliance with legislation for the protection of disabled individuals). Meanwhile, 150 employees retired. The Bank's staff therefore decreased by 100 members to 2,980 at the end of 2004.

As stressed in previous Annual Reports, joining the European System of Central Banks and the Eurosystem has significantly changed and upgraded the role of the Bank of Greece. Therefore, some of the Bank's units have to be restructured and new ones have to be set up. In addition, working methods and procedures need to be improved to ensure that the Bank's structure and operation meet the new conditions and adapt to the best practices employed by the Eurosystem.

More specifically, two Departments, i.e. the Monetary Policy and Banking Department and the International Transactions Department, were abolished in 2004 and two new Departments were established: the Strategic Planning and Organisation Department and the Payment Systems Department. The services of the abolished Departments were merged into other Departments with similar functions. The former Foreign Exchange Department, now named Financial Operations Department, was also reorganised and took on a significant part of the work of the abolished Monetary Policy and Banking Department. Having been significantly upgraded, this new Department now plays an important role within the Eurosystem. Meanwhile, the former Banking Supervision Department was restructured and renamed Department for the Supervision of Credit and Financial Institutions. This new Department, which also assumes the regulatory tasks for the credit system previously performed by the Monetary Policy and Banking Department, has already been expanded and has become specialised in specific supervisory tasks, which are expected to become broader and more composite once the new supervisory framework (Basel II) is put into place in 2006.

In the field of IT, the computerised systems that support the Bank's operations have been completed and upgraded. The equipment and software needed for the real-time settlement of transactions in book-entry form has been replaced in order to ensure faster and more secure processing of the ever-increasing volume of transactions. Access to the internet and electronic mail has been extended to a greater number of users, while work is continuing on the installation of a computerised system for human resource management in the Administration Department. A necessary back-up system that will enable the retrieval of Bank of Greece data in the event of a major breakdown is also being set up.

1 Including one member of the auxiliary personnel who became a tenured employee.

The year 2004 saw the continued construction of new buildings at a fast pace, as well as work for the maintenance, renovation and refurbishment of the Bank's existing buildings, in order to improve working conditions and security. More specifically, the building that will house the Money Handling and Sorting Centre in Athens has been completed and the Centre will soon begin operating. In addition, the buildings at the children's camp on Mount Parnitha, which had been badly damaged a few years ago by earthquakes, were reconstructed in record time and were even used to accommodate some of the teams that took part in the 2004 Olympic Games. The installation of structured wiring in the Bank's head office, necessary for the further upgrading and development of the Bank's networks, was also completed.

The Bank's training programmes continued in 2004. In order to improve personnel skills and specialisation, the Personnel Training Section held special training programmes, which met the needs of the Bank and were attended by a large number of employees. Particular emphasis was placed on credit system supervision relating to the timely diagnosis and assessment of market risks, the evaluation of the solvency of banks and businesses of the financial sector and the understanding and application of International Accounting Standards. A large number of employees followed courses on the security of IT systems, understanding and using new IT systems, developing their managerial skills, as well as foreign language learning programmes. In response to the strong demand from several private and public sector organisations associated with Greece's hosting of the 2004 Olympic Games, the Bank of Greece held a series of seminars for cashiers to help them spot counterfeit euro banknotes. Finally, a wide range of seminars and special vocational training programmes were held for the staff of central banks of countries that joined the EU in 2004, on matters relevant to the tasks and functions of the Bank of Greece in the Eurosystem and the European System of Central Banks.

The Bank of Greece continued to take initiatives to further develop its relations with the central banks and the bank supervising authorities of neighbouring countries, where the activity of Greek banks is expanding. Thus, in January 2005 in Istanbul, the Governor of the Bank of Greece and the Chairman of the Banking Regulation and Supervision Agency of Turkey signed a memorandum of cooperation in financial institution supervision in both countries. A similar memorandum of cooperation was signed two months later in Athens between the Governors of the Bank of Greece and the Central Bank of Cyprus.

On 25 February 2005, the Bank of Greece paid tribute to its former Governor, academician and professor, Xenophon Zolotas, who passed away in June 2004. The speakers at this event, who all referred to the personality and multifaceted contribution of the deceased, were Mr. Demetrios Chalikias, former Governor of the Bank of Greece, Mr. Konstantinos Drakatos, academician, Mr. Minos Zombanakis, economist, and Mr. Michael Psalidopoulos, University Professor. On the evening of the same day, the President of the European Central Bank, Mr. Jean-Claude Trichet, spoke on the subject "Monetary policy and private expectations", in the context of the lecture series held in memory of Professor Xenophon Zolotas.

Professor Xenophon Zolotas devoted a long and productive life to serving both his country and his profession. With his multifaceted activities, he played a significant part in Greece's public life during much of the 20th century.

His connection with the Bank of Greece was long and fruitful. He served as Governor between 1955 and 1981 with the exception of the period of dictatorship, at the beginning of which he resigned. His academic career was longer still and began with his appointment as Assistant Professor of Political Economy at the University of Thessaloniki in 1928. Three years later, he moved to the University of Athens where he taught Political Economy for 40 years. In 1952, he was elected a member of the Academy of Athens. He held numerous positions in Greek and international institutions and organisations. His public life culminated when he became Prime Minister of Greece at the head of a coalition government in 1989-90.

As in previous years, the Bank displayed efficiency and reliability in the execution of its tasks. It carried out the obligations arising from Eurosystem membership and played an active and effective part in a wide array of activities associated with the conduct of the single monetary policy. As the authority responsible for the supervision of credit institutions and other enterprises of the financial sector, but also in its capacity as payment systems supervisor and manager, the Bank carried out its mission successfully in 2004. The contribution of the Bank's staff, known for its dedication, has been decisive in this respect. I would therefore invite the General Meeting to join me in expressing our commendation to the entire staff.

At today's Annual General Meeting, the term of office of General Council members Mr. Georgios Akkas and Mr. Odysseas Kyriakopoulos expires. The General Meeting will therefore be called upon, in accordance with Article 21 of the Bank's Statute, to elect two new General Council members for a three-year term, i.e. until the Annual General Meeting of 2008, to replace these two outgoing members. The General Meeting will also be called upon to elect one more General Council member for a three-year term, i.e. until the Annual General Meeting of 2008, as the term of office of Mr. Michael Chandris also comes to an end. Mr. Chandris had been elected by the General Council on 20 July 2004, in accordance with Article 22 of the Bank's Statute, to replace Mr. Konstantinos Drakopoulos who had resigned.

The outgoing General Council members are eligible for re-election.

II. THE GREEK ECONOMY: DEVELOPMENTS, OUTLOOK AND ECONOMIC POLICIES AIMED AT SUSTAINING STRONG GROWTH

1. INTRODUCTION

The Greek economy continued to grow strongly in 2004, though at a somewhat slower pace than in 2003. According to provisional estimates by the National Statistical Service of Greece (NSSG), real GDP grew by 4.2% in 2004, thereby exceeding the European Union average for the ninth year running.

Inflation, as measured by the increase in the Harmonised Index of Consumer Prices (HICP), fell to 3.0% in 2004, from 3.4% in 2003. Even though inflation followed a downward path during much of the year, the annual inflation rate picked up again in the fourth quarter of 2004, reaching the same level as in the final quarter of 2003. However, core inflation (as measured by the annual rate of change in the HICP excluding energy and unprocessed food) rose above the level of 2003, causing its differential with the euro area average to widen.

Despite the appreciation of the euro and further losses in competitiveness, a large increase in the volume of world trade boosted Greek exports in 2004, especially of services, and contributed to the narrowing of the current account deficit to 3.9% of GDP in 2004, from 5.6% in 2003.

In spite of robust economic growth, employment growth is estimated to have been weak, and unemployment, at 10.5% on average in 2004, remained considerably above the euro area average. Labour market developments are, however, difficult to assess, since labour force survey data for 2004 are not fully comparable with the figures for previous years, owing to statistical revisions introduced last year.

Regarding fiscal developments, the general government deficit widened to 6.1% of GDP in 2004. This overrun (relative to the initial forecast) was due to: (a) optimistic forecasts in the 2004 budget, which had been based on the equally optimistic initial estimate for the 2003 deficit; (b) an upward revision of the 2003 deficit, which also affected 2004 results; (c) shortfalls in government budget revenue; and (d) substantial overruns in primary expenditure, related, in part, to the Olympic Games. The general government debt reached 110.5% of GDP in 2004, up from 109.3% in 2003.

In March of this year, the Ministry of Economy and Finance submitted a revised update of the Stability and Growth Programme covering the period 2004-2007, as required by the ECOFIN Council's decision giving notice to Greece to take the necessary deficit reduction measures so as to put an end to its present excessive deficit situation by 2006 at the latest. To underpin the implementation of the programme, the government announced a package of measures on 29 March 2005, which included an increase in indirect taxation, and reaffirmed its commitment to bringing the budget deficit below the 3% threshold next year.

The Greek economy is at a crucial juncture. After several years of high growth, which extended into 2004, the pace of economic expansion moderated in the second half of 2004 and the first months of 2005. This reflected, first, a return of domestic demand to more sustainable growth after the petering out of the stimulus arising from the expenditure associated with the Olympic Games and, second, the adverse impact of higher oil prices.

Looking forward, GDP growth is projected to moderate this year. The necessary implementation of a fiscal policy of consolidation, which includes lower public investment as well as expenditure cutbacks, is expected to weigh on aggregate demand growth. Private consumption growth is also expected to weaken in view of the acceleration of inflation projected for this year (mainly as a result of the increase in indirect taxation and the rise in oil prices). Consequently, based on the latest available information and estimates, the Bank of Greece expects that GDP growth will moderate this year, but will nonetheless remain strong at around 3%, i.e. much higher than the projected growth rate for the euro area as a whole.

Against the backdrop of an increase in indirect taxes, the persistence of high oil prices and a mild acceleration of unit labour costs in the business sector, average annual inflation is projected to rise to around 4% in 2005. Inflation should then subside once the effect of the increase in indirect taxation has run its course (as estimated, by April 2006). With the future path of global oil prices and the impact of the indirect tax increases being subject to a high level of uncertainty, however, upside risks to inflation exist. To help guard against the unfolding of these risks, it is of paramount importance that second-round effects stemming from wage increases and price-setting by firms throughout the economy be avoided.

Looking beyond 2005, growth and inflation prospects will depend critically on credible and determined policies to tackle macroeconomic imbalances and long-standing structural weaknesses. The upward revision of last year's fiscal data brought Greece's budget deficit ratio for 2004 to the highest level in the EU-25, while the public debt-to-GDP ratio has also remained very high. Higher unit labour costs and higher price inflation than in most trading partners over a number of years have eroded Greece's international competitiveness and contributed to large and persistent external deficits. Employment performance remains weak against a background of several years of strong growth, with the unemployment rate remaining high; also, the restrictions stemming from the regulatory environment and a multitude of bureaucratic procedures continue to weigh on entrepreneurial activity.

Strong and sustained growth in the medium term depends on two fundamental factors:

- First, macroeconomic stability must be ensured, so as to provide the appropriate environment in which policies aimed at improving the real economy can operate. At the present juncture, the policies announced by the government to achieve the needed fiscal consolidation must be successfully implemented, together with other policies aimed at ensuring price stability and strengthening price competitiveness.

- Second, structural reforms must be accelerated so as to put into place the conditions required to foster employment growth and a faster rise in productivity. The structural policies that could improve Greece's long-term economic performance are discussed in Section 9. Specifically, the section focuses on a number of key reform measures that are of particular importance for employment growth and for a faster rise in productivity, as they offer substantial scope for catching up with international best practices.

The achievement of the two fundamental requirements for sustained growth —macroeconomic stability and the strengthening of competitiveness through structural reforms— would help speed up Greece's economic and social convergence with the average of the EU-15, raise employment levels and foster a higher standard of living in Greece.

2. THE INTERNATIONAL AND EUROPEAN ECONOMIC ENVIRONMENT

The international economic environment was particularly favourable in 2004. The growth rate of world economic activity (5.1%) was the highest since 1976, with GDP growth strengthening simultaneously in the US, Japan, China and the euro area. The volume of world trade in goods and services rose by almost 10%, the fastest rate since 2000.

Monetary and credit conditions remained favourable and had a positive effect on the world economy. The key interest rates of central banks generally remained at very low levels, both in regions such as the USA and the United Kingdom, where they rose, and in Japan and the euro area, where they were left unchanged. *Real* short-term interest rates in the US and many euro area economies were negative, while real long-term interest rates were significantly lower than their average historical levels.

The significant rise in international oil prices had a negative, but rather limited, impact on the world economy. In the course of 2004, crude oil prices reached a peak in October, but in real terms they were lower than the levels recorded during the oil shocks of the 1970s. Moreover, relative to previous decades, the oil dependence of the advanced economies is now lower, while their capacity to adjust to oil price shocks is greater. Oil price increases had a dampening effect on world GDP growth during the second half of 2004, while they contributed to a small rise in inflation, although no second-round effects on wages and prices were observed.

Economic recovery in the euro area, which started in the second half of 2003, continued in 2004. The GDP growth rate rose to 2.1%[1] in 2004 (compared with an average

1 Based on data adjusted for working-day effects, GDP growth in 2004 comes to 1.8%.

annual growth rate of 1% in the previous three years), but —on the basis of quarterly rates — decelerated during the year, particularly in the second half, as the strong rise in oil prices boosted inflation and had a negative effect on private consumption, while net exports were adversely affected by the appreciation of the euro.

Inflation in the euro area (as measured by the HICP) hovered slightly above 2% for most of 2004, mainly due to higher oil prices, and stood at an average annual level of 2.1%, as in 2003. Inflation fell to 1.9% in January 2005, before picking up to 2.1% in February and March.

In 2004 the fiscal position of the euro area as a whole remained practically unchanged based on the March 2005 fiscal notifications. The general government deficit, as a percentage of GDP, is estimated to have been marginally lower than in 2003 (2.7% compared with 2.8% respectively) and the cyclically adjusted deficit remained unchanged at 2.4% of GDP. In 2004 the ECOFIN decided that an excessive deficit existed in Greece and the Netherlands and issued recommendations to the two countries calling them to put an end to the excessive deficit situation.[1] France and Germany have already been subject to an Excessive Deficit Procedure since 2003 (both countries posted deficit ratios of 3.7% of GDP in 2004). General government debt in the euro area rose to 71.3% of GDP in 2004, from 70.8% in 2003. At an institutional level, the European Council decided on 22-23 March 2005 to amend the Stability and Growth Pact.

Developments in international foreign exchange markets in 2004 were characterised by a further depreciation of the US dollar against the major currencies. The year 2004 was the fourth consecutive year that saw a depreciation of the US dollar and an appreciation of the euro, although both developments were less marked than in 2003. In the first quarter of 2005, the euro exchange rate (the effective rate as well as bilateral exchange rates against the major currencies) was volatile, with some depreciating trend relative to December 2004 being dominant.

The depreciation of the US dollar occurred amid market concerns about the sustainability of the current account deficit of the United States. A further widening of this deficit to 5.7% of GDP in 2004 was due to a strong rise in private consumption and investment, which also led to higher GDP growth (4.4% in 2004, from 3.0% in 2003). The fiscal deficit in the United States is estimated to have fallen slightly, though remaining particularly high (4.3% of GDP). The continued rapid build-up of foreign reserves, mostly denominated in US dollars, by emerging economies in Asia and oil-producing countries, helped contain the depreciation of the US dollar.

The prospects for the world economy remain positive for 2005, though a small weakening of economic activity is forecast. Interest rates are expected to remain generally low, despite market expectations of a further small increase in key short-term nominal

1 Six new Member States of the European Union were also subject to the Excessive Deficit Procedure in 2004: the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia.

interest rates in certain advanced economies. Moreover, other factors that had exerted a beneficial effect on the world economy in 2003-04 should continue to do so in 2005. According to recent forecasts by the International Monetary Fund (April 2005), world GDP should rise by 4.3% in 2005, provided that international oil prices will not be significantly higher than assumed at that time,[1] and that a sudden adjustment of world macroeconomic imbalances will not take place.

In the euro area, the rise in economic activity is expected to continue in 2005, but at a slower pace (1.6% according to the IMF and the European Commission) than in 2004, although it is expected to accelerate to 2.1-2.2% in 2006. According to ECB staff macroeconomic projections, the GDP growth rate in the euro area will range between 1.2% and 2% this year and between 1.6% and 2.6% in 2006. World economic recovery remains strong, thus supporting euro area exports. Within the euro area, investment should benefit from the very favourable financing conditions and the improved profitability of firms. Moreover, private consumption is expected to increase, supported by a rise in real incomes. With domestic demand rising, it is expected that economic growth in the euro area will become increasingly more self-sustained than in the recent past.

Inflation in the euro area is expected to fall below 2% during 2005, provided that no more external shocks occur. At this juncture there are no indications of domestic inflationary pressures building up. Wage moderation is expected to continue, against the background of modest economic growth and lax labour market conditions.

The fiscal policy stance in the euro area is expected to be slightly tighter in 2005, as the cyclically adjusted deficit of general government, on the basis of recent forecasts by the European Commission, will fall to 2.1% of GDP, from 2.4% in 2004, while the nominal deficit will remain practically unchanged (as a percentage of GDP). The general government debt is projected to rise slightly to 71.7% of GDP in 2005.

The above projections for global growth are subject to considerable downside risks. These include: First, the persistence of oil prices at high levels and their potential second-round effects on inflation. This risk is highlighted by the rise in world oil prices to new historically high levels in early April 2005. Second, the expected further increase in the current account deficit of the United States (to 5.7% of GDP) and the repercussions of its possible correction through a sudden and disorderly adjustment. Third, the persistence of relatively high fiscal deficits in most of the advanced economies in 2004, despite the favourable economic conjuncture, does not provide adequate room for manoeuvre in the event of a significant slowdown in the rate of economic growth.

1 The IMF's world forecast (*World Economic Outlook*, 13 April 2005) assumes average annual oil prices in 2005, at $46.5 per barrel (average for three types of crude oil). The assumption of the European Commission (*Spring 2005 Economic Forecasts*, 4 April 2005) is $50.9 per barrel (Brent crude oil). In the first quarter of 2005, the average Brent crude oil price was $47.8 per barrel.

3. MACROECONOMIC DEVELOPMENTS IN GREECE IN 2004

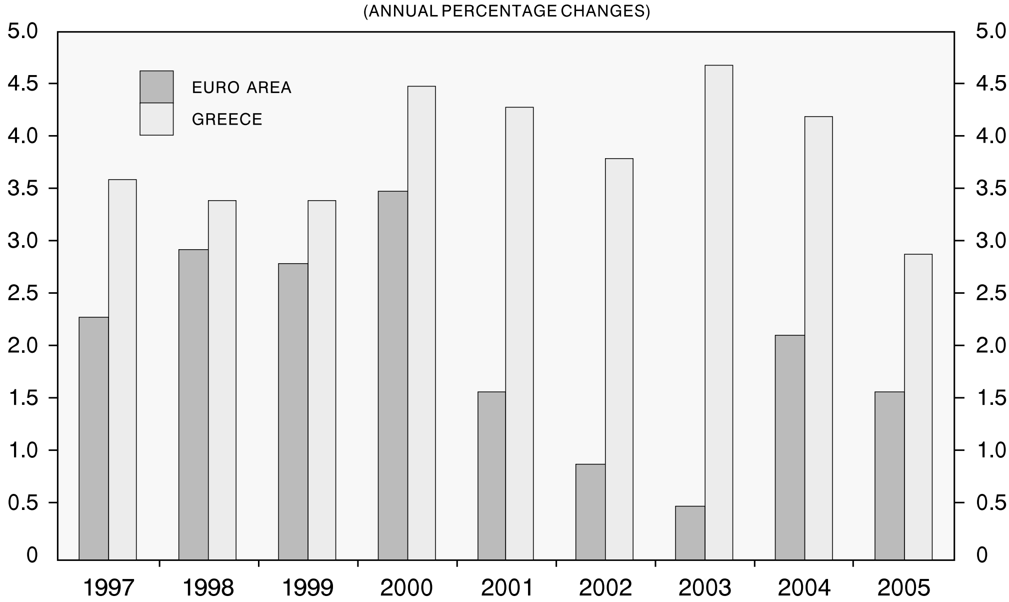
3.1 Economic activity

Following the satisfactory growth rate of the Greek economy in 2003 (4.7%), economic activity in Greece began to slow down in the second half of 2004 and, according to the most recent NSSG estimates, GDP grew at an average rate of 4.2% in 2004. On the basis on these estimates, the Greek economy is still —along with Ireland and Luxembourg— one of the fastest growing economies in the European Union, significantly outperforming the euro area as a whole (see Chart II.1).

CHART II.1

ECONOMIC GROWTH RATES IN GREECE AND THE EURO AREA[1]

(ANNUAL PERCENTAGE CHANGES)



1 GDP growth rates at constant market prices.

Sources: For Greece: National Statistical Service of Greece (NSSG) for the period 1997-2004 and European Commission forecasts for 2005. For the euro area: Eurostat and, for 2005, European Commission forecasts (*Spring 2005 Economic Forecasts*).

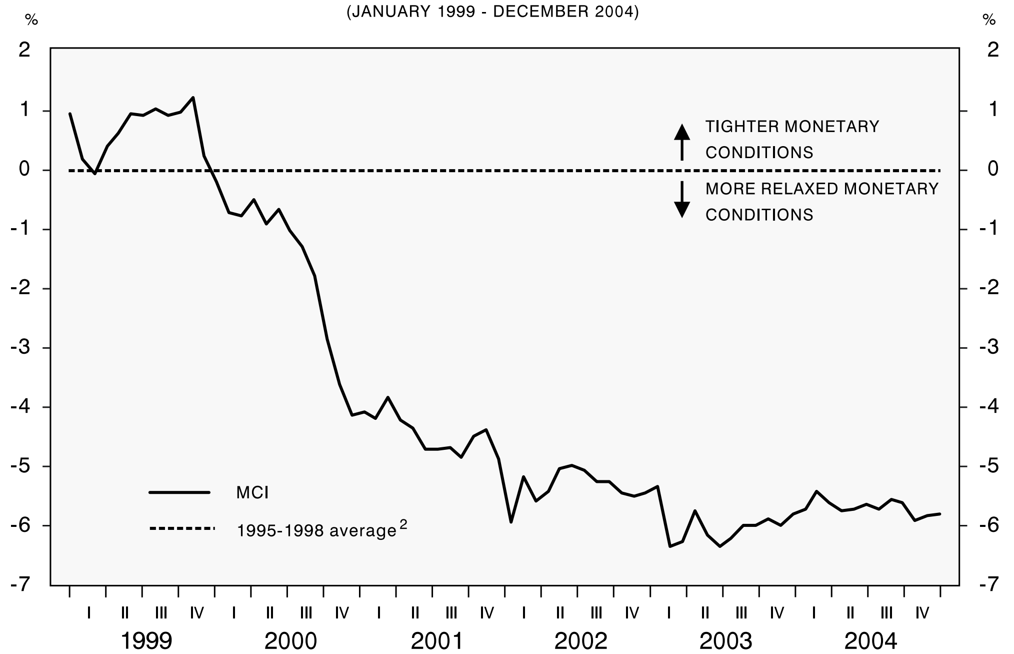
On the demand side, propitious monetary conditions (see Chart II.2), fiscal developments and the favourable international environment contributed to GDP growth in 2004. Real interest rates remained very low in 2004, thus supporting private consumption and private investment. Fiscal developments, though undesirable (since —mainly due to the impact of the Olympic Games— they caused a further increase in the government budget deficit, which puts macroeconomic stability at risk), helped sustain strong GDP growth, both by providing a stimulus to private consumption and public investment and by supporting certain income categories. Moreover, a sharp pick-up in the volume of world trade boosted exports of services, shipping receipts in particular.

According to provisional national accounts data from the NSSG, the strong increase, though at a slower rate, in domestic demand has been the key growth factor of the Greek economy on the demand side, as in previous years, contributing 4.6 percentage

CHART II.2

MONETARY CONDITIONS INDEX (MCI) IN GREECE[1]

(JANUARY 1999 - DECEMBER 2004)



1 The monetary conditions index (MCI) is defined as follows:
MCI=0.25(E(t)/E* - 1) + 0.75 (R(t) - R*), where E(t) is the CPI-based real effective exchange rate, E* is the average real effective exchange rate for the 1995-1998 period, R(t) is the real interest rate (three-month Athibor less CPI inflation until December 2000, thereafter three-month Euribor less CPI inflation) and R* is the average real interest rate for the period 1995-1998 (see note 2 of the chart).

2 Excluding the period of serious market turmoil from October 1997 to February 1998.

Sources: Bank of Greece and IMF.

points to GDP growth. In contrast, the contribution of the external sector to GDP growth was negative for the third consecutive year, albeit smaller than in 2003 (–0.5 percentage point in 2004, –1.3 percentage points in 2003).

Private consumption is estimated to have risen at a high, though decelerating, rate in 2004 (3.3% compared with 4.0% in 2003), reflecting the continued expansion of consumer credit, the cumulative rise in the value of households' wealth in recent years and an increase in households' disposable income. This increase was somewhat smaller than in

2003, owing to the significantly weaker growth of non-labour income. However, disposable income rose faster than private consumption, causing a further increase in households' average propensity to save. Public consumption rose at a very fast rate in 2004 (6.5%, compared with a decrease of 2.3% in 2003), reflecting fiscal relaxation.

The growth rate of gross fixed capital formation fell to 4.9% in 2004, down from the particularly high rate of 13.7% in 2003. This mainly reflected a slower growth of business investment (by both public and private enterprises), as well as no change in residential investment. Taking into consideration the relatively sound financial position of Greek enterprises and the conditions of ample liquidity prevailing in the market, the corporate sector's reluctance to invest may reflect firms' assessments concerning a weaker demand outlook over the medium term, partly owing to the intensification of international competition, combined with a further deterioration in competitiveness. This assumption is supported by survey results, indicating that business confidence, as well as the economic sentiment indicator, in 2004 stood at levels lower than their averages over recent years. Moreover, business confidence indicators deteriorated after April 2004 (although confidence of the services sector partly rebounded in the first quarter of 2005).

Notwithstanding increases in foreign demand, exports of goods, according to national accounts estimates by the NSSG, fell by 1.3%, owing to the cumulative loss of competitiveness in recent years. In contrast, exports of services recovered, rising by 18.4%. In particular, according to Bank of Greece data, transport receipts (mainly from shipping) rose at an impressive rate, almost by 40% at current prices, which is attributed to the recovery of both the volume of world trade and of freight rates.

The growth rate of imports of goods and services accelerated (to 8.2%, from 4.8% in 2003) and significantly exceeded the growth rate of final domestic demand (4.2%). The pick-up in imports was partly to be expected, following their weakness in the preceding three years, despite fast economic growth.

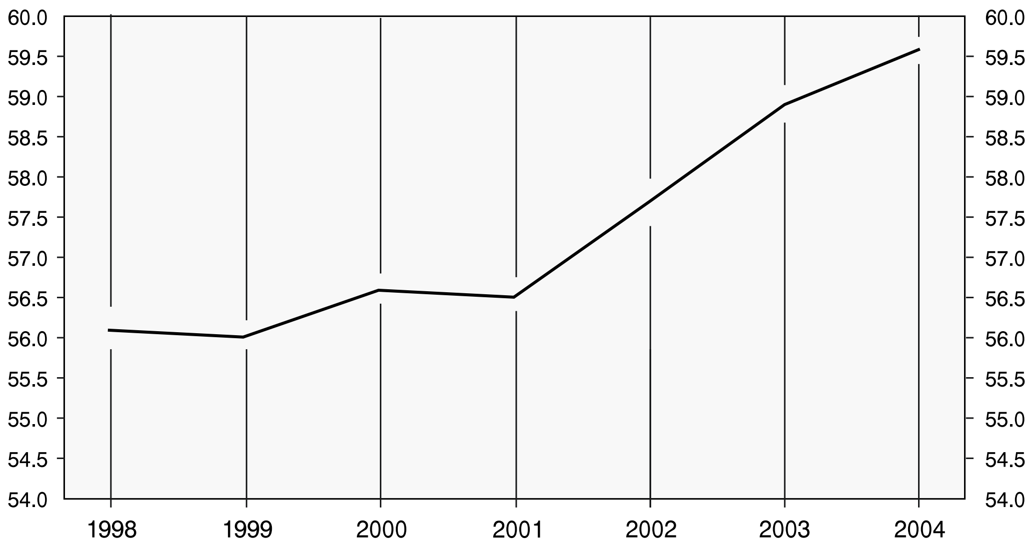
However, supply did not rise in line with demand, causing a further increase in Greece's positive output gap. The average growth rate of the potential output of the Greek economy during recent years has been lower than the average growth rate of demand, despite the big increase in gross fixed capital formation and the satisfactory rise in the labour force (due to the inflow of immigrants). This is attributed to delays in the implementation of structural reforms and in the promotion of policies aiming to upgrade human resources, so that they can deal with increasingly complex and rapidly changing modern technologies. For these reasons, it has not been possible to make full and effective use of productive resources and to embody the expected favourable effects from investment in productivity.

3.2 Employment and unemployment

Strong GDP growth in 2004 and the hosting of the Olympic Games naturally contributed to an increase in employment. The size of this increase and the branches of economic activity affected cannot be accurately determined, since the new data of the Labour Force Survey do not allow comparison with the previous year. Yet, it is estimated that the rise in employment was recorded mainly in the first half of the year and was broadly based across the sectors of the economy. By contrast, in the second half of 2004, while employment in trade and services kept rising, it fell in construction.[1] Data from the Employment Observatory of the Manpower Employment Organisation (OAED) concerning employment flows in the private sector show that fewer new jobs were created in 2004 than in 2003.

CHART II.3

EMPLOYMENT RATE[1]



1 Employed persons aged 15-64 as a percentage of the population aged 15-64.

Source: NSSG, Labour Force Surveys, second-quarter data for each year. Revised data (January 2005), after the adjustment of the sample results to the 2001 National Census.

The employment rate in Greece has risen in recent years, but is still one of the lowest among the 15 most advanced economies of the European Union (EU-15). In 2004, the employment rate (i.e. employed persons as a percentage of the total population aged 15-64) was 59.4% on average in Greece (see Chart II.3), compared with 64.7% in the EU-15.[2] This is attributed to the significantly lower rates of female employment (Greece: 45.2%, EU-15: 56.8%) and youth employment (people aged 15-24 years, Greece: 26.8%, EU-15:

1 See analysis in Chapter III.4.
2 For the EU-15, data for the first nine months of 2004.

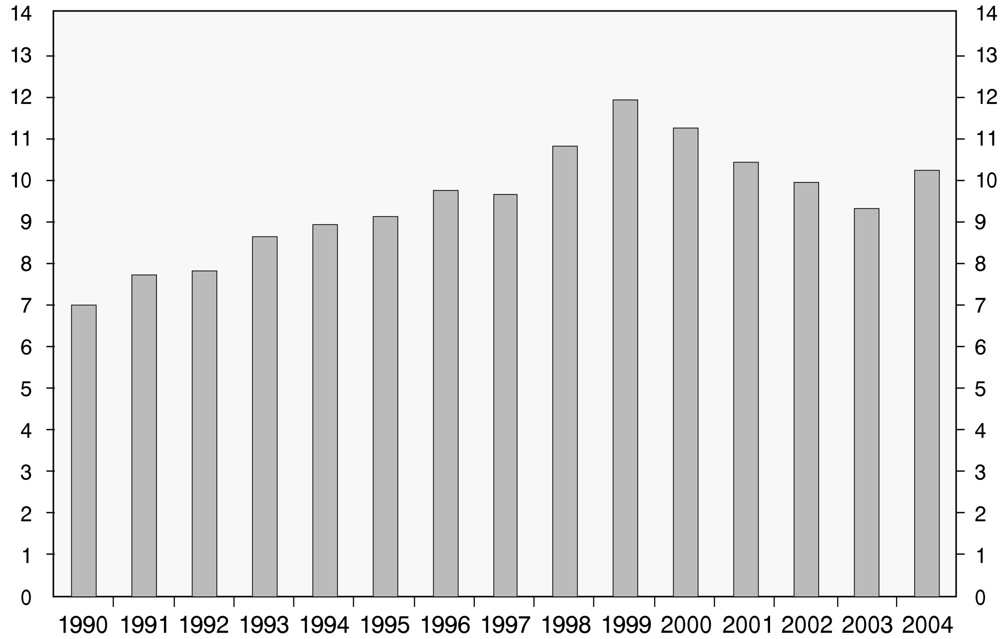
approximately 40%). These divergences in employment rates partly explain the gap between *per capita* GDP in Greece and that in the EU-15 (see Section 9.4).

Despite the increase in employment, unemployment remained high in 2004 (see Chart II.4). The unemployment rate stood at 10.5% on average in 2004 and is still significantly higher in Greece than in the EU-15 (8.0%). The unemployment rates of women (16.2%) and young people aged 15-24 (26.9%) are particularly high, while a considerable proportion of the unemployed (55%) are long-term unemployed. Also a matter of concern is the fact that 41.5% of the total number of unemployed persons have no previous

CHART II.4

UNEMPLOYMENT RATE 1990 - 2004

(PERCENTAGE OF THE LABOUR FORCE)



Source: NSSG, second-quarter data for each year.

work experience (they are new entrants into the labour market). Alongside excess labour supply, there are indications of vacancies and tightness as far as certain "cutting edge" skills are concerned.[1] Mismatches between supply and demand for labour suggest that there is a need to adapt education and training systems, as well as to increase the effectiveness of OAED and of private-sector employment agencies.

For the current year, the updated Stability and Growth Programme of March 2005 estimates (according to a baseline scenario and two alternative scenarios) that employment

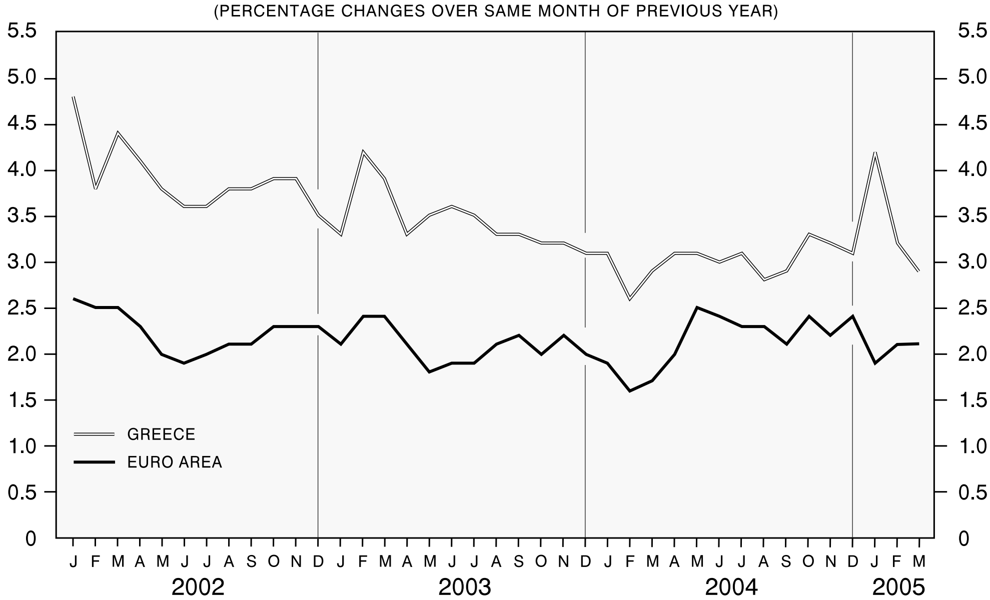
1 See Chapter III.4.

will increase by 0.9-1.5% and the unemployment rate will fall by 0.2-0.5 percentage point or remain unchanged. As suggested by business surveys conducted in the first quarter of this year in industry, construction, retail trade and services, enterprises appear to be pessimistic about the short-term outlook for employment. At the same time, however, the expected positive effects from the implementation of policy measures included in (the recently passed) tax and development laws, as well as from the promotion of public-private partnerships (co-financed projects), the targeted more efficient absorption of funds available under the third Community Support Framework (CSF III) and the simplification of procedures for starting business activity in manufacturing should be taken into consideration.

CHART II.5

HARMONISED INDEX OF CONSUMER PRICES: GREECE AND THE EURO AREA, MONTHLY DATA (JANUARY 2002 - FEBRUARY 2005)

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Sources: NSSG and Eurostat.

The effort to deal with unemployment and possibly the effort to reduce its duration should benefit from the greater emphasis on a personalised approach to the unemployed, which will be made possible by upgrading and streamlining the operation of Employment Promotion Centres (KPA), as well as by continuing the programmes for the acquisition of work experience ("Stage"). In any case, the most probable scenario is that the expected rise in GDP will absorb only part of the increase in the labour force, causing the unemployment rate to remain roughly unchanged this year (see also Section 8).

The low employment rate and the high unemployment rate still continue to represent major challenges for the Greek economy. Dealing with these challenges will require policy actions such as those mentioned above, as well as policy actions that will yield results over a longer-term horizon (see Section 9.4).

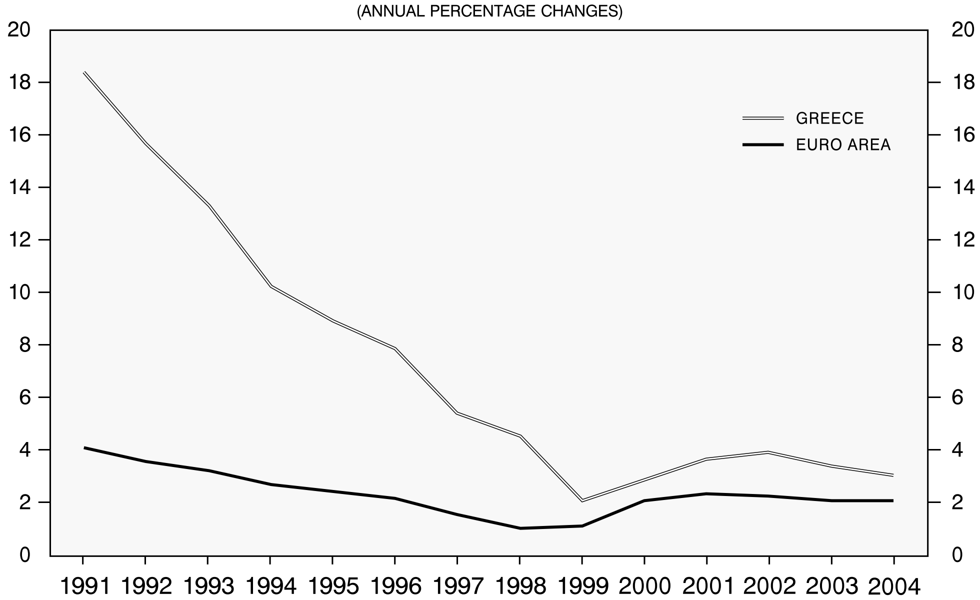
3.3 Developments in inflation

The annual rate of increase in the Harmonised Index of Consumer Prices (HICP) was 3.2% in the fourth quarter of 2004, i.e. the same as in the final quarter of 2003, but its average for 2004 fell to 3.0% from 3.4% in 2003, mainly because the drop in fresh fruit

CHART II.6

HARMONISED INDEX OF CONSUMER PRICES: GREECE AND THE EURO AREA, ANNUAL DATA (1991-2004)

(ANNUAL PERCENTAGE CHANGES)



Sources: NSSG and Eurostat.

and vegetable prices more than offset the faster rise in fuel prices in 2004, compared with 2003, and the increase in core inflation (see Charts II.5 and II.6).

Core inflation, as measured by the annual rate of change in HICP excluding energy and unprocessed food, increased to an average of 3.4% in 2004 from 3.1% in 2003 – see Chart II.7. This chiefly reflects the faster growth of unit labour costs in the whole economy relative to the previous year, combined with persisting demand-side pressures, as well as the indirect effects of oil price increases (dating back to the second quarter of 2003) on the prices of other goods and services. The appreciation of the euro, by containing imported inflation, moderated these inflationary pressures somewhat.

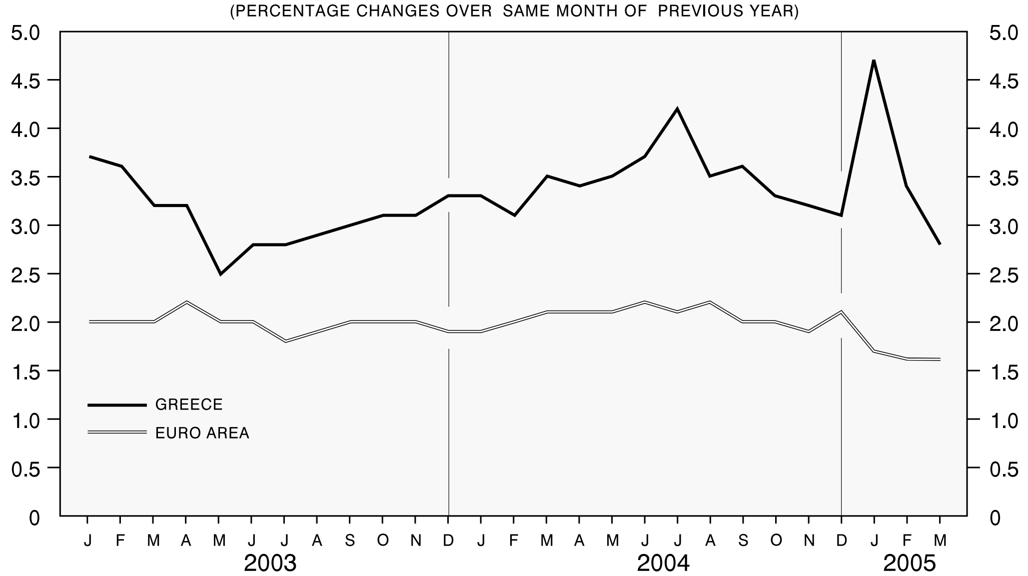
The upward trend in core inflation, the considerably faster rise in wholesale prices of domestic industrial products for home consumption (in contrast to a very small rise in the prices of imported goods) and, finally, the stronger growth of export prices (whether expressed in euro or in foreign currency) suggest that domestic inflationary pressures, combined with the lower inflation rates enjoyed by Greece's trading partners and the appreciation of the euro, are having a negative effect on the price competitiveness of Greek products in both the domestic and foreign markets.

Indeed, during the four-year period 2001-2004, the differential between the *cumulative increase* in the prices of goods and services (excluding energy and unprocessed food) in

CHART II.7

HARMONISED INDEX OF CONSUMER PRICES EXCLUDING ENERGY AND UNPROCESSED FOOD PRICES: GREECE AND THE EURO AREA

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Sources: NSSG and European Central Bank (ECB).

Greece (15.0%) and the corresponding increase in the euro area (8.8%) was more than six percentage points. This implies an appreciable loss of price competitiveness for Greece vis-à-vis other euro area countries. Moreover, price competitiveness against non-euro area countries is affected by the continuing appreciation of the euro. Obviously, following the adoption of the single currency, such a loss in competitiveness cannot be dealt with by an exchange rate adjustment at the national level but requires the use of other policy instruments.

More generally, the persistence of high core inflation is due to the same factors that underlie the inflation differential vis-à-vis the euro area, i.e. macroeconomic conditions and inadequate competition in certain markets which do not operate efficiently.

3.4 Balance of payments

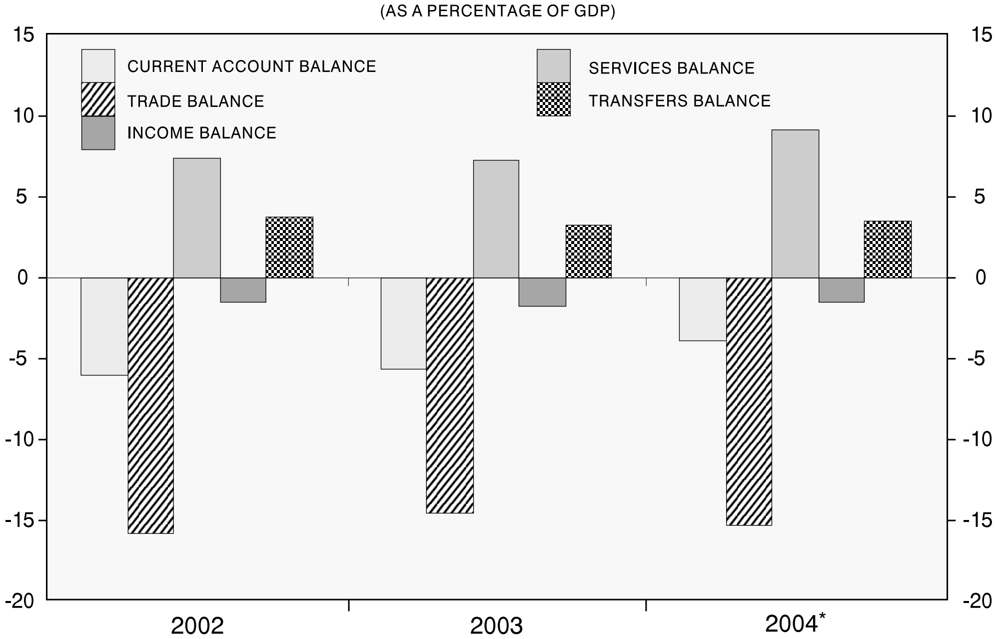
The *current account deficit*[1] narrowed considerably to 3.9% of GDP in 2004, compared with 5.6% in the previous year (see Chart II.8) and an average of 6.2% in the four-year period 2000-2003.

The persistently high current account deficit in recent years reflects to some extent the process of real convergence —as shown by the notable upswing of private investment— and the relaxation of fiscal policy. Between 1999 and 2004, total fixed capital formation increased by 2.8 percentage points of GDP, from 22.7% of GDP in 1999 to 25.5% of GDP in 2004, one of the highest rates in the EU (see Chart II.9). Most of this increase came from private investment, which rose by 2.2 percentage points of GDP, while public investment grew by 0.6 percentage point of GDP. Following a protracted downturn, private savings picked up appreciably over the same period, rising from 15.1% of GDP in 1999 to 19.2% of GDP in 2004 and thus outpaced investment growth. This improvement

CHART II.8

CURRENT ACCOUNT BALANCE

(AS A PERCENTAGE OF GDP)



* Provisional data.

Sources: For the balance of payments: Bank of Greece. For GDP: NSSG.

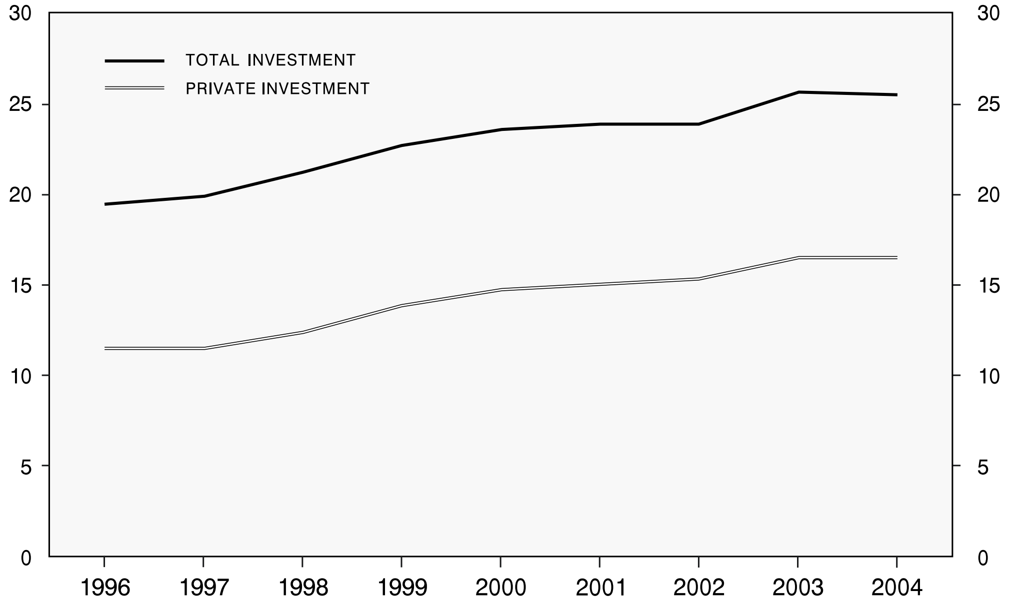
1 Including capital transfers (mainly from the EU Structural Funds).

can be explained by strong GDP growth and the reduction in inflation to low and predictable levels, which indicates that the deterioration of the current account deficit came as a result of a relaxed fiscal policy. In fact, public savings dropped by 3.1 percentage points of GDP to –1.4% of GDP 2004, from 1.7% of GDP in 1999.

The widening of the current account deficit between 2000 and 2003 and its persistence at relatively high levels in 2004 despite its reduction, reflect, in addition, the fact that Greece is at a different stage of the business cycle compared to that of its main EU trading partners, the structural weaknesses of the Greek economy, as well as the loss of competitiveness owing

CHART II.9

GROSS FIXED CAPITAL FORMATION AS A PERCENTAGE OF GDP



Source: NSSG.

to a further increase in relative prices and the appreciation of the euro. Thus, as has been pointed out in earlier Bank of Greece reports, a sustainable decrease in the current account deficit will require further reforms aimed at raising productivity and competitiveness.

The substantial (€2.2 billion) reduction in the current account deficit to €6.4 billion in 2004 was the result of three main factors: *First*, gross receipts from transport (mostly shipping) services rose spectacularly by about 40%, reflecting the sharp growth of the world trade in goods, which boosted demand for maritime transport and pushed tanker and dry bulk freight rates up to historically high levels. *Second*, exports of goods improved remarkably. This improvement was almost exclusively due to sales (exports) of second-hand vessels to renew the merchant fleet, whereas aggregate receipts from exports of other goods remained virtually unchanged. *Third*, capital transfers (mostly transfers from the EU Structural Funds to the general government sector) increased considerably, whereas current transfers (mostly EU-CAP-related transfers) declined.[1] The sharp reduction in the current account deficit occurred despite the pick-up in imports following three years of stagnancy, a rise due, to some extent, to the completion of projects related to the Olympic Games and to a cumulative loss of competitiveness (also felt in the domestic market). Finally, net receipts from travel services increased as well, partly owing to the successful management of the Olympic Games.

Turning to the *financial account*, financial investment (i.e. the sum of FDI, portfolio investment and "other" investment) recorded a net inflow of €5.2 billion in 2004. This reflects net inflows in both portfolio and direct investment, which, however, were largely offset by a net "other" investment outflow. It should be noted that, as in the previous year, the pronounced decline in reserve assets stemmed from the ongoing restructuring of the Bank of Greece's portfolio towards euro area bonds and away from assets denominated in non-euro area currencies (mainly US dollars). As a result, the financial account balance, which is the sum of financial investment flows and the change in reserve assets, showed a significant net inflow, which more than offset the current account deficit.

Although net FDI inflows remained low, investment in Greece by non-residents (mainly from other EU Member States) almost doubled compared with 2003. This recovery is quite encouraging, particularly considering the declining path of FDI in international markets.[2] Portfolio investment recorded a net inflow of €13.7 billion, reflecting €21.6 billion of Greek government bond purchases by foreign investors, compared with €18.8 billion in 2003. Residents' holdings of foreign bonds also rose considerably (€10.3 billion), partly because of the Bank of Greece's portfolio restructuring.

Finally, "other" investment showed a net outflow of €9.1 billion, reflecting higher assets (mainly domestic credit institutions' deposits and repo holdings abroad) and, to a lesser degree, a decrease in liabilities (primarily owing to loan repayment and, secondarily, to a drop in non-residents' deposits and repo holdings in Greece).

4. FISCAL DEVELOPMENTS AND PROSPECTS

4.1 The widening of the deficit

Despite robust economic growth, the general government deficit rose further in 2004, driving fiscal imbalances to worrying levels. At the same time, the Excessive Deficit Procedure was triggered for Greece in May 2004.

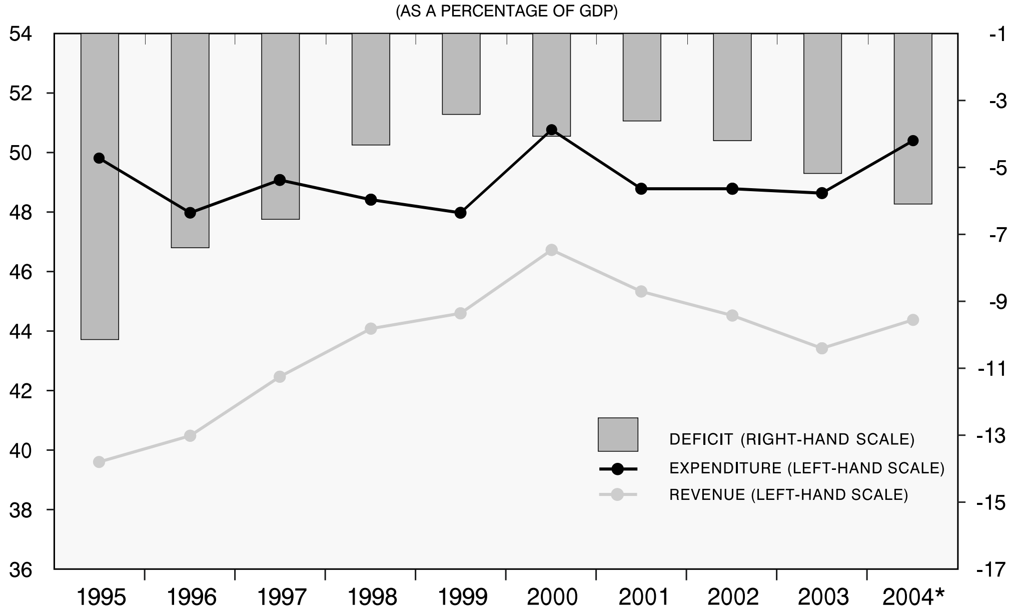
1 The current account balance, as compiled on a *national accounts basis*, shows current transfers *only*.
2 The largest FDI during 2004 can be seen in Chapter IX.

According to the latest revision of fiscal data (March 2005), the general government deficit (on a national accounts basis) increased by 0.9 percentage point of GDP in 2004 relative to the previous year and stood at 6.1% of GDP (see Chart II.10), being the highest in the euro area. This deterioration was entirely due to a 1.3% increase in the central government deficit (on an administrative basis), which was partly offset by developments in the other sectors of general government (mainly social security funds and local government) and central government transactions that are not recorded on an administrative basis. Specifically, regarding central government (in accordance with data on an

CHART II.10

GENERAL GOVERNMENT REVENUE, EXPENDITURE AND DEFICIT[1]

(AS A PERCENTAGE OF GDP)



1 The deficit data for 1997-1999 announced by Eurostat have been taken into account.
* Provisional data.
Source: Ministry of Economy and Finance, Macroeconomic Analysis and Forecasts Department.

administrative basis), total expenditure increased by 12.1% (see Table II.1), mainly owing to higher primary expenditure of the *ordinary* budget, especially for personnel outlays (salaries and pensions), grants, restitution of revenue collected on behalf of third parties and tax refunds. In fact, primary expenditure of the ordinary budget grew by 15.1%, compared with increases of 12.8% in investment budget expenditure and of a mere 0.5% in interest payments. The revenue of central government increased by 8.2% (although it remained almost unchanged as a percentage of GDP), owing to substantially higher Public Invest-ment Budget (PIB) revenue, the bulk of which stemmed from EU transfers.

TABLE II.1
FISCAL DEFICITS
(Million euro)

	Outcome 2003	Budget 2004	Outcome 2004*	Budget 2005	Outcome 2004*/ Outcome 2003	Budget 2005/ Outcome 2004*
Central government (administrative basis)						
Revenue[1]	**41,704**	**47,740**	**45,117**	**49,710**	**8.2**	**10.2**
1. Ordinary budget	39,881	43,620	42,035	46,310	5.4	10.2
2. Public investment budget	1,823	4,120	3,082	3,400	69.1	10.3
Expenditure[1]	**51,551**	**54,000**	**57,785**	**58,227**	**12.1**	**0.8**
1.1 Ordinary budget[2]	43,116	44,750	48,270	50,177	12.0	4.0
– Interest payments	9,416	9,750	9,466	9,800	0.5	3.5
1.2 Ordinary budget primary expenditure	33,700	35,000	38,804	40,377	15.1	4.1
2. Public investment budget	8,435	9,250	9,515	8,050	12.8	–15.4
Net deficit[2](–)	**–9,847**	**–6,260**	**–12,668**	**–8,517**		
% of GDP	**-6.4**	**–3.8**	**–7.7**	**–4.8**		
General government (national accounts basis)						
Deficit (% of GDP)	**–5.2**	**–1.2**	**–6.1**	**–3.5[3]**		
Primary deficit(–)/surplus(+)						
(% of GDP)	**0.6**	**4.7**	**–0.4**	**1.9[3]**		

1 For comparability purposes, tax refunds have been recorded in expenditure and have not been deducted from revenue.
2 Excluding amortisation payments.
3 Updated Stability and Growth Programme, March 2005.
* Provisional data.
Source: Ministry of Economy and Finance.

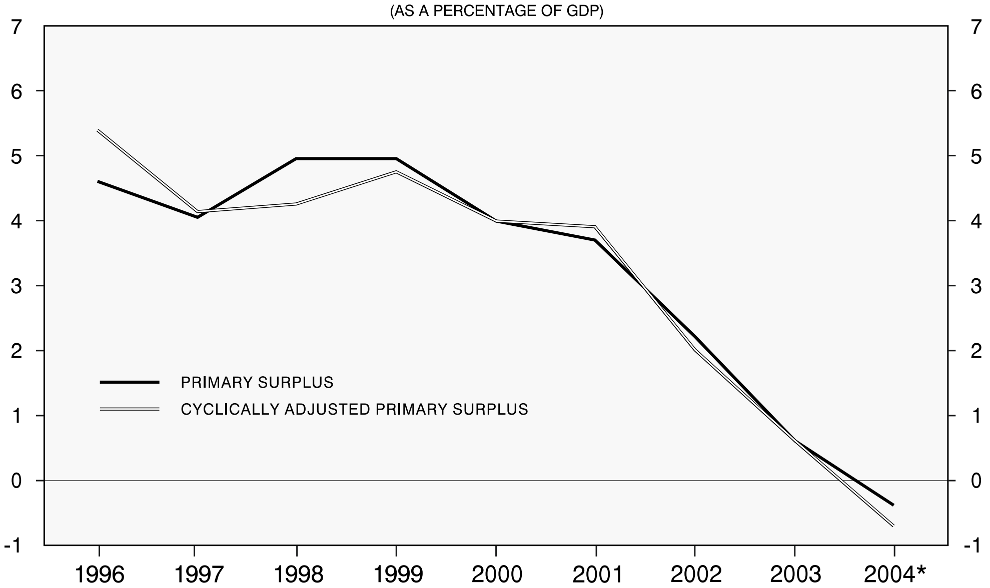
Specifically, PIB revenue rose by 69.1% and ordinary budget revenue by 5.4%.[1] As a result of these developments, the primary balance of general government (on a national accounts basis) turned from a surplus of 0.6% of GDP in 2003 to a deficit —for the first time since 1993— of 0.4% of GDP in 2004 (see Chart II.11).

The general government deficit in 2004 was much higher than the initial budget forecast (made in November 2003) of just 1.2% of GDP. The overrun was due to: (i) optimistic forecasts in the 2004 budget, which reflected an equally optimistic initial estimate

CHART II.11

GENERAL GOVERNMENT PRIMARY SURPLUS AND CYCLICALLY ADJUSTED PRIMARY SURPLUS

(AS A PERCENTAGE OF GDP)



1 The deficit data for 1997-1999 announced by Eurostat have been taken into account.
* Provisional data.
Sources: Primary surplus: Ministry of Economy and Finance. Cyclically adjusted primary surplus: Bank of Greece estimates on the basis of the ECB model.

of the 2003 deficit, (ii) the fiscal audit, which led to a revision of figures for 2004 (e.g. fuller recording of defence expenditure), (iii) lower ordinary budget revenue and inflows from EU Structural Funds,[2] and (iv) a large overrun in primary outlays for salaries and pensions, for the preparation and hosting of the Olympic Games, for grants and for restitution of revenue collected on behalf of third parties.

1 The shortfall in budget revenue was contained by additional measures taken in July 2004 (Law 3259/2004), which provided for the settlement of pending tax cases and the collection of tax arrears.

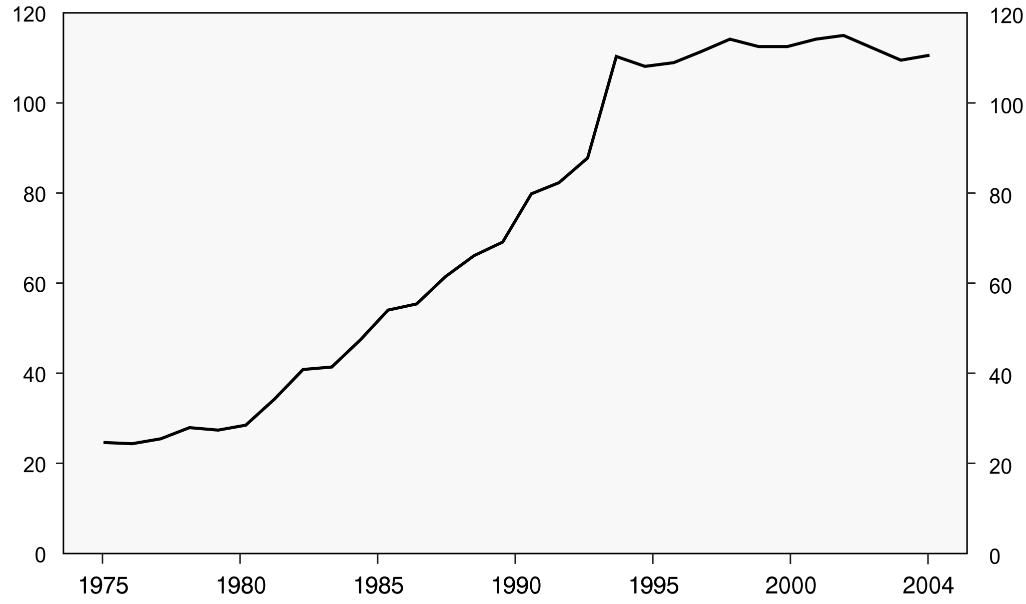
2 Despite their rapid increase in 2004, receipts from EU funds were 25% less than the budget forecast.

4.2 Public debt

On the basis of revised data, the consolidated general government debt stood at 110.5% of GDP at the end of 2004, compared with 109.3% in 2003 (see Chart II.12).[1] Greece's debt ratio is the highest in the EU-25 and almost double the Maastricht Treaty reference value of 60% of GDP. The high level of debt, in conjunction with high deficits, renders the current fiscal position unsustainable and would entail significant risks in the event of an increase in interest rates on government borrowing or a substantial decrease in the growth rate.

CHART II.12

PUBLIC DEBT*/GDP RATIO
(PERCENTAGES)



* Consolidated debt of general government.
Source: Ministry of Economy and Finance.

Following the revision of deficit and debt figures, the stock-flow adjustment for the years 1998 to 2003 declined, on average, to 3.7% of GDP (from 5.2% of GDP according to earlier estimates), while for 2002-2003 in particular it stood at low levels (1.8% and 0.7% of GDP respectively, see Table II.2). This decline reflected the fact that

1 In the context of the "fiscal audit", significant revisions were made in the figures for general government debt, bringing them up on average by 7.7 percentage points per year for the period 2000-2003. The revision of debt figures reflected the inclusion of state liabilities in the form of interest-bearing coupons and new estimates on intra-government debt.

TABLE II.2

DECOMPOSITION OF CHANGES IN THE GENERAL GOVERNMENT DEBT-TO-GDP RATIO[1]

(In percentage points of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997[2]	1998[2]	1999[2]	2000	2001[3]	2002[3]	2003[3]	2004[3,4]
General government debt ratio	79.6	82.2	87.8	110.1	107.9	108.7	111.3	114.0	112.4	112.3	114.0	114.8	112.2	109.3	110.5
Annual percentage changes in the debt ratio	10.6	2.6	5.6	22.3	–2.2	0.8	2.6	2.7	–1.6	–0.1	1.7	0.8	–2.6	–2.9	1.2
– Effect of primary surplus	6.5	3.0	2.1	2.2	–2.7	–2.6	–4.6	–4.0	–5.0	–4.9	–4.0	–3.7	–2.2	–0.6	0.4
– Effect of GDP changes and interest rate changes	–4.0	–7.8	–1.7	–0.4	–1.1	0.3	1.5	–0.8	–0.3	1.2	–0.5	–1.4	–2.2	–3.0	–2.3
– Stock-flow adjustment[5]	8.1	7.4	5.2	20.5	1.6	3.1	5.7	7.5	3.7	3.6	6.2	5.9	1.8	0.7	3.1

1 The formula used for the decomposition of changes in the debt-to-GDP ratio is the following:

$$\left(\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} \right) = \frac{PB_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} \cdot \frac{i_t - g_t}{1 + g_t} \right) + \frac{SF_t}{Y_t}$$

where D_t = general government debt
PB_t = primary balance
Y_t = GDP at current prices
g_t = nominal GDP growth rate
i_t = average nominal interest rate on government debt
SF_t = stock-flow adjustment

2 Debt and primary balance figures are Eurostat estimates.
3 According to data submitted to Eurostat in March 2005 in the context of the Excessive Deficit Procedure.
4 Provisional data.
5 The stock-flow adjustment includes expenditure or assumption of liabilities which do not affect the deficit but *increase* debt, as well as revenue (e.g. privatisation proceeds) which does not affect the deficit but *reduces* debt.

Sources: Ministry of Economy and Finance, Eurostat and estimates of the Bank of Greece.

the revised deficit figures also included expenditure (e.g. for the procurement of military equipment) that had not been recorded in the deficit in the past, but affected the level of debt (as they were financed by borrowing). However, in 2004 the stock-flow adjustment rose to 3.1% of GDP.

4.3 The Excessive Deficit Procedure

On 5 July 2004 the ECOFIN Council, following a recommendation by the European Commission, decided that Greece was in excessive deficit and issued a recommendation under Article 104(7) of the Maastricht Treaty calling on Greece to correct its excessive deficit situation by 2005 at the latest. The fiscal measures reported by Greece to the European Commission in November 2004, albeit in the right direction, were not considered sufficient. Therefore, on 18 January 2005 the Council decided, under Article 104(8) of the Treaty, that Greece had not taken effective measures to correct the deficit. Subsequently, on 17 February 2005 the Council adopted a Decision under Article 104(9) on recommendation by the Commission, asking Greece to take additional measures by March 21 to correct its excessive deficit. Specifically, the Council called upon Greece to bring its deficit under 3% of GDP by end-2006 at the latest by (i) strictly implementing the 2005 budget and (ii) adopting fiscal consolidation measures of a permanent nature, which should lead to a deficit reduction in 2006 of at least 0.6% of GDP. In addition, the Council urged the Greek authorities to continue fiscal consolidation after the excessive deficit had been corrected, by improving the cyclically adjusted fiscal balance by at least 0.5% of GDP per year in order to reach a close-to-balance or in-surplus position in the medium term. In March 2005 the Greek government reported to the European Commission new measures to increase revenue and contain expenditure, which were incorporated in the revised Updated Stability and Growth Programme for 2004-2007. The revised Programme was reviewed by the Commission on 6 April 2005 and by the ECOFIN Council on 12 April 2005. According to the Council Opinion on the Programme, the steps taken towards correcting fiscal imbalances and the government commitment made public on 29 March (i.e. to reduce the deficit below 3% of GDP by 2006) were in line with the Council recommendations in its notice given to Greece on 17 February and "therefore, no further steps in the Excessive Deficit Procedure are needed at present". In October 2005, Greece will submit new fiscal figures and the situation will be reassessed.

4.4 The revised Updated Stability and Growth Programme (USGP) for 2004-2007

As mentioned above, on 21 March 2005 the government submitted to the European Commission a revised Updated Stability and Growth Programme (USGP) for 2004-2007. The programme's baseline scenario suggests a drop in the fiscal deficit by 3.9 percentage points over three years – from 6.1% in 2004 to 2.2% of GDP in 2007. The consolidation effort is frontloaded in 2005 (see Table II.1) and to a lesser extent in 2006, while a deficit reduction of only 0.6% of GDP is foreseen for 2007. The debt-to-GDP ratio (110.5% in 2004) is projected to decline significantly by 2007, nevertheless remaining very high at the end of the time horizon covered by the Stability and Growth Programme (99.9%). The overall fiscal adjustment will stem from a containment of expenditure by 1.5% of GDP and an increase in revenue by 2.3% of GDP. The containment of expenditure will be achieved through a decrease in investment and other capital expenditure (by 1.5% of GDP), drastic cuts in consumption and "other current expenditure" of general government (by 2.3% of GDP) and a reduction of interest payments (by 0.2% of GDP). By contrast, social transfers, which are also included in current expenditure, will increase by 2.5% of GDP. The anticipated boost to revenue from the measures announced on 29 March 2005 —i.e. an increase in VAT and in tobacco and alcohol excise taxes, curbing fuel tax evasion, and containment of expenditure for grants to public transport companies and of costs related to civil servants' travel allowances— is estimated by the government at 0.6% of GDP in 2005 and 0.9% of GDP in 2006.

For 2005 in particular, the revised USGP projects a decrease of 2.6 percentage points in the general government deficit (on a national accounts basis), to 3.5% of GDP. This development will result exclusively from a drop in the central government deficit (on an administrative basis), as the surplus of the other general government subsectors (mainly social security funds) is expected to remain unchanged as a percentage of GDP.[1] Total budget revenue is expected to increase by 10.2% in 2005, while the rise in expenditure should be contained to 0.8%, through a weakening in the growth of ordinary budget expenditure to 4.0% and a 15.4% decrease in expenditure under the public investment budget.

5. MONETARY AND FINANCIAL DEVELOPMENTS IN THE EURO AREA

Throughout 2004 and in the first four months of 2005, the Governing Council of the European Central Bank (ECB) kept its key interest rates unchanged at the historically low levels prevailing since their last cut on 6 June 2003.[2] The decision of the Governing Council to leave the key rates unchanged reflected its assessment that, despite the *short-term* impact of rising oil prices, there was no significant evidence of inflationary pressures building up over the medium-term and that economic conditions in the euro area overall remained consistent with price stability. However, the Governing Council of the ECB has repeatedly stressed the need for vigilance with regard to any developments which would imply upside risks to price stability, mainly risks related to the possibility of a further rise

1 According to the USGP, the central government deficit is expected to come to 5.1% of GDP in 2005, against a budgeted 4.8%, owing to a downward revision of revenue. Moreover, the 2005 budget forecast a decrease in the general government deficit to 2.8% of GDP, compared with 5.3% of GDP in 2004 (the latter figure has since been revised to 6.1% of GDP).

2 The minimum bid rate in the main refinancing operations was set at 2%, the marginal lending facility rate at 3% and the deposit facility rate at 1%.

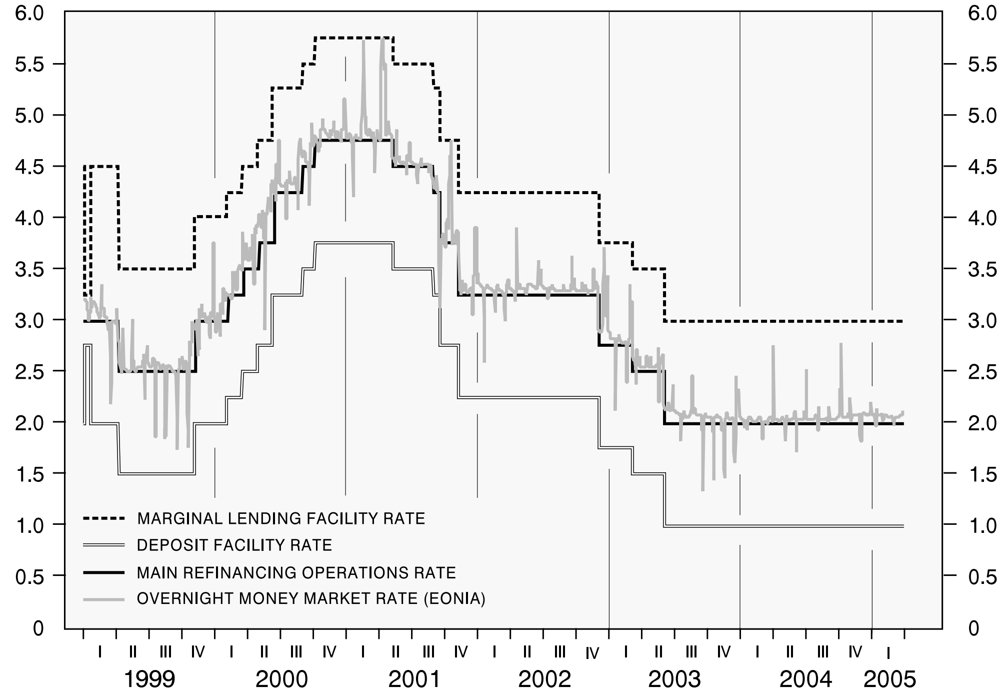
in oil prices and significant second-round effects on consumer prices (through an increase in nominal wages), as well as to the fact that there is still substantially more liquidity in the euro area than is needed to finance non-inflationary growth.[1]

Money market interest rates in the euro area remained at low levels in 2004, mirroring ECB key interest rates (see Chart II.13). Specifically, the three-month EURIBOR, which is the most representative short-term interest rate, as well as euro area government bond yields, stood at historical lows in 2004. Turning to euro area MFI interest rates, the

CHART II.13

ECB INTEREST RATES AND THE OVERNIGHT MONEY MARKET RATE (EONIA)

((PERCENTAGES PER ANNUM, DAILY DATA)



Source: ECB.

rates on deposits by households and non-financial corporations remained at low levels in 2004, as did lending rates, which fluctuated and, in most categories, declined somewhat during the year. As in the past, bank deposit and lending rates responded with a lag to changes in market rates.

1 In this respect it should be noted that the annual growth rate of M3 in the euro area weakened in the first half of 2004, but strengthened in the second half. An acceleration was also seen in credit expansion to the private sector, especially in bank loans to both households and non-financial corporations in the euro area.

6. MONETARY AND FINANCIAL DEVELOPMENTS IN GREECE

6.1 Monetary developments and interest rates

The annual growth rate of the components of the Greek contribution to the euro area M3 (excluding currency in circulation) sped up considerably in the second half of 2004. Over the same period, the annual growth rate of the respective euro area aggregate also accelerated, albeit to a lesser extent, remaining below the Greek figure throughout 2004 and in the first two months of 2005. Monetary developments both in Greece and in the euro area were driven by the very low level of interest rates (implying low opportunity cost of holding money), which encouraged shifts of savings into more liquid assets. In Greece, however, the dynamics of M3 was intensified by a positive nominal GDP growth differential vis-à-vis the euro area and more sizeable portfolio shifts into M3. Moreover, total credit expansion in Greece accelerated significantly, as central government borrowing requirements were much higher in 2004 than in 2003.

The annual growth rate of total deposits included in M3 did not change significantly in 2004 (fourth quarter of 2004: 12.6%, fourth quarter of 2003: 12.2%), although the relatively low opportunity cost of holding money induced divergent developments across individual deposit categories. In particular, the annual growth rate of short-term deposits (overnight deposits) strengthened considerably, while that of deposits with an agreed maturity of up to two years decelerated significantly. Repurchase agreements (repos) continued to decrease in 2004, but their rate of decline moderated considerably. The change in the tax rates on repo yields (to 10% from 7%) and on interest income from deposits (to 10% from 15%), effective from January 2005, contributed to a further significant reduction of repo holdings and to an increase in deposits with an agreed maturity during the first two months of this year. Thus, the growth rate of total deposits accelerated, to stand at 17.2% in February 2005. The growth rate of money market fund units displayed a downward course in 2004 and turned negative in the fourth quarter. It remained negative in the first two months of 2005.

Bank deposit interest rates did not change considerably in 2004, as key ECB rates have remained unchanged since June 2003. More specifically, interest rates on new overnight deposits held by households and on deposits with an agreed maturity of up to one year increased slightly in 2004 and remained higher than the comparable euro area rates (by 23 and 35 basis points respectively). The interest rate on new repos remained virtually unchanged, not much different from the euro area average. In the first two months of 2005, deposit interest rates in Greece remained at the levels of the previous year, with the exception of the rate on deposits with an agreed maturity, which decreased slightly.

More marked movements were seen in interest rates on new bank loans, particularly in those on loans to households, which declined considerably in 2004, while changes in rates on loans to non-financial corporations were marginal. Specifically, a relatively large decline was recorded in consumer loan interest rates (102 basis points for loans with a floating rate or with an initial rate fixation of up to one year and 50 basis points for the total of new consumer loans with an agreed maturity), while interest rates on housing loans fluctuated and declined to a lesser extent throughout 2004 (16 basis points for all new loans). During the first two months of 2005, consumer loan interest rates recorded increases of up to 41 basis points, while interest rates on all new housing loans did not change considerably. Developments in interest rates on new loans during 2004 contributed to a decline in the average rate on the amount outstanding of the most significant categories of loans to households (see Chapter VI). Lending rates in Greece, even though they have declined, remain higher than the euro area average, as is also the case with most deposit interest rates. The widest divergence is observed in loans to households, particularly in consumer loans without an agreed maturity, which include loans through credit cards, while housing loans and large corporate loans display less significant spreads.

6.2 Credit developments

The annual growth rate of total credit extended to the economy by Monetary Financial Institutions (MFIs, i.e. banks and money market funds) accelerated considerably during 2004 and stood at 8.6% in the last quarter of the year, compared with 3.2% in the fourth quarter of 2003. This development can be attributed to a slowdown in the rate of decrease in credit to general government, while credit expansion to enterprises and households decelerated slightly. In particular, the annual rate of change in credit to general government was contained to –5.6% in the last quarter of 2004, from –15.9% in the fourth quarter of 2003, reflecting the ongoing decline —albeit at a slower pace— in MFI holdings of Greek government paper. The net borrowing requirements of central government (on a cash basis) increased significantly (2004: €15,605 million, 2003: €10,526 million), but were more than offset by foreign capital inflows for purchases of government paper. Credit expansion to enterprises and households slowed down slightly, as already mentioned (fourth quarter of 2004: 16.1%, fourth quarter of 2003: 17.1%), mainly reflecting developments in lending to enterprises. This deceleration continued into the first two months of 2005 and, combined with a further slowdown in the rate of decrease in credit to general government, kept total credit expansion in February at 8.6%.

The annual growth rate of MFI lending to enterprises fell to 8.6% in the last quarter of 2004, from 11.0% in the last quarter of 2003. On the other hand, corporate bond issuance gained in importance during 2004, although these bonds are generally held by banks. Including total corporate bonds, the deceleration in the growth of total lending to enterprises is smaller (fourth quarter of 2004: 12.3%, fourth quarter of 2003: 13.9%). In any case, credit expansion to enterprises continues to indicate that their financing conditions remain relatively ample, as the rate of credit expansion was higher than both nominal GDP growth in 2004 (7.7%) and the rate of credit expansion in the euro area (fourth quarter of 2004: 4.1%). The weaker credit expansion to enterprises was due to a slower rise in credit to industry, "other" sectors (which include construction companies) and tourism (although credit expansion to the latter remains strong). By contrast, a considerable acceleration was observed in credit expansion to agriculture and, mainly, trade. The drop in the growth rate of lending to enterprises continued into the first two months of 2005, and in February this rate stood at 5.0%.

The annual growth rate of credit to households remained virtually unchanged at a high level, standing at 28.0% in the fourth quarter of 2004. This overall stability masked a deceleration in the growth of housing loans (fourth quarter of 2004: 23.8%, fourth quarter of 2003: 27.1%), partly reflecting securitisation operations conducted in June 2004, and a strengthening in consumer loans, which gained new momentum after a relative decline in 2002-2003 and grew at an annual rate of 37.9% in the last quarter of 2004 (fourth quarter of 2003: 24.8%). In the first two months of 2005, the growth rate of housing loans recovered somewhat (February 2005: 25.4%), while that of consumer loans fell slightly (February 2005: 35.0%).

The relative importance of loans to households increased further in 2004, as they represented a share of 71.4% in total credit expansion to enterprises and households (2003: 59.3%), significantly above the euro area average (2004: 55.3%, 2003: 56.9%). Thus, at the end of 2004 the outstanding amount of loans to households accounted for 44.1% of total loans to enterprises and households, compared with 39.7% at end-2003 (2002: 36.4%). Owing to strong credit expansion, households' indebtedness as a percentage of GDP has been following an upward trend, although it remains lower than the euro area average. Specifically, in 2004 it stood at 31.2% (2003: 26.2%), compared with 50.4% in the euro area (2003: 48.4%).

6.3 Capital markets

In 2004, capital markets were characterised by the favourable conditions that prevailed in government bond markets and a marked recovery of equity prices in the stock market.

Greek government bond yields moved broadly in line with the respective euro area yields. After a fall in the first three months of 2004, government bond yields increased significantly in the second quarter of the year, owing to greater optimism surrounding the global economy and expectations of a rise in US interest rates.[1] However, in the second half of 2004, yields followed a continuous downward course, which reflected investor concerns regarding the impact that rising oil prices and the appreciation of the euro against the US dollar could have on euro area growth. The decline in yields concerned the entire maturity spectrum, but was more pronounced at the longer end of the yield curve, as the growth outlook of the euro area economy remained dim in 2004.

1 On 30 June 2004, for the first time in five years, the Federal Reserve increased its key interest rate by 25 basis points.

In greater detail, the yield on the 10-year Greek government bond fell to 3.80% at end-December 2004, 62 basis points down relative to end-December 2003, before recovering somewhat to 3.86% at end-March 2005. The yield differential between the Greek 10-year bond and the comparable German bond was 12 basis points at end-December 2004, unchanged from its level a year earlier. It should be noted that the downgrading of Greece's credit rating by Standard and Poor's and Fitch (following fiscal data revisions) had no impact on this differential. In the first three months of 2005 the yield differential widened and stood at 22 basis points at end-March. This is largely explained by the fact that the new Greek benchmark bond issued in mid-February matures 6.5 months later than the corresponding German bond.

Transactions in the secondary market for Greek government securities (HDAT) reached very high levels. The average daily value of transactions rose to €3.8 billion in 2004, having increased by 39% compared with 2003. Trading mainly concerned long-term securities, particularly 10-year bonds.

In the primary market for government securities, the amount of funds raised was higher in 2004, with Greek and foreign investors showing particularly strong preference for Greek government bonds. Primary market activity involved new issues and reopenings of past issues, mainly via syndication procedures and, to a lesser extent, by auctions. The weighted average maturity of securities issued in 2004 fell to 6.85 years, from 7.22 years in 2003.

Reflecting similar developments mainly in euro area stock markets, stock prices on the Athens Exchange (Athex) followed a generally upward path in 2004, which was particularly pronounced in the last four months of the year. Between end-December 2003 and end-December 2004, the Athex composite stock price index rose by 23.1%.[1] This upward trend continued in the first two months of 2005, but came to a halt in March. The average daily value of transactions stood at €141 million in 2004, around the level recorded in 2003. Total funds raised through the stock market rose slightly in 2004, compared with the low levels in 2002-2003 (€476 million in 2004, €378 million in 2003). It should be noted that the rise in the Athex composite share price index in 2004 was significantly stronger than the increase in the Dow Jones EURO STOXX broad index in the euro area (10.0%) or the Standard and Poor's 500 index in the United States (9.0%). On the basis of developments in stock prices and corporate profitability, the P/E ratio is estimated to have risen in 2004 for all Athex-listed shares and particularly for those of the banking sector.

Despite the significant increase in the Athex composite share price index, the Greek mutual fund market recovered only slightly in 2004. A rise mainly in prices and, to a lesser extent, in the number of units in circulation led to a small increase in the value of total mutual fund assets (4.1%). Among the individual categories of mutual funds, the assets of bond-type mutual funds recorded a particularly pronounced increase, reflecting favourable conditions in international bond markets in 2004. The assets of balanced-type

1 This rise in the composite index was the third highest in euro area stock markets.

and equity-type mutual funds also increased, though to a lesser extent. By contrast, the assets of money market mutual funds declined. With regard to equity-type mutual funds, it should be noted that the increase in their assets was due to a rise in the price of units in circulation which more than offset a decline in their number.

In the context of the transposition of all relevant European Union Directives into national legislation, regulations relating to Undertakings for Collective Investment in Transferable Securities (UCITS) were adopted in 2004. These concerned the expansion and internationalisation of mutual fund activities, the introduction of specialised mutual fund categories (index funds, funds of funds) and the strengthening of investor protection.[1] These provisions aim to improve the functioning of the mutual fund market.

7. STABILITY OF THE BANKING SYSTEM

The recovery of Greek commercial banks' income observed in 2003 continued in 2004, albeit at a slower pace. However, despite a moderate increase in the operating costs of most banks in 2004, the net pre-tax profits for banks as a whole on a non-consolidated basis[2] dropped by 11.5%, as extraordinary expenses mainly associated with the implementation of employee voluntary retirement plans or balance sheet consolidation measures weighed heavily on the results of certain banks. If the impact from the voluntary retirement plans is not taken into account, the decrease in profits for banks as a whole in 2004 was only 2.0%. However, profits on a consolidated basis, i.e. at group level, rose by 9.9% in 2004.

As regards the income structure, net interest income as a percentage of total operating income grew slightly in 2004 (to 74.9%, from 74.2% in 2003), exceeding considerably the corresponding average for EU banks as a whole (around 59% in 2003), which partly reflects the higher share of loans in Greek banks' portfolios. Despite increasing competition, net interest income as a percentage of banks' assets remained almost unchanged at 2.8%, compared with an average of 1.4% for all EU banks in 2003. This reflects the growing share of loans —notably consumer loans, which afford higher margins— in banks' assets, as well as the declining share of holdings of fixed-income securities, which have a considerably lower margin. Within non-interest income, a rise in net income from commissions and variable-yield securities largely offset a substantial decline in income from financial operations. Thus, the share of non-interest income in total operating income decreased only slightly (to 25.1%, from 25.8% in 2003). Generally, the continued reliance of Greek banks on their credit operations, notably income from retail business, is a positive characteristic, as it enhances the stability and quality of their income.

1 For more details, see Box VII.1.
2 That is, the results of the parent company, not including those of its subsidiaries.

The decrease in banks' profits on a non-consolidated basis in 2004 led to a drop in both their return on equity (ROE) (from 13.0% in 2003 to 10.8% in 2004) and return on assets (ROA) (from 0.9% to 0.7%). At the banking group level, both ratios, despite falling slightly in 2004, were definitely higher than on a non-consolidated basis (16.1% and 1% respectively in 2004, compared with 16.5% and 1% in 2003).

A 15.2% rise in regulatory own funds[1] in 2004 resulted in a marked increase in the capital adequacy ratio (CAR) of Greek commercial banks as a whole to 13.5% in 2004 on a non-consolidated basis, up from 12.8% in 2003. If the total shortfall in banks' provisions in relation to the Bank of Greece requirements[2] is taken into account, the CAR drops by a mere 0.6 percentage point, but remains at a satisfactory level. The CAR also rose on a consolidated basis, from 12% in 2003 to 12.8% in 2004. By contrast, the non-consolidated CAR, which is calculated on the basis of core (Tier I) capital only, showed a further small decline to 9.6% in 2004, from 10.1% in 2003 and 10.6% in 2002, but is still higher than the corresponding EU average (8.8% in 2003). Underlying the decline in this ratio was a moderate increase of 4.6% in Tier I capital in 2004, while supplementary (Tier II) capital grew substantially (by 50.8%).

The continuing strong credit expansion to the private sector, notably to households, increases bank profitability, but is also a potential source of additional credit risk. It should be noted that the non-performing loans to total loans ratio remained virtually unchanged at 7% in 2004, although there were divergent developments in individual categories of loans (a decline in the case of consumer loans and housing loans and a rise in corporate loans). The net non-performing loans (less provisions) to total loans ratio also changed little (3.4% in 2004, compared with 3.5% in 2003), while the net non-performing loans to own funds ratio of banks declined marginally (from 27% to 26.6%). At the same time, the provisioning coverage of non-performing loans rose from 49.9% in 2003 to 51.1% in 2004. However, with respect to consumer and housing loans in particular, the following should be taken into account: First, over the short term, the non-performing loans to total loans ratio is affected favourably by continued strong credit expansion, as any servicing problems typically arise some time after the initial granting of loans. Second, a considerable part of loans that are refinanced by being transferred to other banks may involve potential servicing problems. This risk is mitigated by the high value of real estate collateral, especially for housing loans. However, the latter has declined as a proportion of total debt per borrower. This is so because real estate collateral is often used to secure both a loan for house purchase or construction and a repair or consumer loan granted to the same borrower. Therefore, the Bank of Greece has recommended that total lending to each borrower should not exceed 80% of the market value of the respective real estate collateral.

1 Regulatory own funds refer to those balance sheet items that, according to Bank of Greece Governor's Act 2053/92 (as currently in force), count against capital requirements for banking risks. These items are divided into core capital, which is considered to provide full coverage against risks, and supplementary capital.

2 See Bank of Greece Governor's Act 2442/99 (as currently in force).

For consumer loans, Bank of Greece Governor's Act 2557/26 January 2005 recently increased the provisioning ratios as follows: (i) from 70% to 90% for non-performing loans one year past due or in permanent arrears; and (ii) from 84% to 100% for doubtful loans. The purpose of this arrangement was, on the one hand, to address the potential credit risk implications of strong credit expansion in the field of consumer loans and, on the other hand, to encourage banks to write off doubtful loans rather than maintaining them on their balance sheets. At the same time, in view of the relatively low credit risk entailed by performing loans backed by residential mortgages, the Bank of Greece reduced from 0.7% to 0.5% the provisioning ratios for these loans, provided that the amount of the loan does not exceed 70% of the objective value of the residential property. It should be pointed out, however, that the generally applicable provisioning framework does not substitute for banks' obligation to regularly review their credit standards and constantly improve their credit risk measurement and management systems.

In recent years, Greek banks have taken major steps towards upgrading their credit risk measurement and management systems. Several banks have already introduced credit scoring models for the approval of consumer loans, while some banks have developed probability of default models. The development of similar systems and, most importantly, their integration into banks' decision-making are necessary conditions for the adoption of the internal-ratings-based approach to the calculation of capital adequacy against credit risk under the new supervisory framework ("Basel II").

However, even those banks which will opt for the less sophisticated, standardised approach should also adjust their systems accordingly, as this will increase their ability to manage risks effectively in an environment of strong competition and economic uncertainty.

The quality of banks' loan portfolios is affected not only by their credit standards and credit risk management systems, but also by developments in borrowers' financial position. In 2004, the financial position of households and firms benefited from Greece's macroeconomic environment, which was characterised by strong growth and low interest rates.

Households' indebtedness as a percentage of nominal GDP rose to 31.2% at end-2004, from 26.2% at end-2003, but this percentage in Greece is still lower than the corresponding average in the euro area as a whole (50.4% in 2004). The ratio of households' indebtedness to the total value of residential property and equities held by them directly or indirectly (through mutual funds) also remains low (around 6% at end-2004, compared with 5.3% at end-2003). Besides, total households' interest payments on housing and consumer loans as a percentage of their disposable income[1] are estimated at 2.8% in 2004, compared with 2.5% in 2003. On the basis of these ratios, households' indebtedness, despite rising over time, appears to remain overall at moderate levels. However, strong credit expansion to households may lead to increased credit risk in the future, notably if economic activity were to slow down, which would affect households' disposable income, or if interest rates were to rise from their current historical lows. Hence, as the Bank of

1 Gross disposable income, as derived from National Accounts data.

Greece has pointed out repeatedly, banks should not ease their credit standards under the pressure of competition, while households should carefully evaluate —on the basis of realistic estimates about their income prospects and interest rate developments— their ability to meet debt obligations.

Developments in residential property prices can be an additional source of credit risk to banks, as they affect the value of real estate collateral. These prices have recently tended to stabilise, following a period of continuous rise. Although a future fall in residential property prices in certain segments of the market cannot be ruled out, substantial correction would seem unlikely, especially if economic conditions develop in line with current forecasts.

In 2004, the pace of credit expansion to enterprises fell considerably short of that to households and showed overall a small slowdown in relation to 2003, albeit with marked differences across sectors. Thus, strong credit expansion to the business sector does not seem in itself to be a potential source of higher credit risk for banks. As regards developments in the financial position of enterprises, on the basis of available published data compiled by the Bank of Greece from a sample of 554 non-financial corporations, the recovery of business profitability observed in 2003 does not seem to have continued in 2004.

Specifically, the net pre-tax profits of all the sample firms declined by 1.2% in 2004, although their total sales increased by 11.1%. The small decrease in total profitability reflected an 8.4% drop in the services and other activities sector, mainly owing to a considerable fall in the profits of the construction and telecommunications sectors. By contrast, the profits of the sample retail firms rose by 23.6% in 2004, while the profits of industrial firms increased slightly (by 3.9%), albeit with marked differences across branches. Besides, in the whole sample, the ratio of financial costs to gross profits, which is a measure of the firms' financial vulnerability, improved from 5.7% in 2003 to 5.3% in 2004, which is particularly low, although some branches show a much higher ratio.

These findings from the sample in question mainly concern big —by Greek standards— firms and therefore do not necessarily hold true for small and medium-sized enterprises in general. Some indications about developments in the financial position of small and medium-sized enterprises in 2004 are provided by changes in firms' bad credit record data, which include a large number of small and medium-sized enterprises. Specifically, in 2004 both the value of unpaid cheques and the amount of payment orders increased substantially (by 33.2% and 59.5% respectively), while the rise in the amount of bankruptcy petitions was clearly smaller (4.6%).

However, as many small firms do not have easy access to bank credit, the problems facing them probably did not affect considerably the non-performing loans to total loans ratio (for the business sector as a whole), which increased only slightly in 2004 (to 7.8%, from 7.4% in 2003).

As regards interest rate risk, a large part of the loans granted by Greek banks carry floating rates, which mitigates the impact on net interest income from any rise in interest rates. However, this impact may become stronger in the future, as certain banks, in the face of a growing deposit gap, have already had recourse to financing through market-based debt, which makes them more vulnerable to interest rate changes. Besides, interest rate changes can have an impact on banks' own funds, to the extent that they affect the valuation of their open positions in debt securities and in financial derivatives on debt securities and interest rates. However, it should be pointed out that, on a non-consolidated basis, capital requirements against general position risk of the trading book from interest rate changes for all the banks that use the standardised approach decreased by 4.5% in 2004 and remain at particularly low levels (0.8% of own funds).

With respect to the other market risks, on a non-consolidated basis for all the Greek commercial banks that use the standardised approach, the capital requirements against equity price risk of the trading book and foreign exchange risk correspond to very small percentages of banks' own funds (0.31% and 0.34% respectively on 31 December 2004). Therefore, these risks should not have a significant impact on the stability of the Greek banking system.

By contrast, operating risk has gained importance worldwide, reflecting the growing complexity of banking operations and banks' increased IT dependency. Against this background, the Bank of Greece has recently supplemented the institutional framework concerning banks' internal control systems and further specified the principles and standards for the development and operation of banks' information systems and for the organisational structure and internal control of banks' IT functions, with a view to ensuring effectiveness and security. Besides, the new supervisory framework ("Basel II"), which will be implemented as from 31 December 2006, introduces capital requirements against banks' operating risk.

Liquidity risk is estimated to have increased, mainly as a result of continued strong credit expansion. Hence, the Bank of Greece amended the existing framework on the monitoring of credit institutions' liquidity and defined two new supervisory ratios of liquidity, laying down their thresholds (Bank of Greece Governor's Act 2560/1 April 2005).

The Bank of Greece attaches particular importance to the resilience of the Greek banking system to potential shocks —notably in terms of adequate capital buffers for absorbing shocks. To this end, banks were requested to carry out stress tests, simulating extreme but plausible worst-case scenarios (as determined by the Bank of Greece) of credit and market risk factors,[1] in order to assess the impact on own funds and CAR.

In 2004, the IMF accepted Greece's application for being included in the IMF's Financial Sector Assessment Program (FSAP), in the context of which the stability of the financial sectors of many countries (including EU Member States) has already been evaluated. During the assessment exercise, which is still under way, the IMF FSAP mission focuses, in addition to the resilience of the banking system to shocks, on the institutional framework for banking supervision and its implementation in Greece against the 25 Core Principles for Effective Banking Supervision and the standards established

1 Including probability of default, loss given default, interest rates, equity prices and the euro exchange rate.

by the Basel Committee on Banking Supervision. The final conclusions of this evaluation will be available soon.

To sum up, in the current circumstances, the Greek banks' CAR provides an adequate buffer for safeguarding the stability of the banking system and exceeds the average for the euro area as a whole (11.9% in 2003). However, account should be taken of the impact on own funds from the introduction of the International Accounting Standards (IAS) as from 1 January 2005, notably of IAS 19, which prescribes disclosure of liabilities arising from employee defined benefit plans. While no major implications are expected for the CAR of the banking system as a whole, certain banks will have to strengthen their capital base to restore their capital adequacy. Furthermore, the implementation of the new capital adequacy framework ("Basel II") as from 31 December 2006 will have repercussions on banks' CAR. The overall impact of all the above factors will depend on the alternative methods for calculating capital requirements to be adopted by banks, as well as on the composition and quality of their loan portfolios, in conjunction with cyclical developments. Given the uncertainty surrounding these factors, banks should further increase their own funds, taking into account that, as already mentioned, the new supervisory framework introduces capital requirements against operating risk. The Bank of Greece, for its part, has already taken important steps to prepare for the future implementation of the new supervisory framework in Greece.

The operating costs of most Greek banks increased at a relatively moderate pace in 2004, thus remaining as a percentage of banks' total assets at the levels of 2002 and 2003 (2.3%). Generally, in recent years Greek banks have made substantial efforts to control their operating costs and should continue to do so in the light of increasing competition. These efforts include the ongoing rationalisation of branch networks that resulted from past mergers, as well as the implementation of personnel voluntary retirement plans in some cases. Furthermore, mainly during the last two years, certain banks absorbed financial subsidiaries in order to cut operating costs, ensure better coordination and take advantage of economies of scale and scope.

Turning to the structure of the Greek credit system, the commercial banks' market share on the basis of assets fell to 80.9% in 2004, from 82.1% in 2003, while the share of specialised credit institutions grew marginally to 8.4%, from 8.0%. A small increase was observed in the market shares of cooperative banks and branches of foreign banks (to 0.7% and 10% respectively in 2004, from 0.6% and 9.3% in 2003). Measured by the market share of the five largest banks, the degree of concentration of the Greek credit system decreased from 66.9% in 2003 to 65% in 2004. Although the degree of concentration remains high, it does not seem to have hampered competition between credit institutions and is well below the corresponding figures of more than 80% recorded in three other euro area countries (Finland, Belgium, Netherlands).

The number of bank branches in Greece continues to rise (2004: 3,403, 2003: 3,300), albeit at a slower pace in the 2003-2004 period in comparison with earlier years. However, there is a trend towards smaller branch size and a focus on core activities and consultancy, while back office operations have tended to become centralised. Nevertheless, on the basis of data for 2003, the number of employees per branch in Greece (19) remains higher than the corresponding EU average (15).

Alternative distribution channels, such as the internet, phone banking and automatic teller machines (ATMs), are increasingly being used in Greece. In particular, the number of ATMs rose from 5,468 in 2003 to 5,787 in 2004. Still, these channels are supplementary to branches, which retain their key role in the marketing and delivery of products. Besides, an extensive branch network also supports the expansion of Greek banks in the bankassurance sector through cross-selling. Given the growth of this sector, cooperation between the Bank of Greece as the banking supervisory authority and the recently created (by Law 3229/2004) regulatory authority for insurance companies would contribute to more effective supervision of bankassurance products and coordination between the supervisory authorities with a view to ensuring the stability of the financial sector.

During the last ten years, Greek banks have expanded their activity abroad, focusing chiefly on Southeastern Europe, where they seek to strengthen their position, mainly through the acquisition of local banks, in order to take advantage of the expected fast and further development of the financial sector in these countries. The improved macroeconomic aggregates of the Southeastern European countries, the prospect that some may join the EU and the ongoing restructuring of their banking systems have reduced Greek banks' country-specific risk and their activities in these countries are expected to boost profitability considerably over the coming years, mainly at group level. However, as Greek banks' exposures to these countries have increased significantly, they should be subject to systematic and specialised monitoring and control, notably at banking group level.

8. THE ECONOMIC OUTLOOK FOR 2005

Available statistical data and leading indicators suggest that the slowdown in Greece's growth rate since mid-2004 will continue through 2005. According to Bank of Greece forecasts published in the latest *Monetary Policy Report* (February 2005), average annual GDP growth was initially projected to reach 3.3% this year. However, as oil prices have continued to rise and consumer and investor expectations have deteriorated further, Greece's growth rate could taper off to around 3% (from 4.2% in 2004 and 4.7% in 2003). As this rise in GDP is expected to absorb *part* of the labour force increase, unemployment is likely to remain unchanged at last year's level.

These GDP forecasts are subject to considerable uncertainties associated with oil price developments and the impact on inflation (and household disposable income) from the increase in indirect taxation, the prevailing imbalances in the global economy and long-term interest rate and exchange rate developments. The projections of the Bank of Greece about the outlook of the Greek economy are quite similar to those of international organisations,[1] while the revised Updated Stability and Growth Programme (March 2005) estimates that Greece's GDP growth rate for 2005 will range between 2.9% and 3.9% (baseline scenario: 3.9%, alternative scenario 1: 3.3%, alternative scenario 2: 2.9%).

Domestic demand will once again be the main driver of growth this year, while the external sector's contribution, negative in 2004, is expected to be neutral. More specifically, private consumption growth should decelerate further, though remaining relatively strong on account of the continued rise in income and employment (albeit at a slower pace than in 2004), easy access to consumer credit at fairly low interest rates and the increase in the value of household assets in recent years (which has encouraged households' increased recourse to loans). According to the revised USGP, the rise in public consumption will slacken to 1.5% in 2005. The growth of gross fixed capital formation is expected to decline for the second year running, reflecting significant cut-backs in the public investment programme (by 17.5% at constant prices on a national accounts basis). Business investment should increase at a relatively high rate (owing to favourable financing conditions and to the positive impact anticipated from the newly enacted development and tax laws), while residential investment is projected to pick up only slightly, after showing no change in 2004. Finally, total exports (goods and services) are expected to register a satisfactory increase, driven for the most part by exports of services (tourism and transport), while total import growth should fall markedly from its high level of 2004, mainly on account of weaker growth in investment.

Turning to *inflation*, the Bank of Greece has already projected a slight acceleration for 2005 in its latest *Monetary Policy Report* (February 2005), taking into account that last year's decline in inflation was mainly due to a decrease in fresh fruit and vegetable prices. However, the measures to increase indirect taxes, along with the recent oil price developments and trends, are likely to raise the average annual rate of both headline inflation (as measured by the HICP or the CPI) and core inflation to about 4%. Inflation projections are also subject to considerable uncertainties, mainly related to the dollar price of crude oil, the exchange rate of the US dollar against the euro, developments in productivity (and consequently in unit labour costs) and, of course, the final impact from the increase in indirect taxation.

More specifically, there are four factors that can be expected to have an *upward* impact on inflation: (i) the significant rise in oil prices, which will have a much greater effect on inflation than in 2004, (ii) the increase in indirect taxation, which is expected to weigh perceptibly on year-on-year inflation (once the measures are fully implemented and if the entire increase is passed on to consumer prices), bringing average annual inflation up to 4% in 2005 according to some estimates,[2] (iii) the build-up, from 2004 onwards, of

1 The European Commission and the International Monetary Fund (April 2005) projected a GDP increase of 2.9% and 3.0% respectively, whereas an earlier forecast by the OECD (December 2004) had placed Greece's growth rate at 3.2%.

2 These estimates are only tentative, since the full inflationary impact of the measures will depend on the pricing policies of businesses (in terms of absorption of VAT increases and the extent and direction of price rounding, etc.), as well as on demand developments.

inflationary pressures at the wholesale price level, and (iv) the fact that the rates for public utility services provided by both public and private enterprises[1] are projected to increase more this year than in 2004.

These upward effects on inflation are expected to be *partly offset* by (i) the average annual appreciation of the euro, which will continue to contain import prices, and (ii) the slackening of domestic demand growth, which will ease inflationary pressures.

9. ECONOMIC POLICIES AIMED AT SUSTAINING STRONG GROWTH

9.1 Medium-term growth prospects

The rapid growth of the Greek economy over the last ten years stemmed mainly from increased domestic demand, which was attributable to a combination of favourable factors, but also from an enhanced productive capacity, which was achieved through investment and structural changes. The improved macroeconomic environment, the reduced cost of borrowing and the deregulation of the credit system boosted private consumption and investment. Sizeable inflows of resources from the EU Structural Funds supported public investment and contributed to the improvement in economic infrastructures. Increased public expenditure connected with the 2004 Olympics also contributed to a rise in domestic demand in 2003-2004. At the same time, the structural measures that were implemented, albeit only partially helpful in addressing the economy's structural weaknesses, nevertheless helped increase the efficiency of the product and labour markets and raise the growth rate of "total factor productivity". These favourable developments resulted in a cumulative increase in Greece's real GDP *per capita* by about 37% over the last ten years. Furthermore, according to Bank of Greece estimates, the *real* average gross earnings of employees followed a steadily upward path, growing by 32% between 1994 and 2004.[2]

Notwithstanding a robust economic performance, a number of long-standing structural weaknesses have not been adequately addressed. Hence the Greek economy still lags significantly behind the more advanced economies of the EU. Inflation and the growth rate of unit labour costs have persistently remained above the respective euro area averages, eroding Greece's international competitiveness. Fiscal imbalances have widened significantly, with the public deficit and debt standing at very high levels. The structural problems in the product and labour markets have been only partially addressed, thus keeping

1 Apart from telecommunications rates, which continue their downward trend.
2 This figure is consistent with NSSG and Eurostat estimates, according to which real compensation per employee (including employers' social security contributions) rose by a cumulative 32.7% in the same period. In the euro area, on the basis of the latest available data, real compensation per employee rose by only 3.1% in the last eleven-year period (1994-2004). See European Commission, *Spring 2005 Economic Forecasts*, April 2005, Statistical Annex (Section 31).

productivity and the rate of employment at relatively low levels. The end result is that, despite the progress achieved as regards real convergence —with the country's GDP *per capita measured in purchasing power parities* (PPPs) rising from 65.1% of the EU-15 average in 1995 to 75.8% in 2004[1]— Greece still lags significantly behind the more advanced economies of the EU in terms of living standards and quality of life.[2] According to the

TABLE II.3
AT-RISK-OF-POVERTY RATES IN EU COUNTRIES

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Austria	13	14	13	13	12	12	12	:	13[2]
Belgium	16	15	14	14	13	13	13	:	:
France	15	15	15	15	15	16	13[1]	12	:
Germany	15	14	12	11	11	10	13[1]	15	15
Denmark	10	:	10	:	10	:	10	:	:
Greece	**22**	**21**	**21**	**21**	**21**	**20**	**20**	**:**	**:**
United Kingdom	20	18	18	19	19	19	19[1]	18	18
Ireland	19	19	19	19	19	20	21	:	:
Spain	19	18	20	18	19	18	19	19[1]	19
Italy	20	20	19	18	18	18	19	:	:
Luxembourg	12	11	11	12	13	12	12	:	10[2]
Netherlands	11	12	10	10	11	11[1]	12	12	:
Portugal	23	21	22	21	21	21	20	20[2]	19[2]
Sweden	:	:	8		8		9	11[1]	:
Finland	:	8	8	9	11	11	11[1]	11	11
EU-15	***17***	***16***	***16***	***15***	***15***	***15***	***16[3]***	***:***	***:***

1 Break in the statistical series.
2 Provisional data.
3 Eurostat estimates.
: data not available.
Note: *The year indicated is the survey year; the income data used refer to the year before.* For the definitions of the "at-risk-of-poverty-rate" and "the risk-of-poverty threshold" see the main text.
Source: Eurostat (calculations based on European Community Household Panel survey data).

aforementioned calculations, GDP *per capita* (in PPPs) in 2004 was 24% lower than the EU-15 average. Moreover, income distribution in Greece was more uneven than in the EU-15, as both its unemployment rate and its key poverty and other inequality indicators exceeded the respective EU-15 averages.

1 According to Eurostat and NSSG data. In addition, GDP *per capita (in PPPs)* rose from 65.4% of the *euro area* average in 1995 to 77.6% in 2004. However, as noted by Eurostat, comparisons over time of GDP in PPPs should be treated with caution.

2 See also some of the structural indicators in Bank of Greece, *Summary of the Annual Report 2004,* April 2005 (Appendix II, Table 27).

The average *unemployment rate* in 2004 was 10.5% in Greece (according to the NSSG labour force survey), compared with 8% in the EU-15 (based on Eurostat data). In addition, the *"at-risk-of-poverty rate"* —i.e. the percentage of persons with a *monetary* income (after social transfers) below the *"risk-of-poverty threshold"*[1]— in 2000 was 20% in Greece, as opposed to 16% in the EU-15, notwithstanding some comparability problems (see Table II.3). Specifically, it is estimated that the at-risk-of-poverty rate is approximately 3 percentage points lower when certain (imputed) non-cash incomes of special importance in our country[2] are also taken into consideration. Disproportionately high contributions to the country's at-risk-of-poverty rate come from the elderly, the persons living in rural areas, the members of households headed by a primary sector employee, a pensioner or an unemployed person, and the members of households headed by a person of a low education level. In particular, the elderly (those aged 65 or over) remain the population group facing the highest at-risk-of-poverty rate (33% in 2000 for Greece compared to 19% for the EU-15). This high indicator explains the larger part of the differential between Greece and the EU, since for the non-elderly (those aged less than 65) the at-risk-of-poverty rate in Greece is similar to that in the other EU-15 countries (17% and 16% respectively). Likewise, the at-risk-of-poverty rate in rural areas is more than double that in urban areas, reflecting mainly the relatively low level of farmers' pensions.

Finally, the *inequality* observed in the distribution of the *monetary* disposable income of households declined in Greece —as well as in most EU countries— in the 1994-2000 period, but remained greater than in the EU-15. Specifically, in our country the "S80/S20" ratio (i.e. the income share held by the richer 20% of the population to the corresponding share held by the poorer 20%) decreased from 6.5 in 1994 to 5.7 in 2000, compared with a corresponding decrease from 5.1 to 4.6 in the EU-15. Over the same period, a similar decline from 35 to 33 in Greece and from 31 to 30 in the EU-15[3] was seen in the Gini coefficient, which measures the inequality of income distribution.[4]

Given the considerable shortfall of Greece's GDP *per capita* vis-à-vis the EU-15 average, it is obvious that the achievement of real convergence will require steadily *higher* rates of growth for a number of years. However, as already mentioned, real GDP growth

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1 The "risk-of-poverty threshold" is defined by Eurostat and the OECD as the income that is equal to 60% of the median of the income distribution of the total population.

2 See NSSG, "2002 Survey of household income and living conditions" (press release of 16 July 2003); Eurostat, *Structural Indicators* (data from the European Community Household Panel survey and the EU Survey of Income and Living Conditions) – 2001 survey (on 2000 income data). The percentage for Greece remained at 20% according to the 2002 survey and rose to 21% according to the 2003 one. These surveys refer to the monetary income of households, overlooking some imputed income items particularly important for our country, such as imputed rents implied from the very high percentage of owner-occupied houses, the "own consumption" observed in —mainly— agricultural households, benefits in kind (e.g. childcare facilities, social tourism, in-house care) etc. Indeed, on the basis of the latest available Family Budgets Survey (on 1999 data), which records total imputed income, the at-risk-of-poverty rate comes to 17.3%, i.e. almost 3 percentage points lower than when imputed income is not taken into account.

3 Data from the 1995 and 2001 surveys. In the case of inequality indicators *as well*, taking into account imputed income data leads to significantly lower inequality.

4 The Gini coefficient indicates the share of total income that should be redistributed so as to achieve an absolutely equal income distribution. Therefore, the closer it is to 100, the more unequal is the income distribution.

is expected to slow down appreciably in 2005. Furthermore, there are considerable uncertainties surrounding economic prospects for 2006 and the following years. At least for the next two years it is likely that fiscal consolidation will limit the rate of growth in demand (including investment), while further erosion of competitiveness —as long as the inflation differential between Greece and its trading partners persists— may reduce gains from the continuing global activity growth. In addition, the sustained high oil prices will also undercut growth. Overall, the aforementioned macroeconomic imbalances and structural weaknesses hinder the attainment of sustainable fast rates of growth.

Against the background of globalisation and the ongoing enlargement of the EU, the international environment will continue to present the Greek economy with considerable opportunities —which are also serious challenges that can only be met if the country's international competitiveness is improved on an early basis. The economies of the new and the candidate Member States of the EU, as well as the emerging economies of Southeastern Asia— typically characterised by low labour costs, low tax rates on businesses and labour income, and, more generally, a business-friendly environment – are highly competitive in international product markets, but also in terms of attracting foreign direct investment. At the same time, these rapidly growing markets offer export and investment opportunities for Greece as well as other countries. With the projected slowdown in global activity in the coming years after a series of high rates of growth in recent years, competition in both the domestic and foreign markets is expected to intensify, as is often the case when demand weakens. The consequences will be unfavourable for the Greek economy if it fails to improve its productivity and international competitiveness considerably. In this regard, it should be noted that, owing to the cumulative erosion of price competitiveness in the last several years, the recent increase in Greek exports (mainly services) is almost entirely attributable to the rise in global economic activity.

9.2 Challenges to economic policy

Achieving rapid economic growth presupposes macroeconomic stability, notably correction of the fiscal imbalance and securing a low rate of inflation. At the same time, it requires a considerable increase in Greece's productive capacity through investment and a more effective input utilisation.

At this juncture, a matter of top priority for ensuring macroeconomic stability is the effective implementation of the policy measures for achieving fiscal consolidation that are envisaged in the revised Updated Stability and Growth Programme. Fiscal consolidation can support sustainable growth by contributing to the attainment of low inflation, reducing public debt and strengthening household and business confidence. Price stability is also crucially important for improving price competitiveness and thus growth prospects. In a monetary union, countries that systematically record higher than average increases in prices and unit labour costs tend to face chronic problems of low employment and growth.

Today, with an independent monetary policy no longer being an option, alternative adjustment policies have to be relied upon. This is yet another reason why developments in public finances must come under control.

Along with policies that directly aim at ensuring macroeconomic stability, there is also a need for policies that seek to improve supply conditions. The Greek economy's productive capacity has not managed to cope with increasing aggregate demand in the last few years, and this was one of the factors behind the widening —up to 2004— positive output gap, the relatively high inflation and the large current account deficit. Productive capacity can be raised through structural reforms in the labour market, as well as in public administration, health and education. Such reforms can simultaneously contribute to substantially less economic inequality and much improved living standards. Especially as regards poverty, to the extent that it is related to unemployment, this problem can be dealt with through structural changes that contribute to the creation of new jobs and a higher GDP *per capita*. However, to the extent that poverty relates to socially weak citizens, there should be support from the state on the basis of a well thought-out long-term plan.

9.3 Policies for macroeconomic growth

9.3.1 Policies for achieving price stability

Following a sharp reduction in the run-up to Stage III of EMU, inflation in Greece picked up again in the course of 2000, just before the adoption of the euro in January 2001, and has persistently remained above the euro area average since then. The inflation differential between Greece and the euro area remained broadly unchanged at 1.4 percentage points in the 2001-2003 period, then fell slightly to 0.9 percentage point in 2004[1] and is expected to rise again in 2005, when inflation is forecast to pick up once more and stand at around 4% following the increases in indirect taxes. Such relatively large and persistent positive inflation differentials vis-à-vis the euro area are a cause of concern since, if not addressed by domestic economic policies, they will lead to a sustained erosion of competitiveness, and will adversely affect output growth and employment in Greece.

As discussed in previous reports of the Bank of Greece, the inflation differential observed between Greece and the euro area is much wider than what the so-called "Balassa-Samuelson effect"[2] would imply. Rather, an examination of the factors lying behind inflation suggests that the positive deviation of Greek inflation from the euro area

1 Mainly because the fall in fresh fruit and vegetable prices more than offset a rise in core inflation (relative to 2003), the differential of which vis-à-vis the euro area average widened.

2 Specifically, in countries that are in a process of real convergence, higher productivity growth in the (exposed) sectors of tradeable goods leads to high wage increases, which tend to spill over into the (sheltered) sectors of non-tradeable goods, where productivity growth is typically lower. Thus, average inflation rises above that of more mature economies, whose productivity growth in exposed sectors is slower than in less mature economies.

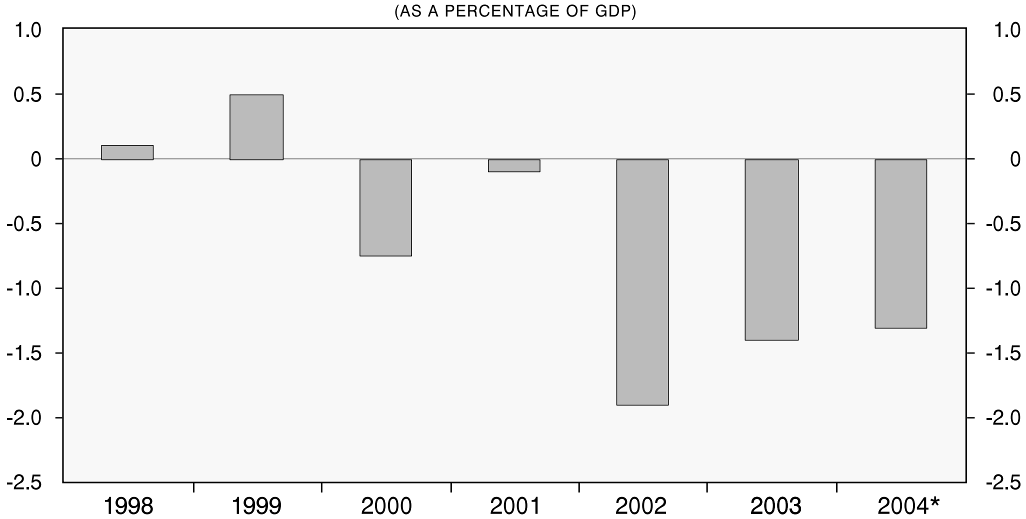
average recorded since 2001 is linked to significant differences in the rate of increase in unit labour costs, which reflect the fact that wage increases in Greece outpace the rise in productivity. Differences in profit margins are another important factor explaining the inflation differential. At the same time, high inflation is also partly attributable to the fast growth of domestic demand, the expansionary fiscal policies pursued in the last several years (see Chart II.14) and the emergence of a relatively large positive output gap.

As already mentioned, the primary objective of the ECB's single monetary policy is price stability in the euro area as a whole. This implies that it is up to Greece's national

CHART II.14

FISCAL POLICY STANCE: ANNUAL CHANGES IN THE CYCLICALLY ADJUSTED PRIMARY SURPLUS[1,2]

(AS A PERCENTAGE OF GDP)



1 Positive values indicate a restrictive fiscal policy and negative values indicate an expansionary fiscal policy.
2 The deficit data for 1997-1999 announced by Eurostat have been taken into account.
* Provisional data.

Source: Bank of Greece estimates on the basis of the ECB model.

economic policies (i.e. fiscal and structural policies) and the social partners' contribution during the wage bargaining process to eliminate the persistent inflation differential, so as to prevent further losses in competitiveness. It is therefore self-evident that fiscal policy has to be firmly committed to the objective of a budgetary position close to balance or in surplus on a medium-term basis, as required by the Stability and Growth Pact.

Fiscal policy, while being a necessary means of adjustment, is surely not sufficient to contain inflation effectively. This is partly due to the fact that, although fiscal policy can affect prices by reducing excess demand, it does so with considerable time lags and thus may have an unfavourable short-term impact on economic activity. To limit the potential unfavourable effects of a tight fiscal policy on activity and employment, efforts geared to reducing inflation should be accompanied by wage increases consistent with price stability. In other words, as already proposed in previous Bank of Greece Reports, the rate of increase in nominal wages should gradually converge towards the sum of the Greek productivity growth rate and the average inflation rate of the euro area (rather than that of Greece), until the inflation differential between Greece and the euro area is effectively eliminated and price stability is achieved. At the same time, it is necessary to strengthen competition, so as to contain the rise in profits at normal levels. Until the inflation differential is eliminated, this policy will prevent further erosion of the country's international competitiveness vis-à-vis its euro area trading partners. Of course, as already noted, at the current juncture increased indirect taxes are expected to lead to higher inflation this year in Greece. However, the annual rate of inflation is expected to subside again when the negative impact of the increase in indirect taxation has run its course by April 2006, provided that there are no second-round effects on prices through higher wages. *Consequently, in order to ensure that the pickup in inflation is only temporary*, it is important that the social partners react responsibly and sensibly to developments. In effect, this means that the temporarily higher inflation must not be "incorporated" in wage increases or in firms' pricing policies across the economy. Finally, well-designed structural reforms —particularly measures aimed at removing nominal wage and price rigidities— can also speed up the wage and price adjustments needed to cope with the loss in competitiveness, as such reforms will prevent the re-emergence of lasting inflation differentials in the future.

9.3.2 Fiscal policy

Fiscal consolidation, in the context of the revised Updated Stability and Growth Programme 2004-2007, as well as in the longer run, is a top priority for the years ahead. The magnitude of fiscal imbalances is indicated by the very high levels of the general government deficit and debt, which are the highest in the euro area. Furthermore, the impact of population ageing on pension and health expenditures is expected to be quite large and growing after 2015 and to be the largest (as a percentage of GDP) in the euro area. If fiscal imbalances are not addressed effectively on time, the public sector's creditworthiness and macroeconomic stability will be jeopardised. There will also be unfavourable implications for the viability of the social security and health systems, specifically as regards their ability to cover pension and health expenditures, as well as for the quality of services the public sector provides. Instead, early progress with the correction of fiscal imbalances will help safeguard such social and public benefits, in an environment of economic stability and growth.

The revised Updated Stability and Growth Programme 2004-2007, which was discussed in Section 4, is a positive first step in a long and difficult process of fiscal consolidation. Programme implementation will require a substantial and resolute effort in order to attain the targeted deficit reduction and to fulfil the government's commitment to correct the excessive deficit situation by 2006, in accordance with the decision issued on 17 February 2005 by the Council of Ministers of Economy and Finance (ECOFIN).

Over the longer term, fiscal policy should be geared towards attaining a budgetary position of close to balance or in surplus, so as to facilitate debt reduction to sustainable levels, i.e. not exceeding the reference value of 60% of GDP provided for by the Treaty on European Union. Besides the envisaged sharp reduction of the deficit in 2005 and 2006, there will be a need for a durable further improvement in the fiscal position through structural changes in public expenditure and revenue collection. Purely indicatively, a debt reduction to, say, 60% of GDP by 2015 would require —on the basis of certain assumptions regarding mainly nominal GDP growth and interest rates— primary surpluses of more than 4% of GDP annually,[1] compared with a primary deficit of 0.4% of GDP in 2004. The gradual decline in government debt will imply lower interest payments, thus releasing considerable resources for other uses. There will also be a need for strict control and review of current expenditures, broadening the tax base and curbing tax evasion. This will ensure that the deficit reduction will be consistent with undertaking adequate public investment in infrastructures and human capital, as well as with implementing further cuts of direct tax rates, which are desirable both because high tax rates act as economic disincentives and because there is intense "tax competition" among the EU countries.

As regards expenditure control in particular, last year's Annual Report[2] briefly discussed international experience with the implementation of "rules" for public expenditure control[3] and suggested major areas of priority in this respect – viz., personnel outlays (38.8% of the overall 2004 ordinary budget expenditure), restitution of revenue collected on behalf of third parties (mainly payments to local authorities, 7.8% of the overall ordinary budget expenditure), and subsidies (18.6% of the overall ordinary budget expendi-

1 This purely indicative calculation of the required level of primary surplus assumes, until 2015, a nominal annual GDP growth of 6% and an average nominal interest rate on government borrowing of 5.5% (unchanged from 2004). On the basis of these assumptions, a decrease in general government debt from 110.5% of GDP in 2004 to 60% of GDP in 2015 would require primary surpluses of 4.2% of GDP per year. With particular regard to pension expenditures, this assumption is in line with the available projections (see footnote 4 on page 51). However, pension expenditures will be increasing between 2015 and 2050, implying the need for even higher annual primary surpluses if the decrease in public debt to 60% of GDP is to be sustained after 2015. Moreover, if the primary surplus is achieved gradually (i.e. according to the consolidation path outlined by the updated Stability and Growth Programme and then through an annual increase in the primary surplus of 0.5% of GDP), the public debt target of 60% would be achieved in 2017.

2 Bank of Greece, *Annual Report 2003*, April 2004, pp. 69-70.

3 These rules usually include ceilings on the annual rate of growth and the size of public expenditure, and, in order to be effective, should fulfil certain requirements – notably transparency. The targeted fiscal variables should be clearly defined, their evolution should be monitored systematically and the outcome should be measurable. The rules should be permanent and cover not only central government, but also all other components of general government (e.g. public hospitals, local authorities, universities, etc.), while annual targets should be consistent with medium-term targets. Moreover, it should be clear which agency or person is responsible for the achievement of each target and the final outcome should be evaluated by independent auditors. Finally, there is a need for an appropriate institutional framework, which could include preparing multi-annual budgets; establishing a system to evaluate public expenditures during the drafting of the budget (e.g. zero-basis budget); a more timely preparation and submission of the budget and the accompanying information to Parliament; and restructuring the budget, e.g. by introducing individual budgets for each and every component of general government.

ture), all of which rose strongly in the 2000-2004 five-year period (at average rates of 9.2%, 9.9% and 13.9% respectively). Also, particular attention should be paid to called guarantees, through which central government assumes additional liabilities. As a percentage of GDP, the outstanding balance of government-guaranteed loans followed a downward path between 1990 and 1999, when it amounted to 6.3% of GDP. However, since 2000 it has started to rise again, reaching 8.7% in 2004.[1] Government guarantees called raise not only the general government's expenditure and deficit on a national accounts basis, but also public debt.[2]

Implicit pension liabilities[3] associated with increasing expenditure due to population ageing have to be taken into consideration in setting the medium-term budgetary objective. Indicatively, according to projections made on the basis of certain assumptions both in the Stability Programme and by the European Commission,[4] total old-age pension expenditures will increase appreciably after 2015. Specifically —compared to 2005— they will rise by 4.9 percentage points of GDP by 2030 and by 10.2 percentage points by 2050.[5] It is obvious that the budgetary implications of population ageing cannot be dealt with through fiscal policy measures alone, i.e. through higher taxation and a cut in other outlays, as this would jeopardise economic growth and undermine the capacity to provide basic public services. In addition to the measures that must be taken immediately to counteract population ageing, a comprehensive approach is needed,

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1 The outstanding balance of guaranteed loans increased twofold, from €7,131.3 million in 1999 to €14,344.3 million at the end of 2004.

2 To the extent that the called guarantees relate to debt of borrowers outside general government.

3 "Implicit liabilities" stand for the present value of future pension liabilities (net of contributions). Purely indicatively, according to OECD projections made in 1996 on 1994-1995 data, if government contributions are included in the revenue of social security funds the present value of net pension outlays amounted to 110% of 1994 GDP. Excluding government contributions, this percentage comes to 196% of GDP (see OECD, *OECD Economic Surveys: Greece 1996-1997*, 1997, p. 91), or —according to slightly later projections— to 193% of GDP (see Paul Mylonas and Christine de la Maisonneuve, "The problems and prospects faced by pay-as-you-go pension systems: a case study of Greece", OECD Economics Department Working Paper No. 215, May 1999). Of course, these estimates, made in 1997-1999, could not possibly have taken into account the more recent demographic data from the 2001 Census or the upshot of Law 3029/2002 on social security.

4 See European Commission, D.G. Economic and Financial Affairs, *March 2005 Revised Update of the Stability Programme of Greece (2004-2007) —An Assessment*, 22 April 2005, pp. 19-22 and 30-32, for comments on the projections included in the March 2005 Stability Programme and the EU Economic Policy Committee (EPC) Report *The impact of ageing populations on public finances— overview of analysis carried out at EU level and proposals for a future work programme*, 22 October 2003. In these projections, future pension expenditure developments take into account the demographic projections that were revised on the basis of the 2001 Census, publicised by the National Actuarial Authority and included in the September 2002 *Greek Report on Pension Strategy* submitted to the European Commission (available at http://europa.eu.int/comm/employment_social/social_protection/docs/el_pensionreport_el.pdf). In this respect, see also Bank of Greece, *Monetary Policy*, *Interim Report 2002*, November 2002, Box 2, pp. 103-07. As mentioned in the Stability and Growth Programme, the National Actuarial Authority is currently preparing projections that will include the latest demographic data and the effects of the legislation adopted in 2002.

5 The same projections imply increases of 5.4 percentage points of GDP by 2030 and 11.5 percentage points of GDP by 2050 in total age-related expenditure. The latter includes (in addition to old-age pensions) healthcare expenditures, which will increase (by 0.9% of GDP by 2030 and by 1.6% of GDP by 2050) and expenditures for education and social benefits, which will slightly decrease (by 0.4% of GDP by 2030 or by 0.3% of GDP by 2050). No projections are available for Greece regarding care for the elderly expenditures (*other* than healthcare).

including (i) fiscal consolidation to increase primary surpluses and reduce public debt, (ii) policy measures to increase the employment rate, and (iii) early reform of the social security system. It is therefore of vital importance to commence the public dialogue on this reform as soon as possible.

9.3.3 Pension and healthcare reforms

As already mentioned, in the next decades Greece —as well as most other developed countries— is expected to face unprecedented demographic changes that will considerably affect its economy and society as a whole. Current demographic projections show that the Greek population of working age (15-64 years old) will start to diminish after 2010.[1] Average lifetime has increased, reflecting the improved living conditions and health level. At the same time, the fertility rate (number of children per woman) is slightly below 1.3, less than the 2.1 threshold needed to renew the population. From 2005 to 2030, the population aged 65 or over will rise by 38%, and from 2005 to 2050 by 86%. On the contrary, the population aged 15-64 will *decrease* by 4.5% and by 18% in the same periods respectively. As a result, the elderly dependency ratio (i.e. the number of persons aged 65 or over as a percentage of the number of those aged 15-64) will rise from 26% in 2005 to 37% in 2030 and to 58% in 2050.[2]

These demographic changes will have major implications not only for the pension system but more generally for prosperity and living standards. First of all, as already mentioned, pension expenditures are projected to rise from 12.4% of GDP in 2005 to 22.6% of GDP in 2050. The total of outlays *affected* by population ageing should increase from 21.1% of GDP in 2005 to 32.6% in 2050, given that healthcare expenditures would rise from 5.0% to 6.6% of GDP,[3] while expenditure for education and unemployment benefits would decrease (due to a change in the population's age composition) from 3.7% to 3.4% of GDP. At the same time, although the increase in the workforce's average age (owing to ageing) should normally entail more experience and thus higher productivity, it also

1 According to the projections of both Eurostat (see "Eurostat 2004 Demographic Projection (Baseline scenario)" in the European Commission Green Paper entitled *Confronting demographic change: a new solidarity between the generations*, COM (2005) 94 final, 16 March 2005, and also "Population projections 2004-2050: EU25 population rises until 2025, then falls", press release 48/8 April 2005) and the *Greek Report on Pension Strategy*, September 2002 (see footnote 4 on page 51). However, according to the latter, total population will start to decrease after 2035 (having reached 11,674,000 people), while for the former it will start falling after 2020 (having reached 11,427,000 people).

2 *Greek Report on Pension Strategy* (2002). The inverse of this ratio, expressing the proportion of contributors to pensioners and currently standing at 3.5, is projected to fall to 2.7 by 2030 and to 1.7 by 2050. Moreover, the latest Eurostat projections (8 April 2005) indicate that the elderly dependency ratio in Greece should increase from 26.4% in 2004 to 35.5% in 2025 and to 58.8% in 2050.

3 The rise in health expenditures is rather limited because employees still pay social security contributions for healthcare after retirement. In addition, as suggested by relevant research, the stronger impact on healthcare expenditures occurs during the last six months of a person's life, regardless of his/her age (see D. Wise, "Program Report on Economics of Aging", *NBER Reporter*, 22 June 2003). Thus, increasing life expectancy has a lesser upward effect on health expenditures than on pension expenditures.

implies lower adaptability to new technologies, which ultimately lessens productivity growth.[1] In turn, these developments are additional factors weighing on the social security system's viability and the fiscal position.

In order to address the population ageing challenge, in particular to help counterbalance the expected decrease in the working-age population, the employment rate has to be raised, including by increasing the average effective age of retirement. As already noted,[2] an increase in the employment rate requires the mobilisation of the "unexploited employment reserves", by encouraging legal immigrant work, combatting unemployment (which mainly affects women and the young), offering incentives (and removing disincentives) for the participation of women and, finally, encouraging the participation of older persons.

The number of economic immigrants has grown significantly in the last fifteen years. *Foreigners* represent a share of 7.3% in the population of Greece (2001),[3] at least 6.4% in employment (second quarter of 2004),[4] at least 12.6% in the directly insured by the Social Insurance Institute (IKA) (April 2004)[5] and 11.0% in the IKA's revenue from social security contributions (2003).[6] Moreover, according to a recent UN report,[7] sustained migration flows such as the ones observed in recent years can play a role in preventing reductions of the working-age population in developed countries[8] and in limiting the increase in the total dependency ratio (the ratio of the population aged 0-14 and 65 or over to the working-age

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1 A recent study focusing on the *European* economy estimated —based on certain assumptions— that the net effect of population ageing could be a deceleration of the annual labour productivity growth rate in the EU, by 0.25 to 0.5 percentage point, while —also on account of demographic trends— between 2005 and 2050 the EU's annual potential growth rate is expected to fall by 0.8 percentage point compared with average growth rates achieved in the 1990s. See European Commission, *Effects of ageing on long run labour productivity growth: a theoretical and empirical assessment*, 2004.

2 *Greek Report on Pension Strategy*, pp. 22-23.

3 Based on the 2001 Census data (796,700 people in a total of 10,964,000), which are considered to be the most precise. For a detailed discussion (in Greek) see the extensive report of the Labour Institute (INE) of the Greek General Confederation of Labour (GSEE) and the Confederation of Civil Servants (ADEDY) *2003-2004 Survey on the forms of social inclusion of economic immigrants in the Region of Attica*, 2004.

4 According to the sample Labour Force Survey of the NSSG, which still underestimates the number of foreign workers, but less than it did in the past.

5 Press release (15 March 2005) by the Social Insurance Institute (IKA): the number of foreigners insured was 222,569 in a total of 1,762,829 IKA members in April 2004. However, according to data published by the Immigration Policy Institute (IMEPO) on 15 February 2005, a survey conducted by the National Centre for Social Research (EKKE) on behalf of the IMEPO reports that the immigrants insured by the IKA were 346,000 people in 2003, while there were also 45,000 foreigners insured by the Farmers' Pension Fund (OGA) in 2004 and approximately 10,000 by the Fund for Craftsmen and Small Traders (TEBE) in 2002.

6 Based on 2003 data published by the IMEPO on 15 February 2005 (contributions to the IKA by foreigners: €0.9 billion, total revenue from contributions: €8.1 billion).

7 United Nations, Department of Economic and Social Affairs, *World Economic and Social Survey 2004-International Migration*, November 2004.

8 With respect to the effect of migration flows on population the report suggests that without immigrant inflows Europe would have experienced a population decline of 4.4 million between 1995 and 2000 (since even with about 5 million immigrants in this period its population increased by only 600,000). In addition, it estimates that without net migration the population of the more developed regions of the world would decline by 200 million between 2000 and 2050.

population, i.e. those aged 15-64).[1] The UN report concludes that the entry of temporary or permanent immigrants may *partially offset* the consequences of population ageing for social security systems, but it *cannot ensure* the financial sustainability of these systems. Thus, as stated in the report, meeting the challenge of ageing population "will require a comprehensive strategy that should also include reassessing the retirement age and benefits and increasing the labour-force participation of the working-age population".

Issues related to dealing with unemployment and encouraging the participation of women and the young in the labour market are discussed further below.[2] Encouraging the participation of older people entails increasing the *effective average* age of retirement. In 2002, the Barcelona European Council[3] called on all EU countries to seek "a progressive increase of about 5 years in the *effective average* retirement age by 2010", while the recent Brussels European Council confirmed that raising employment rates and extending working life, coupled with reform of social protection systems, are the best means of safeguarding the present level of social protection in the EU.[4] The *average* age of retirement —which is lowest in Greece among the EU-15 countries[5]— is a crucial parameter of the pension system because it affects both the outlays and the revenue of social security funds.[6] Therefore, its increase would be a far more effective measure than a change in any other parameter of the social security system. It should be stressed that increasing the effective average age of retirement does not necessarily involve raising the statutory age of entitlement to pension. Efforts could initially focus on limiting the phenomenon of early retirement, by providing strong financial incentives for staying active up to the statutory age of retirement[7] (and even beyond that on a *voluntary* basis – i.e. if both employer and employee so desire), as well as disincentives to retiring early.

The efforts made during the last fifteen years to reform the pension system[8] have been only partly successful. They have helped gain considerable time and improved the

1 According to the latest (8 April 2005) demographic projections by Eurostat (i.e. the "baseline scenario", which is based on the assumption that the annual net migration to Greece in the 2005-2050 period will be around 35,000 to 42,000 people), this ratio will increase in Greece from 47.8% in 2004 to 56.4% in 2025 and to 81.1% in 2050.

2 See Section 9.4.2.

3 See "Presidency Conclusions", 15-16 March 2002.

4 See "Presidency Conclusions", 22-23 March 2005.

5 Comparative 1998 data published in the report: European Commission, Economic Policy Committee, *Progress Report to the ECOFIN Council on the Impact of Ageing Populations on Public Pension Systems*, Brussels, November 2000 (EPC.ECFIN/581/00-Rev.1), p. 25.

6 When insured persons retire, their fund not only starts paying them their pension but also stops receiving social security contributions from them and their employer. Thus, the cost for the fund is many times higher than the pension paid.

7 In Finland, pensions increase by up to 33% if the employee retires at the age of 68. In Canada, employees after the age of 60 cease to pay pension contributions. In Italy, when the statutory retirement age was changed from 60 to 65 years, very strong financial incentives were offered for the employees to continue working until that age.

8 These included: Law 1902/1990 and Law 2084/1992, which appreciably strengthened the system's sustainability; the introduction of the Pensioners' Social Solidarity Benefit (EKAS) in 1996; the thorough reformation of the operational framework of OGA launched in 1998; the merge of all the funds for the self-employed in 1999; the administrative modernisation of IKA launched in 2001; and Law 3029/2002, which contained provisions for the system's permanent funding through the state budget, some parametric changes (in terms of replacement rate, the pension calculation base and the minimum retirement age), as well as an envisaged gradual integration of most main pension funds of wage-earners into the Social Insurance Institute – National Salaried Employees Ancillary Social Security Fund (IKA-ETEAM) by 2008 and convergence of social security legislation by 2017.

organisational structure of the system, but have not addressed the underlying expenditure pressures. A number of analysts[1] have made alternative suggestions, including —besides the self-evident need to prevent contribution evasion[2]— parametric reforms of the existing pay-as-you-go pension system (e.g. increasing the retirement age, cutting benefits) and the introduction of a mixed, partially funded system. However, reform efforts have not progressed, owing to the lack of a consensus among social partners and of willingness on the part of the responsible parties, even though it is widely known and tends to be commonly accepted that population ageing will accelerate after the first 21st-century decade and that it will certainly threaten the viability of the current pension system and, more generally, the long-term sustainability of public finances. As regards the introduction of funded schemes, Law 3029/2002 (Article 7) has set the legal framework for a second "pillar" in the pension system, allowing for the creation, at the industry or enterprise level, of fully funded "occupational funds" operating as private entities. Efforts to exploit this possibility have started slowly, with only three such funds established thus far. The dialogue on the "social insurance issue" of bank employees provides an opportunity for the necessary measures to be taken so as to promote and fully develop the pension system's second pillar.

Given the system's serious actuarial imbalance —which will be exacerbated by the pressures of population ageing on healthcare costs— Greece cannot afford the luxury of delaying any further its pension system reform. There is a pressing need to limit incentives for early retirement, especially in the public sector. Without early structural reforms, onerous increases in taxation or in social security contributions to cover future pension expenditures will become inevitable over the long run, with additional adverse consequences for international competitiveness and growth.

The reforms of the health system implemented so far have not been sufficient. As already mentioned, Greece's health expenditure-to-GDP ratio, one of the highest among OECD countries,[3] is projected to further increase appreciably on account of population ageing. Hence, the need to reform this sector is urgent. In this regard, it is encouraging that the government —as noted also in the Updated Stability and Growth Programme— is preparing a healthcare system reform plan in order to ensure the system's economic viability (by containing expenditure) and to address some of its specific weaknesses, while also ensuring a satisfactory level of services.[4] In addition, the restructuring and settlement of debt incurred by hospitals to their suppliers is currently in progress,[5] while measures are

1 See A. Börsch-Supan and P. Tinios, "The Greek pension system: strategic framework for reform" in *Greece's Economic Performance and Prospects*, Bank of Greece and the Brookings Institution, 2002. See also IMF, *Greece: Selected Issue – An overview of pension reform*, March 2002, as well as F. Zervou, *The financing of the Greek pension system 1981-2000*, Centre of Planning and Economic Research (KEPE) 2004.

2 The importance of contribution evasion is highlighted —along with other problems of the pension system— in the recent *Actuarial study for the IKA-ETEAM: basic conclusions and proposals* carried out by the GSEE/ADEDY Labour Institute (April 2005).

3 OECD, *Towards High-performing Health Systems: Policy Studies*, 2004.

4 This reform includes Law 3329/2005 ("National Health and Social Security System") that was passed last March.

5 Law 3301 that was passed in late 2004 pertains to this.

being prepared (e.g. implementation of "business resource planning" throughout the National Health System (ESY), reliance on public-private partnerships to provide hospitalisation services as well as to construct public hospitals) in order to prevent the re-emergence of this problem.

9.4 Economic reforms to enhance Greece's growth potential

In order to converge with the average living standard of the 15 more advanced countries of the EU within a reasonable time period, Greece needs higher and sustained growth for a number of years. This requires urgently the development of a growth-oriented economic strategy aiming at raising both labour utilisation and labour productivity, always within a framework of sound, stability-oriented macroeconomic policies. It has already been stressed that the policy priorities for improving macroeconomic conditions call for correction of the fiscal imbalance and securing low inflation. In addition, structural reforms are also needed to strengthen the Greek economy's growth potential. The reforms discussed in this section focus, on the one hand, on improving the functioning of the labour market and the quality of human resources and, on the other hand, on accelerating productivity growth and increasing business dynamics. The relaunch of the Lisbon Strategy, with the re-prioritisation of its targets by the European Council last March, offers Greece a vital opportunity to address these challenges, so as to bring its economy back on the path to long-term prosperity through higher and sustainable rates of growth.

9.4.1 The convergence process so far

In 2004, economic expansion in Greece continued for the eleventh consecutive year. In the last five years (2000-2004) the average annual rate of growth was particularly high (4.3%), exceeding by 2.4 percentage points the EU-15 growth rate. Thus, as the average annual rates of population growth in Greece and the EU-15 were not much different (0.3% and 0.4% respectively), GDP *per capita* in Greece (in PPPs) grew faster than in the EU-15, although from a much lower base. Therefore, in 2004 Greece's GDP *per capita* was still just under 76% of that of the EU-15 countries.

The reasons for which the Greek GDP *per capita* is 24% lower than the EU-15 average are well-known: Total employment rate (the employed as a percentage of total population) in Greece in 2004 was about 39% (compared with 44% in the EU-15) or 11%[1] lower than in the EU-15. In addition, labour productivity (GDP per employee)

1 It refers to the percentage difference of the employment rates, not their difference in percentage points.

was 13% lower than in the EU-15.[1] However, it should be noted that, if employment is measured in total hours worked, there is no gap between Greece and the EU-15 average in total labour utilisation as the *average working time* is significantly higher in Greece than in the EU-15,[2] thus overcompensating for the lower *number of employees* as a percentage of the population. On this basis (hours worked), the gap between Greece and the EU-15 in GDP *per capita* is therefore totally attributable to differences in productivity (GDP per hour worked).

The average annual rate of increase in productivity per employee has picked up considerably,[3] from 0.8% in 1980-1989 and 0.4% in 1990-1995, to 2.7% in the 1996-2004 period.[4] Therefore, following a long period of weaker productivity growth in Greece than in the EU-15, the country's efforts to catch up have led to an improvement.[5]

As already mentioned, productivity improvement contributes decisively to long-term economic growth and to enhanced living standards. In this respect, a question arises as to which were the factors behind the acceleration of productivity growth in Greece in recent years. Although it should be noted that productivity growth in Greece has not yet been thoroughly studied, the available data allow a number of clear conclusions to be drawn.[6] A decomposition of the sources of growth of labour productivity suggests that the stronger rates of productivity growth in Greece since the mid-1990s reflect, on the one hand, the higher rate of capital deepening over the 1996-2004 period and, on the other hand, the faster rates of growth in "total factor productivity". The first factor can be associated with the recovery of business investment, which rose at an average annual rate of 10.5% in that period, or, as a percentage of GDP,[7] from 10.5% in 1995 to 14.7% in 2000 and 16.5% in 2004. Thus, total fixed capital formation reached 25.5% of GDP in 2004, from 18.6% in 1995 and 23.6% in 2000, a development also attributable to larger public investment, which led to improved infrastructures. The second factor can be attributed to the use of more efficient processes of production —e.g. Information and Communication Technologies (ICT)— in certain sectors, such as transport and communications, trade, as well as financial and other business services, all of which recorded substantial productivity gains in Greece in recent

1 Greek GDP and population data from the latest available national accounts, but employment data derived from the recently updated Labour Force Survey for the 1998-2004 period, not yet taken into consideration by the NSSG National Accounts Service. It should be noted that the employment ratio in 2004 according to the other commonly used definition (employed persons *aged 14-65* as a percentage of the population *of the same age*) was 59.4% in Greece, as opposed to roughly 65% in the EU-15 (see also Section 3.2).

2 The higher average working time in Greece reflects both the higher average real working hours of full-time employment and the lower share of part-time employment.

3 Not cyclically adjusted.

4 In the 1996-2004 period, the average annual rate of increase in GDP was 3.8%, which reflects an average annual growth rate of 2.7% in productivity per employee and of 1.1% in the number of employees.

5 The average annual growth rate in productivity per employee in the EU-15 was only 1.1% in the 1996-2004 period.

6 The overall assessment that there has been an increase in productivity growth is independent of whether labour productivity is measured per employee or per hour worked.

7 At current prices.

years.[1] The evidence presented in this section shows that special emphasis should be placed both on policies directly affecting the determinants of productivity and on measures to increase the employment and labour force participation rates.

9.4.2 Economic reforms to raise productivity growth

As mentioned in the previous section, the acceleration of labour productivity growth since the mid-1990s is mainly due to capital deepening and higher total factor productivity growth. This evidence —along with the fact that Greece still lags behind the more advanced EU economies as regards its *levels* of capital deepening and total productivity— illustrates the need for enterprises to exhibit even more dynamism and undertake more investment. This can be achieved through the implementation of a reform strategy aimed at improving the business climate by (i) promoting competition, simplifying the regulatory —particularly the tax— environment, providing incentives for and eliminating obstacles to entrepreneurship —particularly to the formation of new enterprises— and (ii) facilitating transition to a knowledge-based economy, encouraging the use of ICT and boosting investment in human capital and R&D.

Certain policy measures aimed towards these objectives were included in legislation regarding taxation (Law 3296/2004) and development (Law 3299/2004) passed at the end of the previous year. These two laws reduce significantly the tax burden on enterprises[2] and encourage private investment,[3] job creation (in the private sector)[4] and per-

1 The higher contributions to the average annual rate of GDP growth in the 1996-2004 period (3.8%) came from retail and wholesale trade/transport and communications/hotels and restaurants (1.7 percentage points), financial and other business services (0.6 percentage point) and education/health/public administration/other services (0.6 percentage point).

2 The tax rate on profits is gradually reduced from 35% in 2004 to 25% in 2007 for Sociétés Anonymes and Limited Liability Companies and from 25% in 2004 to 20% in 2007 for General Partnerships and Limited Partnerships.

3 The new law provides for four kinds of financial backing (subvention, leasing subsidy, tax exemption, subsidy of the payroll cost of the jobs created by the investment plan). For investments that fall under this law, the investor's own minimum required participation is reduced from 40% to 25% of the investment's value. The hitherto distinction between "old" and "new" enterprises is lifted so that all enterprises can access all four kinds of financial backing. The law also establishes the possibility of an additional subvention of small and medium-sized firms, ranging from 5% to 15% of the investment's value. Moreover, it increases by 10 percentage points on average the subvention of investments in all sorts of tourist ventures. It considerably broadens the scope of financially-backed business activities oriented towards the tertiary sector. In addition, it provides for considerable changes in the investment's assessment, approval and supervision procedures. It makes the whole process simpler, shortens the time required for the assessment of the investment plan and the preparation of the supervision report and reduces the number of the subvention's instalment payments (and the respective audits) from 4 to 2. Furthermore, it enhances the role of private institutions in the assessment of investment plans and the supervision of their implementation. On the other hand, this law entails the creation and operation of numerous committees, which does not help in limiting bureaucracy.

4 While eligibility for subvention is henceforth dissociated from the obligation to create new jobs (which in some cases hampered high-technology or capital-intensive investments in the past), the number of new jobs created remains a key criterion in order for investments to fall under the provisions of this law. Part of the payroll cost of every new job created thanks to the investment is subsidised for 2 years (and within 3 years from its completion).

sonnel training,[1] R&D,[2] and decentralisation of economic activity. They represent significant steps in the right direction, but they are not sufficient by themselves to increase investment and attract foreign direct investment in Greece.

As regards entrepreneurship, according to a recent IOBE survey,[3] the share of the population of employment age that was starting a business venture in 2003 was not lower in Greece compared with other developed countries. However, in contrast to most of these countries, Greece recorded a high rate of *"forced entrepreneurship"*, i.e. recourse to a business activity in the absence of other means of earning a living. Moreover, only 16% of these ventures could be characterised as being of *"high potential",* i.e. conducive to market expansion, creating jobs and strengthening the export orientation of the economy. Finally, Greece ranked very low as regards the innovativeness of existing enterprises (mainly SMEs).

The strengthening of competition in the product markets can contribute directly to higher total factor productivity by inducing managers to improve efficiency and introduce more innovation. Experience from structural reforms in our country thus far shows that in the deregulated industries (e.g. the financial sector, telecommunications, post services) there have been clear benefits for the consumers and the economy. Despite this progress, there is room for strengthening competition further, not only in the aforementioned sectors but also in other sectors with public utilities (e.g. power supply, natural gas supply, water supply, oil refinement) in which competition is still limited. The absence or inadequacy of competition in these sectors is attributable to *deficiencies* in the institutional framework (e.g. in power supply) but also to incomplete alignment with community directives (e.g. in telecommunications).[4] In addition, greater progress in privatisation is needed. As mentioned in the Stability and Growth Programme, the privatisation programme for 2005 amounts to €1,010 million.[5] The benefits of privatisation will be even greater if the state relinquishes its ability to control commercial policies in public utilities and withdraws completely from activities that properly belong in the private sector.

More generally, the country's business environment presents serious deficiencies, as also evidenced by the results of a recent OECD survey covering the years 1998 to 2003.[6] According to the OECD, business activity in Greece is heavily encumbered by state control, manifold regulatory interventions (e.g. price monitoring, plethora of administrative

1 Enterprise personnel training costs are recognised for tax return purposes.

2 Allows for a *further 50%* of the enterprises' outlays for scientific and technological research to be deducted from their net income, in addition to the deduction of *total* such outlays from their gross income.

3 Since 2003 the Foundation for Economic and Industrial Research (IOBE) participates in an entrepreneurship survey carried out under the international research programme of the Global Entrepreneurship Monitor (GEM). The first annual report on this international programme was presented on 21 October 2004.

4 See Bank of Greece, *Monetary Policy 2004-2005*, February 2005, Appendix to Chapter III.

5 In the course of 2004 the government proceeded to the sale of Hellenic Petroleum and National Bank of Greece shares (with proceeds amounting to €192 million and €562 million respectively).

6 See OECD, *International Regulation Database,* as well as P. Conway, V. Janod, G. Nicoletti, "Product market regulation in OECD countries: 1998 to 2003", OECD Economics Department Working Paper No. 419, 2005.

controls, etc.) and bureaucracy. The bureaucratic interference is readily attested by the cost, in terms of both time and money, of establishing new enterprises, be it personal companies or corporations – although some progress has been made in recent years as regards enterprise licensing procedures.[1] Impediments to business activity are also created by the markets' lack of sufficient information concerning the regulations and laws in effect (as for example in the case of unauthorised construction). A particular problem arises from the absence of a stable legal framework as regards urban planning regulations —particularly as to the use of land— and from inadequate zone planning. Moreover, the complexity of the bankruptcy legislation and the extremely time-consuming legal procedures that a bank, for instance, must follow in order to collect a loan in the case of a borrower's bankruptcy may be leading banks to require their customers to provide considerably high collateral, thus in effect hindering access to financing. A review of the data used by the OECD to assess the regulatory framework shows that inadequate competition in the Greek economy is not due to the existence of legal hindrances as regards the entry of enterprises, but to the existence of administrative impediments to starting a business activity and the instability and complexity of the regulatory environment. This environment seems to favour collusions and harmonisation of practices among already existing enterprises.[2]

This is precisely why the role of the Competition Commission should be further reinforced. The proposed legislation that amends, replaces and complements Law 703/1977 on "Control of monopolies and oligopolies and protection of free competition"[3] seeks to modernise the institutional framework on competition and align it with the recent EU Regulation 1/2003,[4] as well as to upgrade the Competition Commission, in terms of its institutional entrenchment and independence as well as of its competencies, inspection powers and regulatory interventions. In fact, the provision of Article 5 grants to the Competition Commission the possibility of taking properly justified regulatory or corrective measures as needed to strengthen competition, particularly in certain markets. International experience and comparative studies that have been undertaken[5] show that there is no single model for the legislative strengthening of competition and for the set-

1 Law 2941/2001 was passed in 2001 to simplify the procedure for the formation of sociétés anonymes, while Law 3325/2005 was recently passed to simplify the institutional framework for the authorisation of manufacturing firms.

2 Pertinent examples have been described in detail in a previous Bank of Greece Annual Report. See footnote 4 on page 59.

3 The bill was presented by the Ministry of Development on 16 March 2005 following deliberations with institutional agents such as the European Competition Committee, the Greek Economic and Social Commission, the Greek Competition Commission, etc.

4 European Council Regulation No. 1/2003 of 16 December 2002 on the implementation of the competition rules provided for by Articles 81 and 82 of the Treaty, which came into effect as of 1 May 2004. The new regulatory framework aspires to the maximum possible integration of the legal framework applicable throughout the EU, while placing greater emphasis on economic analysis so that the assessment of competition policies be mainly focused on economic results and seek the rationalisation, transparency and simplification of the competition rule implementation procedures. See also "A far-sighted competition policy for a competitive Europe", European Commission Announcement, 20 April 2004.

5 See, for example, OECD, *Report on Regulatory Reform*, 1997, and *Global Competition Review* 6(6), June 2003.

ting up of the Competition Authority. Nevertheless, making best use of more general principles, such as the independence of the Competition Commission, the transparency in the decision-making process, the cultivation of a competitive spirit in business practices and the constant review of the regulatory provisions, can contribute to the establishment of a competitive climate in the economy. In the case of Greece, it appears that the legislation governing competition and the independence of its Competition Commission, once the proposed bill is passed, will be on a par with that of the other European countries. A more active attitude by the Competition Commission, based on the possibilities offered by the proposed legislation, is expected to expedite developments in the field. Still, as is also noted in an international comparative survey,[1] there are indications that competition policy does not enjoy full support in our country. In an economy with a history of (i) extensive state entrepreneurship and (ii) private entrepreneurship linked to the public sector, the establishment of a competitive spirit and the acceptance of a competitive mentality by economic and social institutions may be a long-term process.

As regards expenditure on R&D as a percentage of GDP, Greece ranks last among the 15 more advanced EU countries (with only 0.64% in 2001, as opposed to 1.99% in the EU-15 in 2002).[2] Therefore, stimulating business R&D spending remains a top priority for Greece. Moreover, the country is still a latecomer in the field of ICT use, although investment in ICT and the use of PCs and the internet has increased considerably over the past fifteen years. In particular, expenditure on information technology (IT) media as a percentage of GDP has remained practically unchanged over the 2001-2004 period.[3] This means that, despite the constantly increasing number of IT media used in the economy (as GDP grows), the rate at which enterprises are being modernised has neither accelerated nor decelerated. It is therefore necessary to encourage the use of ICT, as this tends to act as an important driver of labour productivity.

At the same time, policies for development should also aim at improving human capital. Given the rapid technological changes, the skills of the workers have to be frequently adapted throughout their working life. Moreover, measures promoting the development of human capital will also create the conditions for the introduction of innovations, which today remain limited,[4] especially in cutting-edge technology fields, despite the increased proportion of technology-oriented university graduates in the total number of new graduates. It is a positive development that a large number of programmes promoting the transition to a knowledge-based economy have already been adopted at the EU level. These include (i) European Technological Platforms, which are created by the European Commission and bring in contact public- and private-sector institutions with a

1 Conducted in 2002 by *Global Competition Review* with the participation of competition policy "users", such as enterprise groups, business executives, legists, economists, and consumer associations.

2 Eurostat, "R&D expenditure in the EU", *Statistics in Focus,* 2/2005.

3 Eurostat, New Cronos database. IT expenditure includes outlays for equipment, software and other IT services.

4 See Ministry of Development, Department of Competitiveness, *Investigation of the competition indicators and assessment of the cost of the Greek economy's lack of competition,* March 2005.

view to mapping out a strategy for the development and use of new technologies in Europe, and (ii) the Action Plan for Investment in Research, which aims at improving Europe's performance as regards R&D through a series of measures covering a wide variety of fields, such as research, innovations, financial markets and human capital. Moreover, education and professional training have been selected as key priority domains. The community Directive for the mutual recognition of professional skills will facilitate the mobility of specialised personnel across EU countries. In addition, enterprises can benefit from measures aimed at better recording skill shortages, as well as from closer cooperation with third-level education institutions for the educational system to be better suited to the needs of the enterprises.

The modernisation of public administration so that it becomes more friendly for citizens in general and for —both Greek and foreign— enterprises and employees in particular can contribute to growth decisively. Recent international as well as Greek experience with one-stop shops shows how modern technology can allow and foster faster intragovernmental communication, thereby expediting the provision of services to the user or citizen. On the contrary, time-consuming procedures not only raise the cost of transactions but also foster corruption and often lead to the perpetuation of centralised control solely on the pretext of combatting corruption. However, a more effective method of curbing corruption is through providing *information* and ensuring total *transparency* as to the progress in the procedures and the management of projects. Simplified and reduced bureaucratic formalities are also essential for strengthening citizen confidence in public administration, eliminating mistrust and ensuring an equal footing for all. That is why cooperation between social partners and business institutions would be valuable in identifying the major shortcomings and obstacles to the enhancement of economic activity, productive investment and employment, linked to public administration. At the current juncture, administrative reorganisation should preferably start from economically productive sectors of activity. Experience from the nearly 1,000 Citizen Service Centres (KEPs) now operating throughout the country shows how —by means of appropriate *non-bureaucratic* measures— constructive changes can be advanced. KEPs not only provide a valuable service to the public (relieving the citizens from time-consuming procedures and thus contributing to productivity growth) but also help public administration itself (allowing it to identify problems).

Of course, the extent and complexity of the required reorganisation of the state mechanism necessitates a gradual approach of "small steps" and measures focused on the top priority domains, something that may not only prove to be effective but also produce multiplicative positive results. Such domains include the provision of services to the public (Social Insurance Institute, pensions, health, education) and, over and above, to entrepreneurs. The serious problems that exist in the relationship of the public administration with the citizens and the enterprises are well known and collectively produce an *unfriendly* climate that often deters foreign or domestic investors and businessmen. Indeed, the malfunctions caused by the plethora of inspections and procedures required for the licensing and the establishment of sociétés anonymes are well-reported. Simplifying them would not only encourage investment, but would also help curb corruption, which is fuelled by red tape. A gradual improvement in the functioning of public administration, especially vis-à-vis enterprises, can be achieved through the creation of "efficiency islets" that will have a beneficial effect on their surrounding areas. The task of such units (high-level Service Centres) can be two-fold: on the one hand to solve specific problems and cover specific needs of the users or citizens and on the other hand to study the weaknesses they record and suggest solutions. An effort in this direction has started with the Hellenic Centre for Investment (ELKE), the Investor Reception Centres (KYE) and the Technological Development Centres (EKTA). In striving to modernise the relationship of the administration with the citizens, enterprises and employees, priority must be given to sectors of activity that directly and decisively affect quality of life and growth, the facilitation of all business investments, the construction of public works and utility projects, the problems of zoning and urban planning, the public revenue collection and audit procedures (especially the tax audit system, which tends to deter foreign enterprises) and, finally, the employment issues and conditions that concern both Greek and immigrant employees in our country.

9.4.3 Economic reforms to raise employment and labour force participation rates

As mentioned already, if employment is measured in total hours worked, there is no gap in total labour utilisation between Greece and the EU-15. Nevertheless, given that the employment rates of young people, women and older workers are relatively low, while the working hours of full-time employees are long and part-time employment is low, there still remains much scope for higher labour force utilisation and improved quality of human resources – i.e. developments that would not only raise the Greek GDP *per capita*, but would also contribute substantially to sounder pension finances, lead to a more equitable income distribution and help tackle social exclusion.

The specific policies aimed at raising labour quality and labour utilisation can be grouped into those related directly to the labour market and those that are implemented in other markets or sectors but nevertheless have an effect on employment. Some of the policies mentioned in the previous sections —particularly those fostering a knowledge-based society and improving job-specific skills— can lead to increased employment and labour productivity. Furthermore, policies that encourage the creation of new businesses —by simplifying the administrative procedures and the regulatory framework governing the formation of companies— and, in general, policies that seek to prop up investment consequentially lead to increased employment as well.

However, increasing the rates of employment and labour force participation also requires policies geared more directly to attracting more people into the labour market and improving the market's flexibility. Therefore, the main priorities of labour market policy include:

— Removing the impediments to the entry of the young into the labour market, through better tailoring the education and professional training systems to the labour market requirements.[1]

— Attracting more women, as well as older people, into employment (e.g. by improving child-care systems, promoting equal treatment and opportunities and limiting early retirement).

— Encouraging the social integration of certain population groups, by converting the informal/undeclared labour (e.g. of immigrants) to legal employment.

— Improving the effectiveness of active labour market policies, as well as the operation of public and private institutions[2] that facilitate the match between labour supply and demand.

— Reducing the tax disincentives to working longer hours and reviewing the employment protection legislation, to ensure that they provide a sufficient level of flexibility as much for firms as for workers, especially in periods of economic changes. New forms of labour organisation and a greater variety of contractual arrangements for employees and enterprises can be useful in this respect, provided that they combine flexibility with security.[3]

— More generally, eliminating the impediments to labour mobility and increasing the employees' ability to respond to the requirements of new technologies (e.g. by promoting lifelong learning).

10. SUMMARY AND CONCLUSIONS

Greece has achieved strong growth in recent years, which continued into 2004, averaging about 4.3% during the past five years, well over double the euro area average. The main factor lying behind this sustained expansion was increasing domestic demand, underpinned by a monetary stimulus associated with the adoption of the euro and —more recently— the fact that real interest rates have remained at historical lows, as the European Central Bank has not changed its key rates since their last cut in June 2003. Another factor was an expansionary fiscal stance, which was not sustainable. These drew

1 An earlier NSSG survey *(Transition from education to the labour market - 2000, 2003)* showed that an average period of 35 months elapses between completion of the "basic continuous education" and employment in the first major job. Compared to other European countries it appears that Greece, along with Italy and Spain, presents one of the longest education-to-labour time spells. In addition, a recent NSSG sampling survey of mainly manufacturing firms, recorded tightness in some specialty occupations requiring tertiary education (according to 48% of the firms) and in some specialty occupations requiring lower-level education (according to 60% of the firms). See Federation of Greek Industries (SEV), *Survey on the needs of enterprises in leading-edge specialties in the three-year period 2005-2007,* June 2004.

2 That is, the Manpower Employment Organisation (OAED) and the Employment Promotion Centres, as well as Offices for the Information of Unemployed and Offices for the Information of Enterprises, Temporary Employment Firms and Private Offices of Labour Consultants.

3 See also Brussels European Council, 22-23 March 2005, Presidency Conclusions, paragraphs 30-33.

a strong private sector response, which, however, also reflected to some extent an improvement in business confidence ahead of the then-forthcoming Olympic Games. Total private investment (notably business investment) rose and strong personal income increases have spurred private consumption.

However, strong demand has contributed to relatively high inflation vis-à-vis the euro area. As a result, competitiveness weakened, causing a considerable loss in Greek export market shares and keeping the external balance in substantial deficit. Despite strong economic growth, employment growth has been modest and structural unemployment remains high. Greece's weak fiscal position has deteriorated further and the public debt-to-GDP ratio remains high.

The outlook for 2005 is for slower growth, given (i) the waning of the monetary stimulus provided by euro area entry; (ii) the necessary adjustment of fiscal policy to a more sustainable path; and (iii) the recent international oil price increases. Whether this slowdown will prove to be a temporary pause or a transition to a period of slower growth will depend on several factors. Foremost, it will depend on whether the Greek economy can be transformed from the one of the past several years, in which domestic demand provided the dynamics for growth, to an economy in which the supply side becomes more responsive to economic conditions and is increasingly able to compete successfully in global markets, so that the external sector becomes a key driver of growth. The thesis of this Report is that such a transformation is *both* necessary *and* achievable, and a roadmap that can lead to a new dynamic, competitive economy is presented. Many of the factors that have underpinned growth in the past several years —including the large infrastructure projects— have helped provide a foundation for sustainable growth. It is now time to build on that foundation.

Beyond 2005, prospects depend critically on credible policies to strengthen public finances and improve product and labour market performance so as to lay the groundwork for high and sustained GDP growth. The most pressing priority is to put public finances on a sustainable footing. The revised Updated Stability and Growth Programme recently submitted by the government is a welcome start to the required medium- and long-term fiscal adjustment. In addition, a substantial programme of structural reforms is needed across a broad range of areas.

Important progress has been made in recent years in reforming the Greek economy, especially since the launch of the Lisbon strategy in 2000. Action has been taken to reform product and financial markets, privatise state-owned enterprises, open up markets to the rigours of external competition and improve the functioning of the labour market.

Specifically, the financial sector in Greece has been fully liberalised and its efficiency has improved considerably since the early 1990s, while its stability has been ensured. As pointed out in Section 7, the banks' high capital adequacy safeguards the stability of the banking system in the current circumstances. However, account should be taken of the impact on own funds from the implementation of the International Accounting Standards (IAS) and of the new capital adequacy framework ("Basel II") as from 31 December 2006, the overall magnitude of which cannot be estimated yet. Given these uncertainties, the Bank of Greece has recommended that banks should increase their own funds. Furthermore, as strong credit expansion to households under the pressure of competition may lead to increased credit risk in the future, notably if there is a slowdown in economic activity, the Bank of Greece raised the provisioning ratios for consumer loans with considerable arrears and has pointed out that banks should take into account this factor when they grant loans, so as to reduce credit risk. At the same time, households should evaluate carefully their income prospects before borrowing, in order to avoid undertaking excessive liabilities.

* * *

Notwithstanding the above, it is a fact that the scale of reform is not sufficient to match the challenges facing the Greek economy.

The global economy is in the midst of radical transformation, with far-reaching and fundamental changes occurring in technology, production and trading patterns. Moreover, the increasing integration of emerging markets into the global economy is placing Europe and particularly Greece under sustained and intensifying international competitive pressure.

Along with globalisation, Greece, more than any other European country, also faces a major demographic challenge. Greece's population is ageing, its birth rate is falling and its workforce shrinking; as a result, fewer people of working age will have to support growing numbers of above working age. An ageing population has profound implications for long-term growth in Greece and urgent action is needed to address this challenge.

As discussed in Section 9.3.3. above, demographic trends also have significant implications for age-related public spending programmes, such as pensions and healthcare provision. In spite of the legislative changes made in 1992 and in 2002, the current Greek pension system remains unable to absorb the forthcoming demographic changes. Without structural reform in the near future, a substantial tax hike or a further increase in workers' social security contributions to cover future pension expenditure will become virtually inevitable over the long run if the third option, i.e. that of reducing average annual public pensions in coming decades, is to be avoided. More determined reforms to improve the efficiency of the health care system are also needed.

The long-standing challenge for Greek economic policy is to bridge the sizeable gap with the average EU living standards. High growth in Greece during the past ten years has helped narrow the gap in living standards between Greece and the EU-15 average. However, as shown in Section 9.4.1, in 2004 the Greek *per capita* GDP was still 76% of that of the EU-15 average.

To achieve Greece's strategic goal of stronger economic growth, further action is required to improve Greece's international competitiveness in the years ahead, through reforms to strengthen the key drivers of economic growth, i.e. productivity and employment growth.

With respect to *productivity*, bolder action is needed to strengthen the key factors that drive its growth, including by creating a favourable environment for entrepreneurship and innovation; enhancing product market competition; reducing regulatory barriers; providing incentives and eliminating barriers to entrepreneurship; providing incentives to encourage the transition to a knowledge-based and growth-supportive economy; diffusing and utilising new technologies; and boosting investment in human capital and research and development.

As regards *employment*, tackling the causes of unemployment and low labour market participation is also central in the strategy of improving Greece's growth performance. Section 9.4.3 describes the priorities for reform. The need for action is pressing. Demographic changes make the need for faster growth in employment urgent, while increased international competition and technological change call for greater labour market flexibility. The main objective of labour market reform is to facilitate the re-employment of those employed in declining sectors that are losing market shares as a result of international competition in new and growing sectors, where Greece has a competitive advantage. In this context, it should be ensured that workers have access to the training opportunities they need to upgrade their skills. At the same time, to minimise any adverse consequences from international competition, a policy is needed for providing equal opportunities for all and security for the most vulnerable. As pointed out in Section 9.1 above, the poverty rate is relatively high and unequal income distribution is higher than in the EU-15. Therefore, an active welfare policy is needed to support the weaker and this should be a concern in the implementation of fiscal adjustment.

The relaunched Lisbon Strategy imposes an obligation on —and at the same time offers an opportunity to— Greece and the other EU countries to adopt a national action programme for growth and jobs, based on the European Commission's recent proposals which were approved by the Brussels European Council in March 2005. This programme should set out the reform actions and targets appropriate to the conditions prevailing in Greece. It should be tailor-made to cater for Greece's reform requirements and should involve both Parliament and the social partners. The role of the social partners is vital, because their support will be crucial in the area of labour market reform. A balanced reform programme must take into account important social concerns. Adjustment costs are often painful, although experience shows that these costs can be reduced or absorbed if reform is accompanied by supportive policies, including active labour market policies. Reform is often difficult and opposed by vested interests. Hence, transparent and informed public dialogue on the benefits and costs of reform is necessary for building and maintaining broad public support for reform.

The current state of affairs is not sustainable. The world today is radically different from past decades as a result of a synergy of several factors, including technology, international trade, globalisation, EU enlargement and demographic changes. Greece must adapt to the new conditions dynamically. In order to achieve sustainable economic growth, further improvement of living standards and full employment, there is no choice other than reform.

III. ECONOMIC ACTIVITY AND EMPLOYMENT

1. EXPENDITURE AND NATIONAL INCOME

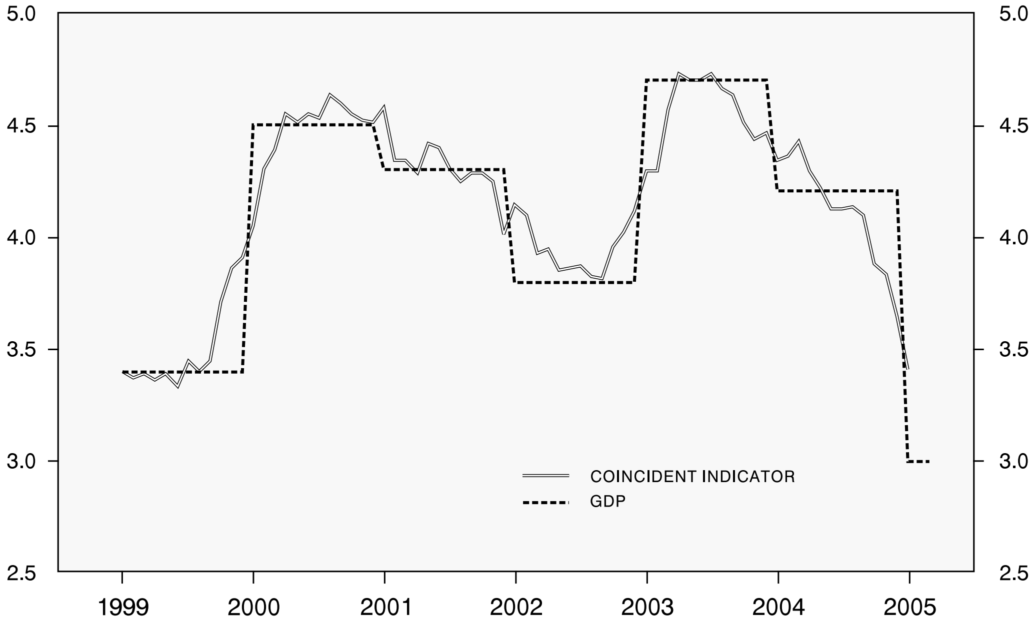
1.1 Summary of developments in 2004 and the outlook for 2005

Following the satisfactory growth rate achieved by the Greek economy in 2003 (4.7%), economic activity started slowing down from the second half of 2004. According to the latest NSSG provisional data, the average GDP growth rate in 2004 was 4.2%. The

CHART III.1

THE COINCIDENT INDICATOR OF ECONOMIC ACTIVITY COMPILED BY THE BANK OF GREECE

(ANNUALISED MONTHLY PERCENTAGE CHANGES)



Sources: Bank of Greece (coincident indicator, as well as GDP for 2005) and NSSG (GDP for 1999-2004).

gradual slowdown of GDP growth has been recorded by various short-term indicators as well as in the results of business surveys, which are summarised in the coincident indicator of economic activity compiled by the Bank of Greece (see Chart III.1). The OECD's leading indicator for economic activity has moved along the same path.

On the demand side, GDP growth in 2004 was a result of favourable monetary conditions, fiscal developments and the propitious international environment. Real interest rates remained at very low levels in 2004, supporting private consumption and investment. Moreover, in the aftermath of the Olympic Games, fiscal developments —albeit undesirable (widening as they did the fiscal deficit further and jeopardising macroeconomic stability)— contributed to the maintenance of a high GDP growth rate, by underpinning public consumption and public investment and also through the support provided to certain income groups. Besides, the large increase in the volume of world trade had a positive impact on the export of services, especially on income from sea transport.

As shown by the provisional national accounts data released by the NSSG (see Table III.1), the robust, albeit decelerating, rise in domestic demand was in 2004, as in previous years, the key determinant of the growth of the Greek economy on the demand side, contributing to GDP growth by 4.6 percentage points. By contrast, the external sector's contribution to growth was negative for the third consecutive year, though to a smaller extent than in 2003 (2004: –0.5 percentage point, 2003: –1.3 percentage points).

Private consumption is estimated to have increased at a rapid, though decelerating, rate in 2004 (3.3% against 4.0% in 2003), reflecting the continuous expansion of consumer credit, the cumulative rise in the value of household assets in recent years and the increase in household disposable income. The latter increase was somewhat weaker than in 2003, since income created by non-dependent labour grew at a substantially lower rate. Disposable income, however, grew faster than private consumption, thereby further boosting the average propensity of households to save. By contrast, public consumption rose significantly in 2004 (6.5% against a 2.3% decline in 2003), reflecting fiscal relaxation.

The growth rate of gross fixed capital formation fell to 4.9% in 2004, from a particularly high 13.7% in 2003, mainly reflecting the slowdown of business and public investment and the zero growth of residential investment. Considering the relatively healthy financial position of Greek firms and the conditions of adequate liquidity prevailing in the market, the hesitation of the business sector to invest may imply expectations of slackening demand in the medium term, partly because of strong international competition, combined with Greece's deteriorating competitiveness. This hypothesis is supported by business surveys, according to which industrial confidence and the business sentiment indicator in 2004 were lower than the average in recent years. In addition, business expectations indicators have worsened after April 2004 (even though expectations in the services sector recovered in the first quarter of 2005).

In spite of the increase in international demand, exports of goods, according to NSSG provisional national accounts data, decreased by 1.3% owing to the cumulative loss of competitiveness over the last few years. By contrast, exports of services rebounded, rising by 18.4%. In particular, income (especially from sea transport) grew impressively (almost 40% at current prices according to Bank of Greece data), owing to the recovery of world trade and freight rates.

Imports of goods and services picked up to 8.2% from 4.8% in 2003, overshooting the growth rate of final domestic demand (4.2%). The recovery of imports was partly

TABLE III.1

GROSS EXPENDITURE OF THE ECONOMY AND GROSS DOMESTIC PRODUCT

(Constant prices of 1995)

			Million euro	Annual percentage changes			
			1995	2001	2002	2003	2004
1.	Private consumption		58,405.3	3.0	3.1	4.0	3.3
2.	Public consumption		12,249.7	–3.2	8.3	–2.3	6.5
3.	Gross fixed capital formation		14,867.2	6.5	5.7	13.7	4.9
3.1.a	By investor:	General government	2,538.0	2.4	–5.4	17.3	8.0
3.1.b		Other sectors	12,329.2	7.4	7.9	13.1	4.4
3.2.a	By type:	Construction	9,422.0	6.9	3.7	10.9	4.0
3.2.b		Equipment	4,680.0	4.9	6.9	18.3	5.8
3.2.c		Other investment	765.2	20.1	21.0	3.4	7.4
4.	Change in stocks and statistical discrepancy (percentage of GDP)		251.4	0.1	0.0	0.1	0.2
5.	Domestic final demand		85,773.7	2.3	4.3	5.4	4.2
6.	Exports of goods and services		14,087.0	–1.0	–7.7	1.0	10.0
6.1	Exports of goods		8,343.9	–1.6	–7.1	4.2	–1.3
6.2	Exports of services		5,743.1	–0.7	–8.1	–1.3	18.4
7.	Final demand		99,860.7	1.7	2.1	4.7	5.1
8.	Imports of goods and services		19,933.7	–5.2	–2.9	4.8	8.2
8.1	Imports of goods		18,084.2	–6.3	3.2	6.6	8.1
8.2	Imports of services		1,849.4	–0.4	–26.5	–5.2	8.8
9.	Balance of goods and services		5,846.7	. . .	. . .	. . .	. . .
	GDP at market prices		79,927.0	4.3	3.8	4.7	4.2
				Contribution to GDP growth (percentage points)			
1.	Private consumption			2.1	2.2	2.8	2.3
2.	Public consumption			–0.5	1.2	–0.4	0.9
3.	Gross fixed capital formation			1.6	1.4	3.4	1.3
3.1.a	By investor:	General government		0.1	–0.2	0.6	0.3
3.1.b		Other sectors		1.5	1.6	2.8	1.0
3.2.a	By type:	Construction		0.9	0.5	1.4	0.6
3.2.b		Equipment		0.5	0.7	2.0	0.7
3.2.c		Other investment		0.2	0.2	0.0	0.1
4.	Change in stocks and statistical discrepancy			–0.5	–0.1	0.1	0.1
5.	Domestic final demand			2.6	4.7	6.0	4.6
6.	Exports of goods and services			–0.3	–1.9	0.2	2.1
6.1	Exports of goods			–0.2	–0.7	0.4	–0.1
6.2	Exports of services			–0.1	–1.2	–0.2	2.3
7.	Final demand			2.3	2.8	6.2	6.8
8.	Imports of goods and services			1.9	1.0	–1.5	–2.6
8.1	Imports of goods			1.9	–0.9	–1.8	–2.2
8.2	Imports of services			0.0	1.8	0.3	–0.4
9.	Balance of goods and services			1.7	–0.9	–1.3	–0.5
	GDP at market prices			4.3	3.8	4.7	4.2

Source: NSSG/National Accounts, March 2005 (provisional estimates for 2001 to 2004) expected, considering their sluggish behaviour in the last three years, despite rapid economic growth.

Supply, however, did not rise as much as final demand, thereby widening the positive "output gap" further. The average growth rate of the economy's productive capacity in recent years has been lagging behind that of average demand, despite the large increase in gross fixed capital formation and the satisfactory rise in the labour force (owing to the influx of immigrants). This is considered to reflect the slow pace of structural reforms and of the upgrading of the labour force, which is necessary if it is to cope with the complexity of, and the rapid changes in, modern technology. This is why the full and effective use of productive resources and the complete incorporation of expected beneficial effects of investment into productivity cannot be achieved.

Existing statistical data and the available leading indicators suggest that the slowdown in the growth rate of the Greek economy, which began in the second half of 2004, will continue in 2005 as well. According to Bank of Greece estimates published in *Monetary Policy 2004-2005* in February 2005, the average annual GDP growth rate was forecast to be around 3.3% this year. If we take account of the recent further rise in oil prices and some further deterioration of consumer and investor expectations, the growth rate could fall to roughly 3% (from 4.2% in 2004 and 4.7% in 2003). The forecast increase in GDP is estimated to absorb *part* of the increase in the labour force, with unemployment thus remaining at 2004 levels.

GDP forecasts are subject to a high degree of uncertainty relating to: the rise in oil prices, the impact on inflation (and on real disposable income) of the increase in indirect taxation, the prevailing imbalances in the global economy, and the adjustment of long-term interest rates and exchange rates. It should be noted that the Bank of Greece estimate concerning the outlook of the economy does not differ appreciably from the corresponding estimates of international organisations,[1] while according to the estimates contained in the revised Updated Stability and Growth Programme (March 2005), GDP growth in 2005 will be between 2.9% and 3.9% (baseline scenario: 3.9%, first alternative scenario: 3.3%, second alternative scenario: 2.9%).

It is estimated that domestic demand will continue to be the main driving force of the Greek economy in 2005, while the contribution of the external sector to GDP growth is expected to turn neutral (from negative in 2004). In more detail, the growth rate of private consumption is forecast to decelerate further, but remain relatively high, owing to the continuing increase in income and employment (although at a slower pace compared with 2004), easy access to consumer credit at relatively low interest rates, and the rise in the value of household assets in recent years (which encourages households to borrow). The increase in public consumption, according to the revised Updated Stability and Growth Programme, is expected to be contained to 1.5% in 2005. Gross fixed capital formation

1 The European Commission and the International Monetary Fund forecast (April 2005) a GDP increase of 2.9% and 3.0% respectively. In December 2004 the OECD published a forecast for a 3.2% increase.

will decrease for the second consecutive year, reflecting the significant cutbacks in the public investment programme (by 17.5% at constant prices on a national accounts basis). Business investment is expected to rise at a relatively high rate (due to favourable financing conditions and the anticipated positive impact of the laws concerning economic growth and taxation), while residential investment should rise a little (after remaining stagnant in 2004). Finally, total exports (of goods and services) are expected to increase satisfactorily, mainly owing to the export of services (tourism and transport), whereas total imports should fall considerably (compared with the high levels of 2004), mainly on account of the slowdown of investment activity.

1.2 Consumer demand

The strong —albeit decelerating— growth of *private consumption* contributed substantially to GDP growth (by 2.3 percentage points) in 2004 as well. According to NSSG provisional data, private consumption increased by 3.3% in 2004 (against 4.0% in

TABLE III.2

RETAIL SALES VALUE INDEX (2004)

(Percentage change over previous year)

Categories	2004
1. Large food stores	8.4
2. Department stores	7.0
3. Food – beverages – tobacco	5.4
4. Pharmaceuticals – cosmetics	6.3
5. Wearing apparel – footwear	5.1
6. Furniture – electrical appliances – household equipment	4.3
7. Books – stationery – other paper goods	7.5
8. Retail sales not in stores	2.8
General index	6.2

Source: NSSG.

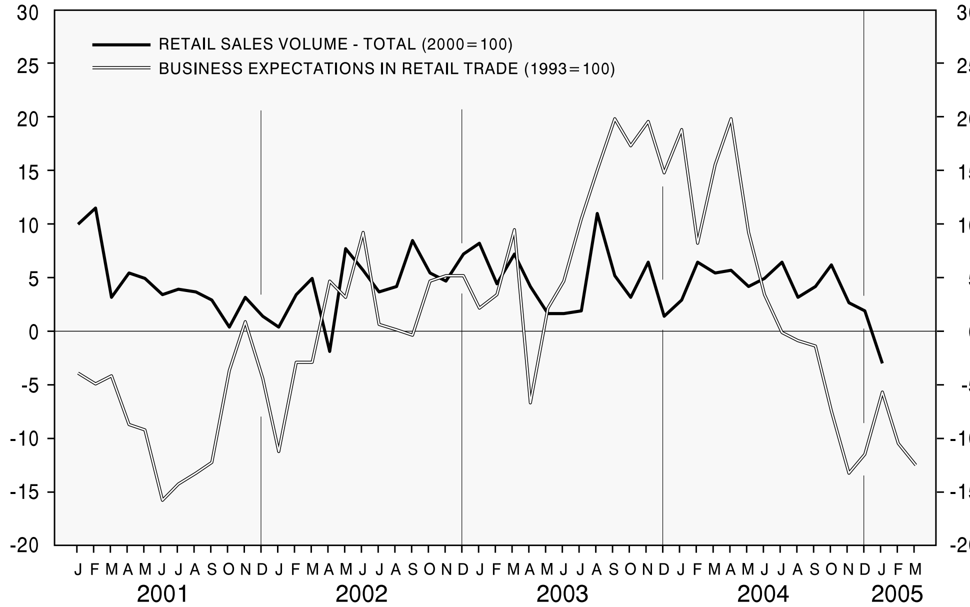
2003 and 3.1% in 2002). As short-term indicators show, the volume of retail sales (of goods) rose by 4.5% in 2004 (see Table III.2 and Chart III.2). Sales of passenger cars recovered, since new passenger car registrations increased by 15.7% in 2004,[1] having declined in 2002-2003, while the import bill for passenger cars rose by 24.8%. Equally substantial was the rise in consumer demand for services, e.g. land and air transport and mobile telephony (public revenue from mobile telephony flat fees increased by 13.0% in

1 This recovery was mainly due to the increase in car imports for the needs of the Olympic Games. The annual growth rate decelerated considerably (to 1.6%) in the first quarter of 2005.

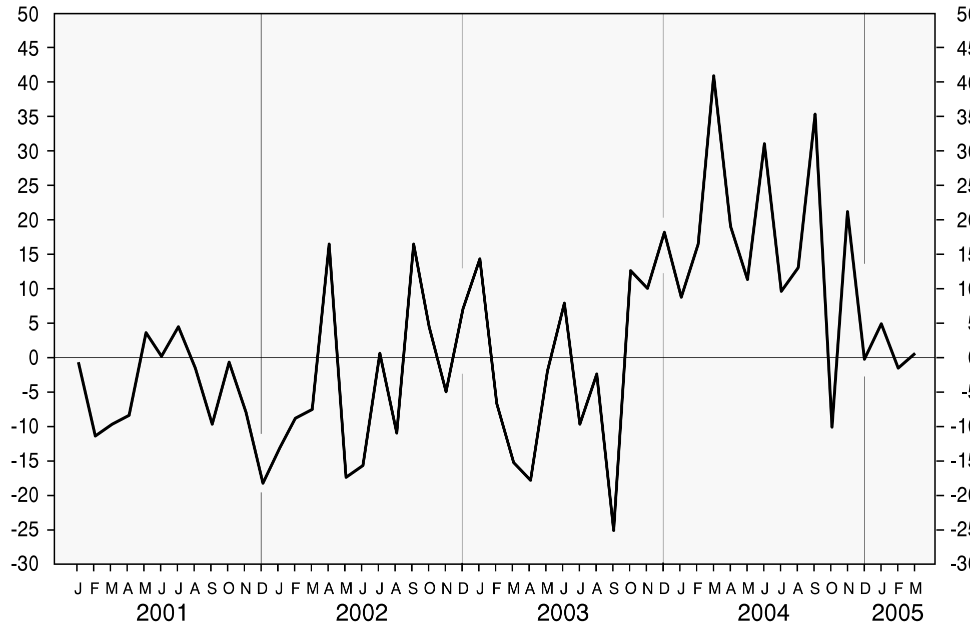
CHART III.2

CONSUMER DEMAND

A. RETAIL SALES VOLUME AND RETAIL TRADE BUSINESS EXPECTATIONS*



B. NEW PASSENGER CAR REGISTRATIONS*



* Percentage change over same month of previous year.

Sources: NSSG - Eurostat (retail sales), NSSG (cars) and Foundation for Economic and Industrial Research – IOBE (expectations). The revised retail sales index is calculated excluding VAT. As from January 2005, new revised retail trade index. The business expectations index is based on firms' estimates of sales and stocks, as well as on their forecasts of business activity over the next six months.

TABLE III.3
INDEX OF DWELLING PRICES

	Urban areas - total			Athens			Other urban areas		
	Index	Percentage changes		Index	Percentage changes		Index	Percentage changes	
	1997=100	Over previous period	Over corresponding period of previous year	1997=100	Over previous period	Over corresponding period of previous year	Q4 1993=100	Over previous period	Over corresponding period of previous year
1994	76.1	. . .	. . .	73.4	9.5	9.5	106.0	. . .	. . .
1995	82.6	8.5	8.5	80.1	9.2	9.2	114.3	7.8	7.8
1996	91.2	10.5	10.5	88.9	11.0	11.0	125.7	10.0	10.0
1997	100.0	9.7	9.7	100.0	12.5	12.5	134.7	7.1	7.1
1998	114.4	14.4	14.4	115.5	15.5	15.5	152.6	13.3	13.3
1999	124.5	8.9	8.9	129.6	12.2	12.2	161.5	5.8	5.8
2000	137.6	10.5	10.5	149.1	15.1	15.1	171.2	6.0	6.0
2001	157.7	14.6	14.6	175.4	17.6	17.6	190.6	11.3	11.3
2002	178.2	13.0	13.0	203.8	16.2	16.2	208.8	9.5	9.5
2003	188.4	5.7	5.7	211.9	4.0	4.0	225.2	7.9	7.9
2004	. . .	. . .	. . .	. . .	. . .	. . .	237.3	5.4	5.4
2003 I	187.2	2.3	9.2	214.6	3.1	10.8	219.0	1.4	7.4
II	186.9	–0.2	4.5	210.6	–1.8	1.3	223.0	1.8	8.6
III	188.6	0.9	5.1	210.6	0.0	2.6	227.1	1.9	8.2
IV	190.8	1.2	4.2	211.5	0.4	1.6	231.7	2.0	7.3
2004 I	190.7	0.0	1.8	209.7	–0.9	–2.3	233.8	0.9	6.8
II	191.1	0.2	2.2	209.4	–0.2	–0.6	235.3	0.6	5.5
III	193.4	1.2	2.6	211.1	0.8	0.2	239.1	1.6	5.3
IV	. . .	. . .	. . .	. . .	. . .	. . .	241.1	0.8	4.0
2003 June	. . .	. . .	. . .	207.6	–1.5	0.0	. . .	. . .	. . .
July	. . .	. . .	. . .	208.6	0.5	1.9	. . .	. . .	. . .
Aug.	. . .	. . .	. . .	211.9	1.6	4.1	. . .	. . .	. . .
Sept.	. . .	. . .	. . .	211.5	–0.2	1.7	. . .	. . .	. . .
Oct.	. . .	. . .	. . .	210.7	–0.4	2.5	. . .	. . .	. . .
Nov.	. . .	. . .	. . .	211.2	0.3	–0.1	. . .	. . .	. . .
Dec.	. . .	. . .	. . .	212.7	0.7	2.5	. . .	. . .	. . .
2004 Jan.	. . .	. . .	. . .	212.7	0.0	0.2	. . .	. . .	. . .
Feb.	. . .	. . .	. . .	207.1	–2.6	–2.4	. . .	. . .	. . .
March	. . .	. . .	. . .	209.5	1.1	–4.5	. . .	. . .	. . .
Apr.	. . .	. . .	. . .	208.0	–0.7	–2.6	. . .	. . .	. . .
May	. . .	. . .	. . .	211.5	1.7	0.3	. . .	. . .	. . .
June	. . .	. . .	. . .	208.5	–1.4	0.4	. . .	. . .	. . .
July	. . .	. . .	. . .	208.8	0.1	0.1	. . .	. . .	. . .
Aug.	. . .	. . .	. . .	212.4	1.7	0.3	. . .	. . .	. . .
Sept.	. . .	. . .	. . .	212.1	–0.1	0.3	. . .	. . .	. . .

Sources: For the other urban areas: quarterly data compiled by Bank of Greece branches. For Athens: calculations based on data from “Property Ltd”. For the total of urban areas: weighted index based on the housing stock in Athens and the other urban areas.

2004). The business expectations index for services (excluding retail trade and banks) rose by 12.8% in 2004.[1]

The marked increase in private consumption was supported by household disposable income, which rose in real terms faster than private consumption. In this way, the household average propensity to save, which had set on a downward course until 2002, increased further. The rise in household real disposable income was supported by the increase in average real pre-tax earnings, tax cuts (which only partly offset the "fiscal drag"[2]), the increase in transfers to economically disadvantaged population groups, as well as the rise in employment.

An equally positive influence on high growth rates of private consumption seems to have been exerted in recent years by certain factors relating to the deregulation of, and the competitive conditions in, the financial market. Among these are low real interest rates and easy access to consumer credit; the latter smooths out consumer spending patterns and maintains relatively high consumption levels, less dependent on short-term fluctuations in disposable income. It is characteristic that the annual growth rate of the outstanding consumer loans reached 37.4% in December 2004, up from 27.2% in December 2003. It is estimated that private consumption continued to be in 2004 under the positive influence of the increased market value of household assets, which, *inter alia*, encouraged household recourse to borrowing. The total market value of the stock of dwellings, i.e. the main household asset, grew by 5.3% in 2004 against 9.3% in 2003 (the annual rate of increase in prices of dwellings decelerated to 2.2% in the first nine months of 2004, from 6.2% in the corresponding period of 2003 – see Table III.3). At the same time, the Athens Exchange (Athex) recovered (the average annual rise in the stock price index was 27.3% in 2004, compared with an 11.2% decline in 2003).

It is worth mentioning that the net-disposable-income-to-GDP ratio dropped from 86.7% in 1995 to 74.2% in 2004. By contrast, the consumption-to-GDP ratio remained unchanged over the same period. This shows the significant impact of consumer credit and of the increased market value of household assets on consumption patterns.

1.3 Investment demand

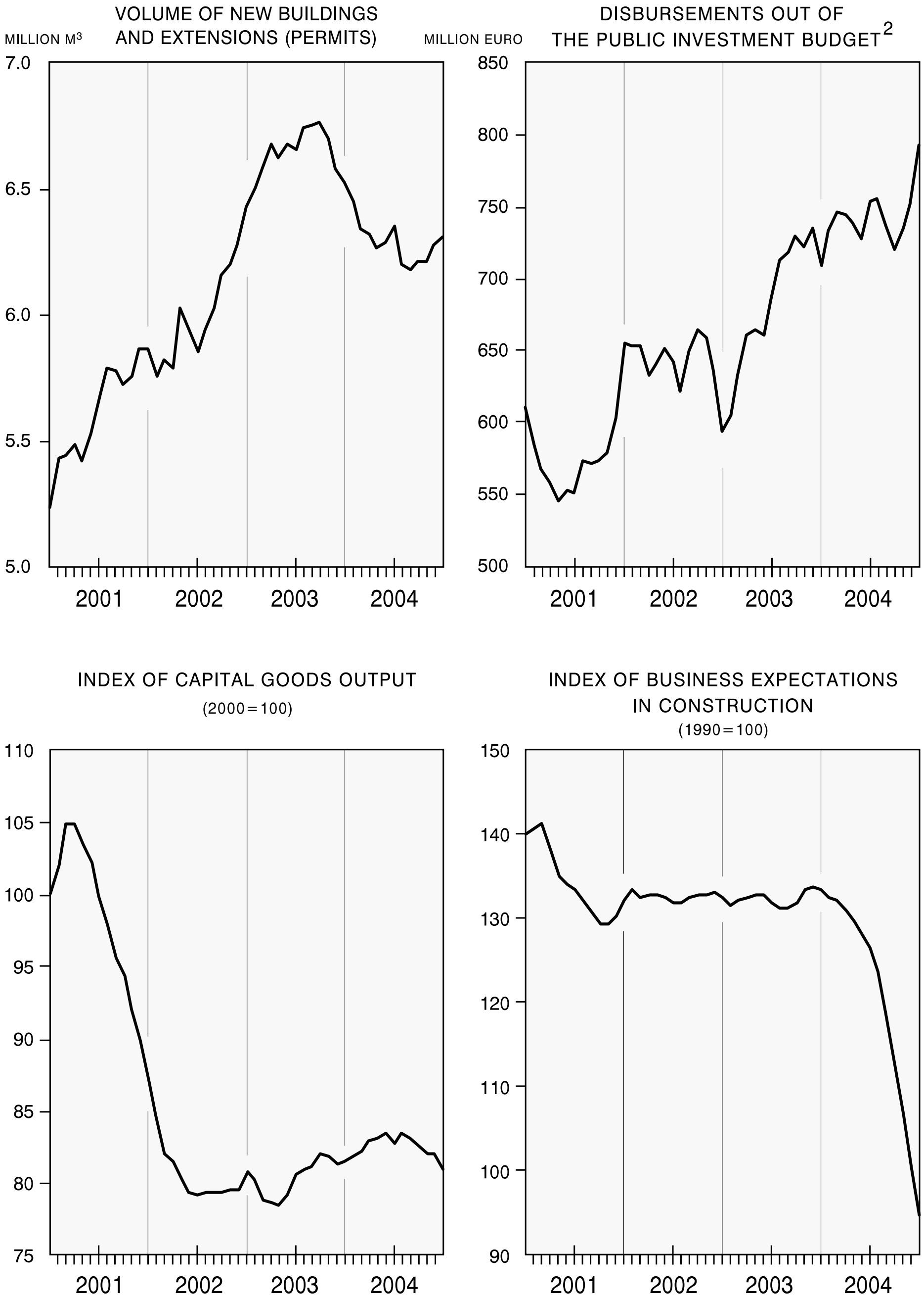
The growth rate of investment demand decelerated considerably in 2004 (4.9%) compared with 2003 (13.7%), affected by the zero growth in residential investment and the slowdown of public and business investment (see Chart III.3). As a result, investment contributed a mere 1.3 percentage points to GDP growth, compared with 3.4 percentage

1 This refers to the relevant IOBE survey which covers hotels and restaurants, travel bureaux, land and other transport, advertising and business services, insurance etc.

2 That is, the increase in the tax burden resulting from the nominal increase in incomes due to inflation, combined with the effect of the progressivity of the tax scale.

CHART III.3

MAIN INDICATORS OF INVESTMENT ACTIVITY[1]



1 Twelve-month moving average centred on the last month of the period.
2 Disbursements to finance the public investment programme (cash basis, current prices).

Sources: NSSG, IOBE and Bank of Greece.

points in 2003. The contribution of investment to GDP, however, remained at the same high levels as in the previous year, i.e. 25.5% against 25.6% in 2003.

In more detail, the growth rate of *general government investment* fell substantially (to 8.0% in 2004 from 17.3% in 2003). The growth rate of *investment by other sectors* dropped below 5%, for the first time in the last few years (2004: 4.4%, 2003: 13.1% and 2002: 7.9%). The close-to-zero increase in *residential investment* (0.2%)[1] is considered a result of the gradual satisfaction of the housing needs of a large segment of the population over the past decade. The growth rate of the outstanding housing loans to households, however, remained high (2004: 24.8%, 2003: 25%), possibly because an increasing portion of this credit was used either for the purchase or the refurbishment of old dwellings. Besides, for reasons attached mainly to the completion of the Olympic projects, investment in other construction projects continued to grow[2] (6.3% in 2004 against 13.2% in 2003) at a pace slightly faster than total investment (for more details on the conditions and the outlook of the construction industry, see Box III.1).

The slowdown in the growth rate of *business investment* (5.6% in 2004 from 14.9% in 2003) is considered to be evidence of the manufacturing industry's hesitation to invest[3] and reflects the fact that a phase of mobilisation of private funds in the framework of the "Olympic" preparation of enterprises and the implementation of CSF III and the law on development (2601/98) is coming to an end.[4] Equally characteristic is the considerable decrease in large investment projects that fall within the competence of the Hellenic Centre for Investment (ELKE): the approved amount for these projects came to €138.9 million in 2003 and to €22.8 million in 2004, against €286 million in 2000, €261 million in 2001 and €205 million in 2002. On the other hand, public enterprises' investment,[5] which according to the Introductory Report on the Budget increased by 9% at current prices, did not offset the slowdown in business investment.

Overall, financing conditions were favourable in 2004 and the financial results of firms in most industries were sound. Nonetheless, the growth rate of bank financing to firms decelerated (see Chapter VI.2.2). More specifically, credit expansion to industry

1 As evidenced both by the decrease (of 3.4% in 2004) in the volume of private construction activity on the basis of building permits issued and by the fact that the months with secured housing production, according to the IOBE survey on constructions, fell from 17.4 in 2001 to 12.0 in 2004.

2 Let it be noted that this type of investment showed signs of a slowdown in the last four months of the year. In the aforementioned IOBE monthly survey on constructions, a significant drop in works, especially in public projects, has been recorded, especially from September onwards, resulting in a 28.9% decline in business expectations in construction and a fall in the months of secured production for public projects from 18.4 in 2002 to 13.4 in 2004.

3 Indicative in this respect is the considerable deterioration of business expectations in industry during the second half of 2004, as well as the continuing decline in the capacity utilisation rate, according to the relevant monthly survey carried out by IOBE (from 78.1 in 2000 to 75.2 in 2004). At the same time, the IOBE investment survey carried out in the second half of 2004 showed that private industrial firms considered that their investment expenditure (at current prices) was reduced by 32.3% in 2004.

4 The growth rate of investment in equipment slowed down substantially at constant prices (from 18.3% in 2003 to 5.8% in 2004).

5 This investment is deemed to be assosiated with the partial implementation of major infrastructure projects in transport and energy networks (as is the case with OSE and DEH).

BOX III.1

The construction industry: conditions and outlook

The construction industry, following a decade of accelerating growth, thanks to the disbursements of CSF II and III and to the 2004 Olympic Games, expanded its contribution to GDP to 14% (in 2004). After the completion of the Olympic projects in 2004, however, construction activity decreased and major items in the financial statements of most enterprises fell. This is attributed to the fact that no further projects were awarded in the past two years and that the short-term and long-term liabilities of construction firms increased because of recourse to bank lending. According to a recent survey carried out by the Construction Economy Institute (IOK), the 25 listed construction firms alone suffered a loss of approximately 45,000 jobs in just one year (September 2003-September 2004).

A significant development for the industry is the reform of the institutional framework governing the award of projectss and public project studies. In particular, Law 3263/2004,[1] which replaced Law 2576/1998 (which had introduced the "mathematical formula" system), established a system of Dutch auctions focusing mainly on quality criteria (the technical bid is weighted by 70% and the financial bid by 30%) and a new procedure for the stages that come after the drawing-up of the designs (preliminary study, pre-study, final study). In this way community legislation is fully incorporated, bureaucracy in the various stages of the tender is reduced and full separation of design firms from contractors is ensured. Moreover, specific deadlines are set for the drawing-up of the designs and both disciplinary and financial penalties (up to €50,000) are introduced. Furthermore, Law 3316/2005 came to fully reform the legal framework governing the award of the studies for public works, to improve the quality of the studies and to harmonise Greek legislation with the latest EU Directives.

Outlook

A solution to the present unfavourable condition in which the construction industry has found itself may be the expected legislative initiative for Public-Private Partnerships (PPPs).[2] PPPs are forms of co-operation between public and private entities aimed at securing the financing, construction, renovation, management and maintenance of infrastructure or the provision of services in sectors of the Greek economy where market deregulation is impossible or undesirable. Private firms participate either as partners co-operating with the project's contractor or as service providers to the public sector. PPPs aim to improve the quality of the services that the state offers the citizens by using additional private resources, complementary to the available ➔

1 The new institutional framework was implemented for the first time in the tender of a set of projects relating to ten sections of Egnatia Odos highway.

2 It is worth noting that major projects were successfully completed in Greece in the past few years through SDITs, especially in the field of transport, such as the Athens International Airport "E. Venizelos", the Rio-Antirrio bridge, Attiki Odos, etc. These projects were not implemented, however, within a general and adequate regulatory framework, as is the case with other European legal systems, but on the basis of *ad hoc* provisions, which caused difficulties in the tender procedure and major delays in the progress of works, increasing relevant costs substantially.

→ public ones, thus creating the necessary infrastructure, providing the know-how and the private sector's methods of operation. The materialisation of projects through PPPs will boost co-financed projects and is expected to contribute to considerable capital inflows in 2006.[1]

Moreover, it is expected that the construction of six road projects, budgeted at €7 billion (minimum) to materialise with the participation of private funds, will begin by mid-2006. The announced major projects relate to the road axis Elefsis-Corinth-Patras-Pyrgos-Tsakona, the Central Greece motorway, the section Corinth-Tripoli-Kalamata and Lefktro-Sparta, Ionia Odos highway (Antirrio-Ioannina), the Maliakos-Kleidi section of the PATHE motorway and the Thessaloniki underwater tunnel. Start-up will take place in mid-summer with the signing of the concession agreement for the Thessaloniki underwater tunnel. The government will contribute €1.8-2 billion, 50% of which will be EU funds. The remaining €5 billion will come from private sources and loans. The government will not guarantee company loans and interested parties will have to submit a letter of debt financing.

At the same time, the expected promotion of projects in support of the Greek countryside (new road axes in PATHE, connection of the Egnatia Odos highway with the Balkan countries and central Europe, Thessaloniki metro, port installations, autonomous water supply for the islands and for mountainous and other regions) is expected to contribute to the increase in the absorption rate of CSF III funds and to create favourable conditions for the largest possible use of CSF IV funds and for the attraction of investment.

Resolving issues such as the National Real Estate Registry, the National Land Plan, the incorporation of approximately 50,000 acres into urban area, and the new Action Plan Attica SOS, is expected to have a favourable impact on the construction industry. Moreover, the post-Olympic use of the Olympic installations is expected to be the subject of a forthcoming draft law on development, which will give solutions and ultimately improve the quality of life in Attica.

As far as the performance of the industry in external markets is concerned, it would be prudent if Greek technical firms sought for their expansion in an organised manner, especially towards the central European countries that have entered the EU recently and are due to receive subsidies under CSF IV. To support Greek construction firms' extroversion, it is necessary to promote efficient national planning.

1 See also the relevant IOK studies referred to in footnote 2 on page 122.

slowed down, although this deceleration was partly offset by the increase in corporate bond issues. As far as the construction and tourist industries are concerned, the outstanding credit balances grew, albeit at a slower pace. By contrast, fund raising through the Athens Exchange (Athex) was higher relative to 2003, but still limited. Inflows from EU Structural Funds rose in 2004, supporting synergies in both the private and the public sector, favourably affecting the economy's productive capacity.

The fact, however, that enterprises did not take full advantage of the financing available from the banking system is additional evidence of the adequacy of capital stock relative to expected demand.

2. PRIMARY AND SECONDARY PRODUCTION

2.1 Summary

According to NSSG provisional estimates, the gross value added (at 1995 prices) of the primary sector recovered strongly in 2004 (10.8%), having declined in the previous four years. The growth rate of the secondary sector's gross value added fell to particularly low levels (0.6% from 5.9%), whilst the increase in the gross value added of services also decelerated, but remained robust (2004: 4.9%, 2003: 6.0%, see Table III.4). For the evolution of the Greek economy's structure by branch of economic activity after 1960, see the Appendix to this chapter.

TABLE III.4
GROSS VALUE ADDED AT BASIC PRICES

		Million euro	Annual percentage changes (constant prices of 1995)				
		1995	2000	2001	2002	2003	2004
1.	Primary sector (agriculture)	7,277	–4.2	–4.1	–1.3	–4.2	10.8
2.	Secondary sector	16,550	5.4	6.4	2.2	5.9	0.6
2.a	Mining and quarrying	476	23.2	2.2	8.5	–4.8	. . .
2.b	Manufacturing	9,572	4.6	3.3	2.4	2.4	. . .
2.c	Electricity - natural gas - water supply	1,751	4.8	1.3	1.8	6.3	
2.d	Construction	4,751	5.7	14.4	1.4	12.3	. . .
3.	Tertiary sector	50,031	5.1	5.2	3.7	6.0	4.9
3.a	Trade	10,018	3.1	11.4	1.2	11.1	. . .
3.b	Hotels - Restaurants	4,821	5.4	6.2	5.2	6.9	. . .
3.c	Transport - Communications	4,978	16.2	1.3	5.9	6.3	. . .
3.d	Financial intermediation	3,112	10.0	5.9	–5.2	8.9	. . .
3.e	Real estate management and other activities	12,577	3.5	3.5	1.8	2.9	. . .
3.f	Public administration - Security	5,308	–2.8	1.0	8.4	–4.3	. . .
3.g	Education	3,298	1.6	–1.2	12.2	12.4	. . .
3.h	Health	3,855	3.0	2.6	6.5	4.9	. . .
3.i	Other activities	2,064	7.6	15.2	6.9	5.7	. . .
4.	Gross value added at basic prices	73,858	4.4	4.8	3.1	5.2	4.4
5.	Financial intermediation services indirectly measured (FISIM)	2,175	13.7	12.1	–9.3	12.8	6.0
6.	Gross value added at basic prices (excluding FISIM)	71,682	4.1	4.5	3.6	4.9	4.4

Source: NSSG/National Accounts, March 2005 (provisional estimates for 2000 to 2004).

2.2 Agricultural production

According to NSSG national accounts data, in 2004 the value added of the primary sector (at 1995 prices) increased markedly (10.8%),[1] reversing the decrease recorded in the previous four years. This mainly reflects the significant rise in the production of basic

1 In terms of gross value of the agricultural sector's production at constant prices, this increase was higher than 12%.

plant products, such as peaches (70.7%), olive oil (37%), durum wheat (14.6%) and cotton (13.5%) (see Table III.5).

According to NSSG data (see Table III.6), agricultural product prices fell by 2.6%, due to the substantial decrease in the prices of plant products (–4.2%), especially fruit (–9.3%) and vegetables (–8.7%), because of the increased harvest. Coupled with the 7.5% rise in input prices,[1] this development led to the deterioration of the terms of trade for producers.

The agricultural sector is fraught with numerous structural problems, as is evident from the adverse development of the country's agricultural balance,[2] the heavy dependence of agricultural income on subsidies and the very low level of entrepreneurship in the primary sector. Indeed, as shown by a study compiled by IOBE[3] in the framework of a survey conducted under the auspices of the Global Entrepreneurship Monitor, only a mere 2.3% of new enterprises in Greece are agriculture-oriented. At the same time, the implementation of the new CAP has already begun[4] and is expected to reshape both business

TABLE III.5
PRODUCTION OF BASIC AGRICULTURAL PRODUCTS
(Thousand tonnes)

Product	1998	1999	2000	2001	2002	2003	2004[1]
Soft wheat	580	621	408	442	427	323	274
Durum wheat	1,300	1,400	1,450	1,457	1,902	1,309	1,500
Maize	2,000	1,800	1,850	2,010	2,194	2,206	2,210
Tobacco	127	127	125	118	116	116	117
Cotton (natural)	1,185	1,320	1,235	1,247	1,137	972	1,103
Industrial tomatoes	1,226	1,094	1,149	1,126	1,000	985	1,187
Sugar beets	1,933	2,160	3,146	2,825	2,531	2,200	2,095
Olive oil	466	413	430	360	414	310	425
Lemons	150	135	139	78	109	102	62
Oranges	801	1,040	903	898	1,176	849	820
Apples	332	336	309	231	262	203	275
Peaches	472	1,002	1,020	952	706	123	948
Meat, total	493	490	492	484	488	480	486
Milk, total	1,821	1,865	1,896	1,902	1,928	1,927	1,940

1 Provisional data.
Source: Ministry of Rural Development and Food.

1 Mainly stemming from the accelerating growth rate of the consumables price index (9.0% in 2004 from 4.2% in 2003).
2 According to data from the Ministry of Rural Development and Food on external trade, the ratio of exports to imports of agricultural products fell from 74.9% in 1998 to 59.9% in 2003, while, according to Bank of Greece provisional data, receipts from agricultural exports decreased by 12.3% in 2004.
3 "Entrepreneurship in Greece", October 2004.
4 As from 1 January 2005, subsidised farmers and livestock breeders are obliged to conform to certain standards ("good agricultural practices") as regards the protection of the environment, food safety, public health and protection of the health of animals.

activity and policy making. Furthermore, in our country the shift of resources and factors of production to milder production types having a possibly higher value added, such as organic farming, is lagging behind compared with other European countries.[1] Combined with the initiatives already undertaken or in queue for implementation in the near future,[2]

TABLE III.6
PRODUCER[1] AND INPUT PRICES (2000=100)

	Weights	2001	2002	2003	2004
		Percentage changes in producer prices (output prices)			
Plant production	70.7	5.4	11.0	11.6	–4.2
Livestock production	29.3	7.7	–2.2	1.3	2.0
General producer price index	*100*	*6.1*	*7.1*	*8.8*	*–2.6*
		Percentage changes in input prices			
Consumables	74.9	1.4	2.3	4.2	9.0
Fixed capital	25.1	4.0	4.4	3.2	3.1
General input price index	*100*	*2.1*	*2.8*	*4.0*	*7.5*

1 Producer prices do not include subsidies on products.
Source: NSSG.

it is considered essential to promote business activity in the agricultural sector in such a way that it will lead to a sustainable increase in agricultural income and to the protection of both agricultural capital and consumer health.

2.3 Manufacturing

The relevant NSSG volume index[3] shows that *total industrial output growth* in 2004 outpaced that of 2003 (1.2% against 0.3%). This mainly reflects the recovery of the production of consumer non-durables and of intermediate goods. At the same time, the production of consumer durables also increased (having declined in the previous three years),

1 According to data from one of the approved Greek organisations for the certification of organic products (DIO), organic production in 2004 accounted for a mere 0.86% of Greece's total agricultural area and 0.69% of its farms, compared with the EU-15 3.51% and 1.99% respectively.

2 According to the Prime Minister's statement in Parliament (18 February 2005), the bill being drafted will provide, *inter alia*, for: (i) the compilation of 13 studies (one for each region) on crop restructuring and the marketing of products; (ii) the restructuring of the Ministry of Agricultural Development and Food and the modernisation of the Payment and Control Agency for Guidance and Guarantee Community Aid (OPEKEPE); (iii) the establishment of Local Centres for Agricultural Development and (iv) the establishment of an Organisation for the Promotion of Agricultural Products.

3 New revised NSSG index, where 2000 is the base year.

same as the generation of energy, whilst the production of capital goods dropped slightly (see Table III.7).

Manufacturing production, having decreased in the past three years (2003: –0.4%, 2002: –0.1%, 2001:–2.5%), recovered in 2004 (1.2%), affected by the expansion of euro area economic activity[1] and the improvement in the international economic environment in general. It should be noted, however, that the increase in manufacturing production in the first eight months of 2004 was higher (2.3% on average), but from September onwards (with the exception of November) the upward trend was reversed and this was carried over into the first two months of 2005.[2] A similar development in 2004 was shown by the index of business expectations in industry (1.3%), reflecting the impressive improvement in business sentiment during the first half of the year, whilst from July onwards there was a gradual deterioration.[3]

TABLE III.7
INDUSTRIAL PRODUCTION (2000=100)

	Weights 2000		Average annual percentage changes 2001	2002	2003	2004	2004 level (2000=100)
TOTAL INDUSTRY	100.0		–1.8	0.8	0.3	1.2	100.4
1. Mining and quarrying	5.9	100	2.4	9.7	–5.2	0.3	106.8
Mining of coal and lignite		48.3	4.5	6.5	–3.4	1.6	109.1
Extraction of crude petroleum and natural gas		5.2	–25.9	–7.3	–24.5	3.0	53.4
Mining of ores		11.5	13.2	20.7	–22.7	–2.5	102.8
Other mining and quarrying		35.1	0.3	12.1	1.0	–0.7	112.7
2. Manufacturing	77.5	100.0	–2.5	–0.1	–0.4	1.2	98.1
3. Electricity - natural gas - water supply	16.6	100.0	–0.1	1.8	5.8	1.4	109.1
Electricity		80.9	–0.9	1.5	6.8	0.8	108.2
Natural gas		5.3	0.4	4.7	13.2	9.9	130.9
Water supply		13.8	4.4	2.8	–2.8	1.6	106.0
TOTAL INDUSTRY	100.0		–1.8	0.8	0.3	1.2	100.4
Main categories							
Energy	28.5		–0.3	2.3	2.9	0.3	105.3
Intermediate goods	31.1		–0.5	1.6	–0.4	1.0	101.7
Capital goods	10.6		–13.0	–7.2	0.8	–0.5	81.0
Consumer durables	2.5		–14.4	–15.4	–3.6	1.8	71.1
Consumer non-durables	27.3		0.7	2.3	–1.4	2.7	104.2

Source: NSSG.

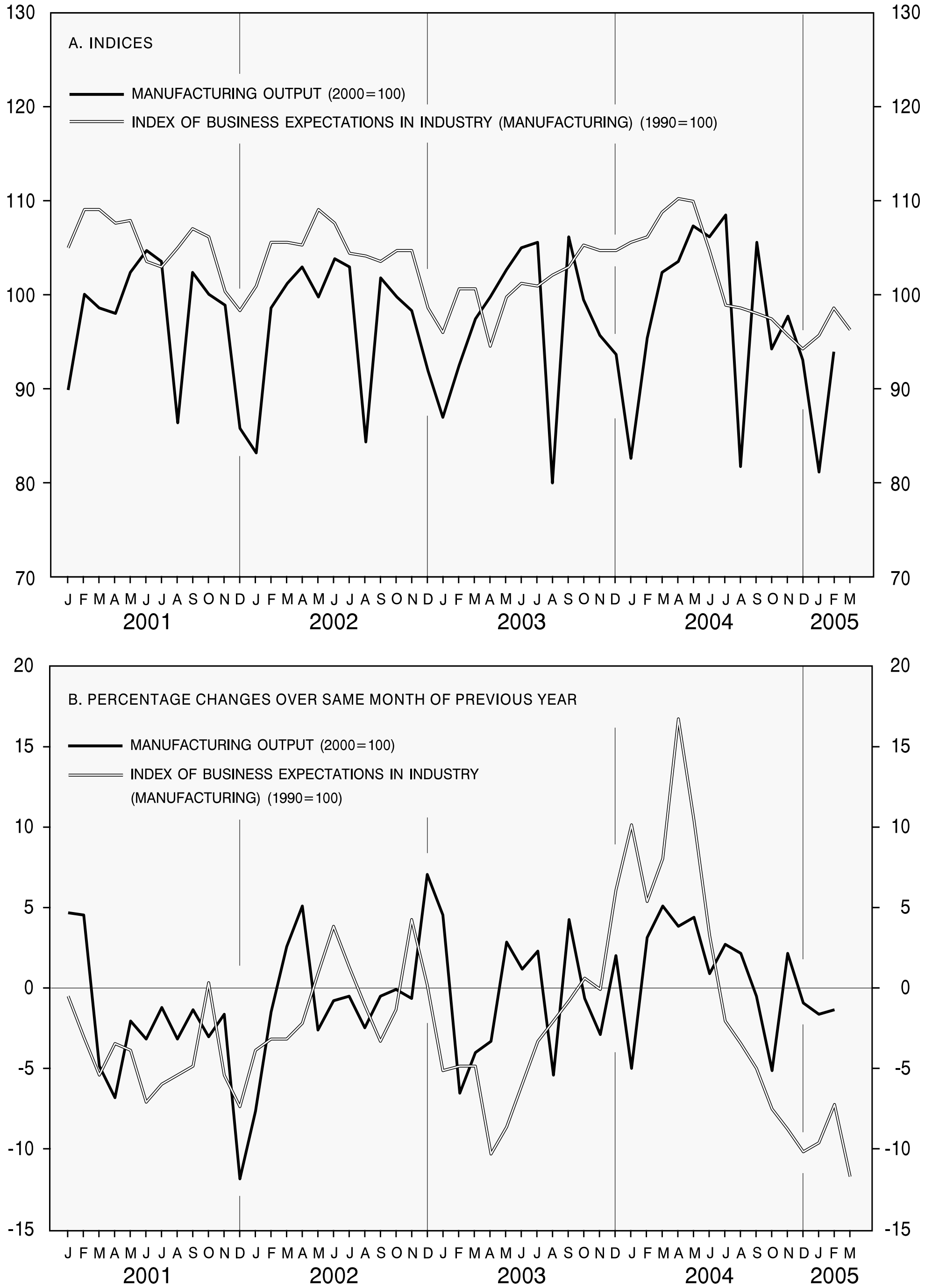
1 In 2004 euro area GDP increased by 2.1%, about the same as manufacturing production.

2 NSSG provisional data show that manufacturing production fell by 1.4% in the first two months of 2005.

3 Expectations, however, looked up in the first quarter of 2005 (96.7) compared with the particularly low levels of the last quarter of 2004 (95.7).

CHART III.4

OUTPUT AND BUSINESS EXPECTATIONS IN MANUFACTURING

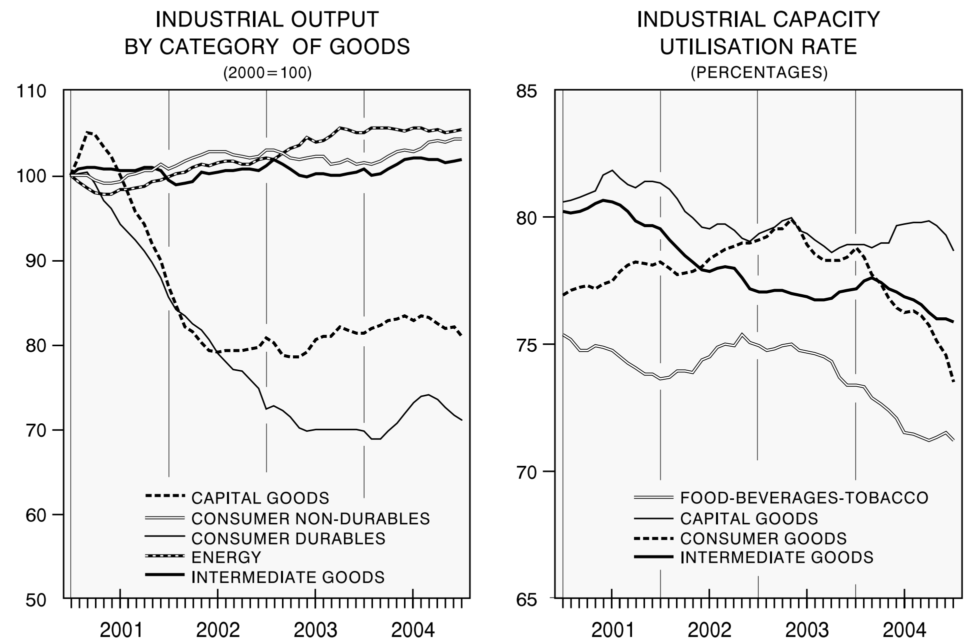


Sources: NSSG (output) and IOBE (expectations). The index of business expectations is based on business firms' estimates of total demand and stocks, and on output forecasts for the next 3-4 months.

In more detail, according to the business survey carried out by IOBE (see Chart III.4), industrial firms' estimates of output and new orders were positive (especially estimates of the output were slightly higher than in 2003). By contrast, estimates of total demand and external demand continued to fall, causing a decline in the index in the second half of the year. Enterprises' forecasts for 3-4 months ahead were positive, but less optimistic than in 2003 (and in the four years 2000-2003). The index of months of secured production stood at lower levels (5.0) compared with 2003 (5.4),[1] while the capacity utilisation rate for

CHART III.5

INDICATORS OF INDUSTRIAL PRODUCTION[1]



1 Twelve-month moving average centred on the last month of the period.
Sources: NSSG and IOBE.

industry as a whole continued to fall in 2004[2] (by 1.3 percentage points – see Chart III.5), especially as far as consumer and intermediate goods are concerned (despite the recovery of production). More positive developments in manufacturing production were recorded

1 Especially from April 2004 onwards, when the index did not exceed 4.8. It followed the same course in the first three months of 2005, when it stood at 4.6 on average.

2 This continued in the first three months of 2005, resulting in a containment of the capacity utilisation rate to 70.7 on average in the first quarter of 2005, from 73.7 in the last quarter of 2004.

by the Purchasing Managers' Index (PMI),[1] however, which throughout the year was constantly above 50, reaching an average of 52.3 in 2004 against 50.6 in 2003 (see Chart III.6).[2] As for the main PMI sub-indices,[3] the greatest increase was recorded in output and new orders, whilst the sub-index for employment improved marginally. By contrast, supplier deliveries took longer and inventory levels recorded a moderate drop.

As regards developments in individual manufacturing industries, out of 23 industries in total, 12 recorded an increase in their production in 2004 and 11 a decrease. It is

CHART III.6

PURCHASING MANAGERS' INDEX (PMI) FOR MANUFACTURING

(SEASONALLY ADJUSTED INDEX, VALUES OVER 50 INDICATE AN EXPANSION OF ECONOMIC ACTIVITY)

Sources: Hellenic Purchasing Institute and NTC Research.

worth mentioning, however, that the production of the seven most dynamic industries[4] showed a cumulative increase of 8.1% in the period 2000-2004. The sharp fall (–21.6%) in

1 The corresponding index for manufacturing in the euro area also increased in 2004, exceeding by far the level of 50 points throughout the year. Nonetheless, it dropped in November and for the period until March 2005 it fluctuated at lower levels, but did not fall below 50.

2 The index continued to move over 50 in the first three months of 2005. In March it stood at 50.1, implying the stable expansion of production and the marginal decrease in orders and employment.

3 The PMI is the weighted sum total of individual indices on production, new orders, employment, supplier deliveries and inventory levels.

4 That is, food-beverages, coke and refined petroleum products, non-metallic minerals, basic metals, chemicals, metal products and publishing-printing, which in 2000 accounted for 64.0% of manufacturing.

the production of six main industries[1] caused the cumulative production of all manufacturing industries to decrease by 1.9% over the same period.[2]

This confirms that duality trends persist in Greek manufacturing, in other words dynamic industries co-exist with deteriorating or slowly growing ones. Looking beyond the level of industries, the existence of duality trends also becomes evident when manufacturing firms are sorted according to their investment growth rate. A recent survey carried out by the Federation of Greek Industries (SEB)[3] showed that during 1998-2003 industrial firms that invested at a lower rate and represented 20% of the sample fell short of sales and operating result margins when compared with firms with higher or medium investment rates. This has brought about a permanent limitation of their ability to invest and modernise.[4]

Among the industries that increased their production in 2004, the leaders were: metal products (10.1% increase in production against 5.8% in 2003), tobacco (9.9% against 2.4%), radio, TV and communication equipment (7.9% against –12.7%), chemicals (6.6% against 2.0% in 2003), electrical machinery and apparatus (6.4% against 16.1%), basic metals (5.2% against –0.9%) and food-beverages (3.7% against –2.9%). The increase in metallurgy output in 2004 is corroborated by the rise in the industry's capacity utilisation rate to 83.5 from 76.6 in 2003[5] as well as by the large growth of sales and profitability recorded by the firms in this industry (see also Chapter IV.3 for more details).

Out of the four remaining industries with smaller increases, it is worth mentioning the continuing rise in the activity of publishing-printing (3.6% against 2.9%), which stemmed exclusively from the publishing component (6.5%), and in means of transport (3.5% against 14.6%), as well as paper and paper products (3.2% against –1.4%) (see Table III.8).

The largest positive contribution to the increase in total manufacturing production came from food-beverages (0.78 percentage point), chemicals (0.59 p.p.), basic metals (0.47 p.p.) and metal products (0.44 p.p). The contribution of publishing-printing (0.16 p.p.), electrical machinery and apparatus (0.15 p.p.), radio, TV and communication equipment (0.14 p.p.) and tobacco (0.13 p.p.) was positive, albeit smaller.

1 That is, textiles, wearing apparel, other transport equipment, machinery, furniture and leather, which in 2000 accounted for 20.5% of manufacturing.

2 Let it be noted, however, that the level of manufacturing production in 2000, which is the base year for the new NSSG index, was relatively high and rose by 5.1% compared with 1999.

3 According to the same survey, which was compiled on a sample of 2,847 manufacturing firms, a large share of big firms' investment during 1998-2003 went to equity holdings, which however did not bring about any significant increase in sales. By contrast, the increase in the fixed assets of small and medium-sized firms led to larger sale volumes. Nevertheless, total investment of the firms in the sample came to €3.3 billion in 1999; this grew in 2000 but from 2001 onwards industrial firms have invested at decelerating rates (2001: €3 billion, 2002: €2.1 billion, 2003: €1.5 billion).

4 It is worth noting that the implementation of investment plans by financially less vigorous firms is facilitated by the new law on development (3299/2004), which offers incentives such as the reduction of the required own participation stake from 40% to 25%. At the same time, the conditions for the establishment and operation of factories became more favourable after the simplification of licensing procedures under Law 3325/2005.

5 It should be noted that significant investments by large companies in the industry had been undertaken one year before (VIOHALKO Group and Halyvourgiki Inc.).

TABLE III.8

MANUFACTURING PRODUCTION (2000=100)

	Weights (2000)	Average annual percentage changes 2001	2002	2003	2004	2004 level (2000=100)
Manufacturing, total	*100.0*	*–2.5*	*–0.1*	*–0.4*	*1.2*	*98.1*
Food-beverages	20.0	2.2	2.0	–2.9	3.7	105.0
Tobacco	1.2	1.5	1.9	2.4	9.9	116.4
Textiles	5.6	–7.4	–2.6	–3.3	–10.4	78.1
Wearing apparel	4.3	–6.9	–5.7	–0.6	–5.2	82.7
Leather-footwear	0.9	–4.9	–5.4	–10.1	–9.0	73.6
Wood and cork	1.1	–10.7	–1.3	–5.2	0.6	84.1
Paper and paper products	2.4	–9.3	–3.3	–1.4	3.2	89.2
Publishing-printing	4.2	–1.0	1.5	2.9	3.6	107.1
Coke and refined petroleum products	11.2	–1.3	2.1	0.4	–2.4	98.7
Chemicals	7.7	2.4	6.1	2.0	6.6	118.2
Rubber and plastics	3.6	2.1	–1.4	–0.6	–4.1	95.9
Non-metallic minerals	8.5	2.2	2.6	1.8	–0.7	106.0
Basic metals	8.0	3.0	6.6	–0.9	5.2	114.5
Metal products	4.3	–8.6	1.1	5.8	10.1	107.6
Machinery and equipment	3.2	–17.5	9.0	–1.9	–1.7	86.7
Office machinery and computers	0.0	–10.3	92.1	–89.3	99.5	36.6
Electrical machinery and apparatus	2.3	–4.3	–14.3	16.1	6.4	101.3
Radio, TV and communication equipment	3.7	–25.2	–29.0	–12.7	7.9	50.1
Medical tools and precision instruments	0.2	36.8	–18.3	30.6	–25.3	108.9
Means of transport	1.0	–20.7	–22.5	14.6	3.5	72.9
Other transport equipment	4.3	2.9	–4.4	–2.5	–7.5	88.8
Furniture-other manufacturing	2.3	–18.5	–16.7	–9.5	–1.7	60.3
Recycling	0.0	–1.2	25.0	8.6	–4.0	128.8

	Contributions by industry to changes in total manufacturing production (percentage points) 2001	2002	2003	2004
Manufacturing, total	*–2.51*	*–0.13*	*–0.40*	*1.18*
Food-beverages	0.43	0.43	–0.61	0.78
Tobacco	0.02	0.02	0.03	0.13
Textiles	–0.42	–0.14	–0.17	–0.53
Wearing apparel	–0.30	–0.23	–0.02	–0.20
Leather-footwear	–0.04	–0.05	–0.09	–0.07
Wood and cork	–0.11	–0.01	–0.05	0.01
Paper and paper products	–0.22	–0.07	–0.03	0.07
Publishing-printing	–0.04	0.06	0.12	0.16
Coke and refined petroleum products	–0.15	0.24	0.04	–0.29
Chemicals	0.19	0.50	0.18	0.59
Rubber and plastics	0.07	–0.05	–0.02	–0.15
Non-metallic minerals	0.19	0.23	0.17	–0.07
Basic metals	0.24	0.56	–0.09	0.47
Metal products	–0.37	0.04	0.24	0.44
Machinery and equipment	–0.55	0.24	–0.06	–0.05
Office machinery and computers	0.00	0.03	–0.05	0.01
Electrical machinery and apparatus	–0.10	–0.33	0.32	0.15
Radio, TV and communication equipment	–0.93	–0.82	–0.26	0.14
Medical tools and precision instruments	0.09	–0.06	0.08	–0.09
Means of transport	–0.21	–0.19	0.10	0.03
Other transport equipment	0.13	–0.20	–0.11	–0.32
Furniture-other manufacturing	–0.42	–0.31	–0.15	–0.02
Recycling	0.00	0.01	0.00	0.00

Source: Calculations based on NSSG data.

By contrast, a significant drop in production was recorded by medical tools and precision instruments (–25.3% against 30.6% in 2003), textiles (–10.4% against –3.3%), leather and footwear (–9.0% against –10.1%), other transport equipment (–7.5% against –2.5%), wearing apparel (–5.2% against –0.6%), rubber and plastics (–4.1% against –0.6%) as well as recycling (–4.0% against 8.6%). More specifically, the production of textiles and wearing apparel, which, according to the new NSSG index, account for 10% of manufacturing, has shrunk by 19.6% compared with 2000. This is attributed to intense competition in recent years from the cheap Chinese products.[1]

A decrease in output was also recorded by firms engaging in the production of coke and refined petroleum products (–2.4% against 0.4% in 2003).[2] According to the new NSSG index, this industry is now the second most important in manufacturing, having more than doubled its share from 4.6% in 1995 to 11.2% in 2000[3] (see Table III.8).

A smaller drop was recorded in machinery and equipment (–1.7% against –1.9%), furniture and other manufacturing (–1.7% against –9.5% in 2003) and non-metallic minerals (–0.7% against 1.8%).

In 2004 exports of manufactured products (except fuel) rose, but at a slower pace compared with 2003 and considerably slower than total goods export. An analysis of the balance of payments statistics compiled by the Bank of Greece shows that receipts from exports of manufactured products (except fuel) grew by 1.5% (while total exports, except fuel, increased by 13.0%). Hence, the manufacturing industry's export performance, i.e. the share of production sold in foreign markets, was reduced from 20.4% to 19.9% (see Table III.9). A considerable rise in exports and at the same time an improvement in export performance in 2004 was achieved by means of transport and other transport equipment, basic metals and metal products, as well as non-metallic minerals.[4] It should be noted, however, that as far as means of transport and other transport equipment are

1 Competition from Chinese products is expected to become fiercer in forthcoming years, due to the abolition of import quotas for textiles as from 1 January 2005, in conformity with the relevant agreement at WTO level. In a quest for ways to support the industry and given that the implementation of industrial policy measures is incompatible with EU requirements, a permanent committee for the support of the Greek textiles and wearing apparel sectors has been established by a joint decision of the Ministry of Development and the Ministry of Economy and Finance. This committee has already proposed measures to increase competitiveness and the external oricentation of the sectors, such as increased participation in international exhibitions, labelling environment-friendly products, obtaining certification of quality, the financing of modernisation etc. (see also Box IX.1).

2 This is also corroborated by the financial results of Hellenic Petroleum S.A., according to which the group's sales decreased to 16.6 million tonnes in 2004 from 17.3 million tonnes in 2003. It should be noted that the group has the largest share in the Greek oil market.

3 According to the ICAP breakdown of sales per industry, sales of oil-coal in 2003 increased by 14.4%, while according to the recent IOBE survey (March 2005) on oil trade in Greece, the sales of refining companies in the period 1997-2001 recorded an average annual increase of 18.6%. The same survey concluded that the domestic supply of oil is expected to be promoted by the construction of the Burghas-Alexandroupolis pipeline (once the intergovernmental agreement is signed on 12 April 2005), which will start operating in 2008-09 and will considerably reduce the cost of crude oil imports, while strengthening the competitiveness of Greek companies.

4 An improvement in both exports and export performance was also achieved by refined petroleum products, furniture and other manufacturing, as well as paper and publishing-printing; a decline of both exports and export performance was recorded in tobacco and wood-cork.

TABLE III.9

IMPORT PENETRATION AND EXPORT PERFOMANCE OF BASIC MANUFACTURING INDUSTRIES

Industries[1]	Annual percentage changes				Import penetration[3]	Export performance[4]
	Current prices			2000 prices		
	Import bill[2]	Export receipts[2]	Gross value of production	Gross value of production		
Food-beverages (15)						
2002	–0.7	9.8	6.2	2.0	33.7	15.0
2003	–2.8	13.3	–0.5	–2.9	33.8	17.1
2004	9.4	–11.3	8.1	3.7	33.2	14.0
Textiles, wearing apparel, leather-footwear(17, 18, 19)						
2002	3.8	3.0	–2.7	–4.1	61.0	46.8
2003	–1.9	11.9	–1.2	–2.8	63.8	53.0
2004	1.8	–3.5	–6.1	–8.2	66.3	54.5
Chemicals, rubber-plastics (24, 25)						
2002	4.8	33.5	4.8	3.9	72.1	34.6
2003	–5.2	17.5	2.9	1.3	72.0	39.5
2004	0.5	5.1	5.6	3.7	70.9	39.3
Non-metallic minerals (26)						
2002	–22.3	232.0	5.0	2.6	19.6	7.3
2003	1.3	–12.5	1.6	1.8	19.4	6.3
2004	5.7	32.5	0.7	–0.7	20.5	8.2
Basic metals and metal products (27, 28)						
2002	4.4	–14.8	3.9	5.3	39.4	19.0
2003	9.4	–3.4	–1.3	0.6	41.8	18.6
2004	17.9	38.9	10.4	6.4	44.9	23.5
Machinery and apparatus (29, 30, 31, 32)						
2002	–3.2	–5.0	–13.1	–10.2	82.4	26.7
2003	–2.1	43.2	3.1	2.8	83.8	37.1
2004	3.3	–15.9	10.6	1.7	80.9	28.2
Means of transport and other transport equipment (34, 35)						
2002	5.2	–25.1	–6.6	–9.6	81.2	3.4
2003	9.3	134.5	5.9	1.7	82.4	7.6
2004	23.8	87.3	–3.6	–4.4	86.7	14.7
Total manufacturing (except fuel)						
2002	*0.6*	*5.5*	*2.7*	*0.7*	*51.2*	*17.7*
2003	*0.0*	*17.1*	*1.2*	*–0.3*	*51.7*	*20.4*
2004	*8.7*	*1.5*	*4.4*	*1.3*	*52.6*	*19.9*

1 The numbers in parentheses are the two-digit codes corresponding to each industry.
2 Based on the Combined Nomenclature Codification (CNC).
3 Ratio of imports to apparent consumption (current prices).
4 Ratio of exports to gross value of production (current prices).
Sources: Bank of Greece and NSSG.

concerned, the improvement in export performance was not combined with a proportionate strengthening of the industry's position in the domestic market. Moreover, an increase in exports was experienced by chemicals and rubber-plastics, although they retained their 2003 export performance, since their increased output seems to have been absorbed by the domestic market, thus limiting import penetration (i.e. the ratio of imports to apparent consumption)[1] in these industries.

By contrast, the industries producing food and beverages as well as machinery and apparatus[2] reduced their exports and export performance, thus channelling their increased output into the domestic market. Hence, import penetration in these two industries decreased despite the increase in their imports. The improved export performance of textiles, wearing apparel and leather-footwear, in spite of the decrease in production and exports, is the result of a larger decrease in output relative to the decline in exports.

Total payments for imports of manufactured products (except fuel), according to Bank of Greece data, increased in 2004 (8.7%), having remained stagnant in 2003, and the import penetration of manufactured products (except fuel) rose to 52.6% from 51.7% in 2003.

2.4 Mining and quarrying

In 2004 *mining and quarrying production* recovered slightly (0.3%), having declined considerably (–5.2%) one year before. According to NSSG data (see Table III.7), the rise in mining output resulted exclusively from the recovery in the production of energy goods (coal, lignite and crude oil), whilst quarrying production decreased. Metal production was also reduced, albeit at a lower rate than in the past year.

According to NSSG data, coal and lignite mining, having decreased in 2003, recovered in 2004, owing to the increased demand for lignite by Public Power Coporation's (DEH) lignite-fired power plants.[3] Crude oil and natural gas output increased by 3.0%, but the industry's production levels were low (53.4) compared with the base year (2000),[4] owing to the continuous decline in production during 2001-2003 (2003: –24.5%, 2002: –7.3%, 2001: –25.9%). Non-ferrous metal ores[5] continued to record a decline in their activity in 2004, although at lower rates. This is connected with the closure of the Chalkidiki mines

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1 Apparent consumption is the gross value of production plus imports less exports.

2 Including machinery and equipment, office machinery and computers, electrical machinery and apparatus, as well as radio, TV and communication equipment.

3 According to DEH data, the quantity of lignite extracted from its own mines in 2004 increased by 2.6% compared with 2003 and amounted to 69,890 thousand tonnes (up from 68,116 thousand tonnes in 2003).

4 It should be recalled that oil production in 2000 had increased substantially, because the Prinos deposit was re-opened that year. Currently, drilling for oil in Kallirachi area (Thassos island) by Kavala Oil, the company working the Prinos deposit, is under way and aimed at discovering new deposits and increasing output. To this end, €50 million has already been invested, with total investment in oil wells amounting to €113 million.

5 Bauxite, chromite and nickel being the most important ones.

as from March 2003.[1] However, foreign demand for certain metals remained high. As shown by provisional NSSG trade statistics, the volume of aluminium and alumina ore exports during January-October 2004 grew by 11.7%, because of the increased demand for these metals in EU countries (73.8%). Over the same period, the volume of aluminium exports grew by 8.9%, owing to increased demand for this mineral from third countries (17.9%) and the EU (4.0%).

The production of quarry materials, having increased in the previous four years and in the first seven months of 2004 (average annual growth rate for January-July: 10.8%), decreased in 2004 as a whole. This is attributable to the completion of the projects related to the Olympic Games. In more detail, quarrying of gravel and sand was reduced (–4.1%), while foreign demand for these materials increased. According to NSSG data, the volume of stone, sand and gravel exports over January-October 2004 rose by 18.3%, reflecting exclusively the increased EU demand (452.6%). A 3.9% decrease was recorded in the production of marble and other stone in 2004, which in 2003 had increased by 1.0%;[2] foreign demand for marble was also limited in 2004, especially from third countries. According to provisional NSSG customs data, during January-October 2004 the volume of marble exported to third countries decreased by 8.7% (having increased by 27.8% over the same 2003 period), with marble exports to third countries declining further (–9.1%). Even larger was the decrease (–15.3%) in marble exports to China, which in recent years has absorbed almost half of Greek marble exports. Thus, according to NSSG data, during January-October 2004 marble exports to China reached 96.9 tonnes against 114.5 tonnes over the same period of 2003. At the same time, increased domestic demand for marble caused a 6.5% increase in the volume of imports (mainly of raw marble) over the same period.

By contrast, a rise of 3.2% was recorded in the production of other mining and quarrying materials (magnesite, asbestos, perlite etc.), while foreign demand for some of these products also increased. Thus, the export volume of raw minerals during January-October 2004 rose by 11.1%. In 2004, the mining of clay and kaolin grew by 6.0%, the quarrying of limestone, gypsum and chalk by 3.3% and the production of salt by 18.6%.

It should be noted that, under the new law on development (3299/2004), mining and quarrying enterprises are given incentives for the modernisation and expansion of their activities, as all investment plans for mining and quarrying are placed in the subsidi-

1 It is worth noting that the Cassandra mines (mixed sulphur deposits) are expected to start opperating again within 2005, since the Ministry for the Environment, Physical Planning & Public Works signed in January 2005 the relevant environmental impact study that was necessary for licensing the company "Hellenic Gold S.A." which has taken up the exploitation of the mines after the pull-out of TVX HELLAS S.A. (Law 3220/15 January 2004). At the same time, the said investment scheme has been committed to establishing a third plant for purging the area, thus further rehabilitating the environment.

2 According to the Greek Mining Enterprises Association, the reduced competitiveness of the Greek marble (which today ranks 10th globally, whereas a few years back it ranked 5th) in international markets is the result of the high operating-production cost borne by Greek firms compared with that of competitive non-European countries, combined with the considerable limitation of the potential to develop new quarrying activities due to the complicated licensing framework .

sation framework (category 1).[1] For investment projects with an overall cost of over €3 million, which are part of integrated long-term (2-5 years) business plans, the subsidy may reach 35% (category 5) irrespective of the region where they are undertaken, provided that the respective mining firms have been established five years earlier.[2] Moreover, the subsidisation of investments (in mining, quarrying and the exploitation of industrial minerals) also covers, under the above law, the cost of the main preparatory works, e.g. the cost of opening new roads, galleries, shafts etc.

2.5 Electricity-natural gas-water supply

In 2004 *electricity generation, natural gas production and water supply* (see Table III.7), as shown by the relevant NSSG index, grew, albeit at a lower rate than in 2003. This was the result of the increased demand for electricity and natural gas, while the index of water treatment and distribution also rebounded. This led to the three industries contributing to the rise in industrial output (1.2%) by 0.3 percentage point.

In more detail, according to the Public Gas Corporation (DEPA) data, the quantities of *natural gas* distributed in 2004 increased by 9.9% (from 2,287 million Nm3 to 2,514 million Nm3). This increase stemmed mainly from the larger demand for electricity generation (8.4%),[3] while industrial demand also increased (7%), resulting in electricity generation absorbing 72% and the industrial sector 19% of total natural gas consumption. At the same time, gas companies (EPAs) supplying small industrial and commercial firms and households absorbed 215 million Nm3 of natural gas, increasing their contribution to total demand (from 6.9% in 2003 to 8.6%), through the expansion and operation of city networks.[4] Special

1 Which provides for their subsidisation up to 40% or their tax exemption up to 100%, depending on their location.
2 This category also includes the investment plans of manufacturing firms.
3 During 1999-2004 the demand for electricity generation grew at an average annual rate of 16.1%.
4 DEPA has decided to build new natural gas distribution networks in 2005 (due for completion in 2007) both for industrial customers and for urban use, of a total budget of €55 million, financed by 40% by the Competitiveness Business Plan (EPAN). As noted by the Regulatory Authority for Energy (RAE – *Report*, January 2003-March 2004), the participation of natural gas in total domestic consumption is lagging considerably behind the EU average, which amounts to 60% of total consumption. For this reason, it is necessary to speed up further the penetration of this particular fuel in the cities, which, according to RAE, is feasible, since, under Directive 2003/55/EU, EPAs will continue to enjoy their privileged operational status, despite the forthcoming deregulation of the natural gas market in our country. RAE also notes that, although the State took supporting measures provided for in Law 3175/2003, Article 30 (such as obligatory installation in new buildings, facilities to convert the central heating systems of multi-storey buildings, obligatory use of gas in industrial plants), which would favour the penetration of natural gas in total consumption, the consistent implementation of these measures remains the crucial factor. At the same time, it is necessary to deepen public awareness of the advantages of using natural gas and to offer financial incentives to consumers. Similar points on the problems relating to the operation of national gas markets, along with proposals to solve them, have been made in a recent IOBE survey on this market (November 2004), which concludes that natural gas will continue to penetrate the domestic energy market at a fast pace in the next 10 years. The most crucial issue, however, still is the pricing policy, especially in the area of conversion (electricity generation) and in the industrial sector, since amortisation costs for the central pipeline come as a surcharge on the price of the fuel (which is indirectly affected by diesel oil prices); hence fuel price stands at high levels. That is why for the central pipeline (which is a national infrastructure project) the establishment of a different set of criteria than those applied to other investments is proposed, which will reduce natural gas transfer costs and strengthen its competitiveness vis-à-vis other types of fuel. Moreover, it is also proposed that a stable and consistent tax regime be maintained and a 75% deduction from taxable income for the purchase of natural gas appliances be re-installed.

commercial consumers (Athens International Airport, Thermal Buses S.A. etc.) absorbed the same quantities as in the previous year (12 million Nm3). Demand is forecast to grow in 2005 (by 2.8 billion Nm3), reaching 6 billion Nm3 by 2010, and is expected to be satisfied in part by the inflow of gas from Turkey after the start-up of the Greek-Turkish pipeline by the end of 2006.[1]

As shown by Public Power Corporation (DEH) provisional data, *net electricity generation*[2] increased by 1.7% in 2004 (having grown by 7.4% in 2003) and amounted to 54,243 GWh. This rise mainly stemmed from the further increase in the production of lignite-fired power plants (2004: 2.6%, 2003: 1.4%), as well as from the increase in the production of gas-fired plants (2004: 5.6%, 2003: 13.5%, 2002: 15.7%), which saw their share in total generation (14.9%)[3] exceeding that of oil-fired plants (13.1%), whose production declined substantially (–7.0%). The production of hydroelectric stations also decreased (–5.5%), against a significant increase in 2002-2003 (2003: 54.1%, 2002: 26.8%). At the same time, DEH's recourse to renewable energy sources (RES) fell (to 76 GWh from 89 GWh in 2003); the capacity of the latter has remained unchanged since 2000 (37 MW). By contrast, in 2004 the capacity of private RES plants operating under Law 2244/1994 increased,[4] since the interest of large foreign investors in the Greek RES market is heightening,[5] pending an amendment to the institutional framework and the simplification of RES plant licensing. At the same time, RES penetration in the energy balance is financially supported by the Operational Programme "Competitiveness" (action 2.1.3)[6] and investing in RES is made easier under the new law on development.[7]

On the demand side, *total electricity consumption* rose by 2.3% in 2004 compared with 2003. This rise was caused mainly by increased demand for commercial and house-

1 The construction of this pipeline is expected to commence in 2005, since the tenders conducted by both DEPA (September 2004) and the Turkish BOTAS (December 2004) have been completed and the joint ventures that will build the pipeline have been selected. Natural gas inflows will initially (2006) amount to 250 million cubic metres, with an annual target of 750 million cubic metres for 2008, since from that year onwards further quantities of natural gas will be required to meet the demand for electricity generation, mainly by independent producers. Moreover, the operation of the pipeline will provide Greece with a third supply source (apart from Russia and Algeria), which will enhance the system's security level.

2 Including DEH purchases (1,617 GWh) from domestic producers and surplus imports by private firms that were fed into the system.

3 This development is connected with the substantial investment undertaken by DEH (Law 2165/93) during 1997-2002, which led to an increase in the established capacity of its gas-fired plants to 1,581 MW in 2004.

4 According to Ministry of Development data, 19 additional operating licenses were issued in 2004, for a total capacity of 77.6 MW. Thus, the capacity of RES stations operating under Law 2244/1994 came to 462 MW and the granted licences to 1,240 MW. Following an assessment by RAE, the Ministry of Development issued 135 new licences for RES-based electricity generation (1,132 MW) in 2004.

5 In the last quarter of 2004 the approved FDI in RES came to €85 million.

6 In the fourth round of the second invitation extended in the framework of action 2.1.3, 44 RES projects with a €107 million budget were approved.

7 According to Article 3 of Law 3299/2004, investment plans for electricity generation using mild energy sources (i.e. wind, solar, hydroelectric energy, geothermal power and biomass), irrespective of the installed capacity, are subsidised by 30-40% or leased under a subsidy or the investment cost is fully (100%) tax-exempted (category 4). Furthermore, as per paragraph 5 of the same article, investment plans for electricity generation from RES or mixed sources are further subsidised for connection to the DEH network.

hold use, whereas industrial demand declined. In more detail, commercial demand[1] rose by 6.1% against 7.4% in 2003 and household demand by 2.5% against 4.2% in 2003. Agricultural demand also grew slightly (0.2%), having increased substantially in 2003 (12%). By contrast, industrial demand for electricity continued to decline (2004: –1.2%, 2003: –0.9%) despite the increase in manufacturing production (1.2%). This decline stemmed exclusively from the continuing decrease in the demand for high-voltage electricity (2004: –2.7%, 2003: –3.3%), whilst the demand for low-voltage and medium-voltage electricity grew slightly (0.2%). Finally, electricity consumption for other uses, mainly in the public sector, continued to grow at a high rate (5.3%).

The gap between generated and required energy worsened the energy balance, with electricity imports rising by 15.2% and electricity exports falling by 1.3%. Thus, the net-imports-to-sales ratio rose to 5.6% in 2004, from 4.3% in 2003. This was also due to an only limited increase in the productive capacity in 2004, since DEH's total installed capacity was raised by a mere 84 MW (from a number of oil-fired plants on the island of Crete) and reached 12,223 MW from 12,139 MW in 2003.[2]

Given this small rise in DEH capacity and the delays in implementing private investment plans that are licensed by RAE,[3] except for the 390 MW Hellenic Petroleum plant, which is expected to operate within 2005,[4] the problem of electricity adequacy mainly for 2005 and 2006 has become worse.[5] It is for this reason, combined with the problem of the generating system's imbalance across the Northern-Southern axis (concentration of generating plants up north), that the Ministry of Development has focused its policy for 2005 on expanding the electricity transmission and distribution system and on measures for energy saving and the management of demand.[6]

At the same time, an important fact for the true deregulation of electricity market is the finalisation and approval by the Ministry of Development of the new *Management Code for Electricity Generation and Transmission*,[7] which is the first integrated proposal for the operation of the deregulated market. Thereafter, the materialisation of licensed pri-

1 Commercial demand includes electricity consumption by the Athens International Airport.

2 Nonetheless, DEH has been licensed to build more plants, mainly the 5th combined cycle plant with a capacity of 400 MW in Lavreotiki, which is anticipated to enter the interconnected electrical network in 2006.

3 According to RAE's files, from February 2001 (commencement of the market's formal deregulation, Laws 2773/1999 and 3175/2003) and until November 2004, 695 licences for electricity generation were granted (total capacity of 10,282 MW), plus 9 licences for electricity supply (2,343 MW). Out of the generation licences, 11 relate to major thermal plants with a total capacity of 4,095 MW.

4 Initially at half capacity. Furthermore, a gas-turbine plant with a capacity of 160 MW has been constructed and is already operating since 2004, ensuring spare capacity generation.

5 According to RAE, in order for adequate electricity supply to be ensured, an extra capacity of 550 MW should be added every year until 2010.

6 In this context, the Ministry of Development in collaboration with DEH intends to apply as from 2005 special rates for major industrial and commercial consumers, provided they transfer their peak consumption to off-peak hours. The establishment of a system of time charge will be applied as from 2006 to urban consumption as well, i.e. after the replacement of electricity meters with new ones that will be able to measure consumption per hour, while different charges will apply depending on the time of day.

7 The relevant ministerial decision is expected to be issued in the near future.

vate investments is expected, same as the conduct of tenders by the System Manager (DESMHE) for the supply of 900 MW of electric power by private producers.[1] The new Code is expected to be implemented in 15-20 months, i.e. the period necessary for the wholesale market to operate. In the meantime, transitional arrangements that will activate Hellenic Petroleum will be implemented. According to the new Code, priority of entry is granted to southern rather than northern plants, since the decision for the entry of a plant into the system, which is managed by DESMHE, will not be taken with solely the element of cost in mind, but also taking into consideration the generation and transmission capacity of the system, same as the need to secure spare capacity.

Finally, the institutional framework for the deregulation of the electricity market is expected to be further amended, in order to conform fully to Directive 2003/54 EC,[2] which has not been effectively transposed into national law.

3. SERVICES

According to provisional estimates,[3] the gross value added of the *services sector*[4] grew by 4.9% in 2004 (against 6.0% in 2003). This increase stemmed mainly from transport-communications, trade, financial intermediation, real estate management and other activities.

In greater detail, the increase in *transport-communications* activity is associated with the larger volume of road and sea transport (owing to the expansion of external trade), air transport (see Chart III.7)[5] and the growing demand for telecommunications services, espe-

1 Under Law 3175/2003, DEH cannot participate on an equal footing in tenders prior to 2007. It can, however, renew and replace its capacity up to 1,600 MW. In this context, the DEH Board of Directors decided on 14 December 2004 to proceed with the construction of a new natural gas plant with a capacity of about 400 MW in Aliveri, in replacement of some of its old oil-fired plants. The new Aliveri plant is expected to start operating in early 2008, contributing to the stabilisation of the southern branch of the system.

2 The European Commission with a letter of warning dated 16 March 2005 requests Greece (and another nine member-States) to proceed immediately with the transposition of Directive 2003/54 into their national law, as they should have done since 1 July 2004.

3 According to the business survey carried out by IOBE for the services sector (covering private enterprises in the sector of services except for retail trade and banks), the business expectations index rose by 12.8%.

4 This sector accounts for 70.1% of GDP. The significant contribution of the services sector is corroborated by a relevant ICAP study, according to which, of the 24,681 new sociétés anonymes and limited liability companies established during the five years 1999-2003, 53.6% belonged to the broad tertiary sector and 29.9% corresponded to new commercial firms, while the number of new industrial firms was limited to 16.5%. According to the same study, the share of new companies of the broad tertiary sector in the total initial capital was 72.8%, against 13.4% and 13.8% for new commercial and industrial firms, respectively.

5 According to Olympic Airlines data, passenger traffic increased by 6.4% in 2004. In addition, Aegean Airlines data indicate a considerable increase in passenger traffic (25.3%), while the total share of the company's passengers in total passenger traffic through the Athens International Airport (among more than 60 other airlanes) grew from 16.7% in 2003 to 21% in 2004. Total passenger traffic (domestic and foreign) through the Athens International Airport increased by 11.5% compared with 2003, while the total number of flights and the total volume of cargo carried rose by 12.3% and 8.4%, respectively, compared with the previous year.

cially mobile telephony.[1] By contrast, coastal transport recorded negative growth rates in 2004,[2] compared with 2003. The liberalisation of coastal transport to the Greek islands as from 1 January 2004 (Law 2932/2001) has not yet led to the creation of a competitive market that would boost the branch's activity and reduce prices. Finally, OSE (Hellenic Railways Organisation) registered a 29.2% increase in its cargo transport (January-October 2004).

The deregulation of the telecommunications market and stiffer competition, especially in mobile telephony,[3] led to drastic cuts in the rates of telecommunication services and increased the supply of new products and services.[4] The rate of penetration of fixed-voice and mobile telephony in Greece exceeds the EU average, but the use of computers and access to the Internet[5] lag behind compared with the EU average, while the broadband service (high data transfer speeds) is practically non-existent.[6] In addition, the commercial availability of third-generation mobile telephony (videotelephony and fast Internet connections), initiated in 2004,[7] sets new standards for competition, although the cost of such services is still rather high.

In fixed-voice telephony, the increase in the market shares of alternative service providers, especially in long-distance and international calls and less in local calls, has contributed towards intensifying competition and reducing prices. Concerning Information and Communication Technologies (ICT), the prospects of the sector will depend on the evolution of demand and the readiness of the firms to make the adjustments dictated by the changing environment, as evidenced by a relevant IOBE study. The projects of the operational programme "Information Society" contribute to this end, as they significantly boost public investment in new technologies. According to data from the Secretariat for the Information Society, at the end of 2004 the rate of absorption of public expenditure for new technologies reached 19.2%, while the contracts signed represented 35% of the total programme budget, against 11.8% and 17%, respectively, in March 2004. In addition, major

1 The rate of penetration in total population exceeds 90%.

2 Specifically, passenger traffic from and to the port of Piraeus decreased by 4.9% in 2004 and cargo transport by 3.9%, on the basis of Piraeus Port Authority data.

3 According to Ministry of Economy and Finance data, revenue from mobile telephony flat fees grew by 13% in 2004. The four companies (Cosmote, Vodafone, Tim, Q-Telecom) increased their subscribers, turnover and profits.

4 The facility offered to fixed-voice and mobile telephony subscribers to change provider while retaining their phone number (number portability), in force since 1 March 2004, has boosted competition, but portability levels are not satisfactory, especially in fixed telephony. According to National Telecommunications and Post Commission (EETT) data, of the 26,500 portability applications submitted in the field of mobile telephony, approximately 14,000 have been approved, as have been around 1,100 of the 2,400 applications in the field of fixed-voice telephony.

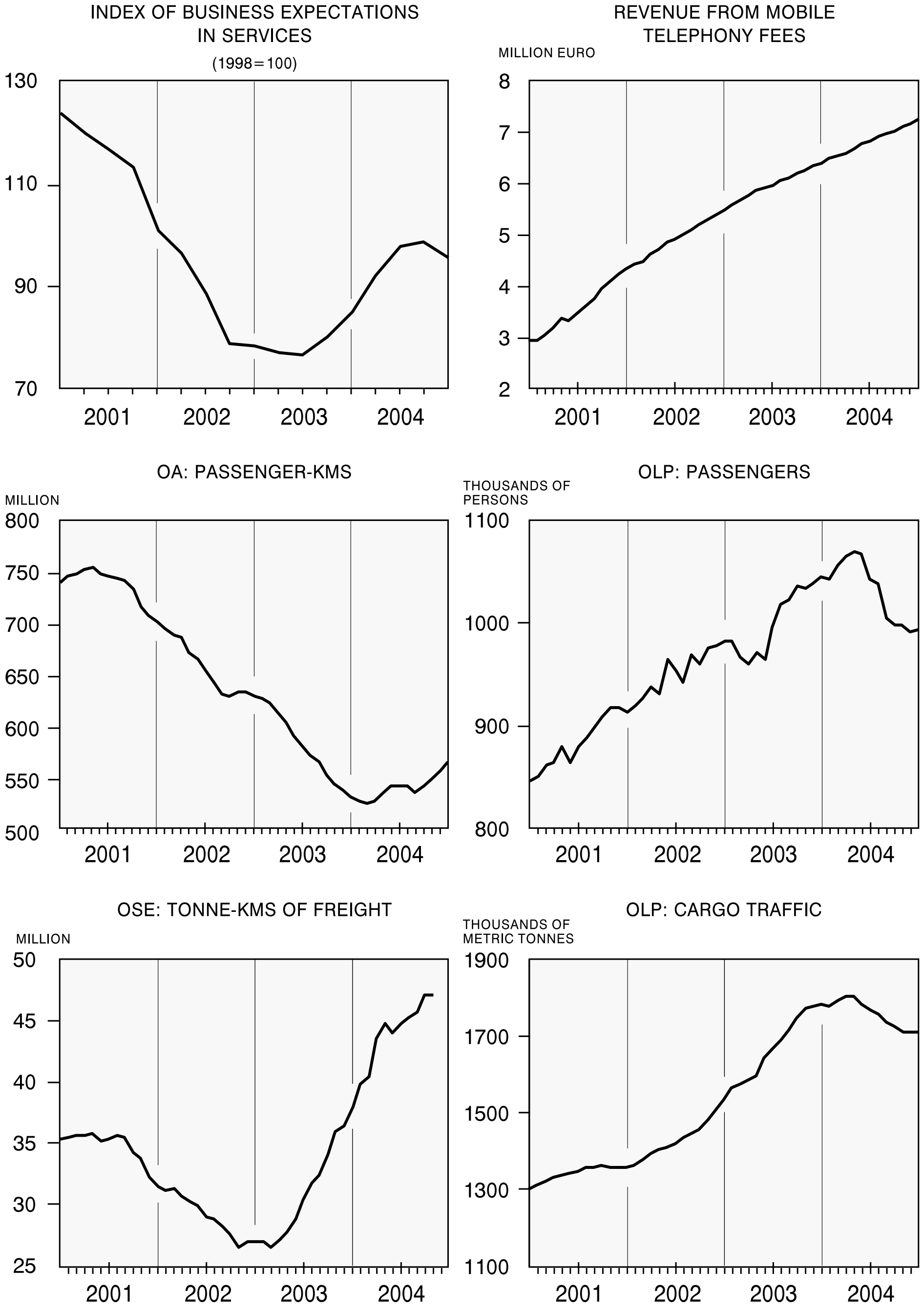
5 Low Internet penetration negatively affects the development of e-commerce. According to a survey conducted by the Greek Research and Technology Network (EDET/GRNET), the total number of Internet users account for 19.7% of the population (on the basis of the sample), a reduced percentage compared with 2003, while a mere 0.6% of the population made purchases through the Internet in 2004.

6 The survey was conducted by Ipsos-INRA on behalf of the European Commission and records the penetration of communication media and their use by households in the 15 EU Member States. It shows that, in Greece, the penetration rate of fixed-voice telephony is 88% (EU: 82%), mobile telephony 90% (EU: 81%), PCs 33% (EU: 53%), Internet access 18% (EU: 39%) and broadband service 0% (EU: 12%).

7 TIM (January 2004), Cosmote (May 2004) and Vodafone (November 2004).

CHART III.7

ACTIVITY INDICATORS FOR SERVICES[1]



1 Twelve-month moving average centred on the last month of the period.

Sources: IOBE, Ministry of Economy and Finance, Olympic Airways (OA), Piraeus Port Authority (OLP), Hellenic Railways Organisation (OSE).

information technology projects were promoted, such as "Syzefxis" for public administration and projects for health care and the police (Police Online). At the same time, the compatibility of the goals of the Information Society Programme with the European goals (e-Europe 2005) was enhanced and the process of formulating the strategy for the period 2007-2013 is under way.

Retail trade activity grew, as shown by the 4.5% increase in retail sales volume (NSSG data). Furthermore, according to the monthly business survey of IOBE for retail trade, the business expectations index rose by 2.8% in 2004. However, commercial firms' expectations about a significant increase in their turnover during the Olympic Games did not come true, as evidenced by a survey carried out by the National Confederation of Hellenic Commerce (ESEE).[1] Small and medium-sized enterprises continue to receive support from the Operational Programme "Competitiveness" (EPAN), which concerns very small firms employing 1 to 9 persons in the fields of trade and services. According to a survey by Franchise Success, franchising displayed significant development in 2004, following a period of stagnation in 2003. Specifically, networks and points of sale increased and new firms entered.

Tourism activity is estimated to have dropped in 2004. The Olympic Games did not contribute to increasing tourism as expected.[2] Despite the rise in travel receipts, arrivals of foreign tourists were reduced[3] and domestic tourism is estimated to have declined, since Greeks either did not travel to tourist areas of the country due to the Games or restricted their stay in such areas. In addition, the Greek tourism product remains less competitive compared with that of other non-euro area destinations. However, according to estimates by the Institute of Tourist Research and Forecasts (ITEP), the increase in travel receipts can be attributed to base effects related to hotel receipts in the previous year, in conjunction with the assumption that the *per capita* expenditure of tourists who came for the Olympic Games was relatively increased, as well as to the higher prices charged during this period. The publicity enjoyed by the country due to the successful holding of the Olympic Games, tourism investment (especially for modernisation, as well as for the establishment or extension of hotels),[4]

1 The survey was carried out in five Olympic cities, in a sample of 400 shops. According to the survey, the number of foreign tourists was appreciably lower than expected and those who came mainly bought Olympic products.

2 According to data from the Attica Hotel Association for 2004 as a whole, increased bookings (46.1%, against 40.8% in 2003) were recorded only in five-star hotels. Average bookings in the other categories were: four-star hotels 53.9%, three-star hotels 57% and two-star hotels 44.1%, compared with 54.9%, 57.2% and 47.2%, respectively, for 2003.

3 According to Bank of Greece data, the number of total arrivals (by air, road and sea) of foreign travellers declined by 1.4% in 2004 compared with the previous year. In addition, according to data from the *Greek Economy and Tourism* report of ITEP (November 2004), the number of total arrivals of foreign tourists at selected airports in the period January-August 2004 fell by 1.5% compared with the same period of 2003.

4 According to data from the *Tourism Enterprises and Equipment Suppliers* report, issued by the "Xenia" exhibitions, in the period 1998-2004 and, more specifically, from the entry into force of the previous development law (2601/1998) until December 2004, a total of 940 tourism investment projects of all types were supported, with a total budget of €1 billion. These projects were subsidised with €284.5 million, investors' own funds totalled €516.7 million and borrowed funds amounted to €202.8 million. However, according to data presented in an ICAP survey on hotel enterprises rated AA, A and B, estimates of total sales of hotel services in 2004 are reduced by 4% compared with 2003. The same study, referring to the period 1998-2004, underlines the increase in total sales up to 2001, explained by the continuous rise in incoming tourism during these four years, and their decline from 2002 onwards, owing to the drop in the number of tourists visiting Greece.

as well as the advertising campaign carried out for 2005, are expected to affect tourism positively this year and in the years to come.

According to data from the Association of Insurance Companies of Greece, *premiums production* increased by a total of 12.4% in 2004, and life insurance was the main lever, with premiums production rising by 21.4%.

Developments in the *banking sector* are reviewed in Chapter X.

4. EMPLOYMENT-UNEMPLOYMENT

Strong GDP growth in 2004 and the hosting of the Olympic Games naturally contributed to an increase in employment. The size of this increase and the branches of economic activity affected cannot be accurately determined, because the data of the Labour Force Survey (LFS) do not allow comparisons with the previous year, owing to changes in

TABLE III.10
PRIVATE SECTOR EMPLOYMENT FLOWS

	1999	2000	2001	2002	2003	2004
New job registrations	886,168	978,266	1,033,085	1,080,305	1,083,880	1,107,809
Labour contract terminations	477,166	534,805	597,575	590,642	652,820	665,778
Voluntary quits	277,725	341,195	386,043	418,233	398,888	417,912
Net balance (new jobs)	131,277	102,266	49,467	71,430	32,172	24,119

Note: Flow data overestimate net job creation, as data on new job registrations and labour contract terminations are more reliable than data on voluntary quits (which are not accurately recorded).
Source: Employment Observatory Research-Informatics S.A. – Greek Manpower Employment Organisation (OAED).

the sampling methodology since the first quarter of 2004. Yet, it is estimated that the rise in employment took place mainly in the first half of the year and was broadly based across the sectors of the economy. By contrast, in the second half of 2004, although employment in trade and services kept rising, it fell in construction.[1]

Data released by the Employment Observatory Research-Informatics S.A. (PAEP S.A., a subsidiary of the Manpower Employment Organisation – OAED) on employment

1 The estimates concerning developments in employment are based on OAED data on employment flows, the IOBE and the Hellenic Purchasing Institute-NTC Research (PMI) business and consumer surveys, the NSSG survey on employment in retail trade, National Accounts, Ministry of Economy and Finance data on employment in the public sector, as well as on balance sheets of companies listed on the Athens Exchange. The usual source of data on changes in employment, i.e. the NSSG Labour Force Survey (LFS), cannot serve this purpose at the current juncture, as the fact that the survey is conducted on a new sample and by a new methodology since the first quarter of 2004 makes intertemporal comparisons unreliable (Eurostat, *Statistics in focus: Population and Social Conditions*, 3/2005). Changes in the LFS have been presented in the recent NSSG press releases, as well as in a communication from the NSSG Press and Public Relations Office (8 July 2004).

flows show that the number of new jobs created in 2004 was approximately 24,000, compared with 32,000 in 2003 (see Table III.10). However, the figure for 2004 masks the differences recorded within the year. Job creation in the first eight months of 2004 was significantly higher than in the corresponding period of 2003 (117,961 new jobs, compared with 77,148),[1] while between September and December 2004 there was a net decrease in

TABLE III.11

POPULATION, LABOUR FORCE AND EMPLOYMENT

	2004 (thousand persons)	Annual percentage changes				
		2000	2001	2002	2003	2004[9]
Population aged 15 or more[1]	9,057	0.9	0.8	0.7	0.6	...
Population aged 15-64[1]	7,127	0.5	0.3	0.2	0.1	...
Labour force[1]	4,823	0.7	–0.8	1.5	1.6	...
Employment:[1]	4,330	1.4	0.1	2.1	2.3	...
– Primary sector[1]	546	1.2	–7.2	–2.0	1.1	...
– Secondary sector[1]	974	–0.2	2.0	1.0	1.2	...
– Tertiary sector[1]	2,811	2.1	1.5	3.6	3.0	...
Labour force participation rate[1,2]	4,742	63.9	63.2	64.2	65.1	66.5
Employment rate[1,3]	4,250	56.6	56.5	57.7	58.9	59.6
Unemployment (as a percentage of the labour force)[1]	493	11.2	10.4	9.9	9.3	10.2
Employment in:						
– Manufacturing[1]	570	–1.0	1.5	–0.2	–2.5	...
– Construction[1]	350	2.9	4.1	3.4	8.6	...
– Banks[4]	62	2.3	–1.0	1.4	0.1	–3.0
– Civil service[5]	464[6]	1.9	1.1	2.2	0.8	1.6
– Public enterprises[7]	79[8]	–4.6	–4.4	–3.8	–2.2	–1.8[10]

1 NSSG, Labour Force Surveys (LFS). Second-quarter on second-quarter changes. Revised data for 1999-2003, which were published in January 2005. New sample as of 2004.
2 Labour force participation rate of population aged 15-64.
3 Employed persons aged 15-64 as a percentage of population aged 15-64.
4 Data obtained from banks: December-on-December changes. Including the Bank of Greece.
5 Ministry of Economy and Finance: December-on-December changes. The increase in average annual employment was 1.8% in 2000 (counting in public hospital personnel and smoothing out fluctuations in the number of secondary school substitute teachers), 0.6% in 2001, 4.0% in 2002, 1.8% in 2003 and 1.2% in 2004.
6 Including public hospital personnel.
7 Ministry of Economy and Finance: December-on-December changes. The decrease in average annual employment was 4.2% in 2000, 4.6% in 2001, 4.7% in 2002, 1.9% in 2003 and 2.1% in 2004 (9 months).
8 Excluding the Hellenic Telecommunications Organisation (OTE).
9 Data from the 2004 LFS are fully comparable with those for previous years.
10 September-on-September changes.

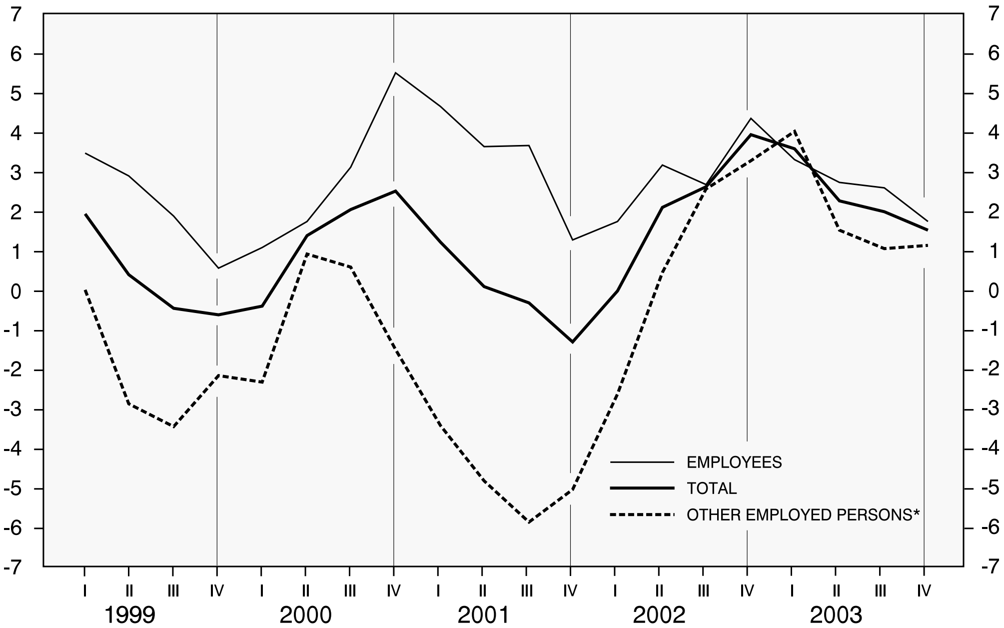
1 OAED data should be treated with caution, because they do not provide a comprehensive picture of employment, as they neither cover the self-employed nor fully record voluntary quits.

jobs —owing to increased terminations of contracts and voluntary quits— which was more than double that recorded in the same period of 2003. This decrease was only partly seasonal (owing to the end of the summer period) and is mostly attributable to reduced activity after the end of the Olympic Games in sectors associated with the Games. The regional breakdown of data shows that the total decrease in new jobs was also due —apart from the loss of certain jobs created in Athens for the summer season and the "Olympic" period— to the loss of jobs in the provinces during the year.

CHART III.8

EMPLOYMENT (1999 - 2003)

(PERCENTAGE CHANGES OVER CORRESPONDING QUARTER OF PREVIOUS YEAR)



* Other employed persons= Self-employed with staff (employers)+Self-employed without staff + Assistants in family businesses.

Note: New revised data for 1999-2003, published in January 2005. No changes are given for 2004, as data are not fully comparable, due to a change in the survey sample.

Source: NSSG, Labour Force Surveys.

As regards developments by branch of economic activity (see Table III.11), it is estimated that the downward trend of employment in the *primary sector* continued.[1] By contrast, there is no evidence that employment in *manufacturing* recorded any significant changes in 2004 compared with 2003. In *construction* (approximately 8% of total employment), it is estimated that employment did not change significantly in the first half of 2004.

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1 Estimates concerning the primary sector are based on National Accounts data, which also make use of the NSSG Agricultural Structures Survey data.

However, in the second half —after the completion of projects associated with the Olympic Games— employment dropped significantly compared with the same period of 2003. Regarding *services*, an important increase (4.1%) in employment was recorded in *retail trade*,[1] which accounts for approximately 12% of all employed persons.[2] As expected, an increase was recorded in employment in *hotels and restaurants* – between the first and the last quarter of 2004, the number of persons employed in this branch rose by 16%. By contrast, in *banks*, according to data declared by the credit institutions themselves, the number of employees fell by about 3% between December 2003 and December 2004, owing to the implementation by some major banks of voluntary retirement programmes which, to a small extent, were offset by increased employment in foreign banks' branches in Greece. Employment in *central government*[3] grew at an average annual rate of 1.2% in 2004. By contrast, employment in *public enterprises* fell by an average annual rate of 2.1% during the first nine months of 2004.

Recent LFS data (see Chart III.8) do not yet enable comparisons with previous years, but show the structure of employment in the Greek economy. These data imply that the employment rate (i.e. employed persons as a percentage of the total population aged 15-64) was 59.4% in 2004, compared with approximately 65% in the EU-15. This is attributed to the significantly lower rates of female and youth employment, which partly reflect the lower rate of *part-time employment* in Greece (4.6%) compared with the EU-15 (over 19%).

Despite the increase in employment in 2004, *unemployment* remained high and stood at 10.5% of the labour force, according to LFS data (see Chart III.9). The rate of unemployment in Greece is among the highest in the EU-15. In the third quarter of 2004, the last quarter for which data are available for the entire EU-15, it was the second highest in the EU-15, after Spain, and much higher than the EU-15 average of about 8%.

Apart from the high rate of unemployment, of special concern is the fact that a significant proportion of jobless persons (55.0%) are long-term unemployed and that more than half of them have no previous work experience ("new unemployed").

Another matter of concern is the high rate of unemployment among young people aged 15-24 (see Table III.12), which, despite the small decline recorded in the last few years, continues to be very high (26.9%), while approximately 50% of the unemployed in this age group have been seeking work for over one year.[4] In the EU-15, the percentage of unemployed aged 15-24 was approximately 16% in 2004.

The above points show that it is difficult to enter the labour market. This is corroborated by an earlier NSSG survey[5] on the process of transition from education to the labour market, which shows that there is an average period of 35 months between the completion

1 According to the new NSSG index.
2 On the basis of the LFS, by two-digit industry classification code number for the first half of 2004.
3 Comprising the personnel of ministries, regional governments, municipalities, hospitals and security forces.
4 Data for the second quarter of 2004.
5 NSSG (2003), "Transition from education to the labour market – year 2000".

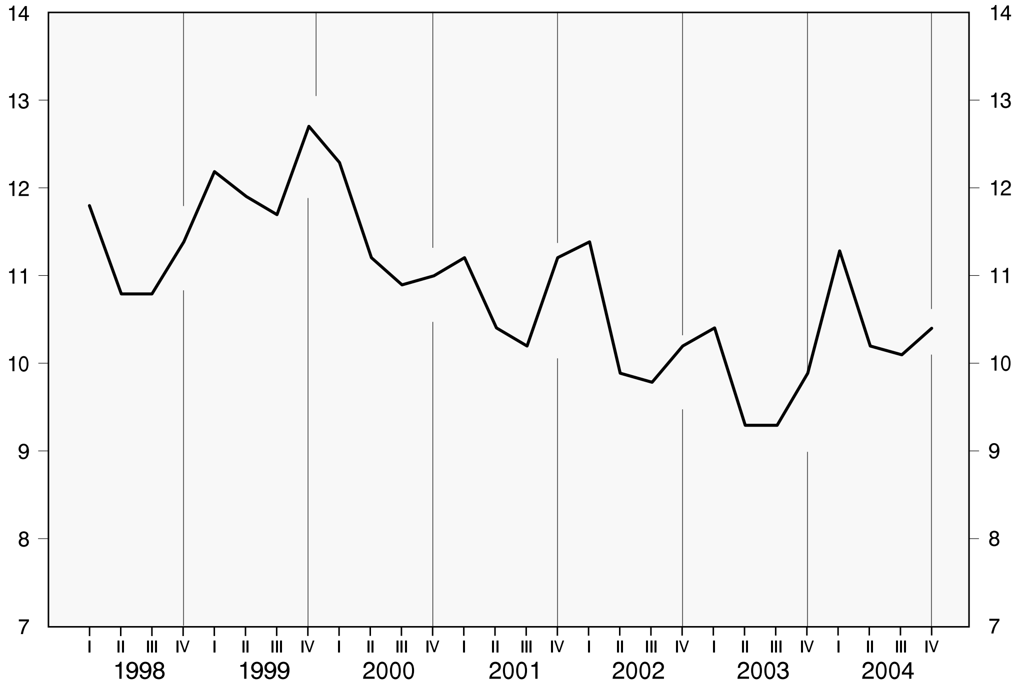
of the basic continuing education and the first important job.[1] Specifically for women, this period is 31 months, while for men, owing to military service, this period is longer and amounts to 39 months. Compared with other European countries, it seems that in Greece, as in Italy and Spain, the period between education and work is one of the longest.

Along with the inability of young people to find work, there seem to be vacant jobs in enterprises. This fact is evidenced both by the NSSG job vacancy survey[2] and the

CHART III.9

TOTAL UNEMPLOYMENT RATE (1998 - 2004)

(PERCENTAGES OF THE LABOUR FORCE)



Source: NSSG, Labour Force Surveys. New revised data for 1998-2004, published in January 2005.

Federation of Greek Industries (SEB)[3] survey on business demand for highly-skilled personnel. The NSSG survey, the latest data of which refer to the fourth quarter of 2003,

1 This survey defines "Basic Continuing Education" as the education that began with primary education and continues without any interruptions of more than one year. The "First Important Job" is the job which was taken after the person completed the basic continuing education, had a minimum length of six months and involved a weekly employment of at least 20 hours. There are, of course, some reservations as to whether these concepts were properly interpreted during the survey, given that no person in Greece is shown to have interrupted the basic continuing education for more than one year (C. Iannelli, 2002, *Evaluation and analyses of the LFS 2000 ad hoc module data on school-to-work transitions*).

2 NSSG, Quarterly Job Vacancy Survey, fourth quarter of 2003.

3 SEB, "Survey on enterprises' needs for highly-skilled personnel during the three-year period 2005-2007", June 2004.

TABLE III.12

POPULATION, LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT: SECOND QUARTER

(Thousand persons)

	Population					Labour force					Employed					Unemployed					Unemployment rate				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Men and women																									
– total (aged 15 and over)	8,831	8,898	8,958	9,009	9,057	4,617	4,582	4,652	4,728	4,823	4,098	4,103	4,190	4,287	4,330	5,19	4,78	4,62	4,42	4,93	11.2	10.4	9.9	9.3	10.2
– aged 15-64	7,074	7,098	7,109	7,118	7,127	4,522	4,489	4,563	4,634	4,742	4,004	4,012	4,102	4,193	4,250	5,18	4,77	4,61	4,41	4,92	11.5	10.6	10.1	9.5	10.4
– aged 15-24	1,453	1,426	1,374	1,324	1,279	563	520	499	463	477	398	375	369	345	351	1,64	1,46	1,30	1,19	1,26	29.2	28.0	26.1	25.6	26.5
– aged 25 and over	7,378	7,473	7,583	7,685	7,778	4,054	4,061	4,153	4,265	4,346	3,699	3,729	3,821	3,942	3,979	3,55	3,33	3,32	3,23	3,67	8.8	8.2	8.0	7.6	8.4
Men																									
– total (aged 15 and over)	4,293	4,326	4,356	4,382	4,406	2,785	2,774	2,803	2,837	2,862	2,578	2,582	2,622	2,666	2,680	2,07	1,91	1,81	1,71	1,82	7.4	6.9	6.4	6.0	6.4
– aged 15-64	3,504	3,518	3,528	3,536	3,544	2,718	2,710	2,738	2,768	2,803	2,511	2,519	2,558	2,598	2,621	2,06	1,90	1,80	1,70	1,82	7.6	7.0	6.6	6.1	6.5
– aged 15-24	736	721	693	665	641	307	282	275	258	259	240	223	222	211	211	67	59	52	46	49	21.9	20.9	19.0	18.0	18.7
– aged 25 and over	3,556	3,605	3,664	3,717	3,765	2,478	2,492	2,528	2,579	2,603	2,338	2,359	2,400	2,455	2,469	1,40	1,33	1,28	1,25	1,34	5.7	5.3	5.1	4.8	5.1
Women																									
– total (aged 15 and over)	4,538	4,572	4,601	4,627	4,651	1,832	1,808	1,849	1,892	1,961	1,520	1,521	1,568	1,621	1,650	3,12	2,87	2,82	2,71	3,11	17.0	15.9	15.2	14.3	15.9
– aged 15-64	3,570	3,580	3,582	3,583	3,583	1,805	1,780	1,826	1,866	1,940	1,493	1,493	1,544	1,595	1,629	3,12	2,87	2,82	2,71	3,10	17.3	16.1	15.4	14.5	16.0
– aged 15-24	717	704	682	659	638	256	238	225	206	218	158	152	147	133	140	97	87	78	72	78	38.0	36.3	34.7	35.2	35.7
– aged 25 and over	3,821	3,868	3,920	3,968	4,013	1,577	1,570	1,624	1,686	1,744	1,362	1,369	1,421	1,487	1,510	2,15	2,00	2,03	1,99	2,33	13.6	12.8	12.5	11.8	13.4

Source: NSSG, Labour Force Survey, 2000-2004. New revised data for 2000-2003, published in January 2005. New sample in 2004.

shows that, despite high unemployment, there were vacancies in several branches of the economy. By way of illustration, vacancies as a percentage of total jobs were close to 4% in hotels and restaurants and about 3% in wholesale and retail trade. The SEB survey, conducted in the second quarter of 2004 in a sample of 374 mostly manufacturing enterprises, showed that enterprises were not content with the educational system, because they thought that it does not equip young executives with the required knowledge and skills. Some 48% of the enterprises stated that, in their region, there is a shortage in certain tertiary education skills and 60% stated a shortage in pre-tertiary education skills.

The unemployment rate of women continues to be very high (16.2%) and their length of unemployment is much bigger compared to that of men. Thus, while the percentage of long-term unemployed men is 48.5%, long-term unemployed women exceed 60%.[1]

The unemployment rate differs significantly by geographical region. The lowest unemployment rates are recorded in Crete (7.7%), Southern Aegean (8.7%) and Attica (9.1%) and the highest ones are recorded in Western Macedonia (16.6%), Eastern Macedonia (13.2%) and Sterea Ellada (12.8%).[2]

As regards the outlook for employment, the Ministry of Economy and Finance (Updated Stability and Growth Programme 2004-2007, March 2005) forecasts that employment in 2005 will grow by 1.5% and that the unemployment rate will fall by 0.5 percentage point (the worst-case scenario of the Programme anticipates a 0.9% increase in employment and an unchanged unemployment rate). Given that, as mentioned in the Programme, recruitment policy in the public sector will be "extremely restrictive" and that certain "public" enterprises (e.g. OTE) plan "voluntary early retirement" programmes for their employees, these forecasts suggest that a significant rise is anticipated in employment in the private sector.

However, enterprises themselves appear to be less optimistic about the medium-term outlook for employment. The latest available data from the IOBE business surveys show that employment is expected to fall in construction, services and retail trade (see Table III.13 and Chart III.10). Only in industry do firms forecast that employment will remain unchanged, although the rate of industrial capacity utilisation has declined significantly (to 70.7 in the first quarter of 2005, from 75.9 in the last quarter of 2004).

However, employment may develop more favourably, if account is taken of the positive effects which will stem from the implementation of the tax and development laws,[3] the more effective absorption of CSF III funds, the simplification of procedures for

1 Data for the second quarter of 2004.

2 There are also significant differences in the length of unemployment. Unemployment in Western Macedonia is of structural nature and is associated with developments in declining branches of activity; as a result, over 70% of jobless persons are long-term unemployed. By contrast, in the Ionian islands, 55% of the unemployed have remained jobless for less than 5 months and the percentage of long-term unemployed (21.5%) is much lower that that for the country as a whole (data for the second quarter of 2004).

3 Apart from the increase in employment anticipated from the general rise in business activity pursued by the development law (3299/2004), a boost to employment is expected by the introduction, for the first time, of a subsidy of the labour cost of jobs created by the investments governed by this law.

business start-ups in manufacturing[1] and the promotion of public-private partnerships (PPPs) in construction. It is mentioned by way of illustration that, in the IOBE business survey (see Table III.13), construction companies express a very negative estimate, but the Construction Economy Institute (IOK) underlines that the rate of participation of the construction branch in GDP may be raised through the PPPs and by increasing the absorption of CSF III funds.[2] In any case, it is more likely that the projected rise in GDP will absorb only part of the increase in the labour force and, therefore, the unemployment rate will remain unchanged in 2005.

In an effort to combat unemployment, the Ministry of Employment and Social Protection continues to implement active policies for the promotion of employment, both through OAED programmes (training courses, programmes for the acquisition of work experience – "Stage" etc.)[3] and via the provisions of Law 3227/2004 ("Measures to address unemployment and other provisions"). The Ministry of Employment places special emphasis on the personalised approach to the unemployed. To this end, the National

TABLE III.13
BUSINESS EXPECTATIONS FOR EMPLOYMENT
(Weighted percentage balances)

	March 2005	1998-2004 average	1998-2004 maximum	1998-2004 minimum
Industry	0	–1	14	–17
Construction	–32	26	60	–64
Services	–8	3	38	–37
Retail trade	–3	13	56	–13

Source: IOBE Business Surveys.

Action Plan for Employment (NAPE), submitted to Parliament in autumn 2004, provides for the enhancement of Employment Promotion Centres (KPAs) by hiring 200 more employment advisers and the re-training and continuous updating of the advisers, the purpose being to complete within the next two years the coverage of all unemployed persons in the country with a fully personalised approach. The PAEP S.A.-OAED data show an increase in 2004, especially in the last quarter, in the percentage of registered unemployed enjoying a personalised approach. However, the latter needs to be extended to all the

1 Law 3325/2005 "Establishment and operation of industrial and small-scale manufacturing firms in the framework of sustainable growth, and other provisions".

2 Giannaros, I. (2004), "Review of the course of the construction branch and approach of the business environment to be shaped in the market after the 2004 Olympics", IOK Meeting on "Shaping business environment in the construction branch after 2004", July 2004. Also see IOK, *Cooperation between the Public and the Private Sector*, January 2005.

3 The "Stage" programmes are also extended to broad public sector entities and in early 2005 a notice was published, calling for the expression of interest in participation of about 7,300 unemployed in the work experience acquisition programme implemented by the Ministry of Health and Welfare, social security organisations, prefectures, local authorities and non-profit making legal persons in private law.

unemployed, especially those with lower educational levels, who, according to the data, are not adequately covered. The NAPE also provides for the simplification of procedures for inclusion in the OAED programmes, since current bureaucratic procedures discourage unemployed persons and enterprises from contacting OAED. It is also scheduled to support OAED offices with 200 administrative support staff and 37 computer specialists and improve the information systems of OAED and PAEP S.A.

CHART III.10

BUSINESS FORECASTS[1] FOR EMPLOYMENT

(PERCENTAGE BALANCES)

1 Firms were asked to assess the prospect of an increase in their number of employees over the coming period.
2 Excluding banks and retail trade firms.

Source: IOBE, Business Surveys.

To deal with the mismatch between supply to, and demand for, labour, the NAPE provides for the improvement of information flows on job vacancies and OAED actions through information campaigns and the Organisation's website. To support geographical mobility, the rent subsidy of unemployed persons who move from their place of residence was increased.[1]

Law 3250/2004 was passed to support part-time employment – in replacement of Law 3174/2003; it aims to simplify the procedure for hiring part-time employees in the public sector, local authorities and legal persons in public law and to expand, under cer-

1 Joint Ministerial Decision 50233/3 May 2004.

tain restrictions, part-time employment to other services as well (in addition to those considered as social services).

Emphasis is also placed on on-the-job training, *inter alia* through the training of 25,000 persons working in small and very small enterprises, financed by the Account for Employment and Vocational Training (LAEK).[1] In addition, the new tax law offers incentives to enterprises for the training of their personnel, since it provides for the deduction (for taxation purposes) of the training costs from their gross revenue.[2]

Another objective of the Ministry of Development is to restrict undeclared employment; this could contribute, in the medium-term, to increasing Social Insurance Institute (IKA) revenue and thus reducing employers' statutory contributions. To this end, it was decided in October 2004 to simplify the procedure for the issuance of residence permits to foreign workers.[3]

An overview of the Greek labour market shows that significant challenges remain, such as the low employment rate and high unemployment, in particular among the young and women, and the relatively low levels of labour productivity (also see Chapter II.9.4). These problems stress the need to implement policies for boosting entrepreneurship, such as those mentioned above, and measures to reduce structural unemployment, through the timely intervention in declining branches of the Greek economy (e.g. through retraining programmes, lifelong education) and the better matching of demanded and supplied skills and knowledge.

1 NAPE (2004), p. 20.
2 Law 3296/2004, Article 9.
3 Decision of the Deputy Minister of Interior, Public Administration and Decentralisation (Government Gazette 1550/B/15 October 2004).

APPENDIX TO CHAPTER III

THE SECTORAL COMPOSITION OF THE GREEK ECONOMY AND ITS EVOLUTION SINCE 1960

Developments in the sectoral composition of the economy are very interesting, since they affect the course of macroeconomic aggregates and the environment in which monetary and, especially, fiscal policies are implemented. Greece's association agreement with the European Economic Community was signed in 1961, in a period of high growth rates, while the significant structural changes that had begun in the 1950s seem to have shaped the structure of the Greek economy —at least at the level of basic sectors— to date. The main feature of the period from 1960 to the early 1980s (see Table III.A1a) was the gradual decline of the agricultural sector's share in the overall product, while significant ground was gained by manufacturing and energy, although the latter's share in GDP is low (approximately 2%). The services sector, mainly trade, housing and central government (including health and education services), represented over 50% of GDP. In the same period there was a small rise in the participation of the public sector in total GDP. Concerning business services, an increase was recorded in banking, insurance and "other" services.

With Greece's accession to the EU in 1981 and the lifting of restrictions on commercial transactions and the mobility of production factors, the Greek economy, an initially closed economy (the overall external trade in 1960 did not exceed 28% of GDP), entered into a broad market for goods and services and an environment more competitive than in the past. In the period that followed, it is hard to isolate the impact of European integration from the effects of other factors, especially the international economic environment and the domestic economic policy options. In general, the share of manufacturing in total GDP was reduced, while the sectors of public administration and social services continued their expansion, which had started before 1981 (see Tables III.A1a and III.A1b);[1] however, it appears that Greece's accession to the EU did not bring about any significant changes in the composition of GDP.

The decline in the share of manufacturing in GDP is due to the fact that the contribution of traditional branches, especially textiles, to GDP decreased without being offset by the development of other manufacturing activities. At the same time, the expansion of the services sector became significant and its share increased to approximately 70% of total value added in 2002. Concerning business services in particular, a significant increase was recorded, especially in the 1990s, and, as a result, this sector accounted for almost 50% of total value added in 2004 (see Table III.A1b). Within this sector, the most impor-

1 Two different sets of data are used to cover the period up to 2004, due to changes in the method of compilation of the National Accounts. The definitions of various branches are not the same and, therefore, the statistical series are not fully continuous and comparable. This is taken into account in this analysis, the purpose of which is to describe certain general trends. Moreover, the fact that both data sets cover the period 1988-1997 contributes to the fuller presentation of these trends.

TABLE III.A1a
GDP BREAKDOWN AT FACTOR PRICES BY BRANCH OF ECONOMIC ACTIVITY
(Percentage share of each branch in the total)

	1960	1965	1970	1975	1980	1985	1990	1995	1997
Agriculture	17.9	19.4	15.7	13.9	15.1	11.8	10.6	9.8	8.2
Mining and quarrying	0.6	0.6	0.7	0.7	0.8	1.5	0.8	0.7	0.6
Electricity, natural gas, water supply	1.3	1.6	1.9	1.5	1.5	2.5	2.6	2.2	2.0
Manufacturing	14.7	14.5	17.5	18.5	17.9	17.0	15.2	12.7	13.0
Construction	7.4	8.3	9.8	8.2	9.4	7.4	8.0	6.6	7.4
Business services	47.6	45.8	44.2	46.0	43.3	44.7	45.8	50.8	52.6
Transport, communications	5.7	5.6	5.9	6.7	6.1	5.8	5.4	6.1	6.5
Trade	14.7	14.9	13.7	16.3	14.6	15.3	14.8	14.2	14.2
Banks, insurance, etc.	2.8	2.9	2.9	3.6	3.2	3.2	3.4	3.9	4.4
Housing	16.1	14.3	13.0	11.7	10.8	10.3	11.7	14.0	14.1
Other business services	8.3	8.1	8.7	7.7	8.6	10.1	10.6	12.6	13.4
Public administration and social services	10.4	9.5	9.8	11.1	12.0	15.2	17.0	17.3	16.4

Source: Ministry of Economy and Finance, "The Greek Economy, 1960-1997", Athens 1998.

TABLE III.A1b
GROSS VALUE ADDED BREAKDOWN AT BASIC PRICES BY BRANCH OF ECONOMIC ACTIVITY
(Percentage share of each branch in the total)

	1988	1990	1995	2000	2001	2002	2003	2004
Agriculture	11.9	10.5	9.9	7.3	7.0	7.1	6.7	6.4
Mining and quarrying	1.0	0.8	0.6	0.6	0.6	0.7	0.6	0.6
Electricity, natural gas, water supply	2.5	2.6	2.4	1.8	1.8	1.8	1.8	1.7
Manufacturing	15.7	15.5	13.0	12.0	11.9	11.6	11.5	11.4
Construction	7.6	8.0	6.4	7.5	8.4	8.2	8.8	8.6
Business services	44.0	43.4	48.0	50.6	50.3	49.1	49.7	49.5
Transport, communications	6.6	5.6	6.7	8.8	8.4	8.6	8.5	9.0
Trade, hotels & restaurants	19.8	20.1	20.1	20.2	20.6	19.6	20.3	19.6
Financial services	3.4	3.4	4.2	5.7	5.7	5.1	5.2	5.1
Other business services	14.2	14.3	17.0	15.9	15.6	15.8	15.7	15.8
Public administration and social services	17.2	19.2	19.7	20.1	20.1	21.4	20.9	21.9

Source: NSSG-National Accounts.

tant branches have been and continue to be “trade, hotels and restaurants” and “other business services” (including real estate management, leasing of machinery and equipment, information services, research and development). However, the other branches increased their participation, although they still represent a relatively small percentage.

TABLE III.A2

MANUFACTURING: STRUCTURE BY INDUSTRY

(Percentage of each industry in the total gross value added of manufacturing)

	1988	1990	1995	2000	2001	2002	2003
Food, beverages, tobacco	19.2	19.1	22.5	20.6	21.5	21.7	22.3
Textiles, wearing apparel	25.3	25.3	20.1	15.2	14.0	14.0	13.9
Leather	3.1	2.9	2.7	2.1	1.9	1.7	1.6
Wood (excl. furniture)	3.4	3.7	3.2	2.7	2.5	2.2	2.4
Paper and paper products, publishing	5.0	5.8	6.4	7.0	7.5	8.3	8.2
Refined petroleum products	3.0	1.9	4.0	8.7	7.7	7.6	7.0
Chemicals	5.6	6.3	6.5	5.4	5.9	5.6	5.6
Plastics	2.6	2.7	2.9	2.6	2.8	2.8	2.7
Non-metallic minerals	6.2	6.5	5.5	7.4	7.7	8.3	8.4
Basic metals and metal products	9.9	9.2	8.7	9.9	9.5	9.1	9.4
Machinery and equipment	6.6	6.0	6.2	7.2	7.6	7.1	6.8
Transport equipment	3.6	4.4	4.3	4.4	4.9	5.8	5.6
Other products (incl. furniture)	5.6	6.1	7.0	6.7	6.5	5.9	6.0

Source: NSSG-National Accounts.

TABLE III.A3

EMPLOYMENT: BREAKDOWN BY BRANCH OF ECONOMIC ACTIVITY

(Percentage share of each branch)

	1988	1990	1995	2000	2001	2002	2003
Agriculture	26.6	24.3	19.6	17.3	16.8	16.2	15.5
Mining and quarrying	0.6	0.6	0.4	0.4	0.4	0.4	0.3
Electricity, natural gas, water supply	1.0	1.0	1.1	1.1	1.0	1.0	1.1
Manufacturing	18.5	18.4	16.4	15.3	15.3	14.8	14.3
Construction	6.1	6.4	6.6	7.1	7.3	7.5	8.1
Business services	28.0	29.6	34.2	36.2	36.5	37.1	37.6
Transport, communications	6.6	6.5	6.9	6.8	6.8	6.7	6.7
Trade, hotels & restaurants	16.7	17.3	20.3	21.3	21.2	21.7	22.0
Financial services	1.9	2.0	2.2	2.4	2.4	2.3	2.4
Other business services	2.8	3.8	4.8	5.7	6.1	6.4	6.5
Public administration and social services	19.0	19.8	21.7	22.7	22.7	23.0	23.2

Source: NSSG-National Accounts.

Developments in the composition of GDP have also affected employment. The gradual decline of the relative importance of the agricultural sector and manufacturing is accompanied by a decrease in the shares of these sectors in employment (see Table III.A3). Specifically, in manufacturing, the decline in employment is associated, on the one hand, with the shrinkage of traditional branches (food, beverages, textiles) and, on the

TABLE III.A4

GROSS VALUE ADDED IN THE EU: BREAKDOWN BY BRANCH OF ECONOMIC ACTIVITY

(Percentage share of each branch in the total)

	Agriculture	Manufacturing	Business services	Construction	Other branches
1990					
Belgium	1.4	21.5	44.4	5.3	27.4
Germany	1.4	26.1	41.5	6.8	24.1
Greece	8.5	14.7	49.4	7.9	19.5
Spain	5.9	18.5	44.8	8.0	22.8
France	3.2	18.3	48.3	6.7	23.4
Ireland	9.6	24.1	39.8	5.2	21.3
Italy	3.1	21.9	47.0	5.8	22.2
Luxembourg	1.0	14.5	49.1	6.7	28.7
Netherlands	3.3	17.9	43.2	6.3	29.2
Austria	2.3	20.7	44.2	7.0	25.9
Portugal	5.9	21.8	39.9	6.7	25.7
Finland	4.7	21.7	41.0	6.7	25.8
Euro area average	*2.9*	*21.8*	*44.6*	*6.5*	*24.2*
Denmark	3.4	16.9	45.9	5.1	28.7
Sweden	2.8	19.7	40.7	5.5	31.3
United Kingdom	2.0	22.6	45.0	6.0	24.4
EU-15 average	*2.8*	*21.8*	*44.6*	*6.4*	*24.5*
2001					
Belgium	1.5	20.6	46.3	4.9	26.6
Germany	1.2	20.1	48.0	4.8	25.8
Greece	8.1	12.4	54.8	7.6	17.1
Spain	4.0	18.7	45.7	8.1	23.5
France	3.1	19.2	48.7	4.3	24.6
Ireland	4.9	37.0	37.8	5.2	15.1
Italy	3.1	21.2	50.3	5.0	20.5
Luxembourg	0.6	11.5	56.3	5.6	26.1
Netherlands	3.0	16.9	49.6	5.2	25.3
Austria	2.4	21.2	46.7	7.1	22.6
Portugal	4.6	20.4	43.4	6.9	24.7
Finland	3.7	28.8	41.2	4.0	22.3
Euro area average	*2.5*	*19.8*	*48.2*	*5.3*	*24.1*
Denmark	3.7	16.6	48.4	4.3	27.0
Sweden	2.1	24.4	44.7	4.0	24.8
United Kingdom	1.3	18.3	50.9	4.8	24.7
EU-15 average	*2.4*	*19.7*	*48.5*	*5.2*	*24.3*

Source: MPC task force, "Sectoral specialisation in the EU: a macroeconomic perspective", ECB Occasional Paper No. 19, July 2004.

other hand, with the use of new production methods (less work-intensive). However, these branches continue to account for a large percentage of employment in manufacturing (approximately 44% in the last five years). In the services sector, apart from the significant increase in employment in public administration, the rise in the percentage of persons employed in business services is remarkable (especially in trade-hotels-restaurants and other business services).

The composition of the Greek economy by branch of economic activity compared with the other EU-15 countries in the period 1980-2001 is examined in an ECB study,[1] which focuses on the main features of the sectoral composition of EU economies and their changes in the framework of European integration, as well as their effects on the macroeconomic environment. In the period covered by the study, agriculture, manufacturing and constructions declined and business services increased in all 15 EU countries (see Table III.A4). Specifically in Greece, the share of manufacturing in the economy as a whole is lower than the EU average, while, despite their shrinkage, the agricultural and the business services sectors are bigger in Greece than the EU average. Concerning the sectoral specialisation of production activity, Greece appears to have the highest degree of specialisation compared with other EU countries, especially in the manufacturing sector *(low-technology products)*. In addition, in the services sector, Greece is among the most specialised countries in the branch of hotels-restaurants. The same study shows that there has been a significant reallocation of resources in Greece,[2] leading to the increase in the relative specialisation of the country in the above sectors.

1 MPC task force, "Sectoral specialisation in the EU: a macroeconomic perspective", ECB Occasional Paper No. 19, July 2004.

2 This last conclusion is based on employment data only.

IV. INFLATION, WAGES AND BUSINESS PROFITS

1. INFLATION

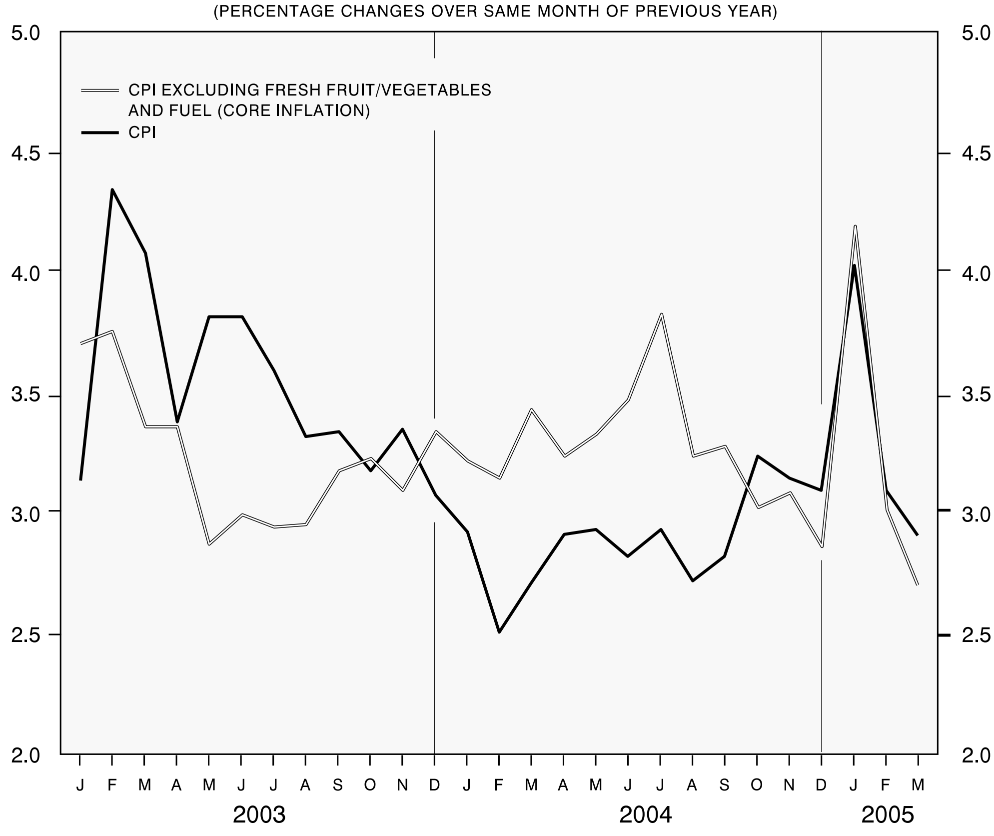
1.1 Inflation: developments and determinants in 2004

The average annual rate of increase in the Harmonised Index of Consumer Prices (HICP) eased to 3.0% in 2004 from 3.4% in 2003 (see Chart II.5), mainly due to a fall in fresh fruit and vegetable prices. During 2004, the annual rate of HICP increase fell gradually in the first nine months, but in the fourth quarter it stood at the same level as in the last quarter of 2003 (3.2%).

CHART IV.1

CONSUMER PRICE INDEX AND CORE INFLATION

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Source: Calculations based on NSSG data.

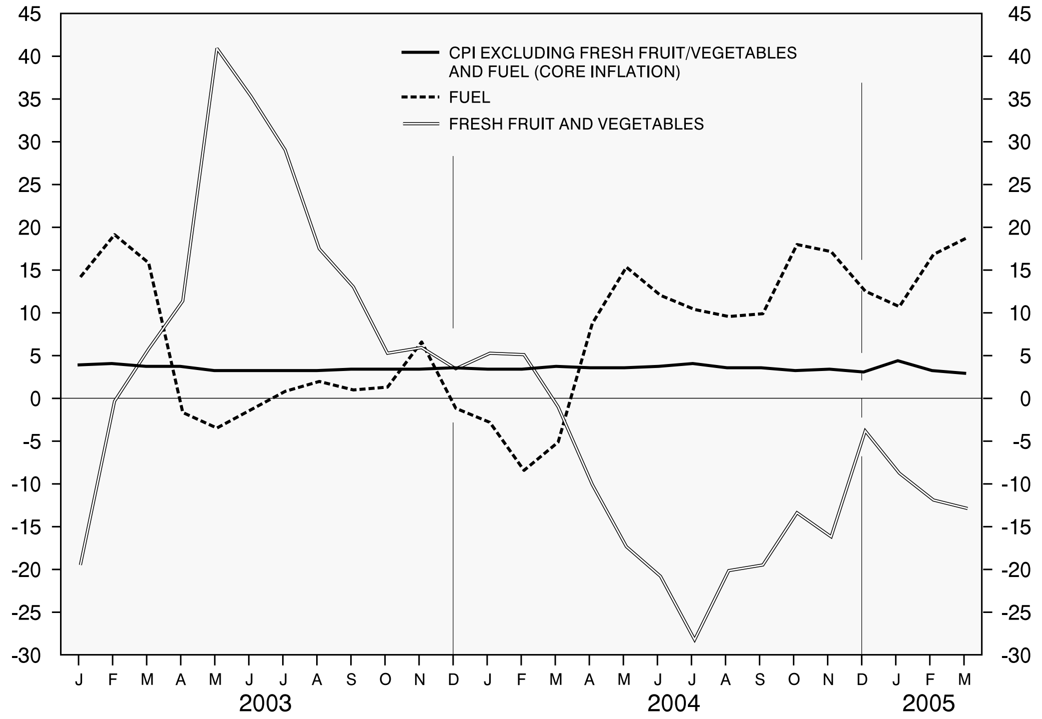
By contrast, core inflation, as measured by the average annual rate of change in the HICP excluding energy and unprocessed food (see Chart II.7), rose in 2004 to 3.4% on average, compared with 3.1% in 2003. Core inflation followed a steadily upward course from the second quarter of 2003 until the third quarter of 2004, but fell slightly in the final quarter of the year (to 3.2%).

Based on the Consumer Price Index (CPI), average annual inflation fell to 2.9% in 2004 from 3.5% in 2003. By contrast, core inflation, as measured here by the annual rate of change in the CPI excluding fuel and fresh fruit and vegetables, did not fall, remaining at 3.3% on average, compared with 3.2% in 2003 (see Chart IV.1).

CHART IV.2

CORE INFLATION, PRICES OF FRESH FRUIT/VEGETABLES AND FUEL

(ANNUAL PERCENTAGE CHANGES)

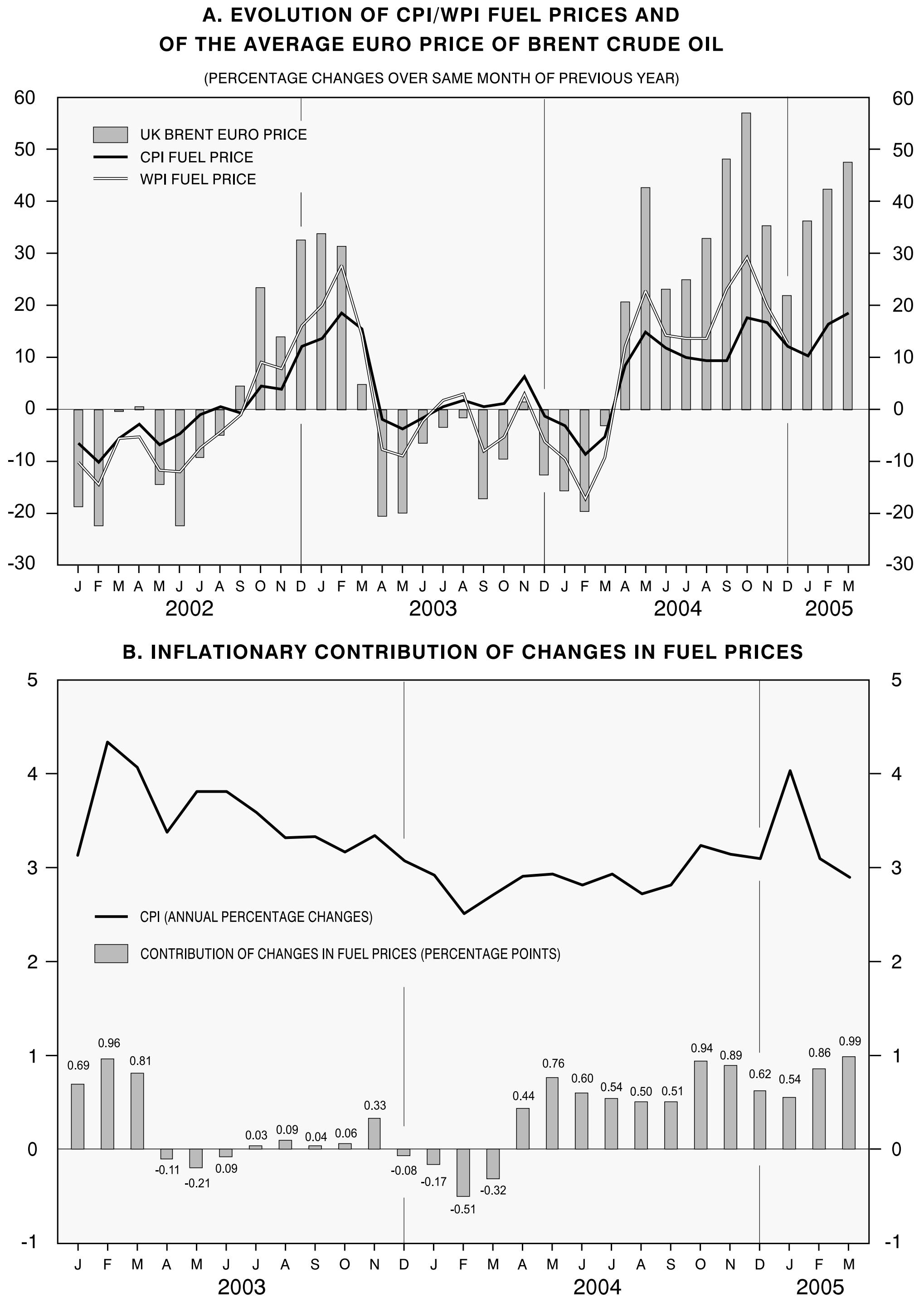


Source: Calculations based on NSSG data.

The slowdown in the average annual rate of increase in the HICP and the CPI in 2004 was almost entirely due to a substantial drop in unprocessed food prices —following three successive years of large increases— from the second quarter until the end of 2004,[1] thanks to exceptionally favourable weather conditions during this nine-month period (see Chart IV.2). The prices of fuels that are included in the CPI were down in the first quar-

1 *The average annual* rate of change in the CPI prices of fresh fruit and vegetables was negative in 2004 (11.9%), whereas in 2003 it had been positive (+10.7%).

CHART IV.3



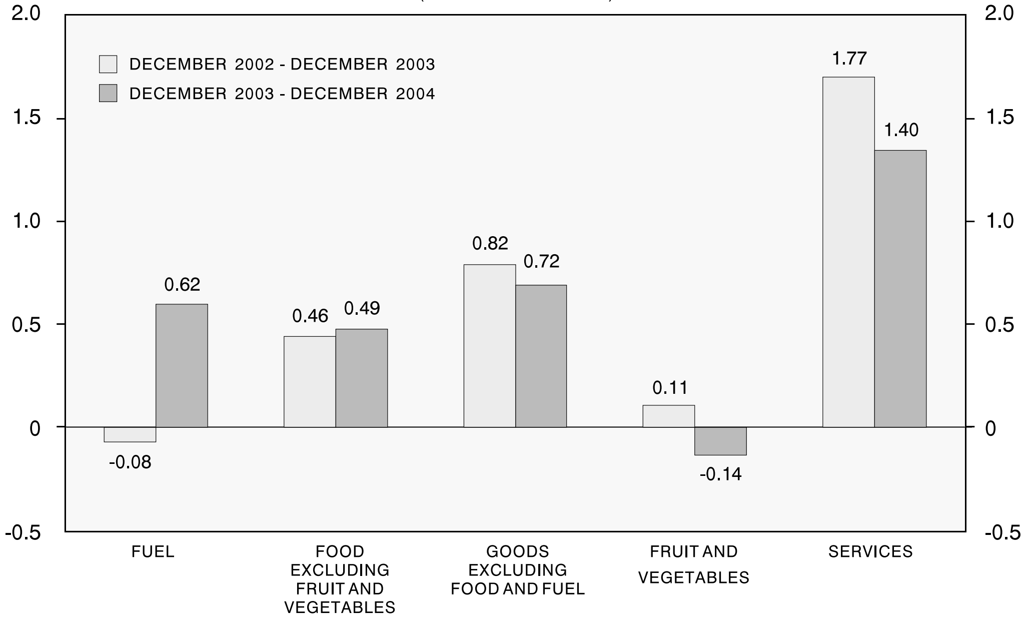
Source: Calculations based on NSSG data and, for crude oil prices (UK Brent), on US Department of Energy data.

ter of 2004 in comparison with the same period in 2003 (when international crude oil prices had reached a very high level as a result of uncertainty surrounding the then expected military conflict in Iraq). In 2004 as a whole, however, the CPI prices of fuels rose at an average annual rate of 7.5%, compared with 3.9% in 2003[1] (see Charts IV.3A and 3B). In particular, world prices of Brent oil in US dollars rose at a high average annual rate (33.5%) in 2004. However, due to the average annual increase of 10% in the euro exchange rate against the US dollar in 2004, Brent oil prices in euro rose at an average annual rate of 21.5%.[2]

CHART IV.4

CONTRIBUTION OF KEY COMPONENTS TO GREEK INFLATION

(PERCENTAGE POINTS)



Source: Calculations based on NSSG CPI data.

The increase in *core inflation* reflects the steeper rise in the prices of goods (excluding fuel and fresh fruit and vegetables),[3] which was only partly offset by the small slowdown in the average annual rate of increase in the prices of services (see Table IV.1).[4] The rate of increase, however, remained higher than the average inflation rate. As for goods,

1 In addition, wholesale fuel prices rose at an average annual rate of 9.6%, compared with 2.1% in 2003.

2 For the reasons behind the difference between the changes in the price of crude oil on the international market and the changes in retail or wholesale prices of oil products on the domestic market, see Bank of Greece, *Monetary Policy 2004-2005*, February 2005, Box III.1.

3 The annual rate of increase in goods prices (based on the CPI) was 2.8% in 2004, compared with 2.4% in 2003.

4 To 3.8% in 2004, from 4.1% in 2003, based on the HICP.

TABLE IV.1

INFLATION INDICATORS

(Annual percentage changes)

Year or quarter	Consumer Price Index								Wholesale Price Index					
	General index	Sub-indices							General index	Sub-indices				
		Goods	Services	CPI excluding fuel & fresh fruit and vegetables	CPI excluding food & fuel	Food and non-alcoholic beverages	Fresh fruit and vegetables	Fuel		Final domestic products for home consumption: Primary	Industrial	Industrial excluding fuel	Exported products	Imported products
1998	**4.8**	**3.9**	**6.2**	**5.3**	**5.7**	**4.4**	**7.0**	**–5.9**	**3.8**	**5.9**	**3.3**	**4.2**	**2.3**	**5.4**
1999	**2.6**	**1.7**	**4.0**	**2.9**	**3.0**	**2.4**	**1.8**	**–1.7**	**1.8**	**2.2**	**2.8**	**2.6**	**0.5**	**0.6**
2000	**3.2**	**3.4**	**2.8**	**2.0**	**2.0**	**1.9**	**1.4**	**26.8**	**6.6**	**1.5**	**5.2**	**3.3**	**12.3**	**6.4**
2001	**3.4**	**3.2**	**3.7**	**3.8**	**3.7**	**5.1**	**9.2**	**–4.8**	**2.3**	**10.0**	**2.7**	**3.4**	**0.7**	**1.9**
2002	**3.6**	**3.2**	**4.3**	**3.6**	**3.6**	**5.3**	**13.8**	**–1.7**	**2.4**	**11.2**	**2.6**	**3.0**	**1.9**	**0.4**
2003	**3.5**	**3.1**	**4.2**	**3.2**	**3.1**	**5.0**	**10.7**	**3.9**	**2.1**	**8.6**	**2.7**	**2.9**	**0.1**	**1.1**
2004	**2.9**	**2.3**	**3.8**	**3.3**	**3.2**	**0.5**	**–11.9**	**7.5**	**2.4**	**–1.7**	**4.5**	**4.1**	**3.4**	**0.5**
2001 Q_1	3.3	2.9	3.9	3.8	3.8	1.9	–5.7	3.4	3.1	–2.0	3.8	3.9	3.7	4.0
Q_2	3.7	3.7	3.7	3.8	3.6	4.6	7.4	2.4	3.6	8.8	4.0	3.8	3.4	2.8
Q_3	3.8	3.9	3.6	4.0	3.9	6.2	14.0	–4.4	2.2	12.2	2.9	3.5	0.0	1.8
Q_4	2.7	2.2	3.6	3.6	3.4	7.8	23.7	–18.7	0.2	22.2	0.3	2.4	–4.0	–0.8
2002 Q_1	4.0	4.0	3.9	3.3	3.4	9.9	43.2	–7.4	4.3	34.7	2.6	3.3	2.4	0.6
Q_2	3.5	3.0	4.4	3.9	3.9	4.7	9.0	–4.9	1.7	6.9	2.2	3.0	1.2	0.2
Q_3	3.5	2.7	4.6	3.7	3.6	4.0	4.5	–0.4	1.6	4.8	2.4	2.9	1.3	0.2
Q_4	3.6	3.0	4.5	3.5	3.5	2.9	1.0	6.7	2.0	0.6	3.1	2.7	2.7	0.6
2003 Q_1	3.8	3.4	4.5	3.6	3.4	2.3	–5.4	15.9	1.7	–2.5	3.6	2.8	1.1	1.5
Q_2	3.7	3.4	4.1	3.1	3.0	8.3	27.6	–2.4	2.2	19.6	1.9	2.6	–2.0	0.9
Q_3	3.4	2.9	4.1	3.0	2.9	6.1	19.2	0.9	2.2	12.2	2.4	2.8	0.2	1.0
Q_4	3.2	2.5	4.3	3.2	3.3	3.3	4.6	1.9	2.2	7.1	3.1	3.5	1.0	0.8
2004 Q_1	2.7	1.8	4.0	3.3	3.2	3.3	2.6	–5.7	1.8	4.6	2.8	3.7	1.6	0.0
Q_2	2.9	2.3	3.9	3.3	3.2	–0.7	–16.3	11.6	2.6	–8.1	5.4	4.8	5.6	0.6
Q_3	2.8	2.1	3.9	3.4	3.4	–1.3	–22.8	9.6	2.4	–6.0	4.9	4.2	4.1	0.5
Q_4	3.2	2.9	3.5	3.0	2.9	0.8	–11.3	15.5	2.8	3.1	4.7	3.7	2.5	0.9
2005 Q_1	3.3	3.1	3.6	3.3	3.5	–0.6	–11.5	15.1	. . .	. . .	. . .	. . .	. . .	. . .

Source: NSSG.

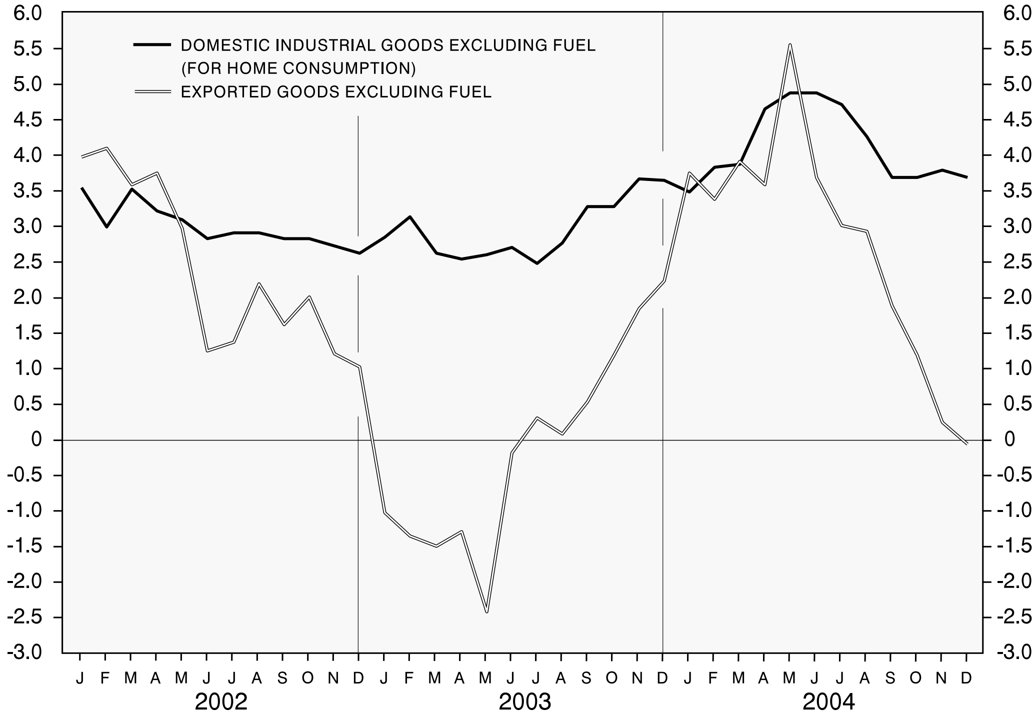
the growing inflationary pressures stemmed mainly from processed food, the prices of which rose at a high average annual rate in 2004 (4.8%, compared with 3.6% in 2003, on the basis of the HICP).[1]

Increased core inflation was combined with stronger inflationary pressures on wholesale prices. Indeed, wholesale prices of domestic industrial products for home consumption (excluding fuel) rose at an average annual rate of 4.1% in 2004, compared with 2.9% in 2003 (see Chart IV.5).

CHART IV.5

WHOLESALE PRICE INDEX IN GREECE

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Source: Calculations based on NSSG data.

The upward trend of core inflation, the considerably faster rise in wholesale prices of domestic industrial products for home consumption (in contrast to a limited rise in the prices of imported goods) and, finally, the faster increase in the prices at which exporters offer their products (whether expressed in euro or in foreign curren-

1 Prices for other industrial consumer goods (excluding energy products and food) rose just 2.3%, although this was still more than in 2003 (1.6%).

cies)[1] suggest that domestic inflationary pressures, combined with the lower inflation rates enjoyed by our trading partners and the appreciation of the euro, are having a negative effect on the price competitiveness[2] of Greek products, both in the domestic and in foreign markets.

These unfavourable developments in core inflation reflect the faster rise in unit labour costs in 2004 than in 2003 in the whole economy, combined with persisting pressures on the demand side.[3] They are also indirectly attributable to the effects of the rise in oil prices (which began in the second quarter of 2004) on the prices of other goods and services.

The growth rate of unit labour costs in the whole economy accelerated noticeably in 2004, whilst in the business sector it slowed down (see Section 2 of this Chapter), but it continued to exceed by a significant margin both the corresponding rate in the euro area (0.7%[4]) and the level which is initially consistent with price stability, i.e. inflation below but close to 2%.

As for demand-induced inflationary pressures, the growth rate of private consumption remained high in 2004 (see Chapter III for more details). Furthermore, according to the latest estimates available (see Chart IV.6),[5] the Greek economy's "output gap",[6]

1 The wholesale prices of goods (excluding fuel) for export rose at an average annual rate of 2.7% in 2004, whereas they had fallen by 0.2% in 2003. If these prices are expressed in foreign currency (using the effective exchange rate of the euro weighted on the basis of Greece's external trade), they are estimated to have risen at an average annual rate of 3.6% in 2004 (compared with 2.7% in 2003 – see also Table IV.2). It should be remembered that in the first 8-9 months of 2003, exporters were lowering or keeping unchanged their prices in euro (thus limiting the price increase in foreign currency that would have occurred as a result of the appreciation of the euro), although there are indications that this pricing policy has been abandoned since the last quarter of 2003, due partly to increased pressures as a result of production costs and partly to the fact that a significant increase was observed in commodity prices in the global market in 2004. However, under pressure from the rising euro, the annual rate of increase in the wholesale prices of exported products showed a marked slowdown from September 2004 and turned slightly negative in December.

2 The decline in the price competitiveness of Greek products is measured, *inter alia*, by the rise in the real effective exchange rate (EER) of the euro weighted on the basis of Greece's external trade. Specifically, it is estimated that: (a) the real EER of the euro calculated on the basis of relative unit labour costs in manufacturing rose at an average annual rate of almost 6.5% in 2004 (due primarily to the increase in relative labour costs and, secondarily, to the appreciation of the euro) and (b) the index calculated on the basis of relative consumer prices rose at an average annual rate of 2% (due almost as much to the increase in relative prices as to the appreciation of the euro).

3 Obviously, the evolution of unit labour costs, at least in the business sector, is not simply an "autonomous" cost factor. It also reflects the impact of changes in demand, as excess demand affects firms' wage policies and workers' bargaining power.

4 European Commission, *Spring 2005 Economic Forecasts*, April 2005.

5 Estimates from the European Commission (*Spring 2005 Economic Forecasts*, April 2005), the OECD (*Economic Outlook*, December 2004), the International Monetary Fund (*Greece – Staff Report for the 2004 Article IV Consultation*, February 2005) and various departments of the Bank of Greece.

6 The "output gap" is defined as the difference between the *level* of actual output (GDP) and the country's production capacity (*level* of potential GDP), as a percentage of the level of potential GDP. The "output gap" is not measurable directly. It is estimated by using various alternative methods. Estimates of potential output and the "output gap" are surrounded by a high degree of uncertainty. These factors must be taken into account when conclusions of analyses are considered. The change in the "output gap", which is measured in percentage points of GDP, is perhaps a more reliable indicator.

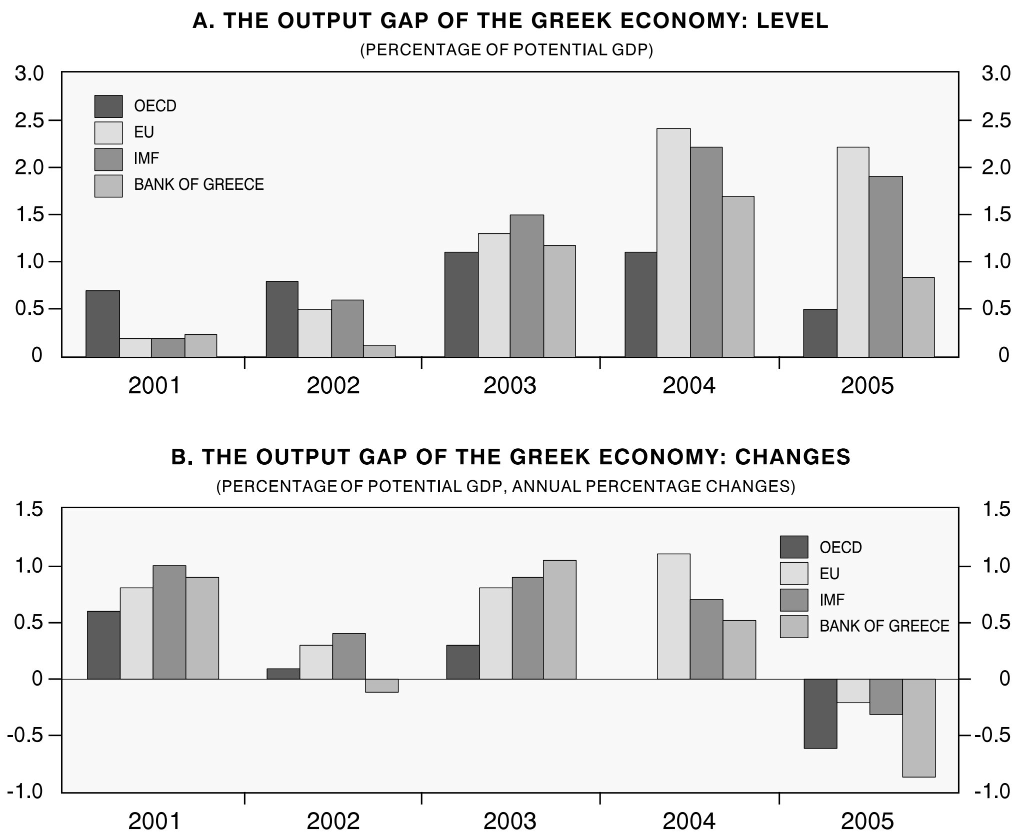
TABLE IV.2
EXPORT PRICE INDEX AND EFFECTIVE EXCHANGE RATE OF THE CURRENCY
(Percentage changes over same month of previous year)

	Exchange rate of the euro weighted by Greece's external trade	Wholesale prices of exported products			
		Total		Excluding oil	
		In euro	In foreign currency	In euro	In foreign currency
2003 Jan.	2.4	1.4	3.7	–1.0	1.3
Feb.	3.0	1.9	4.9	–1.4	1.6
March	3.2	0.0	3.2	–1.5	1.6
Apr.	3.3	–2.2	1.0	–1.3	1.9
May	3.9	–3.3	0.5	–2.4	1.4
June	3.4	–0.3	3.1	–0.2	3.2
July	2.8	0.7	3.5	0.3	3.1
Aug.	2.7	0.7	3.3	0.1	2.7
Sept.	2.4	–0.7	1.7	0.5	3.0
Oct.	2.5	0.2	2.8	1.2	3.7
Nov.	2.2	1.8	4.1	1.8	4.1
Dec.	2.6	1.1	3.7	2.2	4.9
Year average . . .	2.9	0.1	3.0	–0.2	2.7
2004 Jan.	2.3	1.9	4.2	3.7	6.1
Feb.	1.8	0.5	2.3	3.4	5.2
March	1.3	2.3	3.6	3.9	5.2
Apr.	0.5	4.6	5.2	3.6	4.1
May	–0.2	7.5	7.3	5.5	5.3
June	–0.3	4.8	4.5	3.7	3.3
July	0.2	4.1	4.3	3.0	3.2
Aug.	0.5	4.0	4.5	2.9	3.4
Sept.	0.8	4.2	5.1	1.9	2.7
Oct.	0.9	4.1	5.0	1.2	2.0
Nov.	1.3	2.2	3.4	0.2	1.5
Dec.	0.9	1.1	2.1	–0.1	0.9
Year average . . .	0.8	3.4	4.2	2.7	3.6

Source: Calculations based on NSSG and Bank of Greece data.

which was positive in the three-year period 2001-2003 (i.e. actual output exceeded potential output), continued to widen in 2004. Therefore, excess demand has *also* con-

CHART IV.6



Sources: OECD, *Economic Outlook*, December 2004.
European Commission, *Spring 2005 Economic Forecasts.*
IMF, *Greece: 2004 Article IV Consultation* - Staff Report.
Bank of Greece: Estimates of the Economic Research Department.

tributed to some degree to persistently high levels of inflation in recent years.[1] It should be noted, however, that, while increased inflationary pressures were expected to develop

1 Estimates that the Greek economy's "output gap" has been positive over the last four years seem, at first sight, inconsistent with the fact that the unemployment rate remains high and the employment rate relatively low. This contradiction may indicate that the utilisation of labour reserves with a view to increasing the country's potential output is impeded by labour and product market rigidities which lead to higher inflationary pressures and wider current account deficits. Moreover, in industry (which, however, accounts for only 11% of GDP), the degree of capacity utilisation (already slightly lower in 2003 at 76.5) fell further to 75.2 in 2004 (see Chart III.5), which implies that there is room for increasing capacity utilisation in this sector.

in 2004, especially in services, as a result of excess demand during the Olympic Games, such pressures did not eventually arise, thanks to efforts by the Ministry of Development to restrain price rises, the contribution of the social partners[1] and the smaller than expected number of foreign visitors, which all helped to moderate the consequences of excess demand.

It is also the case that, to some extent, inflationary pressures were mitigated by the appreciation of the euro, which limited the effects of imported inflation. Spe-

CHART IV.7

EFFECTIVE EXCHANGE RATE INDEX, WEIGHTED ON THE BASIS OF GREECE'S EXTERNAL TRADE

(1990=100, DAILY DATA)

* As of January 2001, changes in this index are relatively limited, since Greece's trade with the other euro area countries (which are among its most important trading partners) is carried out in euro.

Source: Bank of Greece.

cifically, despite rising less than in 2003 (the average annual rate was 0.8% in 2004 compared with 2.9% in 2003), the exchange rate of the euro, weighted on the basis of Greece's external trade (see Chart IV.7), helped to further contain the increase in the wholesale prices of imported goods (excluding fuel) to 0.3% in 2004, from 0.9% in 2003 (see Chart IV.8).

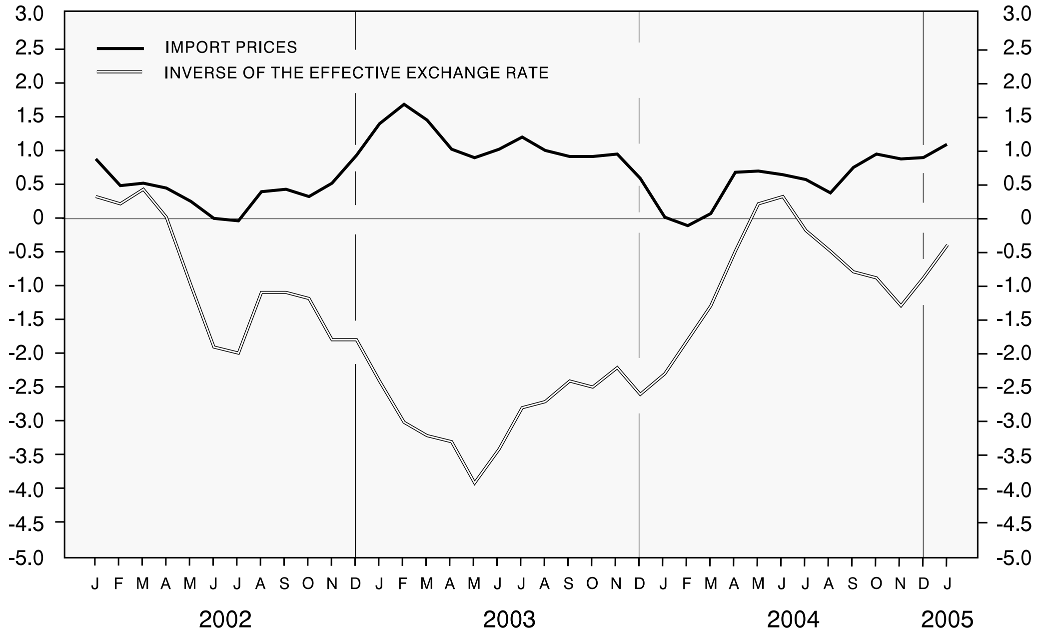
1 For more information concerning the agreement reached between the government on the one hand and producers and the social partners on the other, in order to ensure that the market would operate smoothly and prices remain stable during the Olympic and Paralympic Games, see the statements of the Minister of Development on 20 July 2004 and 15 September 2004.

Finally, according to the most recent data available for the whole year concerning a sample of non-financial corporations (see Section 3 of this Chapter), it appears that, in 2004, with the exception of certain branches, the growth of profit margins (which had begun in 2003 following a decline in profit margins in 2001-2002) came to a halt.[1]

CHART IV.8

IMPORT PRICE INDEX AND THE INVERSE OF THE NOMINAL EFFECTIVE EXCHANGE RATE OF THE CURRENCY

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Source: Calculations based on NSSG and Bank of Greece data.

1.2 The inflation differential between Greece and the euro area

The differential (based on the HICP) between inflation in Greece and average inflation in the euro area (2.1%) fell to 0.9 percentage point on average in 2004 from 1.3 percentage points in 2003, 1.6 percentage points in 2002 and 1.4 percentage points in 2001 (see Table IV.3 and Chart IV.9). The differential between core inflation in Greece and the corresponding figure in the euro area (2.1%), however, *increased* to 1.3 percentage points from 1.1 percentage points in 2003. In December 2004 the core inflation differential was 1.2 percentage points (3.1% compared with 1.9%).

1 According to these data, forecasts for the whole year differ from those made on the basis of a smaller sample of businesses for the development of profits and sales in the January-September 2004 period (see Bank of Greece, *Monetary Policy 2004-2005*, February 2005, p. 61).

TABLE IV.3

THE EVOLUTION OF PRICES IN GREECE AND THE EURO AREA

(Annual percentage changes)

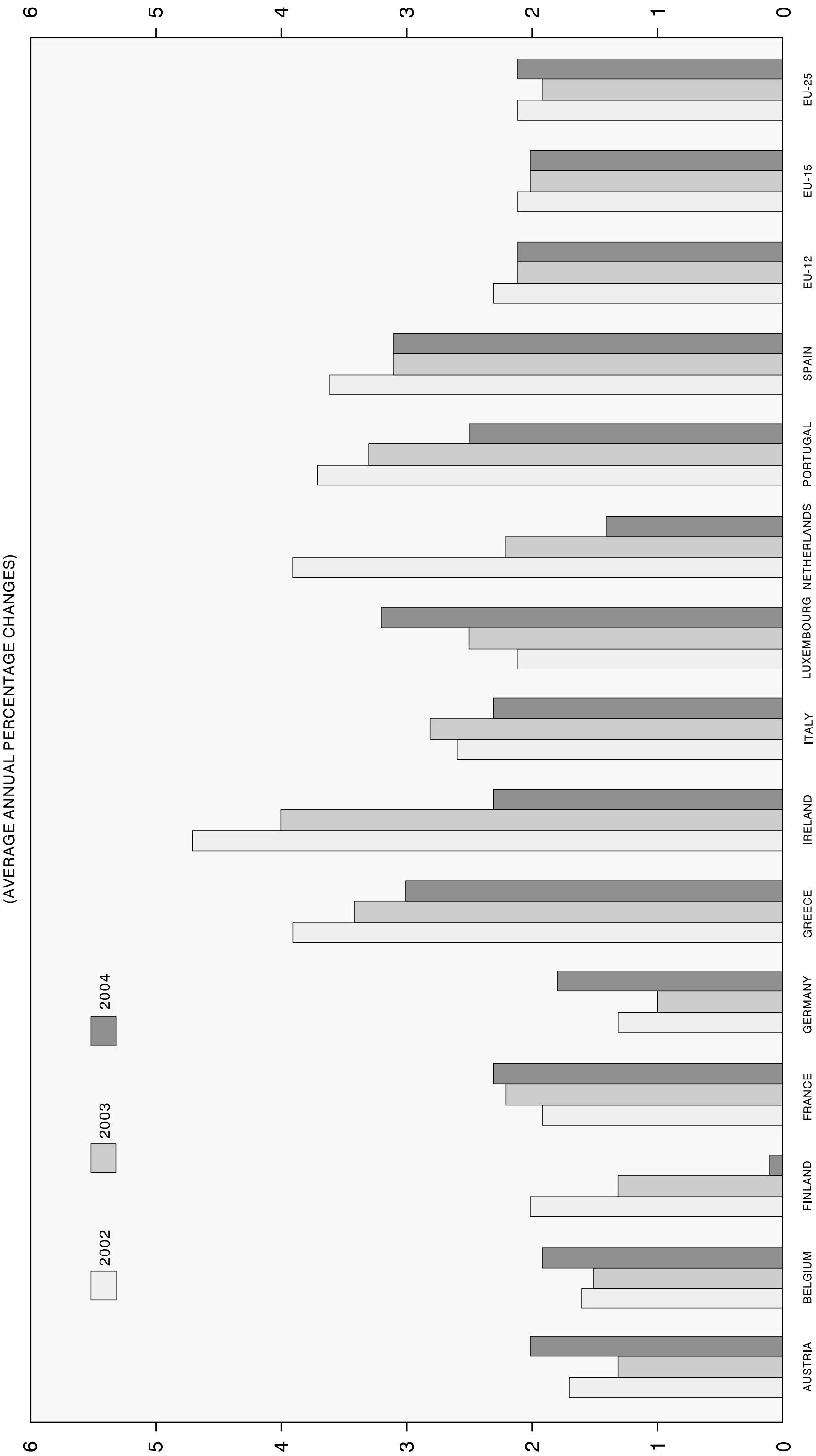
	2003	2004	2004 Aug.	2004 Sept.	2004 Oct.	2004 Nov.	2004 Dec.	2005 Jan.	2005 Feb.	2005 March
A. Euro area										
Harmonised Index of Consumer Prices (HICP) and its components										
General index	***2.1***	***2.1***	***2.3***	***2.1***	***2.4***	***2.2***	***2.4***	***1.9***	***2.1***	***2.1***
Goods	*1.8*	*1.8*	*2.1*	*1.8*	*2.2*	*2.0*	*2.0*	*1.6*	*1.8*	*1.9*
Food	2.8	2.3	2.1	1.4	1.2	1.0	2.0	1.5	1.9	1.5
Processed food[1]	3.3	3.4	3.6	3.3	2.8	2.3	3.2	2.8	2.6	1.6
Unprocessed food	2.2	0.7	–0.2	–1.5	–1.2	–1.0	0.0	–0.6	0.7	1.3
Industrial goods	1.2	1.6	2.1	2.0	2.7	2.5	2.0	1.7	1.8	2.1
Industrial goods excluding energy	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.5	0.2	0.4
Energy	3.0	4.5	6.5	6.4	9.8	8.7	6.9	6.2	7.7	8.8
Services	*2.5*	*2.6*	*2.7*	*2.6*	*2.6*	*2.7*	*2.7*	*2.4*	*2.4*	*2.5*
Producer prices in industry	**1.4**	**2.3**	**3.1**	**3.3**	**4.1**	**3.7**	**3.5**	**3.9**	**4.2**	...
International non-oil commodity prices[2]	**–4.5**	**10.8**	**11.0**	**6.9**	**3.7**	**0.4**	**–0.2**	**3.1**	**3.1**	**–0.4**
Oil prices (euro per barrel)[3]	**25.1**	**30.5**	**34.1**	**35.0**	**39.4**	**34.5**	**30.0**	**33.6**	**35.2**	**40.4**
B. Greece										
Harmonised Index of Consumer Prices (HICP) and its components										
General index	***3.4***	***3.0***	***2.8***	***2.9***	***3.3***	***3.2***	***3.1***	***4.2***	***3.2***	***2.9***
Goods	*3.0*	*2.5*	*2.1*	*2.4*	*3.2*	*2.9*	*2.9*	*4.6*	*2.8*	*2.4*
Food	4.8	1.6	0.6	–0.2	0.5	0.5	1.8	0.8	–0.4	–0.8
Processed food[1]	3.6	4.8	5.2	3.5	3.5	3.7	3.7	3.4	2.5	1.7
Unprocessed food	6.4	–2.9	–6.1	–5.9	–4.0	–4.4	–1.0	–3.0	–4.6	–4.4
Industrial goods	1.9	3.1	3.0	4.0	4.8	4.3	3.5	7.1	5.1	4.4
Industrial goods excluding energy	1.6	2.3	2.0	3.3	2.9	2.6	2.4	6.9	3.5	2.4
Energy	3.7	6.4	7.8	7.5	13.3	12.7	8.9	7.9	12.1	13.4
Services	*4.1*	*3.8*	*4.0*	*3.8*	*3.5*	*3.6*	*3.6*	*3.5*	*3.6*	*3.6*
Producer prices in industry for the domestic market	**2.3**	**3.5**	**4.5**	**4.4**	**5.2**	**4.1**	**3.0**	**3.9**	**4.6**	...

1 Including alcoholic beverages and tobacco.
2 In euro.
3 Brent blend (delivery after one month).
Source: Calculations based on ECB and NSSG data.

CHART IV.9

INFLATION IN EU COUNTRIES ON THE BASIS OF HICPs

(AVERAGE ANNUAL PERCENTAGE CHANGES)



Source: Eurostat.

To start with, the persistent inflation differential between Greece and the euro area may be attributed to macroeconomic factors:

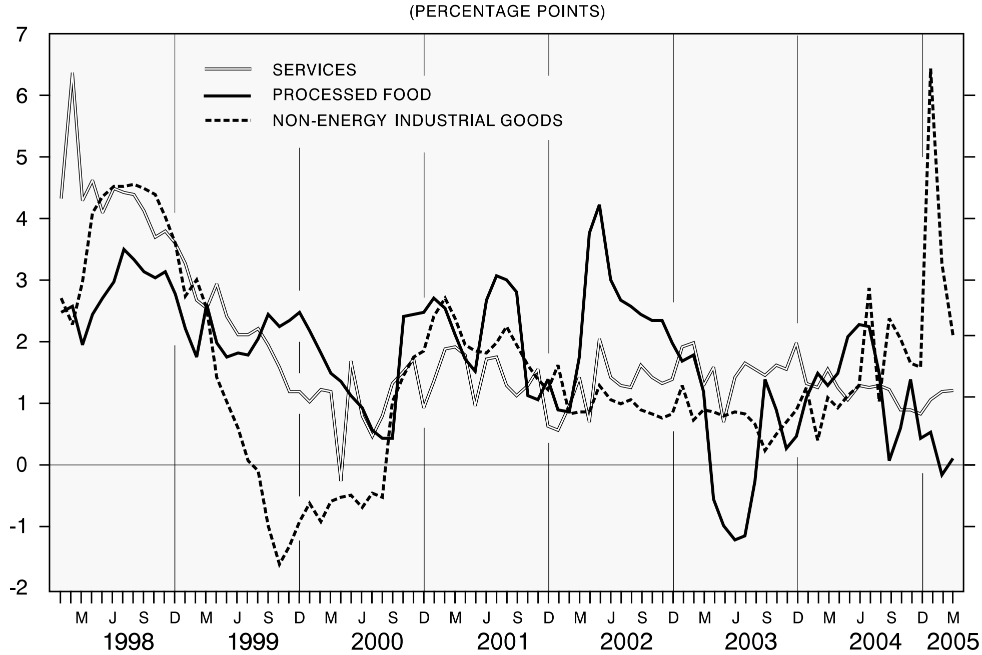
— First, to the high growth rate of domestic demand compared with supply, which is reflected in the positive "output gap" that has been observed in Greece since 2001 and is in part due to the expansionary fiscal policy pursued in Greece in recent years (see Chapter VIII). By contrast, the "output gap" in many other euro area countries is negative.

— Second, to the rise in unit labour costs in Greece, which was greater than the euro area average.

CHART IV.10

INFLATION DIFFERENTIALS BETWEEN GREECE AND THE EURO AREA (SELECTED SUB-INDICES)

(PERCENTAGE POINTS)



Source: Calculations based on Eurostat, NSSG and Bank of Greece data.

In addition, the differential of Greek inflation from that of the euro area can be attributed partly to the convergence of price and income levels, which is linked with the process of real convergence (the "Balassa-Samuelson effect").

Finally, the differential is also the result of structural weaknesses, such as greater downward price rigidities and inadequate competitive conditions in key domestic markets. Depending on the particular case, excess demand, price inelasticity of demand (for some articles) or the fact that a number of companies take advantage of their dominant market position, all lead to price increases greater than justified by developments in cost factors.

From the point of view of international competitiveness, the inflation differential is especially significant in the case of *tradable goods* (and —especially for Greece— tradable services, e.g. tourism). An analysis of price developments concerning the three groups of goods and services (non-energy industrial goods, processed food and services) that make up the "basket" used to calculate core inflation on a harmonised basis (see Chart IV.10) shows the following:[1]

— The positive differential between Greece and the euro area as to the average annual rate of increase in the prices of *non-energy industrial goods* (a major category of internationally tradable goods) rose from 0.8 percentage point in 2003 to 1.5 percentage points in 2004.

— As for *processed food* (another major category of internationally tradable goods), the positive inflation differential between Greece and the euro area widened much more, from just 0.3 percentage point in 2003 to 1.4 percentage points in 2004.

— For *services* (which, with the exception of services associated with tourism, are not internationally tradable), the positive differential remained high, but decreased nonetheless from 1.6 percentage points in 2003 to 1.2 percentage points in 2004. This was partly due to the success of efforts to restrain inflationary pressures during the Olympic Games.

During the four-year period 2001-2004, the differential between the cumulative increase in the prices of goods and services (excluding energy and unprocessed food) in Greece (15.0%) and the corresponding increase in euro area prices (8.8%) was more than six percentage points. This implies an appreciable loss of price competitiveness by Greece against other euro area countries. In addition, price competitiveness against non-euro area countries is affected by the continuing appreciation of the euro. Obviously —following the adoption of the single currency— such a loss of competitiveness cannot be dealt with by an exchange rate adjustment at the national level, but requires other policy measures.

1.3 Inflation prospects in 2005

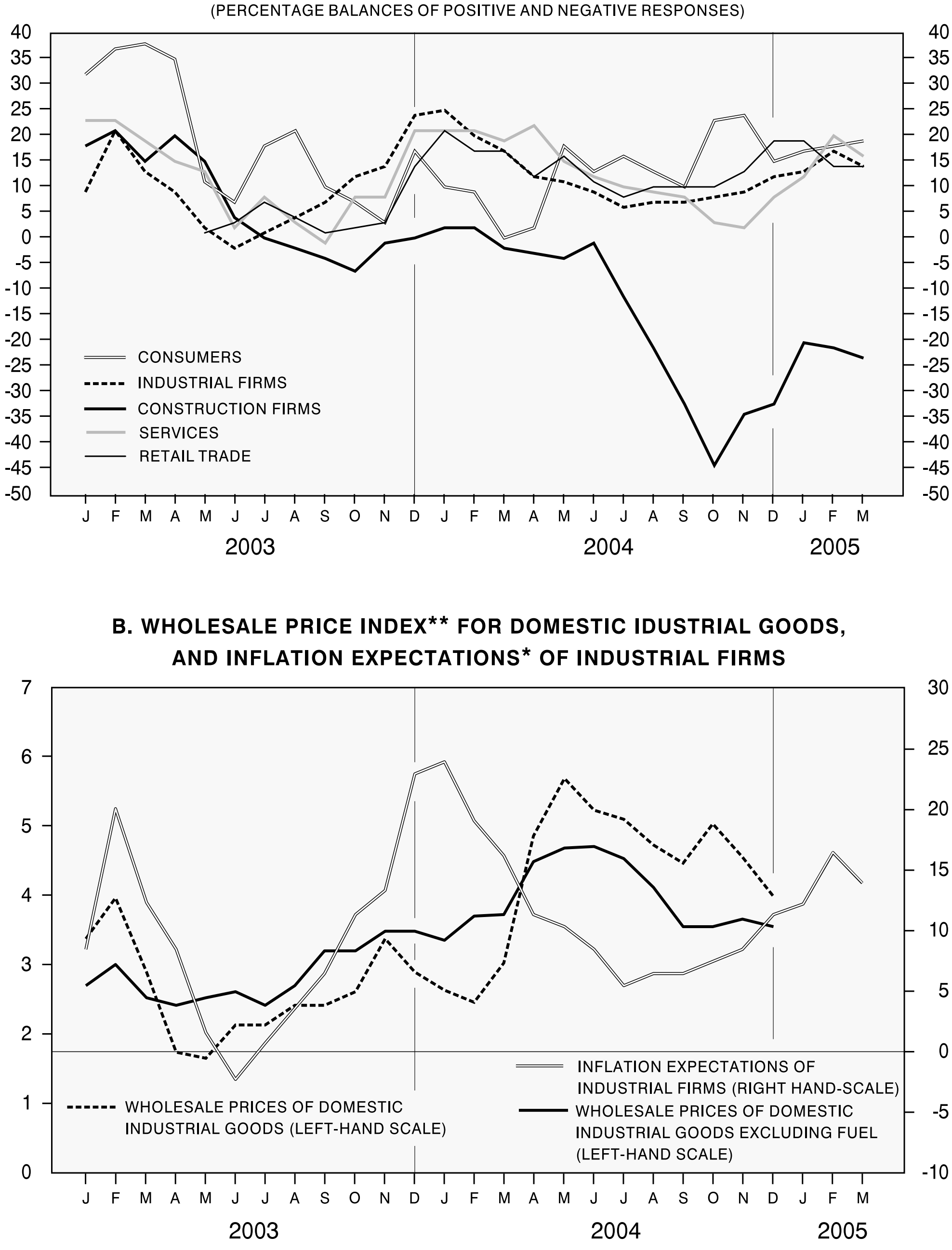
In the first quarter of the current year, inflation based on the HICP rose to 3.4% on average (from 3.2% in the last quarter of 2004), while on the basis of the Consumer Price Index (CPI) it rose to 3.3%. Core inflation, as measured by the annual rate of change in the HICP excluding energy and unprocessed food, also rose in the first quarter of the current year to reach an average of 3.6%. This development of inflation in the

1 An examination of inflation differentials using data on consumer prices is useful, but is not enough to allow conclusions to be drawn about the development of competitiveness. It should be pointed out that: (a) consumer price changes incorporate the effects of imported inflation and, therefore, any change in inflation differentials between Greece and the euro area may in part reflect differences between these effects, not simply differentials relating to "domestic" inflation, and (b) because enterprises change their profit margins, price changes do not give a full picture of changes in competitiveness.

CHART IV.11

A. INFLATION EXPECTATIONS* OF CONSUMERS AND BUSINESS FIRMS

(PERCENTAGE BALANCES OF POSITIVE AND NEGATIVE RESPONSES)



* Expectations: Percentage balances of responses. The responses of business firms concern the prospect, in the next 3-4 months, of price increases for the goods they produce, while consumers' responses concern the prospect of a faster increase in consumer prices over the next 12 months .Data on consumers are seasonally adjusted.

** Annual percentage changes.

Source: Calculations based on NSSG, IOBE and European Commission *(Business and consumer survey results)* data.

first quarter of 2005 partly reflects the temporary acceleration of the annual rate by approximately one percentage point in January, which was due to the fact that the winter sales this year began on 1 February, whereas in 2004 they had begun on 15 January.[1] It also partly reflects the rise in fuel prices and the indirect impact this had on the prices of other goods and services. Moreover, the business surveys carried out by the IOBE during the first quarter of the current year, which, in fact, were conducted before the announcement, on 29 March, of increases in indirect taxation, showed an increase —compared with the previous quarter— in the percentage of businesses in the manufacturing sector, retail trade and the services sector (excluding retail trade and banking), which expect an increase in the prices of their products in the coming 3-4 months. In addition, the percentage of consumers who expect inflation to increase in the coming twelve months (as recorded in a survey carried out on behalf of the European Commission – see Chart IV.11) remained high and increased gradually during the first quarter of 2005. By contrast, construction companies continued to forecast cuts in their prices (though this does not affect the level of consumer prices).

The assessment of the prospects for inflation in 2005 as a whole is based on estimates and assumptions concerning key determinants, such as the development of oil prices on the world market and exchange rates or developments in production costs, profit margins and demand, in conjunction with the productive capacity of the economy. It is also based on estimates of the impact of economic policies being pursued, including, of course, the recent measures which increased indirect taxation. Specifically, it is forecast that both core inflation and "headline" inflation (as measured by the annual rate of change in the HICP and the CPI) will rise markedly in 2005 to reach an average level of 4%. The inflation forecast presented in February in the Bank of Greece's *Report on Monetary Policy* is revised upwards for two main reasons: first, the revised forecast takes account of the effect of the measures announced on 29 March and, second, based on new data and estimates, it is expected that international oil price increases will be greater than originally forecast.

It is estimated that inflation-boosting factors are stronger this year than those pushing inflation downwards.

As far as inflation-boosting factors are concerned, the technical assumption is being used that weather conditions will be "normal" and that, as a result, beginning from the second quarter, the prices of fresh fruit and vegetables will increase markedly in comparison with the same period in 2004, when these prices had remained relatively low due to favourable weather conditions.

In greater detail, it is expected that the increase in oil prices, which has accelerated significantly since the beginning of the year, will continue to have an inflationary effect on

1 The shorter period of winter sales this year (1-28 February, in comparison with 15 January-28 February in 2004) affects the average annual inflation (and also core inflation) for the whole of 2005 with an increase of almost 0.1 percentage point. This reflects the fact that in 2005 the winter sales period was two weeks shorter than it was in 2004.

price levels, both directly (via increased prices for fuels contained in the consumer's "basket") and indirectly (affecting, with a time lag, production costs). According to current trends, it is estimated —in contrast to what was said in the February 2005 *Report on Monetary Policy*— that the *total* effect of rising oil prices on *inflation* will be greater than in 2004. More specifically, based on the most recent forward prices, it can be assumed that average annual Brent crude oil prices on the world market will increase to around $51-52 per barrel in 2005 (from $38 in 2004), i.e. by around 35%. Besides, the average annual appreciation of the euro against the dollar will be 4.1% in 2005 based on the technical assumption that exchange rates will remain stable at the average level reached in the first fifteen days of April this year (€1 = $1.29). Thus, the expected increase in the average annual price of crude oil in euro is close to 30% (from 21.5% in 2004). It should be noted, however, that this forecast is marked by a high degree of uncertainty, both as regards oil prices in dollars and the exchange rate of the dollar against the euro.

In addition, according to certain estimates, the increase in indirect taxation (increased VAT rates, rise in Special Consumption Taxes (SCT) on alcoholic beverages and certain categories of cigarettes) is expected to have a marked effect on the twelve-month inflation rate (commencing at the time of the full implementation of the measures and if the increase is fully passed on to prices) and to contribute to an average annual inflation rate of around 4% for 2005.[1] Of course, it must be emphasised that these estimates are only indicative: The final effect of the above measures on inflation will depend on how business firms will react with their pricing policies (whether they will "absorb" the VAT increases or pass them on via higher prices, whether they will round prices up or down) in combination with the evolution of demand (this is especially so for goods which will be subject to significant SCT increases). It should be stressed, however, that if no second-round effects result from the increase in indirect taxation, its total effect on the annual inflation rate will be eliminated one year after the implementation of the measures, i.e. in April 2006.

It should also be noted that certain inflationary pressures which have built up at the wholesale level (as indicated by the significant acceleration in 2004 of the increase in wholesale prices for non-oil domestic industrial goods for home consumption) will probably filter through into consumer prices during 2005.

Finally, rates for public utilities (provided by both public and private enterprises) and certain fees set by the State,[2] which in 2004 are calculated to have risen at an average annual rate of 3% *(after excluding telecommunications rates, which are still on a downward*

1 These estimates result from direct calculations of the expected increase in (i) the prices which are included in the CPI "basket" and are affected by different VAT rates and (ii) the prices of the goods (cigarettes and alcoholic beverages) where the SCT will be increased.

2 Comprising the rates applied by the Public Power Corporation (DEH), the Hellenic Post Office (ELTA), the Hellenic Railways Organisation (OSE), the Water Supply and Sewerage Company (EYDAP) and other water supply companies, Olympic Airlines and other private airlines and hospitals and private clinics, as well as public transport fares, National Radio and Television Network (ERT) fees, municipal fees, tolls and road taxes. All these together in 2004 represented 5.8% of the "consumer's basket". The rates applied by the Hellenic Telecommunications Organisation (OTE) and private mobile telephony companies (2.4% of the "basket" in 2004) are excluded.

path owing to relatively competitive conditions in the market), are expected to increase at an average annual rate of some 5-5.5%[1] in 2005, reflecting an increase in various cost factors. Thus, the above increases may add 0.3 percentage point, compared with just 0.16 of a percentage point in 2004.

As for factors which help slow down inflation, it is calculated that the average appreciation of the euro exchange rate, weighted on the basis of Greece's external trade, will be 0.6% in 2005 (almost the same as in 2004) based on the technical assumption that the euro exchange rate against all other currencies will remain stable at the level reached in the first fifteen days of April this year. Hence, it is expected that increases in the prices of the other products (excluding oil) imported into Greece from non-euro area countries will continue to be limited. In the case of commodities (raw materials etc.) excluding oil, prices in US dollars are expected to increase less in 2005 than in 2004. At the same time, the forecast *average annual* appreciation of the euro on the basis of today's figures will continue to contribute to the mitigation of inflationary pressures in the euro area, resulting in the continuation of the slowdown in the already low rate of increase in the prices of imported goods and services from euro area countries.

Inflationary pressures on the demand side are expected to be limited in comparison with 2004, since the growth rate of private consumer demand is expected to fall, reflecting a slowdown in the growth rate of real disposable income due to the increasing inflation rate and an expected significant slowdown in the GDP growth rate in 2005. Excess demand will not be eliminated, but it will become weaker (according to the available forecasts, the "output gap" will remain positive, but will nonetheless fall in 2005 – see Chart IV.6). The forecast slowdown in the growth rate of public spending, part of the government's efforts to reduce substantially the general government deficit as a percentage of GDP, will also play a role in slowing down the growth of disposable income and reducing inflationary pressures.

The intensification of controls to ensure adherence to market regulations is expected to have a downward effect on inflation, as is the more active involvement of the Competition Commission and the upgrading of its role.

(*As for the rate of increase in unit labour costs*, it is estimated that, although it will decline markedly in the whole economy in 2005, it will accelerate slightly in the business sector – see Section 2 of this Chapter. However, the rate of increase in unit labour costs will continue to be significantly higher than in the euro area.)

On the basis of all this data, it is forecast that headline inflation (as measured on the basis of the HICP) and core inflation will increase in 2005 to reach around 4% (compared with 3.0% and 3.4% respectively in 2004).

This forecast involves a considerable degree of uncertainty chiefly surrounding factors such as the ultimate effect of increased indirect taxation on prices, the price of crude oil, exchange rates and the development of productivity (and therefore unit labour costs).

1 Without taking into account the additional increase as a result of rises in VAT rates.

2. WAGES AND SALARIES

The rate of increase in unit labour costs accelerated markedly during 2004 in the whole economy, while in the business sector it slowed down,[1] continuing, however, to exceed by a significant margin both the corresponding euro area rate (0.7%[2]) and the level which is in principle consistent with the objective of price stability i.e. a rate of inflation below but close to 2%. Specifically, according to revised estimates,[3] unit labour costs in the *whole economy* rose by 4.5% in 2004 (compared with 3.2% in 2003),[4] reflecting the accelerating rise in average pre-tax earnings, which increased from 5.3% in 2003 to 7.3% (see Table IV.4), while compensation per employee (which includes employers' contributions to employees' social security funds along with central government outlays for pensions) rose to 7.6% in 2004 from 5.3% in 2003.[5] This was greater than was the estimated upturn in productivity growth (GDP per employee), which was expected to reach 2.9% in 2004 from 2.0% in 2003. By contrast, the annual rate of growth of unit labour costs in the *business sector* is estimated to have slowed to 2.9% from 3.5% in 2003.[6] The significant differential in the rate of change in unit labour costs between the whole economy and the business sector is due to the significant acceleration of the increase in central government personnel outlays.

The slowdown of the increase in unit labour costs in the *business sector* reflects the fact that the increase in productivity, which was greater in 2004 than in 2003, more

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1 The business sector includes public and private enterprises and banks.

2 European Commission, *Spring 2005 Economic Forecasts*, April 2005.

3 The revised employment data on the period 1998-2003 announced by the NSSG in January 2005 and the revised data on GDP for the years 2001-2004 announced in March 2005 have been taken into account.

4 The rates of change in unit labour costs in the Greek economy as a whole, which are included in the reports produced by the Bank of Greece, refer to the change in the ratio of total compensation of employees (at current prices) to GDP (at constant prices) or, expressed in a mathematically equivalent form, to the change in the ratio of "compensation per employee" to "GDP per employee". The NSSG and Eurostat have always used a different definition (change in the ratio of "total compensation of employees" to "GDP per employed person in general", i.e. GDP is divided by the total number of employed persons, including the self-employed). This results in different rates being calculated. For its reports, the Bank of Greece prefers to measure the change in productivity on the basis of the change in the ratio of GDP (at constant prices) to the number of employees, as it considers that this is a better approximation of the change in labour productivity in branches of economic activity where employees work (see also *Monetary Policy 2002-2003*, Box 2, March 2003, pp. 47-48). It should also be noted that, since 1977, the Bank of Greece has published its own estimates concerning the increase in average earnings in the economy as a whole. These estimates are based on developments in four subsectors of the economy (central government, public utilities, banks and the non-bank private sector). The estimates take into account collective agreements, legislation (e.g. relating to the salaries of civil servants), state budget forecasts and figures on actual budget implementation, together with developments in salaried employment in each subsector. The estimates concerning these subsectors (summarised in Table IV.4) are weighted and used to produce the estimate for the economy as a whole. This estimate is not always the same as the one produced by the National Accounts Department of the NSSG.

5 The corresponding aggregate in the euro area rose at an average annual rate of 2.1% in 2004 (European Commission, *Spring 2005 Economic Forecasts*).

6 Particularly as far as manufacturing is concerned, the rate of growth of unit labour costs is estimated to have reached 4.5% in 2004, almost the same as in 2003 (4.7%).

TABLE IV.4

EARNINGS, UNIT LABOUR COSTS AND PRODUCTIVITY (1997 - 2004)

(Annual percentage changes)

	1997	1998	1999	2000	2001	2002	2003	2004
WHOLE ECONOMY								
– Average gross earnings [1] (nominal)	10.5	6.3	4.5	6.1	4.8	6.6	5.3	7.3
– Average gross earnings [1] (real)	4.7	1.4	1.9	2.8	1.4	2.9	1.7	4.3
– Net income of an employee with average earnings (nominal)	10.7	5.7	3.6	8.1	3.5	6.3	6.0	5.4
– Net income of an employee with average earnings (real)	4.9	0.9	1.0	4.7	0.1	2.6	2.4	2.4
– Total compensation of employees [1, 2]	10.7	7.7	6.8	9.0	8.4	9.2	8.0	8.9
– Compensation (earnings and employer contributions) per employee	10.1	6.8	4.5	5.9	4.9	6.0	5.3	7.6
– Unit labour costs [1, 3]	6.9	4.2	3.3	4.3	3.9	5.2	3.2	4.5
– Consumer price index [4]	5.5	4.8	2.6	3.2	3.4	3.6	3.5	2.9
– Gross domestic product [5]	3.6	3.4	3.4	4.5	4.3	3.8	4.7	4.2
BUSINESS SECTOR [6]								
– Total compensation of employees [1]	9.4	6.8	7.1	9.2	9.4	8.6	8.3	7.2
– Unit labour costs [1]	5.6	3.3	3.6	4.5	4.9	4.6	3.5	2.9
CIVIL SERVICE [7]								
– Average gross earnings of employees	13.5	9.2	3.5	7.1	5.5	7.3	5.9	10.5
– Total outlays for salaries and pensions	13.3	9.9	6.1	8.5	6.3	10.5	7.4	12.6
– Total outlays for salaries (excluding pensions)	14.7	8.0	5.7	9.0	6.1	11.6	7.8	11.8
PUBLIC ENTERPRISES								
– Average gross earnings of employees [8]	11.0	5.7	5.1	13.7	8.2	11.2	7.0	7.8
– Total compensation of employees [8]	9.7	2.1	3.1	8.9	3.2	5.5	5.1	5.5
– Monthly earnings of white-collar workers in electricity-water supply [4]	9.9	8.9	. . .	. . .	. . .	. . .	. . .	. . .
– Hourly earnings of blue-collar workers in electricity-water supply [4]	10.4	11.4	. . .	. . .	. . .	. . .	. . .	. . .
BANKS								
– Average gross earnings of employees [1]	9.7	4.0	13.1	6.8	6.4	2.9	3.1	8.0
– Total outlays for salaries [9]	10.8	5.9	14.3	9.3	5.3	4.3	3.2	6.5
– Total compensation of employees [9]	9.8	6.6	12.7	9.4	6.4	3.6	3.1	7.3
– Monthly earnings of employees [4, 10]	9.4	8.6	. . .	. . .	. . .	. . .	. . .	. . .
NON-BANK PRIVATE SECTOR								
– Minimum earnings [11] (nominal)	8.0	5.4	3.5	4.2	3.5	5.4	5.1	4.8
– Minimum earnings [11] (real)	2.4	0.6	0.9	1.0	0.1	1.7	1.5	1.8
– Average contractual earnings [12]	8.2	5.7	3.9	4.2	4.2	5.7	5.1	5.0
– Average gross earnings [1]	8.8	5.8	4.4	5.0	5.3	6.5	5.8	5.8
– Total compensation of employees [1]	9.3	7.6	6.2	9.2	10.7	9.6	9.4	7.5
– Hourly earnings of blue-collar workers in manufacturing [4]	8.9	4.7	4.4*	5.5*	5.5*	6.4*	5.9*	5.8*
– Monthly earnings of white-collar workers in manufacturing [4]	9.8	5.9	. . .	. . .	. . .	. . .	. . .	. . .
– Output per hour worked (manufacturing) [4]	4.4	4.4	0.6*	2.0*	-0.6*	0.6*	1.2*	1.2*
– Unit labour costs (manufacturing) [4]	4.4	0.2	3.8*	3.4*	6.1*	5.3*	4.7*	4.5*
– Weekly earnings of blue-collar workers in mining [4]	12.2	5.2	. . .	. . .	. . .	. . .	. . .	. . .
– Monthly earnings of white-collar workers in mining [4]	14.3	13.7	. . .	. . .	. . .	. . .	. . .	. . .
– Monthly earnings of employees in retail trade [4]	12.0	9.6	. . .	. . .	. . .	. . .	. . .	. . .
– Monthly earnings of employees in wholesale trade [4]	10.5	6.3	. . .	. . .	. . .	. . .	. . .	. . .

1 Bank of Greece estimates.
2 NSSG and Ministry of Economy and Finance estimates on the growth in total compensation of employees (March 2005): 1997: 13.6%, 1998: 10.4%, 1999: 8.9%, 2000: 6.8%, 2001: 7.0%, 2002: 8.2%, 2003: 6.4%, 2004: 10.9%.
3 NSSG and Ministry of Economy and Finance estimates on the rate of increase in unit labour costs (as defined by the Ministry of Economy and Finance): 1997: 9.1%, 1998: 6.1%, 1999: 3.0%, 2000: 1.3%, 2001: 0.8%, 2002: 5.7%, 2003: 0.8%, 2004: 4.4%.
4 Calculations based on NSSG survey data.
5 NSSG estimates (March 2005).
6 The business sector comprises public enterprises, banks and the non-bank private sector.
7 Estimates based on data from the Ministry of Economy and Finance, and Introductory Reports on the Budget. Data for 1997 have been adjusted for comparability purposes. In calculating expenditure growth from 1998 onwards, healthcare outlays were not taken into account.
8 Calculations based on Ministry of Economy and Finance data and estimates. For comparability purposes, public enterprises include OTE for the entire period.
9 Data from annual profit and loss accounts (1996-2004).
10 October-on-October rates of change.
11 National General Collective Labour Agreement.
12 Calculations based on data from collective labour agreements at branch and occupational level.
* Estimates.

than offset the faster rise in earnings. In 2004, wage increases for most employees in the business sector were determined by two-year collective agreements covering 2004 and 2005.

Specifically, in the *non-bank private sector*, on the basis of the two-year (2004-2005) collective labour agreements, it is estimated that the average annual rate of increase in *contractual* wages (at branch level) was 5.0% (compared with 5.1% in 2003), with the corresponding figure for *gross earnings* standing at 5.8%. Particularly as regards minimum wages (which are determined by the National General Collective Labour Agreement – NGCLA), the *average annual* increase for all NGCLA categories is put at 4.8%. (The *average annual* increase in minimum wages which was agreed on 13 May 2004 was between 4.7% and 5.3% – or 4.8% on average. The increase between the beginning and the end of the year ranged from 6.1% to 7.7% – or 6.4% on average.)

It is estimated that the average annual contractual increase was 6.3% in *public utilities*[1] and 5.1% in *banks*, while average gross earnings in these two branches increased by 7.8% and 8.0% respectively. The agreements reached with employees of the Public Power Corporation (DEH), the Hellenic Telecommunications Organisation (OTE) and banks were for two years.

In *central government*, taking into account the introduction of new salary scales on the basis of Law 3205/2003, the most recent *ex post* data concerning the development of personnel outlays in 2004 and the change in employment, it is estimated that, while on the basis of the new salary scales the average annual increase was 6.4% (according to announcements concerning salary scales made on 4 November 2003), the gross compensation per employee rose by 10.5%.[2] The fact that the estimated rate of increase in compensation per civil servant in 2004 was considerably higher than the already high rate of increase stemming from the introduction of the new salary scales reflects: the retroactive payment (pursuant to court decisions) of family allowances for the years 2001-2002 to both spouses when they are both civil servants, and the wages paid for additional or overtime employment during the elections for the Greek Parliament and those for the European Parliament. Finally, the even higher rate of increase in government expenditure when pensions are also taken into consideration is attributable to increased payments for pensions in implementation of the 2004 incomes policy and to the retroactive payment of part of the pay rises awarded for 2003.

1 The two-year collective agreements provided for an average annual contractual increase of 6.9% for employees of the Hellenic Telecommunications Organisation (OTE) and 5.7% for Public Power Corporation (DEH) employees in 2004.

2 According to the most recent report of the General Accounting Office, the central government wage bill (excluding pensions) increased by 11.8% in 2004. If outlays for pensions are included, the increase was 12.6%. *If the cost for a special bonus to certain categories of personnel involved with security during the 2004 Olympic Games (which is listed under "operating and other expenses") is included, the total increase in personnel outlays excluding pensions reached 13.8% and including pensions came to 14.1% (without* including the healthcare expenses for civil servants). The number of civil servants rose at an average annual rate of 1.2% in 2004.

Regarding the current year, it is estimated on the basis of certain data and assumptions that the growth rate of unit labour costs will fall noticeably in the economy as a whole (to 3.0% from 4.5% in 2004), though it will accelerate only slightly in the business sector (to 3.1% from 2.9% in 2004).[1] This forecast reflects the estimate that the rate of increase in average earnings in the whole economy will decelerate (mainly because of wage restraint in central government) by approximately one percentage point (i.e. to 5.4%). Compensation per employee (including employers' contributions) is expected to increase by 5.2% (compared with 7.6% in 2004). A slowdown is also expected, albeit to a lesser degree, in the rate of increase in productivity (GDP per employee) to 2.2% in 2005 from 2.9% in 2004.

As far as average earnings in 2005 are concerned, it is expected that the average compensation of *central government* employees will increase by 6% (compared with 10.5% in 2004). According to the 2005 Budget, the total increase in the wage bill excluding pensions will reach 6.5% (compared with 11.8% in 2004), while outlays for salaries and pensions will increase by 5.9% (compared with 12.6% in 2004). If the increase in the number of civil servants is limited (to the order of 0.5%), the average compensation of civil servants will grow by 6%. As always, this figure covers all other charges included in wage costs beyond the increase in regular civil service earnings. The latter increase —according to government announcements made on 14 February 2005 and to Article 2 of Law 3336/2005, which was enacted by Parliament in mid-April— will range from 3.1% to 3.5%, while basic salaries will increase by 3.6-3.7%.

In the *non-bank private sector, banks and public enterprises*, increases were as a rule determined by the two-year collective agreements signed last year and were roughly the same as those awarded for 2004. Specifically, the NGCLA provides for an average annual increase of 4.7% for unskilled blue-collar and white-collar workers *with previous employment* and 5.6% for those *without previous employment*, while the average increase for all categories covered by the agreement is estimated at 4.9%. At a branch level, the contractual increases in the private sector are in the order of 5%. The average annual increase in contractual earnings is 4.9% for bank personnel, 5.5% for Hellenic Telecommunications Organisation (OTE) employees and 6.3% for the Public Power Corporation's (DEH) personnel. In addition, if account is taken of the forecast slowdown in the growth rate of GDP (see Chapter III), the high rate of unemployment and the voluntary early retirement plans in certain enterprises, the positive differential between the increase in actual (gross) earnings paid and that in contractual earnings may be limited this year. It is therefore estimated that the average increase in *gross earnings* is likely to be 5.6% in the non-bank private sector, 5.4% in banks and 6.4% in public enterprises (where it will exceed the average wage increase in the whole economy for the sixth year in a row).

1 According to the European Commission *(Spring 2005 Economic Forecasts)*, the rate of increase in unit labour costs in the euro area is expected to accelerate, but still remain at low levels (1.3%).

3. BUSINESS PROFITS

3.1 Profits, sales and profitability

Profits in 2004 are examined using a sample of 554 non-financial corporations, 256 of which (122 industrial firms, 48 commercial firms and 86 service providers or other companies) are listed on the stock exchange.[1] Although the sample is relatively small and the published data for many businesses are provisional and not very detailed, it is nonetheless possible to draw some general conclusions about both the evolution of sales and profits of these firms in 2004 and their financial structure.

The significant rise in profits observed in 2003 in all sectors of the economy (industry, commerce and other activities) appears to have slowed down or even come to a halt in 2004. Net pre-tax profits for the sample companies as a whole have fallen slightly (–1.2%) in 2004 in comparison with the previous year, although sales grew by 11.1%. This development reflects the drop in profits suffered by companies in the "provision of services and other activities" category (–8.4%), which was mainly the result of the large downturn in profits of telecommunications (–49.9%) and construction firms (–17.0%). By contrast, as in previous years, profits for commercial firms in the sample rose significantly (by 23.6%), while the increase in profits for industrial businesses was small (3.9%).

Net profit margins, i.e. the ratio of net pre-tax profits to sales, fell by approximately one percentage point, from 9.5% in 2003 to 8.4% in 2004, essentially returning to the 2002 level (8.8%). In addition, gross profit margins declined by approximately one percentage point (2004: 22.4%, 2003: 23.6%, 2002: 23.3%). These developments reflect the fact that the sum total of administration and marketing expenses, financial costs and extraordinary expenses (which is deducted from gross profits in order to calculate net profits) remained almost the same (to be more exact, it fell slightly) as a percentage of sales volume.

For the firms in the sample as a whole, administration and marketing expenses rose at a lower rate than sales (8.7%, compared with 11.1% for sales), while financial costs fell for the second year in a row by 2.6%. Net extraordinary expenses (extraordinary expenses less extraordinary revenue) came to €106.8 million in 2004, compared with net extraordinary revenue of €6.3 million in 2003. *If no account is taken of net extraordinary expenses, i.e. of the impact of factors which are not closely related to the operation of businesses, pre-tax operating profits showed just a marginal increase (1.6%), compared with a major increase the previous year*. (It should be recalled that both in 2002 and in 2001, businesses had recorded

1 Data are derived from balance sheets or summary financial statements published recently in the daily press. The criterion for inclusion in the sample was a sales volume of over †5 million. The sample excluded businesses whose published data for 2004 are, for various reasons (splits, mergers, etc.) not comparable to those for 2003. It also excluded public enterprices and financial corporations, as well as holding companies whose subsidiaries' published data were included. Finally, the 554 businesses of the sample represent, in terms of sales volume, net fixed assets and own funds, 29.7%, 32.9% and 36.3%, respectively, of the 29,524 non-financial enterprises (sociétés anonymes and limited liability companies) monitored by ICAP.

significant net extraordinary expenses, due mainly to losses incurred as a result of the valuation of securities, which expenses had reduced the rate of increase in total profits).

The limited reduction in profits in 2004 resulted in a slight drop in profitability both in terms of return on equity (ROE) and return on total assets (ROA). ROE fell to 12.9% in 2004 from 13.5% in 2003, while ROA dropped to 6.5% in 2004 from 6.8% in 2003.

The ratio of financial costs to gross profits, which is frequently used as an indicator of financial fragility, dropped to 5.3% in 2004 from 5.7% in 2003, reflecting a major fall in financial costs. In general, this ratio has reached very low levels for the companies in the sample. The textiles and transport branches are exceptions to this, with ratios hovering at very high levels (29.4% and 28.2% respectively), as are the "other" firms (i.e. excluding those which retail consumer goods) in wholesale trade (9.7%) and the healthcare sector (10.7%), reflecting the greater sensitivity of firms in these branches to interest rates changes. The drop in the financial fragility indicator is directly the result of a cut in interest rates, given that, in 2004, bank borrowing by the companies in the sample fell by less than financial costs (bank borrowing: –1.1%, financial costs: –2.6%). It is obvious, therefore, that the fall in bank rates in recent years has not just boosted company profitability but has also led at the same time to an improvement in the financial fragility indicator (see also Chapter X.5.1.4).

3.2 Profits and sales by branch of economic activity

In *industry*, profits recorded a limited increase (3.9%) in 2004, despite a 12.5% rise in sales. The branches of food-beverages-tobacco, textiles-clothing and non-metallic minerals were chiefly responsible for preventing any greater increase.

The food-beverages-tobacco industry, one of the healthiest branches of Greek manufacturing industry and with a steadily upward course, showed signs of flagging. Although it recorded a small increase of 3.9% in sales, profits fell for the first time in three years, down by 4.4%. This drop was chiefly due to smaller profits recorded by pasta producers, flour mills and the Hellenic Sugar Industry, while results reported by fish farming companies improved the total figures.

The textiles and clothing industry, which is one of the most export-oriented branches and also one of those which are most exposed to international competition from low-cost countries, the 3.6% increase in sales did not prevent losses (€29.2 million) being reported for the first time in many years. (Were it not for the losses reported by two companies, the branch would have remained profitable).

Wood-paper-publishing-printing firms continued to report increases —though smaller than in 2003— in sales (13.8%) and profits (8.6%) in 2004. As in 2003, the increased profits were due chiefly to the performance of publishing firms.

The refineries-chemicals-plastics industry continued to report major increases in sales in 2004 (18.7%). Profits rose by 11.9%.

The non-metallic minerals branch, a major player in which is the cement industry, saw an end in 2004 to the significant rise in sales and profits noted in recent years. Sales remained stable (–0.3%), while profits fell by 13.3% (mainly due to results reported by the cement industry).

Metallurgy was the branch with the best results in 2004. It is highly dynamic and export-oriented and thanks to the major scale of its export activity in recent years it has managed to take over the position previously held by the textiles industry. The sales stagnation and the large drop in profits —mainly the result of the falling US dollar— evident in 2003 were reversed in 2004. Sales rose by 18.2% and profits more than doubled (increase of 121.1%).

Finally, the electrical appliances and equipment-furniture and other products firms saw a rise in sales of just 5.6% and a fall in profits of 4.4%, though the overall picture for these firms was less unfavourable than in 2003.

In contrast with manufacturing industry, *commercial firms* reported satisfactory results overall, as in previous years. Sales grew by 13.5% and profits by 23.6%, resulting in a further improvement in net profit margins, from 4.6% in 2003 to 5.0% in 2004. Wholesale trade (consumer and other goods) showed a satisfactory increase in sales (15.0%) and profits (38.0%), but retail trade saw a slower growth in sales (11.4%) and a relatively small increase in profits (5.0%).

In the *information technology* branch, the large number of companies operating and the intense competition of the past resulted in a squeezing of prices and a decline in sales and profits. However, sales increased slightly in 2004 (1.9%), for the first time in recent years, and profits rose by 23.0%.

Businesses in the sample belonging to the *hotels-restaurants-recreation* branch, which had witnessed a drop both in sales and profits in 2003, achieved a satisfactory increase in sales (14.1%) and a particularly large increase in profits (61.5%) in 2004, the year of the Olympic Games.

In the *transport branch*, the drastic reduction in operating expenses, the performance of foreign routes and the deregulation of the domestic market all had a beneficial impact on results in 2003. In the financial year 2004, however, sales rose only marginally, 1.3%, while profits were down by 31.1%.

The most successful years for *construction firms* had been 2002 and 2003, chiefly due to the projects carried out for the Olympic Games. These projects were a major source of revenue for all the firms in the group, without exception. In 2004, however, sales fell by 2.5% and profits by 17.0%.

In the *telecommunications* branch, competition is intense and the entry of new firms has led to considerable restructuring. Previous major increases in sales and profits did not continue in 2004. Sales showed a small increase of 2.1%, while profits fell by a significant 49.9% due to the large drop in OTE's profits (in contrast to 2003, when the company reported profits of €381.2 million, 2004 saw losses of €131 million).

Although sales increased by 11.6%, the *healthcare* branch saw a 4.9% drop in profits.

Finally, the *other activities* branch, which includes the *Public Power Corporation (DEH)*, reported a satisfactory rise both in sales (23%) and profits (44.1%), accompanied by a corresponding increase in fixed assets (16.7%) and equity (11.1%).

In conclusion, the overall situation of the 554 businesses included in the sample did not improve in 2004 in comparison with 2003. Profits, even after taking account of extraordinary expenses/revenue, remained essentially at the same level (increase of just 1.6%), despite the major increase in sales (11.1%); this resulted in the narrowing of profit margins (2004: 8.4%, 2003: 9.5%) and a drop in ROE and ROA (from 13.5% and 6.8% respectively in 2003 to 12.9% and 6.5% in 2004).

V. MONETARY POLICY AND MONETARY AND CREDIT DEVELOPMENTS IN THE EURO AREA

1. THE SINGLE MONETARY POLICY OF THE ECB

Throughout 2004 and in the first four months of 2005, the European Central Bank (ECB) kept its key interest rates unchanged. In particular, following their latest cut on 6 June 2003, the minimum bid rate for the main refinancing operations stood at 2%, the marginal lending facility rate at 3% and the deposit facility rate at 1%, i.e. at the lowest levels observed since 1999 when the single monetary policy was first implemented in the euro area (see Chart II.13 and Table V.1). Based on economic and monetary developments, the Governing Council of the ECB estimated that inflationary pressures remained

TABLE V.1
CHANGES IN KEY ECB INTEREST RATES
(Percentages per annum)

Date of interest rate change[1]	Deposit facility	Main refinancing operations	Marginal lending facility
6 Dec. 2002	1.75	2.75	3.75
7 March 2003	1.50	2.50	3.50
6 June 2003	1.00	2.00	3.00

1 For the deposit and marginal lending facilities, effective dates of interest rate changes (one day following the relevant ECB decision); for the main refinancing operations, interest rate changes are effective from the first operation following the date indicated.
Source: ECB.

moderate and that the level of interest rates was consistent with price stability over the medium term.

In the first quarter of 2004, the quarter-on-quarter growth rate of economic activity in the euro area accelerated to 0.7%, while inflation stood at levels consistent with price stability, i.e. close to but below 2%. At the same time, the annual growth rate of M3 decelerated to 6.4%, from 7.6% in the last quarter of 2003. In the second quarter of 2004, economic recovery continued, albeit at a slower pace (0.5%), while the rise in inflation above 2% was due to the short-term impact of the increase in oil prices, administered prices and indirect taxes in some euro area countries. In addition, the annual growth rate of M3 continued its downward course and came to 5.4%. The Governing Council judged that interest rates should be kept unchanged, as their level supported economic recovery in the euro area without entailing risks to price stability over the medium term. However, the Governing Council noted that there remained more liquidity in the euro area than was needed to finance non-inflationary growth and stressed the need for vigilance with regard to developments that might entail inflationary risks.

In the second half of 2004 and in the first months of 2005, economic recovery continued, albeit at a slower pace than expected (third quarter of 2004: 0.3%, fourth quarter: 0.2%). Nevertheless, on the basis of the Governing Council's assessment and ECB staff forecasts,[1] the growth rate of economic activity in the euro area is expected to strengthen in the course of this year, as the recovery of the world economy will continue, favourable financing conditions and increased corporate profits will boost investment, while the expected growth of real disposable income will support consumption. Over the same period, with the exception of January 2005, the continuous rise in oil prices kept inflation over 2%, though there was no evidence of inflationary pressures building up over the medium-term, as wage increases remained contained. However, the Governing Council stressed repeatedly the need to monitor closely risks to price stability over the medium term. These risks relate mainly to the possibility of a further rise in oil prices or new increases in indirect taxes and administered prices, as well as to the possibility of second-round effects on euro area prices and wages.

With regard to monetary developments, the annual growth rate of M3 accelerated to 5.6% in the third quarter, to 6% in the fourth quarter of 2004 and to 6.4% in February 2005. On the basis of the Governing Council's assessment, excess liquidity in the euro area, together with the strengthening of credit expansion to the private sector (at levels exceeding 6%), may lead to a rise in inflation over the medium term, as well as to a significant increase in asset prices, particularly in the housing market. Thus, the Governing Council kept on stressing the need for vigilance with regard to upside risks to price stability.

2. THE EVOLUTION OF M3 AND ITS COMPONENTS

As already mentioned, in the first half of 2004 the annual growth rate of M3 in the euro area followed a downward course, which was reversed in the second half. This development reflects the impact of two counterbalancing factors: the low interest rate level and portfolio shifts to longer-term assets following the strong preference of investors for liquid assets included in M3 from 2001 to mid-2003. Specifically, the annual growth rate of M3 fell to 5.4% in the second quarter of 2004, from 7.6% in the last quarter of 2003 (see Chart V.1 and Table V.2), as the impact of portfolio restructuring prevailed over that of low interest rates. By contrast, in the second half of 2004 portfolio restructuring decelerated as investors seem to have remained cautious and the cost of portfolio shifts from liquid assets included in M3 to longer-term assets was high compared to the interest rate level. Thus, the annual growth rate of M3 accelerated to 6.0% in the last quarter of 2004 and to 6.4% in February 2005.

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1 See "ECB staff macroeconomic projections for the euro area", ECB, *Monthly Bulletin*, March 2005, Box 10.

The annual growth rate of M1 fell throughout 2004, remaining, however, at high levels (fourth quarter of 2004: 9.3%, fourth quarter of 2003: 11%) due to the low interest rate level and the increased holding of euro banknotes both within and outside the euro area (see Table V.2). Nevertheless, in the first months of 2005 the growth rate of M1

TABLE V.2

MAIN COMPONENTS OF M3 IN THE EURO AREA

(Annual percentage changes,[1] derived from data adjusted for seasonal and calendar effects, quarterly averages[2])

	2003	2004				2005
	Q4	Q1	Q2	Q3	Q4	February
M1	**11.0**	**11.0**	**10.2**	**9.6**	**9.3**	**9.9**
Currency in circulation, M0	26.5	24.0	21.6	20.3	19.1	18.3
Overnight deposits	8.7	9.1	8.5	7.9	7.6	8.5
Other short-term deposits (=M2–M1)	**4.8**	**3.3**	**1.7**	**2.0**	**3.5**	**4.1**
Deposits with an agreed maturity of up to two years	–3.0	–4.4	–7.0	–5.8	–2.4	0.3
Deposits redeemable at notice of up to three months	11.0	9.2	8.1	7.6	7.5	6.7
M2	**7.9**	**7.2**	**6.0**	**5.8**	**6.4**	**7.1**
Marketable instruments (=M3–M2)	**5.8**	**2.3**	**2.0**	**4.0**	**3.8**	**2.2**
Repurchase agreements	–1.6	–4.0	–1.7	2.9	2.9	–1.3
Money market fund shares/units	12.7	8.4	5.9	4.3	4.3	2.6
Money market paper and debt securities issued with a maturity of up to two years	–10.6	–13.9	–10.1	4.8	2.5	8.0
M3	**7.6**	**6.4**	**5.4**	**5.6**	**6.0**	**6.4**

1 Annual rates of change in the corresponding index, which is compiled on the basis of outstanding stocks for December 2001 and cumulative monthly flows, adjusted for exchange rate variations, reclassifications etc.
2 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the ECB *Monthly Bulletin*).
Source: ECB.

resumed its upward course and stood at 9.9% in February, due to investors' preference for overnight deposits rather than instruments with relatively longer maturities included in M3 (repurchase agreements, money market fund shares).

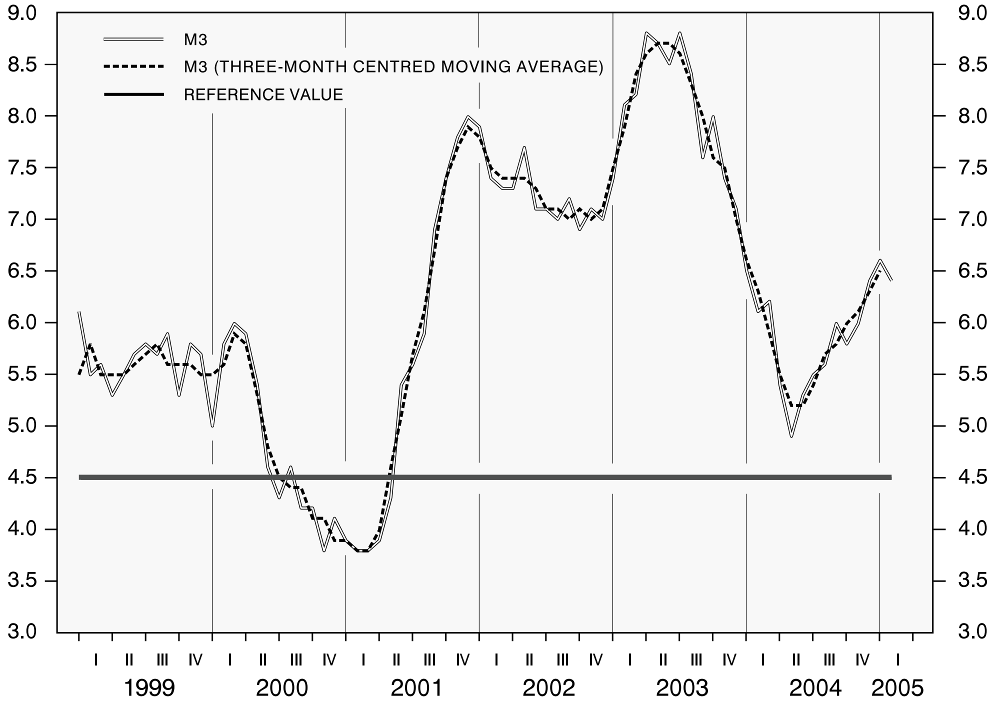
3. COUNTERPARTS OF M3

As regards the evolution of M3 counterparts, the annual growth rate of MFI longer-term liabilities accelerated to 7.9% in the last quarter of 2004 and 8.6% in February 2005, compared with 6% in the fourth quarter of 2003, due to investor portfolio restructuring. At the same time, credit expansion to the private sector sped up to 6.6% in the fourth quarter of 2004 and 7.3% in February 2005, compared with 5.6% in the last quarter of 2003, because of the low interest rate level and favourable financing conditions (see Table V.3). In the first half of 2004, the faster growth of MFI longer-term liabilities and the decrease in MFI net external assets, which were attributed to outflows of euro area residents' funds for the purchase of assets in countries outside the euro area, were only partly offset by the acceleration of credit expansion to the private sector, resulting in a fall in the rate of M3 growth. By contrast, in the second half of 2004 the growth rate of

CHART V.1

M3 IN THE EURO AREA

(PERCENTAGE CHANGES[1] OVER SAME PERIOD OF PREVIOUS YEAR, MONTHLY DATA)



1 Adjusted for seasonal and calendar effects.

Source: ECB.

M3 accelerated due to the further strengthening of credit expansion to the private sector and the increase in MFI net external assets, developments which more than offset the increase in the growth rate of longer-term liabilities.

The annual growth rate of loans to the private sector rose to 6.8% in the fourth quarter of 2004 and 7.2% in February 2005, compared with 5.3% in the last quarter of 2003. Specifically, the annual growth rate of loans to households rose to 7.8% in the fourth quarter of 2004, compared with 6.4% in the last quarter of 2003, mainly reflecting the rise in the growth rate of housing loans, which was due to both the low interest rate level and the high dwelling prices in some euro area countries. The annual growth rate of loans to non-financial corporations accelerated to 5.4% in the fourth quarter of 2004, compared with 3.5% in the last quarter of 2003, owing to the low interest rate level, the improved expectations regarding corporate profits and the relaxation of bank credit standards (according to the latest Eurosystem bank lending survey, January 2005).[1]

TABLE V.3

MAIN COUNTERPARTS OF M3 IN THE EURO AREA

(Annual percentage changes,[1] derived from data adjusted for seasonal and calendar effects, quarterly averages[2])

	2003	2004				2005
	Q4	Q1	Q2	Q3	Q4	February
Longer-term financial liabilities of MFIs	**6.0**	**6.2**	**7.5**	**7.6**	**7.9**	**8.6**
Deposits with an agreed maturity of over two years	5.1	5.5	6.4	7.1	7.7	8.5
Deposits redeemable at notice of over three months	–14.0	–11.5	–8.5	–4.4	–1.8	0.4
Debt securities issued with a maturity of over two years	8.7	9.6	10.5	10.3	10.3	11.1
Capital and reserves	4.6	3.4	5.0	4.6	4.5	4.9
Credit to euro area residents	**5.8**	**5.8**	**6.0**	**6.2**	**6.0**	**6.6**
Credit to general government	**6.5**	**6.0**	**6.4**	**6.4**	**3.7**	**3.9**
Debt securities other than shares	9.7	9.0	8.9	8.9	5.6	6.1
Loans	1.5	1.2	2.3	2.4	0.7	0.2
Credit to other euro area residents	**5.6**	**5.7**	**5.9**	**6.2**	**6.6**	**7.3**
Debt securities other than shares	15.9	12.3	9.0	9.6	6.8	10.3
Shares and other equity	3.6	4.9	7.2	3.6	4.3	6.1
Loans	5.3	5.4	5.6	6.2	6.8	7.2

1 Annual rates of change in the corresponding index, which is compiled on the basis of outstanding stocks for December 2001 and cumulative monthly flows, adjusted for exchange rate variations, reclassifications etc.
2 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the ECB *Monthly Bulletin*).
Source: ECB.

Credit expansion to general government slowed down considerably and stood at 3.7% in the fourth quarter of 2004, compared with 6.5% in the last quarter of 2003. This development is attributed to the increased demand for government securities by non-euro area residents, owing to expectations concerning the course of the euro exchange rate. However, in February 2005 credit expansion to general government rose to 3.9%, due to the increased holding of general government securities by MFIs.

1 See ECB website and ECB, *Monthly Bulletin*, February 2005, Box 1.

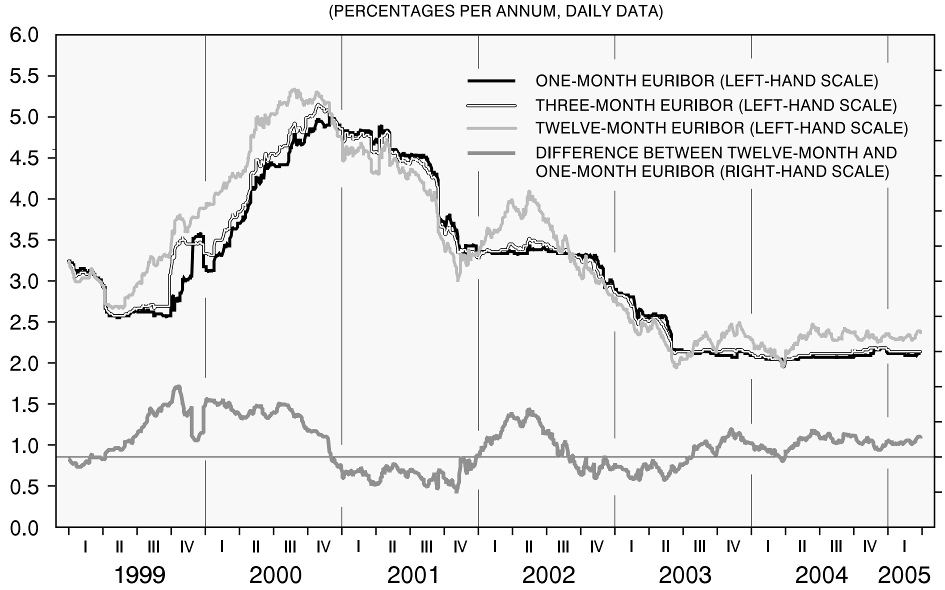
4. MONEY MARKET INTEREST RATES

Interest rates in the euro area money market remained at low levels in 2004. Specifically, the one-month, three-month and twelve-month EURIBOR stood at 2.17%, 2.17% and 2.30% respectively in December 2004, compared with 2.13%, 2.15% and 2.38% in December 2003. In particular, throughout 2004 the shorter-term EURIBOR rates (up to three months) were close to the ECB marginal lending rate, which has been standing at 2% since 6 June 2003. At the longer maturities, the twelve-month EURIBOR fluctuated in the course of the year (it fell in the first quarter, increased in the second quarter and

CHART V.2

SHORT-TERM INTEREST RATES IN THE EURO AREA

(PERCENTAGES PER ANNUM, DAILY DATA)



Source: ECB.

fluctuated within a range of 10 basis points in the second half of 2004). Similar fluctuations were recorded in the slope of the money market yield curve[1] (see Charts V.2 and V.3), which nevertheless remained positive in 2004 except for the last two weeks of March.

In the first quarter of 2005, shorter-term money market interest rates fell somewhat, to around 2.10% (one-month EURIBOR), while at the longer maturities interest rates stand slightly above the levels of December 2004 (twelve-month EURIBOR: 2.30%).

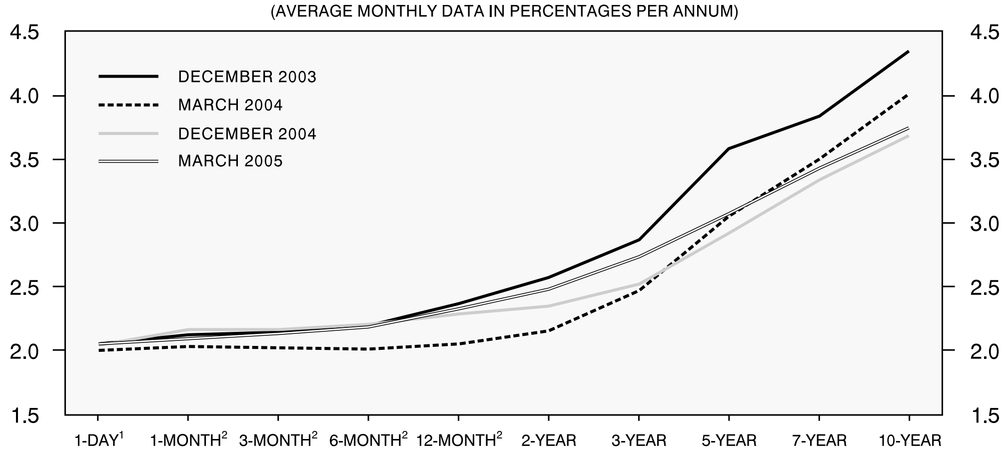
1 The slope of the euro area money market yield curve is measured by the difference between the twelve-month and the one-month EURIBOR.

Expectations regarding short-term interest rates in 2005 were revised slightly downwards between end-2004 and March 2005, as implied by the decline in the rates of three-month

CHART V.3

MONEY MARKET AND BOND MARKET YIELD CURVES IN THE EURO AREA

(AVERAGE MONTHLY DATA IN PERCENTAGES PER ANNUM)



1 Overnight money market rate (EONIA).
2 Interbank offered rates (EURIBOR).
Source: ECB.

EURIBOR futures contracts maturing in June, September and December 2005, compared with the beginning of December 2004.

5. MFI INTEREST RATES

Bank deposit and lending rates also stood at low levels in 2004. As far as deposit rates are concerned, this development reflects the relative stability of money market interest rates. As for lending rates, it was due to credit risk reduction in most loan categories.[1] Turning to longer-term bank rates, they fell less than the yields of capital market securities with the same maturity, as they converged with the usual time lag on the more volatile market rates.

Specifically, in most categories households' deposits interest rates displayed minor fluctuations during the year and in January 2005 they stood at a lower level than in

1 See "Eurosystem bank lending survey", January 2005, as in footnote on page 161.

January 2004. By contrast, the rates on deposits of non-financial corporations displayed more significant fluctuations and in January 2005 were higher than one year ago.

Interest rates on new loans to both households and non-financial corporations fell in 2004 in all categories (with some fluctuations in the course of the year). The decline was more pronounced in household loan rates, particularly for loans with an initial rate fixation of over five years.

In February 2005, interest rates in most categories of new deposits and loans remained unchanged or decreased further.

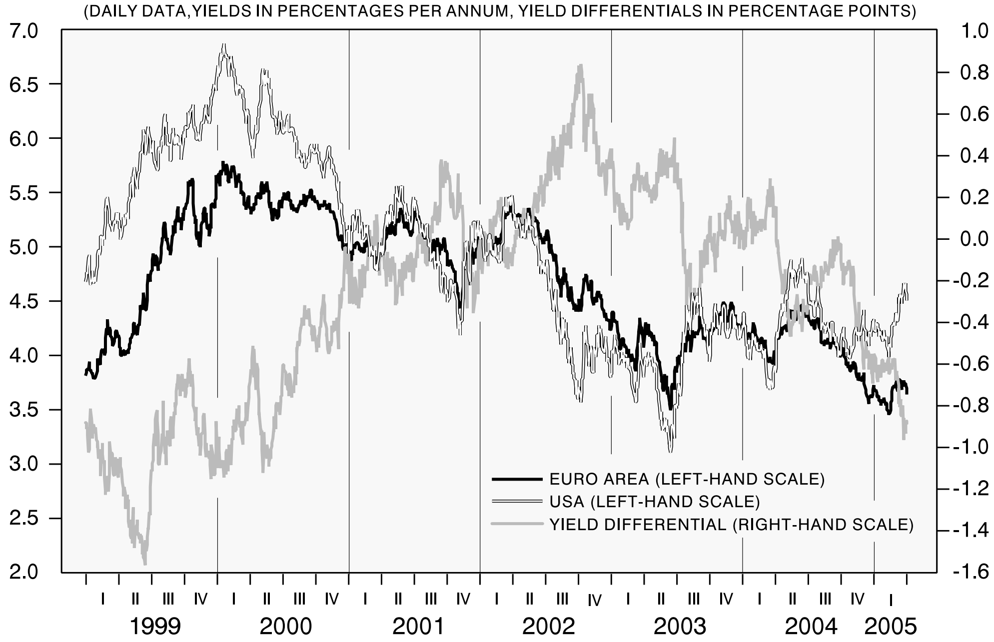
6. YIELDS ON LONG-TERM SECURITIES

Yields on long-term securities in the euro area bond market followed a downward course in 2004, except for the period between April and June (see Chart V.4), and stood

CHART V.4

TEN-YEAR BOND YIELDS IN THE EURO AREA AND THE UNITED STATES

(DAILY DATA,YIELDS IN PERCENTAGES PER ANNUM, YIELD DIFFERENTIALS IN PERCENTAGE POINTS)



Source: ECB.

at 3.69% on average in December 2004, against 4.36% in December 2003 (ten-year bond). For most of 2004, long-term bond yields in the United States were higher than in the euro area (with the exception of the first quarter). In December 2004, euro area ten-year bond yields were 54 basis points lower than in the United States, while they had exceeded them by 10 basis points in December 2003.

In particular, in the first quarter of 2004 the euro area ten-year bond yield declined, mainly reflecting external factors, especially concerns regarding the sustainability of economic recovery in the United States. Between April and June, the rise in ten-year bond yields was fuelled by the upward revision of market expectations about the recovery in euro area economic activity, combined with improving global economic prospects, as well as by the possibility that the inflationary risk premium which is incorporated in the yield would increase due to the rise in oil prices. In the second half of 2004, yields resumed a downward course, owing to the downward revision of expectations regarding economic recovery in the euro area (related to the rise in oil prices and the appreciation of the euro), as well as because expectations of monetary policy tightening were transferred to a later point of time.

In the first six weeks of 2005 long-term bond yields in the euro area continued their downward course, probably due to conjunctural effects, such as increased demand for long-term bonds by institutional investors, rather than to unfavourable expectations about economic activity. Thus, in mid-February the ten-year bond yield reached its lowest levels since 1999, when the single monetary policy began to be implemented. Thereafter, yields recovered, a development which seems to be associated with the rise in bond yields in the United States, where monetary policy is expected to tighten in the near future.

In 2004, implied bond market volatility[1] in the euro area declined further (to levels below the average of the last five years), indicating a decline in uncertainty among bond market participants.

7. STOCK MARKET DEVELOPMENTS

The euro area stock market followed an upward course in 2004 (see Chart V.5), owing to low long-term interest rates and the significant rise in corporate profits. The broad Dow Jones EURO STOXX[2] index increased by 9.9% in 2004 (compared with end-2003). The sectors that mostly benefited from the general rise in stock prices were those of health, services and energy, while a recovery was also recorded in the telecommunications sector.

From mid-March to mid-August 2004, the upward course of the broad Dow Jones EURO STOXX index, which had started in spring 2003, came to a halt and the index stood below the levels of March 2004 due to pessimism about the impact of the rise in oil

1 Volatility in the euro area government bond market is calculated on the basis of implied volatility of the prices of options on ten-year German Bund futures, which is compiled by Bloomberg and monitored by the ECB.

2 This index, which is compiled on the basis of the stock prices of the approximately 500 euro area companies with the highest level of capitalisation, is designed in a way that provides a representative picture of the euro area stock market.

prices on world economic activity and corporate profits. However, from mid-August up to February 2005 this index recovered. In spite of high corporate profits in the euro area, the index fell again in March 2005 owing to the negative effect of rising oil prices on international stock markets.

CHART V.5

STOCK PRICE INDICES

(31 DECEMBER 1998 = 100, DAILY DATA)

Source: ECB.

Stock market uncertainty, as measured by the index of implied volatility,[1] subsided further in 2004 and in the first quarter of 2005 and stood at a level below the average of the last five years.

1 This index is compiled by Bloomberg using a method similar to the one described in footnote 1 on page 165.

APPENDIX TO CHAPTER V

CHRONOLOGY OF MAIN MONETARY POLICY MEASURES OF THE EUROSYSTEM

8 January 2004

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

12 January 2004

The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in the year 2004 from €15 billion to €25 billion. This increased amount takes into consideration the higher liquidity needs of the euro area banking system anticipated for the year 2004. The Eurosystem will, however, continue to provide the bulk of liquidity through its main refinancing operations. The Governing Council may decide to adjust the allotment amount again at the beginning of 2005.

5 February, 4 March, 1 April, 6 May, 3 June, 1 July, 5 August, 2 September, 7 October, 4 November, 2 December 2004 and 13 January 2005

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

14 January 2005

The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in the year 2005 from €25 billion to €30 billion. This increased amount takes into consideration the higher liquidity needs of the euro area banking system anticipated in 2005. The Eurosystem will, however, continue to provide the bulk of liquidity through its main refinancing operations. The Governing Council may decide to adjust the allotment amount again at the beginning of 2006.

3 February, 3 March, 7 April 2005

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

VI. MONETARY AND CREDIT DEVELOPMENTS IN GREECE

1. MONETARY DEVELOPMENTS

The annual growth rate of the Greek component of the euro area M3[1] (excluding currency in circulation) picked up in the second half of 2004, as did the corresponding euro area rate. However, the acceleration observed in Greece was higher and thus the annual rate of M3 growth throughout the previous year (and during the first two months of the current one) stood above the euro area level. These developments are still influenced by the historically low level of interest rates (and hence the relatively low opportunity cost of holding money). In addition, the rise in M3 in Greece was partly attributable to the higher (vis-à-vis the euro area) growth rate of nominal GDP and the different rates of substitution of assets not included in M3 with M3 assets, while credit expansion also accelerated considerably, as the central government's borrowing requirements were much higher in 2004 than in 2003.

The very low levels of interest rates differentiated the rates of change in the individual deposit categories, strengthening significantly the rate of increase in short-term (overnight) deposits. In contrast, a considerable deceleration was recorded in the growth rate of deposits with an agreed maturity of up to 2 years, as well as in the rate of change in holdings of money market fund shares/units, which in fact has turned negative since September 2004. The rate of decrease in repos slowed down significantly during 2004. However, the increased tax rate on repo yields since last January (from 7% to 10%) resulted in a considerably higher rate of decrease in repos holdings in the January-February 2005 period.

The foregoing differentiation in the growth rate of individual deposit categories in 2004 did not affect the growth rate of total deposits included in M3, which remained broadly unchanged (fourth quarter 2004: 12.6%, fourth quarter 2003: 12.2%, see Table VI.1). Nevertheless, in the first two months of the current year, the annual growth rate of these deposits accelerated (February 2005: 17.2%), a development linked to the shift of savings away from repos (due to the aforementioned increase in the tax rate on their yields since the beginning of the year and a simultaneous reduction in the tax rate on interest from deposits to 10% from 15%).

In more detail, the growth rate of savings deposits (which represent the largest category of deposits and are included in overnight deposits[2]) picked up considerably during

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1 The Greek M3, as well as that of any other euro area country (see the Glossary for the definitions of monetary aggregates), can no longer be calculated accurately, as quantities of euro banknotes and coins put in circulation by one euro area country may be held by residents of other euro area countries (and/or residents of third countries). Therefore, due to the technical problems with the calculation of currency in circulation in each euro area country, developments are discussed with respect not to the Greek M3 but only to its key components (excluding currency in circulation).

2 Savings deposits (as already mentioned in previous Bank of Greece *Annual Reports* and *Monetary Policy Reports*) are broadly similar to current account deposits, since they are redeemable on demand (without penalty) and enable depositors to effect payments to third parties (e.g. standing payment orders and fund transfers through cards). Thus, they are included in overnight deposits along with sight deposits and current account deposits.

TABLE VI.1

GREEK CONTRIBUTION TO THE KEY MONETARY AGGREGATES OF THE EURO AREA

(Not seasonally adjusted data)

	Outstanding balances on 31 Dec. 04 (million euro)	Annual percentage changes[1]								
		2001	2002	2003	2004					2005
		Q4[2]	Q4[2]	Q4[2]	Q1[2]	Q2[2]	Q3[2]	Q4[2]	December[3]	February[3]
1. Overnight deposits	91,695	11.1	8.9	6.8	11.7	13.4	15.5	16.8	15.5	15.6
1.1 Sight deposits and current account deposits	20,697	5.3	5.7	17.7	19.3	18.0	11.8	19.1	17.8	20.1
1.2 Savings deposits	70,998	12.5	9.8	4.1	9.7	12.2	16.5	16.1	14.7	14.2
2. Time deposits with an agreed maturity of up to 2 years	33,408	–9.3	10.1	29.3	19.9	14.8	5.1	5.3	6.0	25.4
3. Deposits redeemable at notice of up to 3 months[4]	1,939	19.7	8.1	1.5	2.8	1.6	3.9	2.8	0.3	–2.4
4. Total deposits (1+2+3)	**127,042**	**5.1**	**9.3**	**12.2**	**13.4**	**13.1**	**11.8**	**12.6**	**11.8**	**17.2**
5. Repurchase agreements (repos)	9,529	38.3	–19.0	–47.7	–45.9	–41.3	–23.8	–12.6	–12.1	–57.7
6. Money market fund units	15,227	–38.4	–3.7	68.0	24.6	7.5	0.1	–1.9	–2.9	–4.3
7. Bank bonds with a maturity of up to 2 years[5]	466	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .

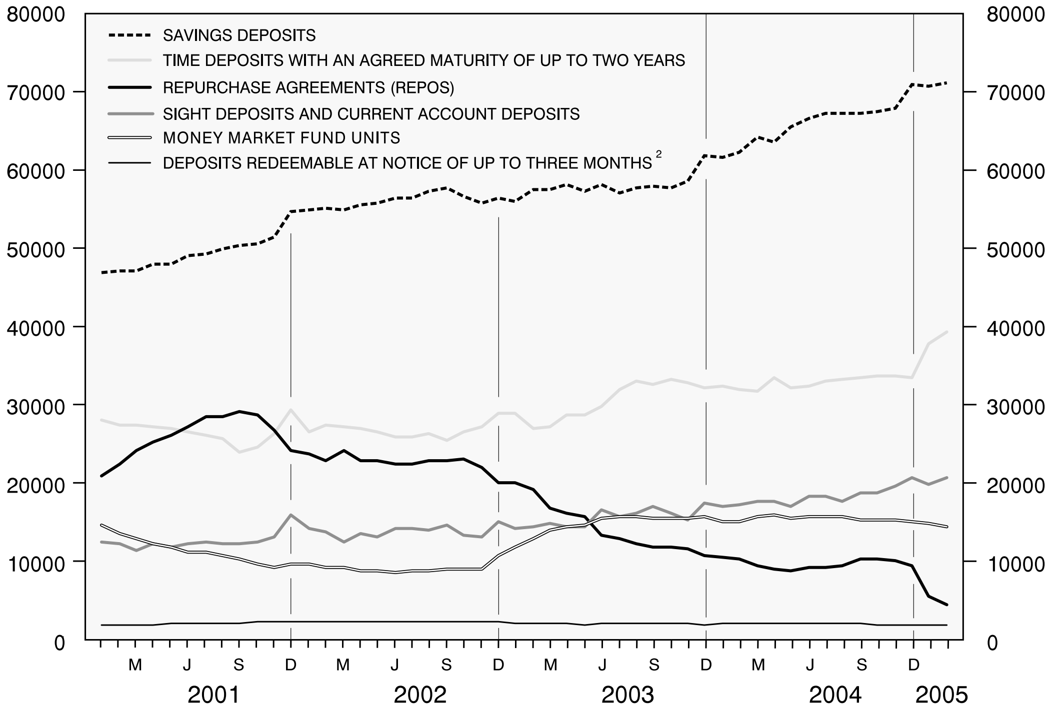
1 Annual rates of change in the corresponding index, which is compiled on the basis of outstanding stocks for December 2001 and cumulative monthly flows, adjusted for exchange rate variations, reclassifications etc.
2 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the ECB *Monthly Bulletin*).
3 Annual rates of change on the basis of the corresponding index at the end of the month.
4 Including savings deposits in currencies other than the euro.
5 Rates of change are not shown because, owing to the low calculation base, they are very high.
Sources: Bank of Greece and ECB.

the previous year (fourth quarter 2004: 16.1%, fourth quarter 2003: 4.1%). The fast growth of savings deposits reflects the increased demand for highly liquid assets, as there was a fall in government bond yields in 2004 and a further decrease in repo holdings. Another factor that contributed to this development was the relatively low opportunity cost of holding savings deposits (as this is expressed by the difference in interest rates

CHART VI.1

DEPOSITS, REPURCHASE AGREEMENTS AND MONEY MARKET FUND UNITS IN GREECE[1]

(END-OF-PERIOD BALANCES, IN MILLION EURO)



1 These aggregates concern deposits, repos and money market fund units which, according to the ECB definition, are included in M3 and therefore constitute the Greek contribution to the corresponding euro area aggregates.
2 Including savings deposits in currencies other than the euro.

Source: Bank of Greece.

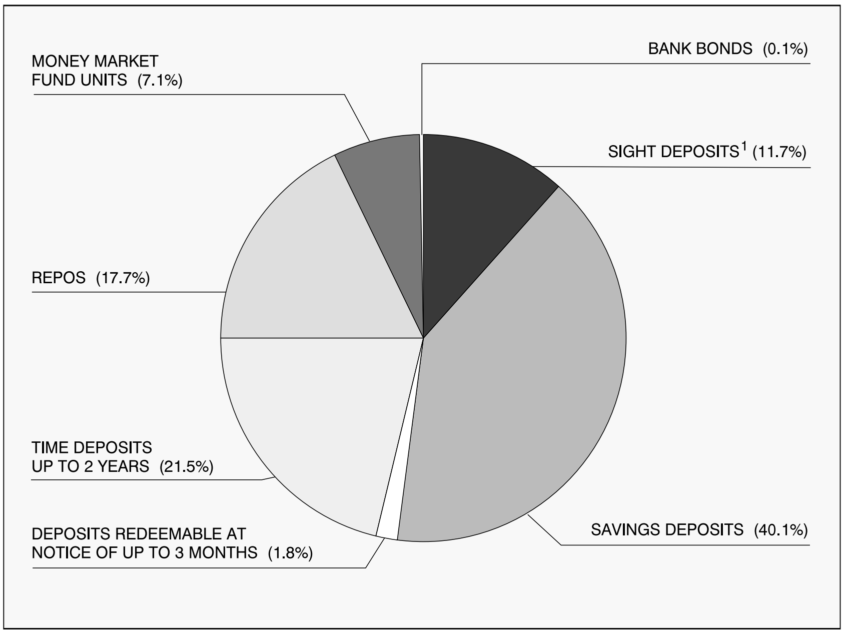
between time deposits and savings deposits). Moreover, for the same reason, the annual rate of increase in deposits with an agreed maturity of up to two years slowed down considerably in 2004 (fourth quarter 2004: 5.3%, fourth quarter 2003: 29.3%). The change in the tax rates on the yields of deposits and repos since January 2005 greatly strengthened the growth rate of time deposits, while it slowed down the rate of increase in savings deposits in the January-February period. It should be noted that the reduction in the sin-

CHART VI.2

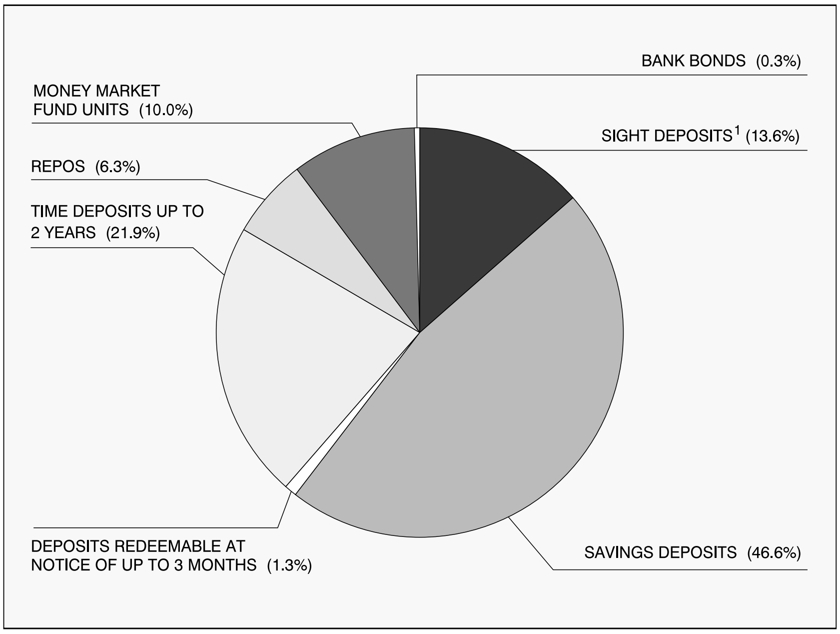
PERCENTAGE CONTRIBUTION OF M3 COMPONENTS (EXCLUDING M0) IN GREECE

(END-OF-YEAR DATA)

A. IN 2001



B. IN 2004



1 Including current accounts.

Source: Bank of Greece.

gle tax rate on deposits broadens the post-tax difference between interest rates on time deposits and savings deposits.

Among the other components of M3, repo holdings decreased further in 2004 (see Chart VI.1), although their rate of decrease decelerated significantly (fourth quarter 2004: –12.6%, third quarter 2004: –23.8%, fourth quarter 2003: –47.7%). However, as already mentioned, in the first two months of the current year (following the change in the tax rate on their yields) repos recorded again a fast rate of decrease (February 2005: –57.7%). The particularly low levels of repo holdings (funds raised through repos fell from €24,230 million in December 2001 to €4,434 million in February 2005) are linked, aside from the change in the taxation[1] on their yields, to the considerable restructuring of credit institution portfolios (relative decrease in the holdings of Greek government securities and a respective increase in loans to the private sector, which have higher returns). Indicatively, the percentage share of repos in the whole of M3 components (excluding currency in circulation) gradually fell from 17.7% in 2001 (when their yields were not taxed) to 6.3% at the end of 2004 (see Chart VI.2), while in February 2005 this share was even lower (2.9%). As regards investment in money market fund shares/units, after its relative stability up to the end of August 2004, it recorded a downward trend and thus its rate of change gradually turned from strongly positive at the end of 2003 to negative in the last months of 2004 (fourth quarter 2004: –1.9%, fourth quarter 2003: 68%) and remained negative in the January-February period of the current year. This development is mainly attributable to the decline in the yields of money market funds due to the fall of bond yields in 2004 (bonds constitute a considerable share of the portfolio of money market funds), as well as the normalisation of the savers' investment pattern that had started since the previous year. It should be noted that investment by households and enterprises in money market funds usually appears particularly increased in periods of relatively high uncertainty, mainly in the stock markets. Therefore, it could be argued that the slowdown in the rate of change in investment in money market funds observed in the previous year partly implies reduced uncertainty concerning developments in the domestic stock market.

2. CREDIT DEVELOPMENTS

2.1 Total credit expansion and bank financing of general government

Total financing by Monetary Financial Institutions (MFIs) accelerated notably in the previous year, as its annual rate of increase rose to 8.6% in the fourth quarter of 2004

1 It should be noted that the tax rate on repo yields has changed three times since the introduction of such taxation in May 1994 (at a rate of 15%). The other two changes were the abolition of taxation in September 1998 and its reintroduction in January 2002 (at a lower rate, 7%).

TABLE VI.2

TOTAL CREDIT EXPANSION IN GREECE

(Annual percentage changes)

	2001	2002	2003	2004					2005
	Q4[1]	Q4[1]	Q4[1]	Q1[1]	Q2[1]	Q3[1]	Q4[1]	December[2]	February[2]
1. Total credit expansion	8.9	7.1	3.2	3.8	8.6	9.3	8.6	7.7	8.6
2. Credit expansion to general government	–2.4	–5.2	–15.9	–15.5	–6.2	–2.8	–5.6	–8.0	–3.4
3. Credit expansion to enterprises and households	23.2	18.3	17.1	16.9	17.4	15.7	16.1	15.8	14.4
3.1 Credit expansion to enterprises	16.7	11.4	11.0	10.9	10.5	8.2	8.6	7.5	5.0
3.2 Credit expansion to households	40.0	33.1	28.2	27.5	28.9	28.2	28.0	28.5	28.6
of which:									
3.2.1 Housing loans	36.7	35.4	27.1	24.5	24.7	22.9	23.8	24.8	25.4
3.2.2 Consumer loans	44.3	27.4	24.8	29.2	34.5	38.2	37.9	37.4	35.0

1 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the ECB *Monthly Bulletin*).

2 Annual rate of change at the end of the month.

Source: Bank of Greece.

from 3.2% in the same quarter of 2003. This acceleration reflects the considerably slower rate of decline in the MFI financing of general government,[1] whereas credit expansion to enterprises and households decelerated in the course of the year. Owing to these countervailing trends, the annual rate of total credit expansion remained unchanged at 8.6% in February 2005 (see Table VI.2).

More specifically, as regards MFI financing of general government, the decline recorded in 2003 continued in 2004 as well, but at a fairly slower pace (fourth quarter 2004: –5.6%, fourth quarter 2003: –15.9%). In particular, MFI investment in Greek government paper fell by €5,045 million in 2004 (2003: decrease of €9,335 million), while an increase of €868 million (2003: decrease of €100 million) was observed in the outstanding balance of MFI loans to general government. This continuing decline in the total financing of general government is linked to the restructuring of bank portfolios, which consists in a decrease in their claims on central government (mainly involving securities) and an increase in the share of loans to enterprises and households, which yield higher interest income.[2] Thus, while in December 2002 MFI loans to domestic enterprises and households accounted for 41% of MFI assets, and their claims on general government for 21%, in December 2004 these percentages stood at 48% and 14%, respectively. It should be noted that, in 2004 as well, the central government's considerably increased net borrowing requirements (2004: €15,605 million, 2003: €10,526 million) were more than offset by capital inflows from abroad for investment in government paper.

2.2 Bank lending to enterprises and households

The growth of loans to enterprises and households slowed down slightly to 16.1% in the fourth quarter of 2004, from 17.1% in the corresponding quarter of 2003. This development is mainly attributable to the noticeable deceleration in credit expansion to enterprises, which fell to 8.6% in the last quarter of 2004, from 11.0% in the last quarter of 2003. By contrast, the annual rate of increase in bank loans to households recorded only a marginal change, to 28.0% in the fourth quarter of 2004, from 28.2% in the corresponding quarter of 2003. In February 2005, credit expansion to enterprises and households decelerated further and stood at 14.4%, reflecting the continuing drop in the rate of increase in loans to enterprises (February 2005: 5.0%), while, in contrast, a slight increase was recorded in the rate of credit expansion to households (February 2005: 28.6%). Total bank loans to enterprises and households as a percentage of GDP rose to 70.9% at the end of 2004, from 65.9% at the end of 2003.

1 MFI financing of general government comprises loans granted thereto, as well as the total of government paper held by the central bank, credit institutions and money market funds.

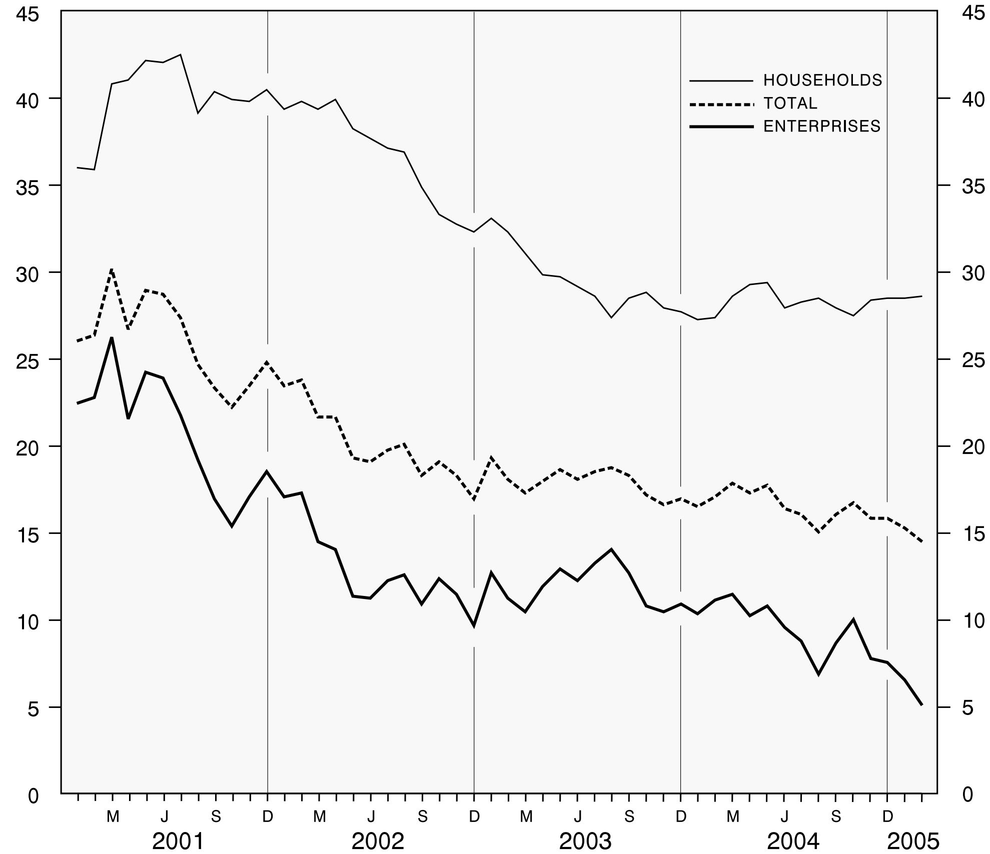
2 The average yield of the ten-year Greek government bond stood at 3.77% in December 2004, while the average interest rate on new loans to non-financial corporations was 5.15% and to households 7.04%.

As discussed in the *Annual Reports* of previous years, credit expansion to enterprises is affected by the issuance of corporate bonds, which remain in the portfolios of MFIs and, to some extent, substitute for bank loans. Respectively, the rate of increase in bank lending to households is affected by housing loan securitisation by domestic credit institutions. Total credit expansion to enterprises and households, including corporate bonds held by

CHART VI.3

GREECE: CREDIT EXPANSION TO ENTERPRISES AND HOUSEHOLDS

(PERCENTAGE CHANGES OVER SAME MONTH OF PREVIOUS YEAR)



Source: Bank of Greece.

MFIs but excluding the effect of securitisation, remained practically unchanged in 2004 (December 2004: 19.2%, December 2003: 19.1%).

The contribution of loans in foreign currency to the increased total bank lending to enterprises and households was, as in the previous years, negative (see Table VI.3). Thus, while at the end of 2003 such loans represented 5.5% of total loans, at the end of 2004 their share was only 4.5%. However, the balance of loans in foreign currency, when valued in euro, includes the effect of foreign exchange valuation differences. As a result, the decrease in the balance of loans in foreign currency reflects the appreciation of the euro against the other major foreign currencies,[1] particularly the US dollar. If valuation differences are not taken into account, the rate of change in such loans becomes marginally positive in December 2004 (0.7%, from –5.0% including valuation differences).

The annual growth rate of short-term loans (i.e. loans with an initial maturity of up to one year) was relatively slow in 2004, as also in the previous two years, and stood at 8.7% in the last quarter of 2004 (fourth quarter of 2003: 3.4%). By contrast, loans with an initial maturity of more than one year increased at a much higher rate (fourth quarter of 2004: 22.2%, fourth quarter of 2003: 31.2%). Thus, the share of longer-term loans increased further to 58.7% of total loans to enterprises and households at the end of 2004, from 55.9% at the end of 2003. The structure of loans according to initial maturity depends greatly on their type. Specifically, the majority of loans to non-financial corporations are short-term loans (December 2004: 56.8%), as a great deal of lending to enterprises involves credit lines (almost 1/3). However, the share of short-term loans is gradually declining (December 2003: 60.5%, December 2002: 63.3%). As for lending to households, the largest part of consumer loans have an initial maturity of up to one year (December 2004: 59.8%). In contrast, practically the whole of housing credit involves loans with an initial maturity longer than five years (December 2004: 98.2%).

A breakdown of lending to enterprises by branch of economic activity shows an acceleration in the last quarter of 2004, compared with the corresponding quarter of 2003, in credit expansion to trade, agriculture, other financial institutions and, to a lesser degree, shipping, and a deceleration in all other branches (see Table VI.3). A relatively faster rate of increase (compared with the average of total loans to enterprises) was observed in the balance of loans to trade, tourism, other financial institutions and “other” branches, while lending to all other branches changed at a slower pace.

In more detail, credit expansion to industry decelerated considerably, falling to 1.1% in the last quarter of 2004 from 10.4% in the corresponding quarter of 2003, while the share of industry in total loans to non-financial corporations decreased to 24.9% at the end of 2004 from 27.3% at the end of 2003. In the first two months of 2005, the annual rate of change in loans to industry was negative (February 2005: –2.0%), prolonging the trend that had started since November 2004. To some extent, this development is linked to the financing of industrial firms through alternative sources of fund raising. Thus, in the course of 2004, industrial firms issued corporate bonds amounting to €605 million, compared with €210 million in 2003,[2] while the funds raised through the Athex also increased (2004: €102 million, 2003: €80 million). Nevertheless, the observed slowdown cannot be entirely attributed to the use of alternative financing sources, given that, if the additional —compared with the previous year— funds raised by such sources are included

1 Except for the Swiss franc, which strengthened marginally between end-December 2003 and end-December 2004.

2 Data from the relevant announcements by companies listed on the Athex.

T A B L E VI.3

BREAKDOWN OF DOMESTIC MFI CREDIT TO ENTERPRISES AND HOUSEHOLDS IN GREECE

	Outstanding balances on 31 Dec. 04 (million euro)	Annual percentage changes								
		2001	2002	2003	2004					2005
		Q4[1]	Q4[1]	Q4[1]	Q1[1]	Q2[1]	Q3[1]	Q4[1]	December[2]	February[2]
A. Enterprises	**65,566**	**16.7**	**11.4**	**11.0**	**10.9**	**10.5**	**8.2**	**8.6**	**7.5**	**5.0**
1. Agriculture	3,248	–2.6	–14.0	3.3	2.6	5.5	9.1	7.8	5.4	3.9
2. Industry[3]	15,676	10.2	11.5	10.4	10.2	7.5	1.8	1.1	–1.2	–2.0
3. Trade	18,821	20.3	7.8	4.0	4.5	7.6	10.2	12.7	14.0	12.0
4. Tourism	4,040	14.2	33.7	24.4	18.6	19.4	18.9	17.6	15.8	15.1
5. Shipping	4,495	7.8	5.5	2.3	4.0	7.0	4.0	3.0	4.1	5.2
6. Non–monetary financial institutions	2,693	141.8	72.5	–3.2	–2.2	6.0	2.9	9.5	–2.7	–31.7
7. Other	16,593	24.6	14.3	26.5	25.6	18.5	12.6	11.7	11.0	9.0
B. Households	**51,636**	**40.0**	**33.1**	**28.2**	**27.5**	**28.9**	**28.2**	**28.0**	**28.5**	**28.6**
1. Housing loans	33,127	36.7	35.4	27.1	24.5	24.7	22.9	23.8	24.8	25.4
2. Consumer loans	17,054	44.3	27.4	24.8	29.2	34.5	38.2	37.9	37.4	35.0
– Credit cards	7,665	62.1	37.1	27.8	24.8	23.3	23.0	23.4	23.2	21.4
– Other consumer loans[4]	9,389	31.8	19.2	21.8	33.9	46.9	54.9	53.1	51.7	48.4
3. Other	1,455	165.5	62.6	135.7	119.2	87.5	47.6	18.8	15.9	29.7
TOTAL	**117,202**	**23.2**	**18.3**	**17.1**	**16.9**	**17.4**	**15.7**	**16.1**	**15.8**	**14.4**
– In euro	111,951	35.2	21.9	19.8	19.1	18.7	17.2	17.6	17.0	15.5
– In other currencies	5,251	–28.6	–12.3	–14.1	–11.1	–2.5	–6.3	–7.2	–5.0	–3.6

1 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the ECB *Monthly Bulletin)*.
2 Annual rate of change at the end of the month.
3 Comprising manufacturing and mining/quarrying
4 Including personal loans and loans against supporting documents.
Source: Bank of Greece.

in the calculation of the rate of credit expansion, in December 2004 the latter stood at 1.4% (as opposed to 1.2% if the alternative sources are excluded). Therefore, this recent trend is rather connected with the industrial firms' lower investment activity,[1] as well as with the less optimistic business expectations in this branch in the second half of 2004 (see Chapter III).

Credit expansion to trade recovered considerably, particularly in the second half of 2004, and rose to 12.7% in the fourth quarter of the year, from 4.0% in the corresponding quarter of 2003. Thus, the trend of slow rates of increase in loans to that branch, observed since the end of 2002, seems to have been reversed. The above rate remained at a relatively high level in the current year as well, standing at 12.0% in February. As a result of the above acceleration, the share of loans to trade in the total of loans to non-financial corporations increased to 29.9% in December 2004 from 28.4% in December 2003. Consequently, trade remains the business industry attracting the largest part of bank lending.

In the second half of 2004, an acceleration was observed in credit expansion to agriculture, which, however, slowed down at the end of the year as the Agricultural Bank of Greece proceeded to the rescheduling of overdue loans and the write-off of interest receivables, pursuant to the new relevant legislation.[2] Yet, even after these arrangements, the annual rate of increase in loans to agriculture rose to 7.8% in the fourth quarter of 2004, i.e. appreciably more than in the corresponding quarter of 2003 (3.3%). However, this rate was lower in the first two months of 2005 (February 2005: 3.9%).

The slowdown in credit expansion to tourist enterprises, which, however, remains relatively high, reflects the completion of investment projects by such enterprises in view of the 2004 Olympic Games. The relevant rate decelerated to 17.6% in the fourth quarter of 2004, from 24.4% in the corresponding quarter of 2003 and the trend is continuing this year (February 2005: 15.1%). Nevertheless, tourist enterprises also had recourse to alternative sources of financing in 2004, raising €200 million through bond issues and €46 million through the Athex. If these funds are included in the calculation of total credit expansion to tourism, the latter stands at 22.9% in December 2004 (as opposed to 15.8% if not).

Likewise, the completion of the infrastructure projects connected with the 2004 Olympics has negatively affected credit expansion to "other" branches (a major category of which is the construction industry), which fell to 11.7% in the last quarter of 2004, from 26.5% in the fourth quarter of 2003, while a further deceleration was observed in the first two months of the current year (February 2005: 9.0%). Construction firms also sought other sources of financing in addition to bank loans in 2004 and raised €129 million through bond issues and €41 million through the Athex (2003: €8 million). However, the observed slowdown cannot be attributed to the funds raised through alternative sources of

1 According to the investment survey conducted by the IOBE in October-November 2004, private industrial firms estimated that their investment expenditure fell by 32.3% in 2004, compared with 2003, at current prices.

2 Law 3259/2004.

financing, given that, if these are included in the calculation of credit expansion to "other" branches, the latter stands at 12.1% in December 2004 (as opposed to 11.0% if not).

The annual rate of increase in loans to shipping became slightly faster and came to 3.0% in the fourth quarter of 2004 from 2.3% in the last quarter of 2003. However, this change includes the effect of developments in the exchange rate of the euro against the US dollar, as the largest part of loans to shipping enterprises are denominated in the latter currency. Specifically, in the course of 2004 the euro gained 7.8%[1] against the US dollar, thus correspondingly reducing the balance of US-dollar-denominated loans when valued in euro. Not taking into account the foreign exchange valuation difference stemming from the appreciation of the euro, the annual rate of increase in loans to shipping stands at 10.4% in December 2004 (December 2003: 18.6%).

Credit expansion to non-monetary financial corporations picked up considerably and stood at 9.5% in the fourth quarter of 2004, from –3.2% in the corresponding quarter of 2003. However, this acceleration is linked with the reduction in the balance of loans to this branch in the last quarter of 2003, due to the high level of bond issues by these corporations and the use of related proceeds for the repayment of bank loans.[2] Nevertheless, in February 2005 these corporations proceeded to new bond issues (amounting to approximately €500 million), which entailed a corresponding decrease in the level of their bank borrowing. As a result, the annual rate of change in bank loans to this branch stood at –31.7% in February 2005.

As already mentioned, in 2004 the annual rate of increase in loans to households remained practically unchanged at a high level. This development resulted from the countervailing trends observed in housing credit growth, which decelerated, and consumer credit growth, which accelerated. The high rate of credit expansion to households led to an increase in their indebtedness as a percentage of GDP (December 2004: 31.2%, December 2003: 26.2%), which nonetheless remains lower than the euro area average (December 2004: 50.4%, December 2004: 48.4%).

In more detail, the annual rate of increase in housing loans slowed down to 23.8% in the fourth quarter of 2004, from 27.1% in the corresponding quarter of 2003, largely reflecting the securitisation of housing loans worth €750 million in June 2004.[3] Not taking into account the effect of securitisation, the annual rate of increase in housing loans stands at 26.8% in the fourth quarter of 2004. Moreover, an increase was recorded in the total of housing loans as a percentage of GDP, which rose to 20.0% in December 2004 (December 2003: 17.3%), but remains lower than the corresponding percentage for the euro area as a whole (December 2004: 34.3%, December 2003: 32.5%). The trend of housing credit growth seems to be upward in 2005, as in February it came to 25.4%.

1 Annual rate of change at end-December 2004.

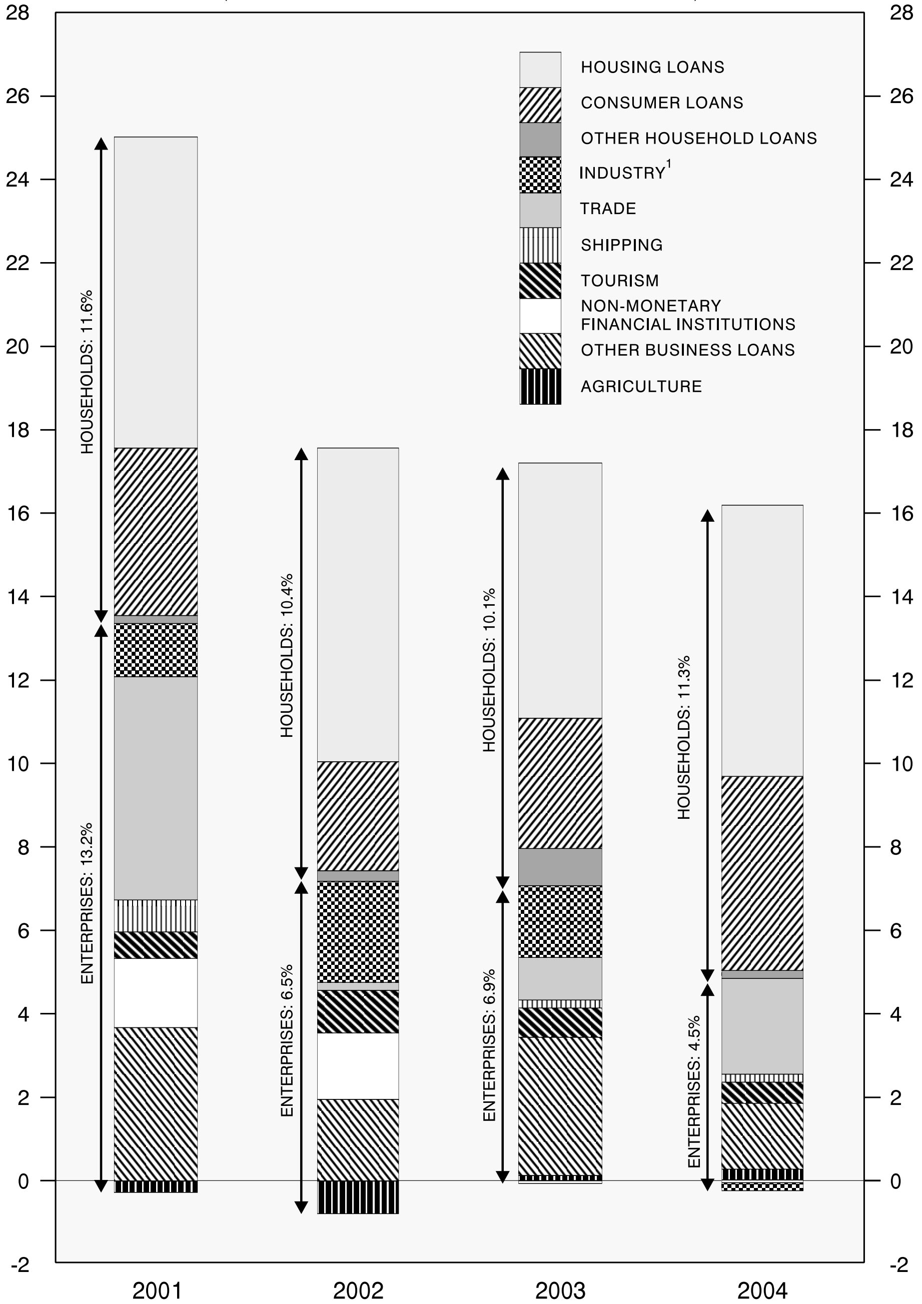
2 See Bank of Greece, *Annual Report 2003*, Chapter VI.

3 This was preceded by another housing loan securitisation, of €250 million, in November 2003. For a more detailed analysis of securitisation in Greece, see Bank of Greece, *Monetary Policy 2004-2005*, Appendix to Chapter IV.

CHART VI.4

BREAKDOWN OF CREDIT EXPANSION TO ENTERPRISES AND HOUSEHOLDS

(PERCENTAGE CHANGES IN OUTSTANDING BALANCES*)



1 Including manufacturing and mining-quarrying.
* Compared with the end of the previous year.

Source: Bank of Greece.

The recovery in the rate of increase in consumer loans, following the abolition of all remaining restrictions on consumer credit in June 2003, continued in the past year as well. Thus, in the last quarter of 2004 this rate rose to 37.9%, from 24.8% in the corresponding quarter of 2003. However, at the end of 2004 consumer credit growth showed signs of weakening and in February 2005 it stood at 35.0%. At the same time, the reallocation within consumer loans continued, as the annual rate of increase in the balance of loans through credit cards slowed down (fourth quarter of 2004: 23.4%, fourth quarter of 2003: 27.8%), while the rate of increase in other consumer loans accelerated considerably (fourth quarter of 2004: 53.1%, fourth quarter of 2003: 21.8%). This development is associated with the higher interest rates on credit card loan balances compared with those on other consumer loans (see next section). As a result, the share of credit card loans in total consumer loans fell to 44.9% in December 2004, from 50.1% in December 2003.

Finally, a great deceleration was observed in the growth rate of other loans to households, which pertain mostly to overdraft facilities on current accounts. In particular, their rate of increase was limited to 18.8% in the last quarter of 2004, from 135.7% in the corresponding quarter of 2003, while it recovered in the first two months of the current year and stood at 29.7% in February 2005. However, the exceptionally high rate observed in the last quarter of 2003, as noted in earlier Reports, is largely attributable to the reclassification of loans amounting to €206 million from the category of "loans to enterprises" to the category of "other household loans". Nevertheless, the share of other loans in the total of loans to households remains very low (December 2004: 2.8%, December 2003: 3.1%).

3. BANK INTEREST RATES

After following a downward path in 2003, bank interest rates[1] in Greece generally showed small changes in 2004, as the ECB interest rates remain unchanged since June 2003. Specifically, slight increases were recorded in the interest rates on most categories of bank deposits, while relatively greater changes were observed in the rates on bank loans, which generally followed a downward course.

In more detail, the average interest rate on new overnight deposits by households recorded a slight increase (of 9 basis points) between the beginning and the end of the year and stood at 0.96% in December 2004 (see Chart VI.5), while it remained roughly at that level in the first two months of 2005. The interest rate on savings deposits, which represent the bulk of overnight deposits, showed a similar increase in 2004 (December 2004: 0.94%) and also remained unchanged in the January-February 2005 period. The real interest rate on savings deposits (as calculated on the basis of current inflation) remained

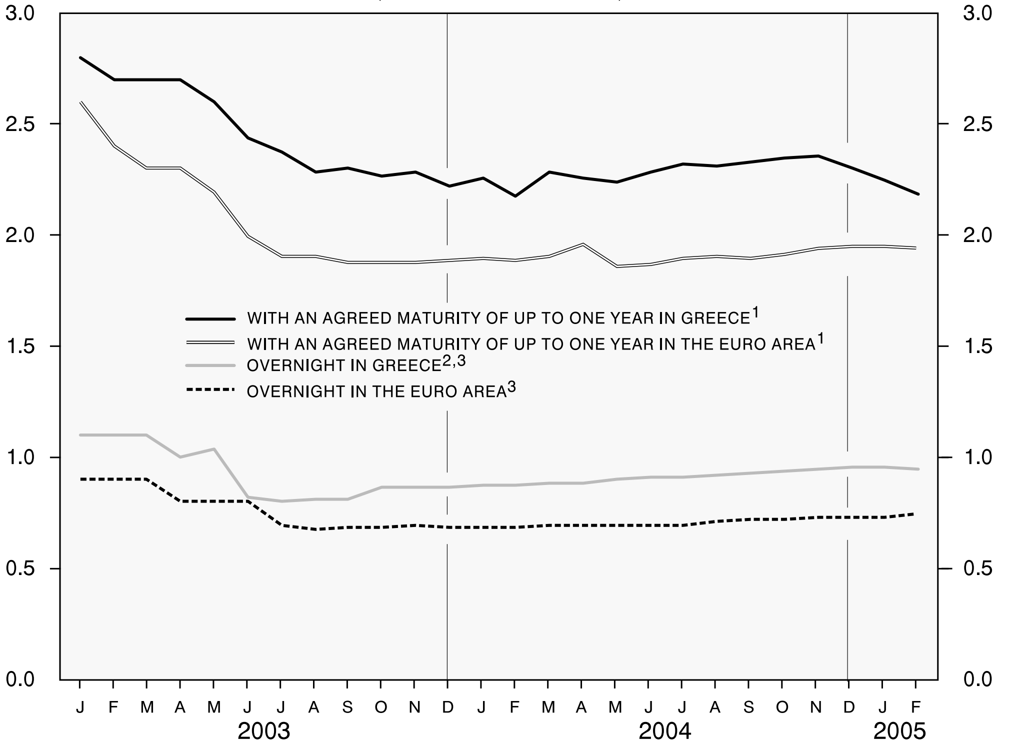
1 As of the beginning of 2003, bank interest rates on deposits and loans throughout the euro area are recorded using a common methodology (see Bank of Greece, *Monetary Policy 2003-2004*, Box 2).

negative in 2004 (on average: –2.0%), though it decreased compared with the previous year, as annual average inflation declined slightly, while, as already mentioned, the corresponding nominal interest rate increased a little. The relatively low interest rate on overnight deposits is related to the historically low level of ECB interest rates and the high liquidity of these deposits, but also to the operating cost of the services offered by banks

CHART VI.5

BANK INTEREST RATES ON NEW DEPOSITS FROM HOUSEHOLDS IN GREECE AND IN THE EURO AREA

(PERCENTAGES PER ANNUM)



1 Monthly average rate.
2 The interest rate on savings deposits is used, as these deposits represent the bulk of overnight deposits and their interest rate is almost the same as the overnight rate.
3 End-of-month rate.

Sources: Bank of Greece and ECB.

through deposit accounts (carrying out standing payment orders, bill payments through credit cards and cheques processing).

A small rise (of 8 basis points) was recorded in 2004 in the interest rate on new deposits with an agreed maturity of up to one year, which, however, remains higher (December 2004: 2.30%) than the interest rate on savings deposits, though it decreased slightly in the first two months of 2005. Moreover, the interest rate on new repos remained

TABLE VI.4

BANK INTEREST RATES ON NEW DEPOSITS AND LOANS IN GREECE AND IN THE EURO AREA

(Percentages per annum)

	December 2003	February 2005	Change Feb. 2005/ Dec. 2003
A. Deposits			
A.1 Overnight from households[1]			
Weighted average interest rate in the euro area	0.70	0.74	0.04
Maximum interest rate	1.20	1.20	0.00
Minimum interest rate	0.12	0.12	0.00
Interest rate in Greece	0.87	0.95	0.08
A.2 With an agreed maturity of up to one year from households[2]			
Weighted average interest rate in the euro area	1.89	1.94	0.05
Maximum interest rate	2.38	2.24	–0.14
Minimum interest rate	1.47	1.51	0.04
Interest rate in Greece	2.22	2.19	–0.03
B. Loans with a floating rate or an initial rate fixation of up to one year[2]			
B.1 Loans up to €1 million to non-financial corporations			
Weighted average interest rate in the euro area	4.06	3.91	–0.15
Maximum interest rate	5.63	5.91	0.28
Minimum interest rate	3.21	3.44	0.23
Interest rate in Greece	5.13	5.08	–0.05
B.2 Loans over €1 million to non-financial corporations			
Weighted average interest rate in the euro area	3.12	3.02	–0.10
Maximum interest rate	4.33	4.21	–0.12
Minimum interest rate	2.90	2.71	–0.19
Interest rate in Greece	3.78	3.53	–0.25
B.3 Housing loans			
Weighted average interest rate in the euro area	3.62	3.40	–0.22
Maximum interest rate	4.63	4.35	–0.28
Minimum interest rate	3.29	3.12	–0.17
Interest rate in Greece	4.31	4.20	–0.11
B.4 Consumer loans			
Weighted average interest rate in the euro area	7.17	6.20	–0.97
Maximum interest rate	10.87	10.56	–0.31
Minimum interest rate	4.96	4.45	–0.51
Interest rate in Greece	9.60	8.99	–0.61
C. Loans with an initial rate fixation of 1-5 years			
C.1 Consumer loans			
Weighted average interest rate in the euro area	6.54	6.84	0.30
Maximum interest rate	10.03	10.84	0.81
Minimum interest rate	4.34	4.24	–0.10
Interest rate in Greece	10.03	9.53	–0.50

1 End-of-month interest rate.
2 Monthly average rate.
Sources: ECB and euro area NCBs.

virtually unchanged in 2004 (December 2004: 2.01%, December 2003: 1.98%), as well as in the first two months of 2005.[1]

As a result of the slight increase in Greek interest rates on deposits in combination with the likewise limited change in the corresponding euro area rates, the differential between the former and the latter rates remained positive (see Table VI.4). Specifically, at the end of 2004, Greek interest rates on overnight deposits by households and on new deposits with an agreed maturity of up to one year were, respectively, 23 and 35 basis points higher than the euro area ones. In February 2005 the above positive differential remained practically unchanged for the first of these deposit categories (21 basis points), while it fell for the second (to 25 basis points). As an exception, the interest rate on new repos stays very close to the corresponding euro area average. The fact that yield differentials across euro area repo markets are small reflects the homogeneity of the products offered and the typically large amounts involved in such transactions.

The level of bank lending rates, aside from the cost of raising the relevant funds, is also associated with the collateral offered by the borrowers, the magnitude of the risks assumed by credit institutions and the maturity of the loan. In general, interest rates are higher for loans without a defined maturity, and lower for housing loans and large corporate loans with a floating rate or an initial rate fixation of up to one year. In Greece in 2004, among the individual categories of bank loan interest rates, a sharper fall was recorded in new consumer loan rates (irrespective of maturity) and a lesser one in new housing loan rates (see Chart VI.6), while changes in the interest rates on new corporate loans were marginal. In more detail, in the previous year the interest rate on consumer loans without a defined maturity, which form the major category of consumer loans, recorded a relatively sharp fall of 67 basis points (to 13.41% in December 2004). The average interest rate on the total of consumer loans with a defined maturity also fell, by 50 basis points (to 9.36% in December 2004). The interest rate on new consumer loans with an initial rate fixation of more than one and up to five years, which represent nearly 43% of all defined maturity consumer loans, fluctuated in the first eight months of 2004, but subsided thereafter and stood at 9.45% in December[2] (December 2003: 10.03%). Nevertheless, the interest rates in all three categories of consumer loans mentioned above recorded an increase of 8 to 30 basis points in the first two months of 2005.

The weighted average interest rate on the total of new housing loans fluctuated in general in the course of 2004, but in December it stood at a slightly lower level than at the

1 As mentioned above, as from 1 January 2005 the tax rate on interest from deposits was reduced from 15% to 10%, while the corresponding rate on repo yields was raised from 7% to 10%.

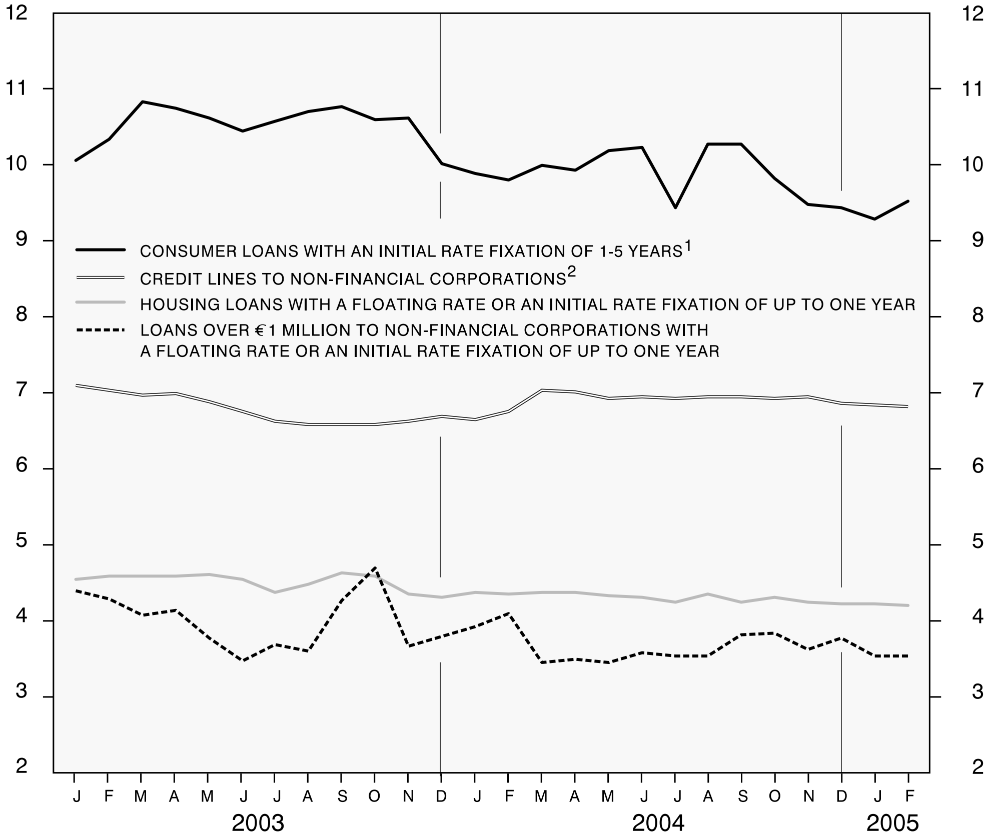
2 It should be noted that the interest rate on the other, equally important category of consumer loans, i.e. those with a floating interest rate or an initial rate fixation of up to one year, which represent 42% of all consumer loans with a defined maturity, recorded the steepest fall (of 102 basis points) in 2004, but rose again in the first two months of 2005 (by 41 basis points).

end of 2003 (December 2004: 4.37%, December 2003: 4.53%). The interest rate on new housing loans with a floating rate or an initial rate fixation of up to one year, which represent 83% of all new housing loans, fell in 2004 by 10 basis points (December 2004: 4.21%, December 2003: 4.31%). The interest rates on these two loan categories remained at roughly the same levels in the first two months of the current year.

CHART VI.6

INTEREST RATES ON NEW BANK LENDING IN GREECE

(PERCENTAGES PER ANNUM)



1 Monthly average rate.
2 End-of-month rate.

Source: Bank of Greece.

As for interest rates on loans to non-financial corporations, in 2004 the interest rate on loans without a defined maturity,[1] which account for 1/3 of the total balance of corporate loans, recorded a rise of 19 basis points (December 2004: 6.97%), which is, how-

1 The most important subcategory of such loans are those extended through credit lines, the interest rate on which increased by approximately the same percentage.

ever, attributable to statistical reasons.[1] In 2004, a small decrease (of 9 basis points) was observed in Greek interest rates on corporate loans of up to €1 million with a floating rate or an initial rate fixation of up to one year. The interest rates on this loan category and on loans without a defined maturity showed no significant change in the first two months of 2005. The interest rate on corporate loans of more than €1 million with a floating rate or an initial rate fixation of up to one year remained practically unchanged in 2004, but fell by 24 basis points in the January-February 2005 period. The interest rate on relatively large corporate loans (of more than €1 million) was 1.27 percentage points lower than that on relatively small ones (of up to €1 million) in Greece in December 2004, and this spread widened to 1.55 percentage points in February 2005 (compared with a corresponding spread of 89 basis points in the euro area in the same month). Given that the relatively larger loans are usually extended to large corporations, this interest rate spread also shows the more favourable terms of borrowing such enterprises enjoy. In this regard, it should be noted that loans to smaller-size enterprises generally entail greater uncertainty and also incur higher operating costs.

The average interest rate on the outstanding amounts of euro-denominated loans, which affects the banks' operating income, recorded a slight fall near the end of 2004 and remained at roughly the same level in the first two months of 2005. Specifically, the interest rate on the major category of consumer loans (with a maturity of up to one year) decreased, as did the rate on the most significant category of housing loans (with a maturity of over five years). In the first two months of the current year the former rate increased, while the latter showed no significant change. Moreover, the interest rate on short-term loans to non-financial corporations (the most important category of corporate loans) remained practically unchanged in 2004, and subsided only slightly in the January-February 2005 period. A decrease was observed in the course of 2004 mainly in the interest rate on long-term corporate loans, which dropped further in the first two months of 2005.

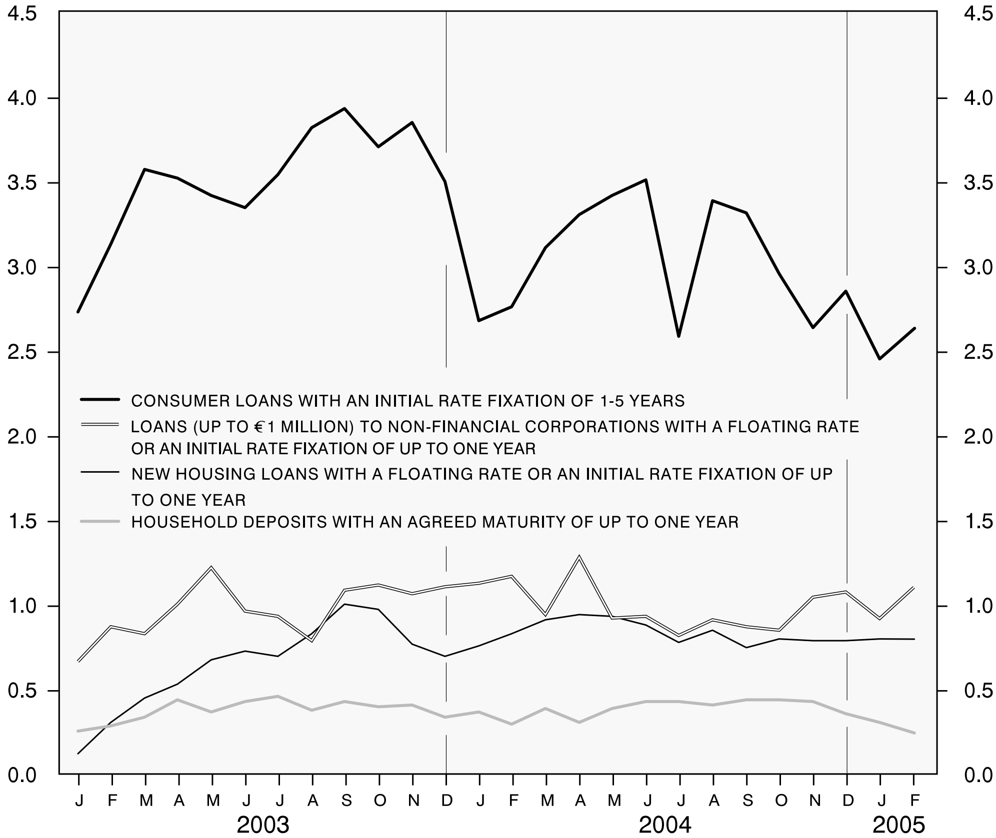
In 2004, interest rate differentials between Greece and the euro area in most categories of bank loans narrowed further, but nonetheless remained wide, especially in consumer loans. In more detail, in new consumer loans with an initial rate fixation of more than one and up to five years, the differential between the Greek interest rate and the corresponding euro area rate shrank in 2004 (to 2.85 percentage points in December 2004, from 3.49 percentage points in December 2003, see Chart VI.7) and decreased further in February of the current year. In consumer loans without a defined maturity, despite a narrowing in the course of the year, the interest rate differential remained wide (3.89 percentage points in December 2004, compared with 4.39 percentage points in December 2003), while it increased slightly in February 2005. This substantial differential is chiefly attributable to the large share of loans through credit cards in the total of consumer loans in Greece and the higher interest rate on such loans (December 2004: 14.29%), which

1 In February and March 2004, one bank reclassified certain low-interest-rate corporate loans from the category of credit lines to that of loans with a defined maturity, thereby raising the average interest rate on loans through credit lines.

reflects mainly the high levels of risk premia and the operating costs this loan category entails for banks. In housing loans with a floating rate or an initial rate fixation of up to one year, the differential stood at a slightly higher level in December 2004 (78 basis points) than in December 2003 (69 basis points) and remained practically unchanged in the first two months of 2005 (see Table VI.4). It is worth noting that the differentials

CHART VI.7

INTEREST RATES ON NEW BANK DEPOSITS AND LOANS: DIFFERENTIALS BETWEEN GREECE AND THE EURO AREA
(PERCENTAGE POINTS)



Sources: Bank of Greece and ECB.

between Greek and euro area interest rates on housing loans are also associated with the longer time required for the liquidation of real estate serving as loan collateral in Greece, as well as with the uncertainty surrounding the measurement of the cost of doubtful loans. In corporate loans without a defined maturity, the differential widened (to 1.71 percentage points in December 2004, from 1.21 percentage points in December 2003), but narrowed slightly in the first two moths of 2005. This substantial interest rate differential reflects the fact that the above loan category is not homogeneous across the euro area as regards the relevant collaterals and other terms on which the loans are extended.[1] It should also be noted that there are other euro area countries with higher interest rates than the Greek one. In loans with a floating rate or an initial rate fixation of up to one year, in December 2004 the differential was 1.07 percentage points for loans of up to €1 million and 72 basis points for loans of more than €1 million, while in February 2005 the differential increased to 1.17 percentage points in the former category and decreased to 51 basis points in the latter.

1 In some euro area countries such as France and the Netherlands these loans are fully covered by collateral, hence they have a relatively lower interest rate.

VII. THE CAPITAL MARKETS

1. THE MARKET FOR GOVERNMENT PAPER

1.1 The primary market

In 2004 the primary market for Greek government paper was marked by an increase in the value of securities issued. Underlying this development were factors such as an increase in the central government's gross borrowing requirement, redemptions of

TABLE VII.1
BREAKDOWN OF GREEK GOVERNMENT PAPER ISSUES
(In percentages)

Type	2002		2003		2004	
Treasury bills	**4.7**		**4.8**		**5.7**	
Bonds	**95.3**		**95.2**		**94.3**	
1–year		0.0		7.4		17.5
3–year		22.7		22.5		21.2
5–year		24.1		25.9		30.3
7–year		5.0		0.5		0.2
10–year		29.1		28.0		23.7
12–year		–		–		0.9
15–year		0.0		1.9		–
20–year		19.1		10.2		0.7
23–year		0.0		3.6		5.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Total value (million euro)	**32,069**		**36,521**		**43,361**	

Note: By initial (not residual) maturity as regards the re-opening of past issues.
Source: Bank of Greece.

past issues[1] and the favourable conditions prevailing in the Greek and international bond markets throughout the year.

The nominal value of government paper issued in 2004 rose to €43.4 billion, from €36.5 billion in 2003 (see Table VII.1). Fund-raising took place both through new issues and through reopenings of past issues. New issues mostly concerned syndicated loans and, to a lesser extent, issues through auction procedures in the domestic market. Specifically, issues of syndicated loans, which include the new 10- and 5-year benchmark bonds, accounted for approximately 81% of the total value of new government paper issued in

1 Redemptions totalled €25.6 billion in 2004, compared with €21.6 billion in the previous year.

2004. Moreover, reopenings of past government issues were executed through auction procedures. Reopenings helped the government to deepen the primary market and to take advantage of the favourable conditions in the secondary market in 2004.

The bulk of the issuance activity was concentrated in the first half of 2004, reflecting the need to launch benchmark bonds as from the beginning of the year, the higher liquidity needs associated with the Olympic Games, as well as the uneven distribution of amortisation payments during the year.

The liquidity of the primary market increased further in 2004 from the already high levels it had reached in 2003. In particular, in 2004 the capital supplied by investors participating in government bond and Treasury bill auctions was more than quadruple the demand by the government. Indeed, the coverage ratio of the issues rose to 4.6 in 2004, from 3.3 in 2003, indicating the sustained strong interest of both domestic[1] and foreign investors in Greek government paper.

The government securities issued in 2004 were mostly bonds with a maturity of 1 to 23 years[2] (no 15-year bonds were issued) and, to a much lesser extent, Treasury bills with a maturity of 3, 6 and 12 months. Treasury bill issues remained low and stood at €2.5 billion in 2004 (2003: €1.7 billion), representing 5.7% of total issues (see Table VII.1). Specifically, these issues mainly concerned 3-month Treasury bills, with a share of about 41% in the total amount of Treasury bills issued.

The nominal amount of government bonds issued in 2004 stood at €40.9 billion, compared with €34.8 billion in 2003 and €30.6 billion in 2002. Table VII.1 shows that the greatest part of this amount (52%) concerned bonds with a maturity of 3 and 5 years, 17% concerned securities with a maturity of up to 1 year[3] and the rest concerned issues with maturities of 7, 10, 12,[4] 20 and 23[5] years. Thus, the weighted average maturity of all Greek government paper issued in 2004 fell to 6.85 years, from 7.22 years in 2003 and 8.55 years in 2002.

1.2 The secondary market

The key features of the secondary market for government bonds in 2004 were the strong rise in transactions and the significant decline in yields during the second half of the year.

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1 The decision to give to small domestic investors access to the primary market through public offering is considered to have been particularly successful. The yields on these securities are exempted from tax, provided they are held to maturity.

2 Note that the first Greek 30-year bond appeared in early March, within the scope of the 2005 government borrowing programme. The issue amounted to €5 billion and was oversubscribed about twice, while the greatest part of the issue was absorbed by foreign institutional investors. The coupon rate is 4.5% and the bond matures on 20 September 2037.

3 Bonds with a maturity of up to one year include Special Savings Bonds (ETA) issued in February 2004. They also include short-term securities (euro commercial paper), which are short-term financial instruments and, combined with asset management, they aim to improve liquidity and reduce borrowing costs for the government. These securities are sold to Primary Dealers.

4 Issue of new zero coupon bonds with a 12-year maturity and a value of €384 million.

5 Reopenings of a 23-year syndicated index-linked bond which is connected with euro area inflation (except tobacco prices), basis coupon rate: 2.90%, total value: €2.3 billion.

Specifically, in line with developments in their euro area counterparts,[1] yields of Greek government bonds, after declining in the first three months of the year, rose until June 2004 to stand at the highest levels of the year (see Chart VII.2). This change is attributable to market estimates about a heightened growth rate of the world economy, as well as to investors' expectations of an increase in US interest rates.[2] However, from July onwards, concerns about the impact of rising oil prices on economic activity in the euro area, as well as of the large appreciation of the euro against the US dollar, strongly shifted investors' demand to government bonds and, therefore, caused a significant decline in their yields, which was even steeper for long-term bonds. Note that the volatility of the Greek secondary market[3] and the euro area bond markets dropped sharply during 2004.[4] During the first two months of 2005, yields on Greek government paper kept falling until the first ten days of February, when they reached historically low levels. However, they recovered strongly until the end of February, while they fluctuated in March.

In greater detail, the average daily value of transactions in the Book-Entry Securities System of the Bank of Greece rose by 13% compared with 2003 and stood at €27 billion in 2004 (see Chart VII.1A). The average daily value of transactions in the Electronic Secondary Securities Market (HDAT) rose markedly to €3.8 billion in 2004 (by 39% compared with 2003), reflecting the increased demand for bonds both by domestic investors and, mainly, by foreign ones (see Table VII.2 and Chart VII.1B). In the first quarter of 2005 the average daily value of transactions in HDAT remained high, although it fell somewhat (see Table VII.2 and Chart VII.1B). Long-term bonds (10 years and over) accounted for 82% of the total value of transactions in HDAT in 2004, compared with 76% in 2003 (see Table VII.2). Ten-year bonds attracted the majority of investors and had a share of about 66% in the total value of transactions in 2004.

Foreign institutional investment in Greek government paper was particularly high in 2004. According to balance of payment statistics, foreign investment in Greek government bonds recorded a net inflow of €21.6 billion in 2004, i.e. 15% higher than in 2003.[5] By contrast, Greek banks proceeded to restructuring their portfolios by limiting Greek government paper holdings in order to enhance their lending activity.

The yield on the 10-year Greek government bond dropped to 3.80% at end-December 2004, i.e. 62 basis points lower than at end-December 2003 (see Chart VII.2). Specifically, in 2004 the difference between a peak (4.61% on 14 and 15 June) and a

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1 See Chapter V.6 for developments in the euro area bond markets.

2 These expectations came true on 30 June 2004, when the US Federal Reserve raised, for the first time in the last five years, its target for the federal funds rate by 25 basis points.

3 Characteristically, the standard deviation of the yield on the 10-year Greek benchmark bond in HDAT in 2004 ranged at levels lower than its average in the last four years.

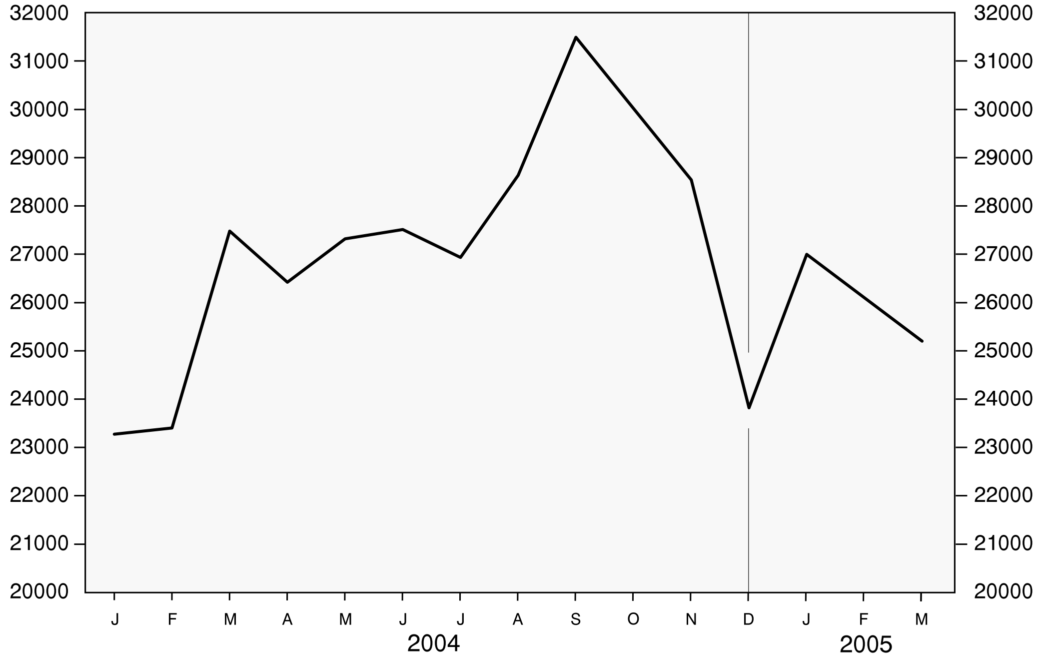
4 Volatility in international bond markets, as measured by the implied volatility of options prices on ten-year bond futures, fell markedly in 2004 and was generally lower than the average in the last five years. For further analysis on this issue see the ECB *Monthly Bulletin*, December 2004.

5 The outstanding balance of foreign investment in Greek government paper at the end of 2004 is estimated to have reached almost 58% of the total outstanding amount of these securities.

CHART VII.1

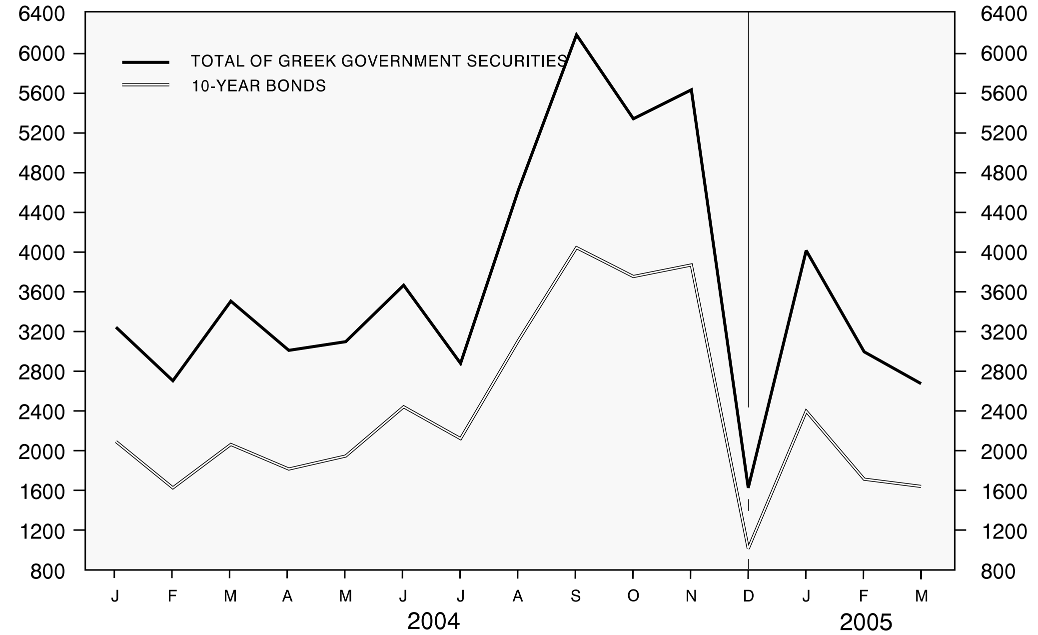
A. AVERAGE DAILY VALUE OF TRANSACTIONS IN GREEK GOVERNMENT SECURITIES IN THE BOOK-ENTRY SECURITIES SYSTEM

(MILLION EURO)



B. AVERAGE DAILY VALUE OF TRANSACTIONS IN HDAT

(MILLION EURO)

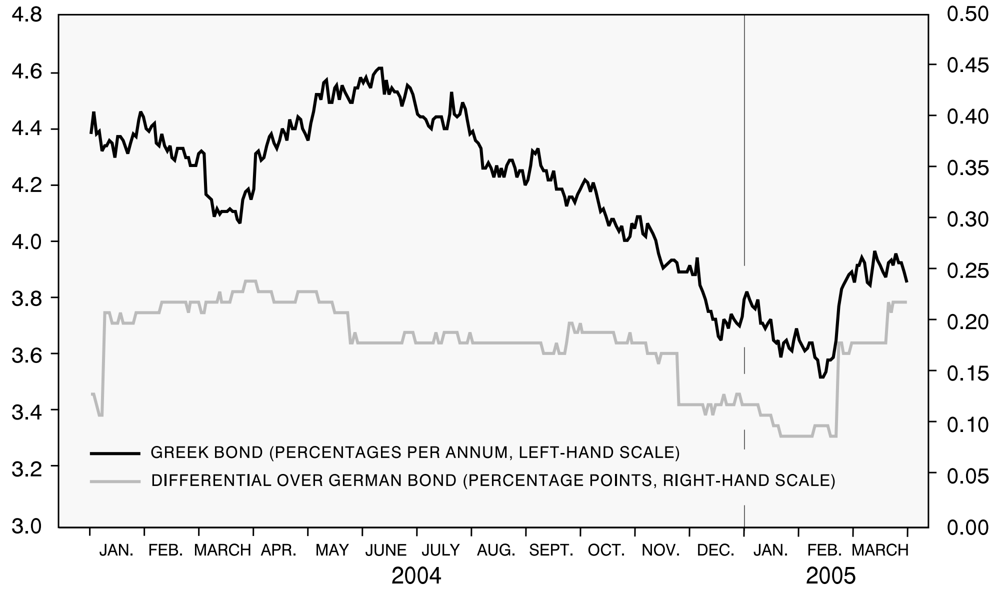


Source: Bank of Greece.

trough (3.66% on 16 December) stood at 95 basis points, i.e. it was the same as in 2003. The yield spread between the Greek 10-year bond and the comparable German bond stood at 12 basis points at end-2004,[1] i.e. it remained at end-2003 levels. The downgrading of Greece's long-term credit quality (from A + to A) by the international rating agencies Standard & Poor's and Fitch (on 17 November and 16 December, respectively) due to the fiscal data revision is estimated to have had almost no effect on this spread. During the first two months of 2005 the yield spread between the Greek 10-year bond and the com-

CHART VII.2

YIELD ON GREEK 10-YEAR GOVERNMENT BOND AND YIELD DIFFERENTIAL OVER THE CORRESPONDING GERMAN BOND



Source: Bank of Greece.

parable German bond widened markedly to 18 basis points, as a new Greek benchmark bond was issued in mid-February 2004 with a maturity 6.5 months longer than the comparable German bond, while in March 2005 this spread widened further.

1 By mid-January 2004 this spread widened significantly to 21 basis points, due to the issuance of a new Greek benchmark bond with a residual maturity 5.5 months longer than that of the corresponding German bond. From the beginning of June to the end of November, the spread narrowed and came to 18 basis points on average. The significant further decline of this spread to 12 basis points since the end of November is due to the issuance of a new German reference bond on 24 November 2004, maturing on 4 January 2015, i.e. 7.5 months after the comparable Greek bond (20 May 2014). If both bonds had the same maturity date, the yield spread would have reached 21 basis points at the end of December 2004.

TABLE VII.2

VALUE AND STRUCTURE OF TRANSACTIONS IN GOVERNMENT SECURITIES IN HDAT

Years/months	Average daily value of total transactions (million euro)	Percentage share in the total value of transactions[1]								
		Treasury bills	Government bonds							
			3-year	5-year	7-year	10-year	15-year	20-year	23-year	32-year
2004 Jan.	3,237.8	– [2]	3.4	9.4	3.0	64.4	7.7	12.1	–	–
Feb.	2,704.3	– [2]	10.9	10.9	3.4	60.2	4.1	10.3	0.2	–
March	3,505.1	0.2	7.5	13.7	4.1	59.0	6.8	8.6	0.1	–
Apr.	2,999.0	0.6	7.4	12.5	2.6	60.6	7.1	9.0	0.1	–
May	3,091.7	0.4	8.8	11.2	2.0	62.8	7.2	7.5	0.1	–
June	3,658.1	– [2]	4.9	13.9	2.1	66.8	5.3	6.9	0.1	–
July	2,875.0	0.1	2.6	7.8	0.9	73.8	5.6	9.2	– [3]	–
Aug.	4,617.9	0.1	7.6	8.9	2.4	67.4	6.6	7.1	–	–
Sept.	6,170.4	– [2]	5.8	9.6	1.5	65.3	8.9	8.9	– [3]	–
Oct.	5,325.9	0.1	4.4	7.5	1.3	70.3	11.3	5.1	– [3]	–
Nov.	5,614.0	0.1	3.8	6.1	1.3	68.7	15.2	4.8	– [3]	–
Dec.	1,625.8	0.3	5.8	8.7	1.4	62.4	12.3	9.1	– [3]	–
Jan.– Dec.	3,785.4	0.2	5.9	9.7	2.1	65.7	8.6	7.8	– [3]	–
2005 Jan.	3,999.9	0.2	8.4	5.9	0.9	59.7	15.6	9.3	– [3]	–
Feb.	2,994.3	0.5	9.8	5.6	2.2	57.3	12.5	12.1	– [3]	–
March	2,669.3	– [2]	8.3	6.6	1.8	61.7	6.5	8.1	– [3]	7.0

1 As per initial maturity.
2 The average daily value of transactions in Treasury bills amounted to €2.0 million in January 2004, €1.58 million in February 2004, €0.68 million in June 2004, €2.73 million in September 2004 and €0.5 million in March 2005.
3 The average daily value of transactions in the 23-year bond amounted to €0.2 million in July 2004, €0.9 million in September 2004, €0.5 million in October 2004, €0.2 million in November 2004, €0.2 million in December 2004, €0.8 million in January 2005, €0.8 million in February 2005 and €1.2 million in March 2005.
Source: Bank of Greece.

At end-December 2004 the government paper yield curve shifted downwards appreciably compared with end-December 2003, as yields declined across the maturity spectrum. The most marked yield reductions were seen in long-term (20-year and 10-year) bonds. The slope of the yield curve, as measured by the spread between yields on the 10-year government bond and the 12-month Treasury bill, fell by 67 basis points (to 1.44 percentage points at end-December 2004, from 2.11 percentage points at end-December 2003).

The steep rise in secondary market transactions contributed to a further increase in the already high liquidity of the market and improved its efficiency. This is reflected in the narrowing of the bid-ask spread for bonds to 6.1 basis points in December 2004, from 8.2 basis points in December 2003.

2. THE STOCK MARKET

The rise in the composite share price index, which had started in 2003,[1] continued in 2004 (see Chart VII.3A). Transactions stood at levels similar to those of 2003, while the value of funds raised was slightly higher.

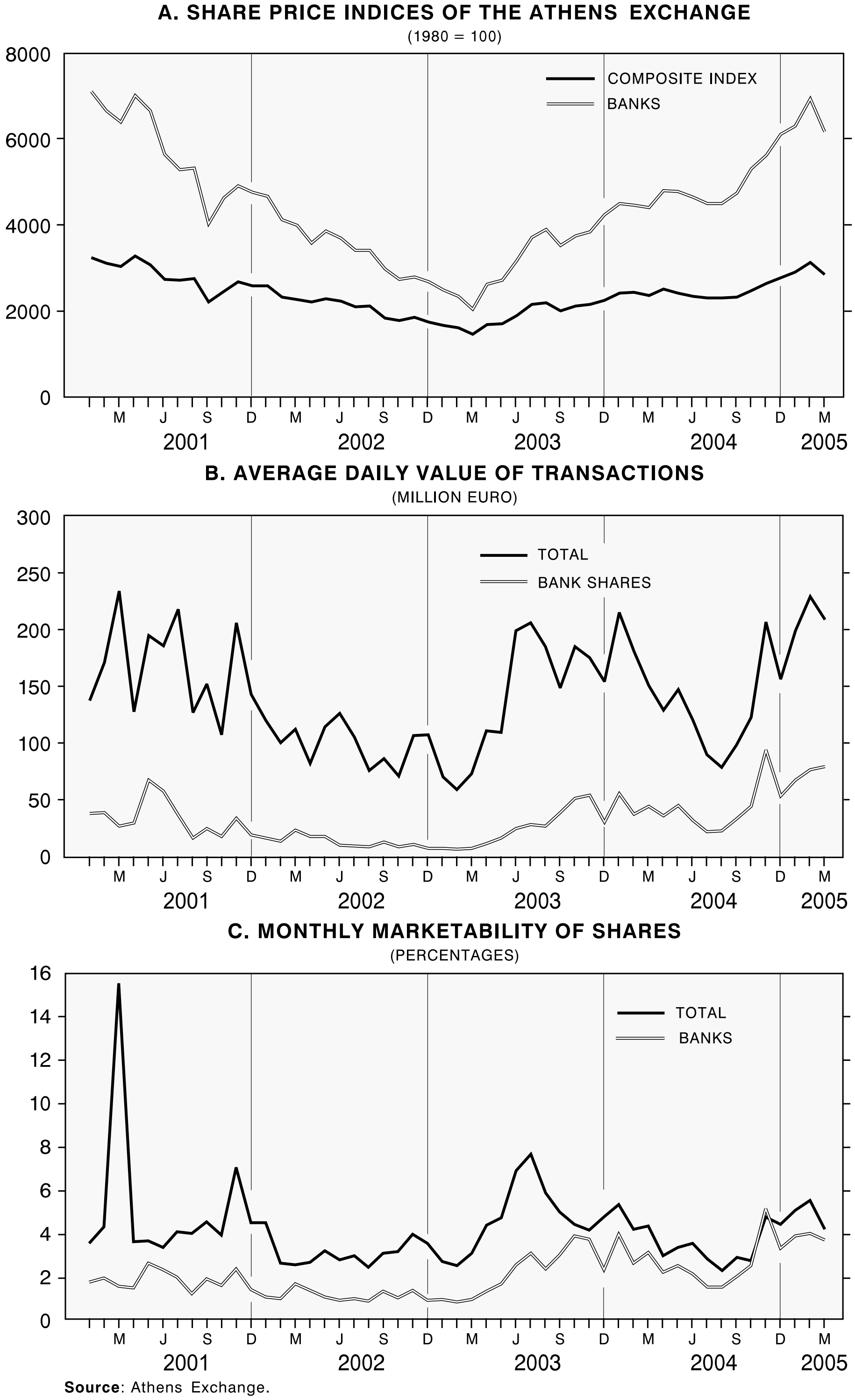
The Greek stock market was affected both by domestic developments, such as a further improvement in corporate profitability, and by the positive developments in international, mainly euro area, stock markets. In particular, during the first two months of 2004 the Athex composite share price index rose, mainly owing to the significant recovery (35%) in the profits of companies with shares listed on the Athex in 2003. Then, stock prices showed a downward trend until end-August, when they stood at the lowest levels of the year, as during this period the stock market was adversely influenced by investors' concerns about the impact of higher oil prices on corporate profits and economic activity. However, from end-August, stock prices rose continuously and strongly, reflecting a further improvement in corporate profits during 2004,[2] as well as the favourable conditions prevailing in international stock markets. The upward trend continued in the first two months of 2005, but came to a halt in March.

In more detail, the composite share price index of the Athex increased by 23.1% at end-December 2004, compared with end-December 2003. This development was mainly due to the significant rise in stock prices of companies with a high capitalisation level, as reflected in the 32.3% rise in the Financial Times 20 (FTSE ASE 20) index. By contrast, both the index for companies with medium capitalisation levels, Financial Times 40 (FTSE ASE 40), and the index for companies with low capitalisation levels,

1 Following the lowest level in five years recorded at end-March 2003.

2 In 2004, total profits of companies listed on the Athex rose by 12.2% at group level and fell by 2.9% at parent company level. Moreover, in 2004, the profitability of non-financial corporations rose by 11.4% at group level and by 1.2% at parent company level.

CHART VII.3



Source: Athens Exchange.

TABLE VII.3

STOCK MARKET AGGREGATES

Year	Share price indices[1] (1980 =100)		Average daily value of transactions[2] (million euro)	Market capitalisation[1] (million euro)			Market capitalisation (percentage of GDP)			Funds raised through the Athens Exchange (Athex)[4] (million euro)		
	Composite	Banks		Shares	Bonds[3]	Total	Shares	Bonds	Total	Listed companies	New companies	Total
2001	2,591.6	4,788.1	166.1	96,950	81,180	178,130	74	62	136	367	470	836
2002	1,748.4	2,688.2	100.2	65,760	114,570	180,330	46	81	127	267	86	353
2003	2,263.6	4,246.9	141.1	84,547	135,219	219,766	55	88	143	317	61	378
2004	2,786.2	6,129.0	140.8	92,140	157,905	250,045	56	96	151	397	79	476

1 At year-end.
2 In shares. Excluding transactions in existing shares.
3 Comprising Greek Treasury bills and government bonds, bank bonds and corporate bonds.
4 Through capital increase and issuance of new shares. Subscriptions to new capital are entered on the last day of the subscription period.
Sources: Athex, Bank of Greece and (for GDP) Ministry of Economy and Finance.

Financial Times 80 (FTSE ASE 80), fell (by 2.8% and 21.3% respectively).[1] However, the rise of the Athex composite share price index in 2004 was notably higher than that of Dow Jones EURO STOXX in the euro area (10.0%)[2] and Standard and Poor's 500 in the USA (9.0%).[3]

On the basis of the above developments, the price to earnings per share (P/E) ratio for all Athex-listed shares[4] rose to 17.8 at end-December 2004, from 15.8 at end-December 2003. The dividend yield of all Athex-listed shares, on the basis of stock prices at the end of 2004 and the data about dividends distributed for 2004, is estimated to have remained at a satisfactory level, although it fell compared with the previous year.

The average daily value of transactions stood at €141 million in 2004, i.e. at almost the same level as in 2003 (see Chart VII.3B and Table VII.3). The total value of transactions in shares rose to €35,623 million in 2004, from €34,854 million in 2003 (see Table VII.4). A large increase in trading was recorded in shares of banks and, to a lesser extent, of telecommunications companies. This is also confirmed by the sectoral composition of the value of transactions in shares, which shows that trading in shares of the above two sectors increased strongly in 2004, while trading in shares of most of the other sectors dropped (see Table VII.4). Moreover, the bulk of transactions concerned shares of high-capitalisation companies, i.e. those covered by the FTSE ASE 20 index (average daily value of transactions in 2004: €97 million, 2003: €72 million). By contrast, the average daily value of transactions in shares of medium- and low-capitalisation companies (covered, respectively, by the FTSE ASE 40 and FTSE ASE 80 indices) declined in 2004 (to €17 million and €14 million, respectively, from €23 million and €21 million in 2003). Moreover, the value of transactions in the new stock market also fell significantly (see Table VII.4).

Share marketability[5] followed a path similar to that of the average daily value of transactions and fell slightly to 4.4% in December 2004, from 4.7% in December 2003 (see Chart VII.3C).

The market capitalisation of Athex-listed shares grew to €92,140 million or 56% of GDP at end-2004, from €84,547 million or 55% of GDP at end-2003 (see Table VII.3). This rise was due to shares quoted on the main market, since the market capitalisation of shares quoted on the parallel and the new market fell. This development reflects a substantial increase in stock prices on the main market, while the influence on market capitalisation exerted by the listing of new companies and the capital increases of Athex-listed firms continued to be limited in 2004.

The investment behaviour of foreign institutional investors contributed decisively to the favourable developments in the Greek stock market in 2004. According to balance

1 Characteristically, from end-December 2003 to end-December 2004 only 24% of the shares listed on the Athex recorded a rise in their prices.
2 For a more detailed analysis of stock market developments in the euro area, see Chapter V.7.
3 The change in this index, in euro terms, is 1.0%.
4 Excluding the Bank of Greece.
5 Number of shares traded to the total number of listed shares.

TABLE VII.4

VALUE AND STRUCTURE OF STOCK MARKET TRANSACTIONS

(Million euro)

	2001		2002		2003		2004	
	Value of transactions	Percentage of total	Value of transactions	Percentage of total	Value of transactions	Percentage of total	Value of transactions	Percentage of total
Shares	**41,525.3**	**100.0**	**24,759.1**	**99.9**	**34,854.8**	**99.9**	**35,623.0**	**99.7**
Main market	34,555.6	83.2	19,447.4	78.5	29,558.3	84.7	31,928.1	89.4
–Banks	8,485.7	20.4	3,274.1	13.2	6,450.2	18.5	11,071.9	31.0
–Leasing	82.3	0.2	22.6	0.1	41.4	0.1	42.6	0.1
–Insurance	2,276.9	5.5	119.6	0.5	183.4	0.5	106.2	0.3
–Investment	630.5	1.5	268.2	1.1	338.1	1.0	404.0	1.1
–Construction	2,775.4	6.7	1,449.6	5.9	1,508.0	4.3	732.2	2.0
–Commercial/industrial	8,076.6	19.4	3,503.8	14.1	5,200.0	14.9	3,615.2	10.1
–Telecommunications	4,684.7	11.3	4,330.6	17.5	5,152.0	14.8	6,049.9	16.9
–Holding	3,035.6	7.3	1,903.5	7.7	2,400.8	6.9	1,637.3	4.6
–Other	4,507.9	10.9	4,575.4	18.5	8,284.5	23.7	8,268.8	23.2
Parallel market	6,818.9	16.4	5,084.6	20.5	4,975.2	14.3	3,519.0	9.8
New stock market	151.0	0.4	227.1	0.9	321.3	0.9	173.1	0.5
Emerging capital markets within the Greek market	–	–	–	–	–	–	2.8	0.0
Bonds[1]	**18.6**	**0.0**	**13.0**	**0.1**	**49.1**	**0.1**	**94.1**	**0.3**
Total	**41,543.9**	**100.0**	**24,772.1**	**100.0**	**34,902.8**	**100.0**	**35,717.1**	**100.0**

1 Corporate bond issues.
Source: Athex.

of payments statistics, the net inflow of foreign investment in Athex-listed shares rose by 53% to €3,420 million compared with €2,240 million in 2003. Moreover, according to Central Depository of Securities data, at the end of December 2004 foreign investors accounted for 36% (2003: 31%) of the market capitalisation of Athex-listed shares, of which 24% (2003: 17%) concerned institutional investors. By contrast, mutual funds' and portfolio investment companies' holdings in Athex-listed shares fell by €189 million or 3.6% at end-2004.[1]

Fund-raising through the Greek stock market remained low in 2004,[2] though slightly higher compared with 2003. Specifically, funds raised through the stock market totalled €476 million,[3] compared with €378 million in 2003. These funds were raised by 43 companies (2003: 48 companies), of which 10 (2003: 13 companies) were newly-listed and accounted for €79.4 million. In particular, about 39% of total funds were raised by companies of the banking sector (2003: 28%) and 21% (2003: 12%) by industrial companies.

Between end-December 2003 and end-December 2004, the index of bank share prices grew by 44.3%, a rate almost twice as high as that of the composite share price index of the Athex. The average daily value of transactions in bank shares rose considerably (68%) and stood at €44 million in 2004, from €26 million in 2003. Similarly, the average monthly marketability of bank shares increased to 3.25% at end-December 2004, from 2.3% in 2003.

The fact that bank share prices increased at a much higher rate than the total of share prices led to an increase to 22.5 in the P/E ratio[4] at end-December 2004, from 14.8 at end-December 2003. By contrast, the dividend yield of banks[5] fell to 2.5% at end-December 2004, from 3.1% in 2003.

Developments in the stock market performance of the banking sector reflect the sustained interest of investors, mainly foreign institutional investors, in bank shares, due to a further recovery of the operating profitability of banks in 2004, as well as to expectations that profitability would increase because of the expansion of Greek banks to Balkan countries. In greater detail, net profits (before provisions, extraordinary expenses and taxes) of Greek banks[6] with Athex-listed shares rose by 6.7% (16% at group level), while the corresponding increase for the six major Greek commercial banks[7] was 8.5% (18.6% at group level). This rise stemmed both from the increase in individual income items and the limited increase in operating costs.

1 Provisional data.
2 Funds raised in 2004 represent around 7% of the 1998-2000 average.
3 Another €15 million (2003: €1,523 million, mostly by public enterprises) was raised in 2004 through secondary offerings.
4 Excluding the Bank of Greece.
5 The five major Greek commercial banks.
6 Excluding the Bank of Greece.
7 Transactions in shares of these banks represented almost 96% of the total value of transactions in bank shares.

As regards the other sectors, the share price indices of refineries and telecommunications companies increased significantly (23.3%) from end-December 2003 to end-December 2004. The share price index of investment companies rose by 18.7%, an outcome related to the increase in Athex-listed share prices, since a large part of the portfolio of these companies consists of Athex-listed shares.

Industrial share prices rose by about 4.7% compared with the end of 2003, although the total profitability of industrial firms remained unchanged. Among individual manufacturing industries, those of basic metals, furniture, vehicles, jewellery, tobacco and publishing-printing recorded increased profits.

By contrast, textile firms' share prices dropped significantly (–50.9%), due to the structural problems and the loss in competitiveness facing these firms, while construction company share prices also fell notably (–30.4%), as these companies recorded lower profits, both at parent company level (–12.7%) and at group level (–13.0%).

Finally, during 2004, the institutional framework for the organisation and operation of the stock market was strengthened, by finalising, in December, the draft law concerning the protection of the capital market from market manipulation and abuse of inside information. This draft law, which was submitted to Parliament in February 2005, incorporates the provisions of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003, as well as of Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

3. THE MUTUAL FUNDS MARKET

Activity in the mutual funds market recovered only slightly in 2004, despite the appreciable rise in stock prices. Specifically, the value of mutual funds' assets rose slightly, compared with end-2003, by 4.1% to €31.6 billion at end-2004 (see Chart VII.4 and Table VII.5). This was mainly due to the rise in prices and, to a lesser extent, the number of mutual fund units in circulation. As regards individual categories, the largest rise was recorded in the prices of equity-type mutual fund units, while the unit prices of the other types of mutual funds[1] recorded a slower growth. The demand for bond-type mutual fund units rose, due to favourable conditions prevailing in international bond markets in 2004, leading to a large increase in the number of units of this type of funds. The number of balanced-type mutual fund units also rose, though less markedly, while the number of equity-type and money-market-type mutual fund units fell. Specifically, as regards equity-type mutual fund, the increase in unit prices more than offset the drop in their number caused by the increased liquidation of units.[2]

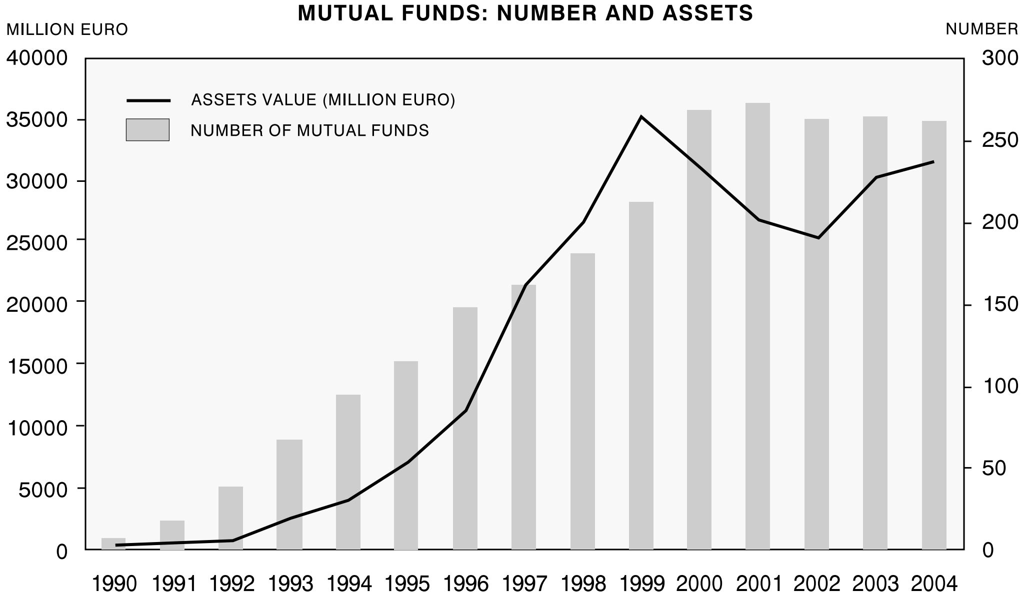
1 In particular, money market mutual funds recorded a weighted average return of 1.5%, equity-type mutual funds 13.2%, balanced-type mutual funds 5.5% and bond-type mutual funds 3.4%.

2 At the end of 2004, equity-type mutual funds recorded a net outflow of €247 million.

The demand for mutual fund units during 2004 was met primarily by the sale of units already on the market at the end of 2003 and, to a lesser extent, by the launch of new mutual funds in 2004. In greater detail, 9 mutual funds were established in 2004 (1 of the money-market type, 2 of the equity type and 6 of the balanced type), with assets totalling €526 million at the end of 2004, representing approximately 1.7% of the total value of mutual funds' assets. Moreover, 12 mutual funds withdrew from the market in 2004 (1 of the money-market type, 2 of the bond type, 6 of the equity type and 3 of the balanced type). Following these developments, the number of mutual funds amounted to 262 at the end of 2004, compared with 265 in 2003 and 263 in 2002

CHART VII.4

MUTUAL FUNDS: NUMBER AND ASSETS



Source: Bank of Greece.

(see Table VII.5). It should be noted that three Mutual Fund Management Companies (MFMC) ceased operating in 2004. Thus, at the end of 2004 the total number of MFMCs was 26, compared with 29 in 2003 and 28 in 2002.

The rise in the value of mutual funds' total assets mainly reflects corresponding developments in the assets of bond-type funds (+16.5%) and, to a lesser extent, balanced-type funds (+6.6%) and equity-type funds (+6.3%). By contrast, the value of money-market-type funds fell (–2.2%).

The rise in mutual funds' assets is mainly due, as stated before, to the increased demand for mutual fund units of the bond type and to the considerable rise in share prices in the Greek stock market. Moreover, money-market-type funds shares, which mainly invest in deposits and money market instruments, recorded low yields in 2004, as interest rates stood at very low levels, shifting investors towards bond-type mutual funds.

On the basis of these developments, the share of money market mutual funds in the total value of mutual funds' assets rose to 24.1%, from 21.5% in 2003, while a slight increase was recorded in the share of equity-type (2004: 16.3%, 2003: 15.9%) and balanced-type mutual funds (2004: 10.8%, 2003: 10.6%). In contrast, the share of

TABLE VII.5
MUTUAL FUNDS: NUMBER AND ASSETS[1]
(Million euro)

Type of mutual fund	2003		2004		Percentage change in value compared with previous year	Percentage of total assets	
	Number	Assets value	Number	Assets value		2003	2004
Money-market type	**40**	**15,787**	**39**	**15,435**	**–2.2**	**52.0**	**48.8**
Domestic	36	15,636	35	15,149	–3.1	51.5	47.9
Foreign	0	0	0	0	–	0.0	0.0
International	4	151	4	286	89.4	0.5	0.9
Bond type	**65**	**6,539**	**62**	**7,620**	**16.5**	**21.5**	**24.1**
Domestic	32	5,110	32	5,358	4.9	16.8	16.9
Foreign	16	748	15	1,059	41.6	2.5	3.3
International	17	681	15	1,203	76.7	2.2	3.8
Equity type	**119**	**4,844**	**116**	**5,147**	**6.3**	**15.9**	**16.3**
Domestic	69	4,181	68	4,313	3.2	13.8	13.6
Foreign	37	618	38	800	29.4	2.0	2.5
International	13	45	10	34	–24.4	0.1	0.1
Balanced type	**41**	**3,214**	**45**	**3,426**	**6.6**	**10.6**	**10.8**
Domestic	27	3,052	26	2,860	–6.3	10.0	9.0
Foreign	4	9	4	92	922.2	0.0	0.3
International	10	153	15	474	209.8	0.6	1.5
Total	**265**	**30,384**	**262**	**31,628**	**4.1**	**100.0**	**100.0**

1 At year end.
Source: Bank of Greece.

money-market-type mutual funds declined substantially (2004: 48.8%, 2003: 52.0%, see Table VII.5).

The EU mutual funds market recorded a positive outcome in 2004,[1] mainly due to the increase in share prices in international stock markets and the gradual return of EU investors to equity-type mutual funds. Moreover, sales of mutual fund units at cross-border level rose remarkably, which suggests increasing consolidation of this market.

1 The value of mutual funds' assets increased by 11% in the EU (end-December 2004, in euro) and by 2% in the United States (end-September 2004, in US dollars).

B O X VII.1

The new institutional framework for mutual funds and mutual fund management companies

Law 3283/2004, concerning "Mutual Fund Management Companies (MFMC), undertakings for collective investment in transferable securities (UCITS), mutual funds and other provisions", passed on 2 November 2004, transposed into Greek law Directives 2001/107 and 2001/108 of the European Parliament and of the Council of 21 January 2002 and replaced as a whole Law 1969/1991 and its subsequent amendments.

The new institutional framework is expected to improve significantly the operation and structure of the Greek mutual funds market, intensify competition and enhance protection and information of investors. Some of the most significant changes brought about by Law 3283/2004 are the following:

1. Expansion and internationalisation of the activities of MFMCs

Article 4 of the new law provides that the exclusive purpose of an MFMC is to manage mutual funds, though it may undertake the management of UCITS, for which it will be subject to prudential supervision. The Capital Market Committee may additionally permit MFMCs to offer portfolio management services to their customers, including pension funds. Finally, if the MFMC is permitted to provide such management services, it may also provide ancillary services, such as consultancy services for financial instruments, as well as administrative management of UCITS units along with custodian services. These developments are expected to enhance competition among MFMCs, investment companies and banks providing similar services, thus changing the structure of financial conglomerates.

Moreover, according to the new law, MFMCs based in another Member State and authorised to operate thereby are allowed to establish a branch in Greece and sell the mutual fund units they manage, which may intensify foreign competition in the domestic market.

2. Enhancement of the capital adequacy and creditworthiness of MFMCs

Article 5 provides that MFMC shares are nominal and are not to be traded on a regulated market. The equity capital of an MFMC must be paid in in cash and its minimum amount is increased to €1.2 million (from €1.175 million). Moreover, when the value of the portfolios managed by an MFMC exceeds €250 million, the MFMC must increase its equity capital by an amount equal to 0.02% of the amount by which the value of the portfolios managed exceeds €250 million, until the sum total of the initial capital and the additional amount reaches a €10 million ceiling.

Moreover, at least 51% (from 40% applying previously) of the MFMC's equity capital must be held by one or more credit institutions or investment companies or insurance companies or holding companies or pension funds. Each of the above shareholders must meet the requirements of Law 3283/2004 on its paid in capital. ➔

➔ *3. Establishment of new specialised mutual funds*

Articles 23 and 24 allow the establishment of (i) funds of funds, i.e. mutual funds which invest in units of other mutual funds or undertakings for collective investment (the amount involved must be up to 20% of the investing mutual fund's net assets per mutual fund) or (ii) index funds, i.e. mutual funds which link the yields they offer with the evolution of a specific index of share or bond prices (the amount involved must be up to 20% of the index fund's net assets in equity or in bonds of the same issuer, though this percentage may extend up to 35%).

4. Protection of, and information to, investors in mutual funds

The new investment limits are specified in detail in Article 22 of the new law and aim to achieve a wider dispersion of risks over different investment instruments and issuers, as well as to limit investment concentration in members of the group of companies to which the MFMC belongs.

Moreover, according to Article 30, MFMCs are required to issue a simplified and a detailed prospectus for each mutual fund they manage, which must be updated following any modification of they data they include. MFMCs must deliver free of charge the simplified prospectus to unit-holders, while the detailed prospectus, the regulation of the mutual fund and its annual or biannual report are to be delivered on request. These prospectuses, as well as all the publications of the mutual funds, must be submitted to the Capital Market Committee for audit and approval. They must include the information necessary for investors to be able to form a documented opinion on the investment proposed to them and the risks involved. According to the provisions of the new law, the detailed prospectus is more comprehensive and better structured and includes a series of analytical data concerning the mutual fund, the MFMC and the custodian. The simplified prospectus must contain specific information about the mutual fund and be drawn up in such a way that its content is easily understood by the public.

In 2004 the Capital Market Committee issued two supplementary decisions, 2/317/11 November 2004 and 24/318/23 November 2004. According to these decisions, MFMCs are required to draw up, at the end of each calendar quarter, a table on the investment of the fund they manage and to regularly inform unit-holders, inter alia, about management fees, depository fees and the three-year cumulative yield of the fund. Additionally, Capital Market Committee Circular No. 25, with a view to promoting transparency and furnishing investors with clear and accurate information determines in detail the fees and expenses to be borne either by the mutual fund or by its unit-holders.

5. Classification of mutual funds

As a supplement to Article 21 (§5) of Law 3283/2004 the Capital Market Committee issued Decision 1/317/11 November 2004, by which the category of "international" mutual funds is abolished. The new categories of mutual funds, on the basis of geographical distribution of their investment, are as follows: ➔

→ (a) domestic mutual funds, i.e. those which mainly[1] invest in financial products (deposits, money market instruments, bonds and equity) issued by an agent domiciled in Greece and

(b) foreign mutual funds, i.e. those which mainly invest in financial products issued by an agent not domiciled in Greece.

MFMCs have already put into motion the procedures necessary to adjust to the new institutional framework, so as to meet operating requirements and also take advantage of the new opportunities offered.

1 That is, an investment amounting to at least 65% of the mutual fund's net assets.

The investment behaviour of mutual funds in 2004 was characterised by increased placements abroad, particularly in repos, shares and bonds. More specifically, between end-December 2003 and end-December 2004, the €1.2 billion rise in assets resulted from

TABLE VII.6
PORTFOLIO STRUCTURE OF MUTUAL FUNDS[1]
(Million euro)

	2003	2004	Change	Percentage change
Domestic investment	**19,144**	**17,389**	**–1,755**	**–9.2**
– Greek government bonds and Treasury bills	4,816	5,397	581	12.1
– Shares listed on the Athex	4,313	4,241	–72	–1.7
– Repos	5,577	3,008	–2,569	–46.1
– Synthetic currency swaps	4,196	4,023	–173	–4.1
– Bank deposits and cash	242	720	478	197.5
Foreign investment	**10,362**	**13,425**	**3,063**	**29.6**
– Bonds	5,234	6,724	1,490	28.5
– Shares	609	923	314	51.6
– Repos	260	2,358	2,098	806.9
– Synthetic currency swaps	3,938	3,152	–768	–20.0
– Bank deposits and cash	321	268	–53	–16.5
Other investment	**878**	**814**	**–64**	**–7.3**
	30,384	**31,628**	**1,244**	**4.1**

1 At year-end.
Source: Bank of Greece.

increased investment in repos abroad (€2,098 million), foreign bonds (€1,490 million), Greek government paper (€581 million), foreign shares (€314 million), as well as in deposits and cash (€478 million) (see Table VII.6). By contrast, there was a decline in placements in domestic repos (–€2,569), foreign (–€786 million) and domestic (–€173 million) synthetic currency swaps, Athex-listed shares (–€72 million) and deposits abroad (–€53 million).

VIII. PUBLIC FINANCE

1. THE PUBLIC SECTOR BORROWING REQUIREMENT AND ITS FINANCING

The high deficit in 2004, the fiscal audit and the launch of the Excessive Deficit Procedure against Greece not only dominated fiscal developments last year, but will have a decisive impact on fiscal developments in the years to come.

The fiscal audit conducted in 2004 led to a significant upward revision of the general government deficit and debt figures for the 1997-2004 period, as compiled in accordance with the methodology of the European System of Accounts 1995 (ESA 95 – national accounts data). The revised figures for the general government deficit are presented in the first row of Table VIII.1. It should be noted, however, that neither the state budget data (on an administrative basis) nor the Bank of Greece data (on a cash basis) appearing in the same table have been revised.

TABLE VIII.1

GENERAL AND CENTRAL GOVERNMENT DEFICITS

(Percentage of GDP)

	2000	2001	2002	2003	2004*
General government deficit[1] *(national accounts data – convergence criterion)*	*–4.1*	*–3.6*	*–4.1*	*–5.2*	*–6.1*
– Central government	*–6.4*	*–5.3*	*–7.0*	*–8.1*	*–9.2*
– Social security organisations and local authorities	2.3	1.7	2.9	2.9	3.1
Central government deficit[2] *(administrative data)*	*–4.3*	*–4.0*	*–3.8*	*–6.4*	*–7.7*
Central government deficit[3] *(cash basis)*	*–5.8*	*–5.9*	*–5.0*	*–6.9*	*–9.4*

1 Ministry of Economy and Finance data, as communicated to the European Commission (Excessive Deficit Procedure).
2 State General Accounting Office data published in the state budget.
3 Bank of Greece data. They regard only the borrowing requirement of central government on a cash basis. The borrowing requirement of public entities (social security organisations and local authorities) is now calculated by the NSSG on the basis of detailed data collected directly from these entities through a special quarterly survey on their financial results (revenue-expenditure) and financial situation (borrowing, investment in securities, deposits, etc.), as data from the banking system are no longer adequate for reliable estimates.
* Provisional data.
Sources: Bank of Greece, Ministry of Economy and Finance, NSSG.

The analysis of the revised data points to a significant relaxation of fiscal policy between 2003 and 2004. The general government deficit, which had not exceeded 4.1% of GDP in the 2000-2002 period, widened to 5.2% in 2003 and 6.1% in 2004. Without underestimating the fact that 2004 was a difficult year from a fiscal perspective (owing to the staging of the Olympic Games and of general and European parliament elections, etc.), the data show that these developments were mainly due to trends in revenue and expenditure which had emerged before 2003 but were not brought under control in time.

Both the euro area and the EU as a whole enjoyed a slightly improved fiscal position in 2004, with the deficit-to-GDP ratio dropping from 2.8% in 2003 to 2.7% in the euro area and to 2.6% in the EU. This improvement resulted from the fiscal measures taken by the countries that were subject to the Excessive Deficit Procedure, as well as from a small upturn of economic activity in 2004. In both 2003 and 2004, Greece experienced very high growth rates (2003: 4.7%, 2004: 4.2%) —higher than the respective potential growth rates— combined with a marked deterioration in public finances. Therefore, this deterioration cannot be attributed to cyclical factors; rather, it reflects extraordinary expenditure (related to the preparations and hosting of the Olympic Games), cumulatively accounting for more than 2.5% of GDP in the 2003-2004 period, and at the same time a substantial overrun in primary spending and a shortfall in revenue in both years. Indicative of the loosening of fiscal policy is the course of the general government primary surplus (on a national accounts basis), which, after falling from 2.2% of GDP in 2002 to 0.6% of GDP in 2003, reversed to a primary deficit of 0.4% of GDP in 2004, for the first time since 1993.

The deterioration in public finances is also reflected in the near-doubling of the central government deficit (on an administrative basis)[1] between 2002 and 2004 (2002: 3.8%, 2003: 6.4%, 2004: 7.7% – see Table VIII.1). A detailed discussion of state budget developments can be found in Section 2 below.

Finally, the central government borrowing requirement, as derived from the cash flows of general government and OPEKEPE,[2] also rose, from 5.0% of GDP in 2002 to 6.9% of GDP in 2003 and 9.4% of GDP in 2004.

Owing to the exclusion of data on social security organisations and local government from central government data on a cash or administrative basis, the latter are only comparable with central government data on a national accounts basis, not with general government data.

Central government borrowing requirement

According to available provisional data, the central government borrowing requirement rose from 6.9% of GDP in 2003 to 9.4% in 2004 (see Table VIII.2), almost exclusively because of the doubling of the ordinary budget cash deficit (2003: €4,106 million or 2.7% of GDP, 2004: €8,841 million or 5.3% of GDP). By contrast, a slight improvement was observed in the investment budget cash deficit, which narrowed to €6,536 million or 4.0% of GDP in 2004, from €6,727 million or 4.4% of GDP in 2003, despite expenditure overruns related to the Olympic projects.

1 Based on state budget data.

2 The Payment and Control Agency for Guidance and Guarantee Community Aid (OPEKEPE) manages Common Agricultural Policy (CAP) subsidies to farmers and is essentially balanced. Any deficit (or surplus) is attributable to the time lag between the payment of the subsidies to the farmers and their collection from the EU, as well as to interest payments.

Underlying this improvement in the investment budget was a marked pick-up in receipts from various EU Funds, following four years of steadily declining investment budget revenue.

Finally, the OPEKEPE's borrowing requirement reached €228 million or 0.1% of GDP, against a surplus of €307 million in 2003.

Due to a lack of complete data to estimate public entities'[1] borrowing requirement, the Bank of Greece has stopped calculating the general government cash deficit since 2003. The relevant national accounts data are compiled on the basis of a special quarterly survey conducted by the NSSG, whereby data on the financial results and position of these

TABLE VIII.2
NET BORROWING REQUIREMENT OF
CENTRAL GOVERNMENT ON A CASH BASIS[1,2,3]
(Million euro)

	2002	2003	2004*
1. Central government	**7,102**	**10,526**	**15,605**
Percentage of GDP	**5.0**	**6.9**	**9.4**
– State budget	6,674	10,833	15,377
(Ordinary budget)[4]	(2,128)	(4,106)	(8,841)
(Public investment budget)	(4,546)	(6,727)	(6,536)
– OPEKEPE[5]	428	–307	228

1 Bank of Greece data. They regard only the borrowing requirement of central government on a cash basis. For the borrowing requirement of public entities, see footnote 3 in Table VIII.1.
2 As shown by the respective accounts with the Bank of Greece and other credit institutions.
3 Excluding the repayment of government debt to the Social Insurance Institute (IKA) through bond issuance (Law 2972/2001, Article 51). The debt, totalling €3,927.9 million, was repaid in three instalments (2002: €1,467.4 million, 2003: €1,549.5 million and 2004: €911 million). The figure for 2004 includes the repayment, through the issuance of *ad hoc* bonds, of debt to social security organisations (€1,043 million) and the Agricultural Bank of Greece (€554 million).
4 Including movements in public debt management accounts.
5 Payment and Control Agency for Guidance and Guarantee Community Aid. It replaced DIDAGEP (Agricultural Markets Management Service) as from 3 September 2001.
* Provisional data.
Source: Bank of Greece.

entities are collected. Nonetheless, on the basis of Bank of Greece data on public entities' securities holdings[2] and deposits, as well as on changes in their liabilities to the banking system, the consolidated cash deficit of central government and public entities stood at around 7.3% of GDP in 2004, against 5.6% in the previous year. With regard to the parties involved, this corresponds to the national accounts deficit of general government, which, as already mentioned, was 6.1% of GDP in 2004.

The financing of the central government borrowing requirement ran smoothly, mainly through the issuance of long-term government bonds, a sizeable part of which was

1 Social security organisations, local authorities and other legal persons in public law.
2 Exclusively referring to holdings through a special fund managed by the Bank of Greece on behalf and in the name of social security organisations.

purchased, as in previous years, by non-residents (see Table VIII.3). In addition, the central government borrowing requirement was further financed by domestic private investors. By contrast, a decline was observed in central government liabilities to both domestic credit institutions and non-residents. It should be made clear that non-resident

TABLE VIII.3
SOURCES OF FUNDS FOR FINANCING THE BORROWING REQUIREMENT OF CENTRAL GOVERNMENT
(Million euro)

	2002		2003		2004*	
	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total
Greek Treasury bills and government bonds[1,2]	11,929	168.0	13,378	127.1	16,829	107.8
Change in the balances of central government accounts with the credit system[3]	90	1.3	–871	–8.3	–901	–5.8
External borrowing[4]	–4,917	–69.2	–1,981	–18.8	–323	–2.0
TOTAL BORROWING	**7,102**	**100.0**	**10,526**	**100.0**	**15,605**	**100.0**

1 Domestically issued Treasury bills and government bonds, as well as privatisation certificates.
2 Excluding bonds issued by the Greek government for debt repayment to the Social Insurance Institute–IKA (Law 2972/2001, Article 51). The figure for 2004 includes the repayment, through the issuance of *ad hoc* bonds, of debt to social security organisations (€1,043 million) and the Agricultural Bank of Greece (€554 million). See also footnote 3 in Table VIII.2.
3 Comprising changes in central government accounts with the Bank of Greece and credit institutions, as well in the OPEKEPE's account.
4 Comprising government borrowing abroad and securities issuance abroad, as well as the change in government deposits with foreign banks. Excluding non-residents' holdings of domestically issued government bonds.
* Provisional data.
Source: Bank of Greece.

holdings of domestic euro bonds are not classified as "external borrowing". Interest rates on Greek government bonds remained broadly unchanged in 2004.

2. FISCAL AGGREGATES

2.1 The state budget

The continued relaxation of fiscal policy is also evident in the state budget,[1] which, despite robust economic growth, eventually showed a deficit twice as much as the amount budgeted for 2004. More specifically, in 2004 the deficit overshot the initial forecasts (of 3.8% of GDP) by €6,408 million (or 3.9% of GDP) and stood at €12,668 million or 7.7%

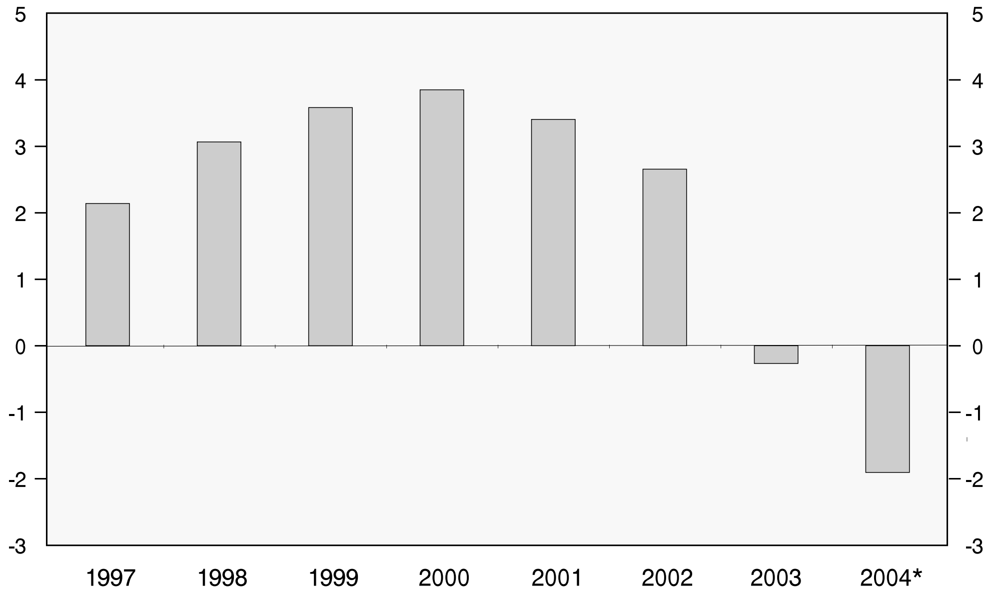
1 Drawn up on an administrative basis by the State General Accounting Office.

of GDP, up from 6.4% and 3.8% of GDP in 2003 and 2002 respectively, i.e. it virtually doubled between 2002 and 2004 (see Table VIII.9).

Without underestimating the one-off factors that affected fiscal management in 2004 (namely the Olympic Games, the fiscal audit and the holding of general and European Parliament elections) which contributed to a further widening of the deficit, the main bulk of the deficit slippage came from revenue and expenditure trends that had already emerged since 2003 but were not dealt with in time. More specifically, fiscal management in 2004 was marked, as in the previous two years, by a significant overrun of

CHART VIII.1

PRIMARY SURPLUS/DEFICIT OF STATE BUDGET AS A PERCENTAGE OF GDP



* Provisional data.

Source: State General Accounting Office.

€3,804 million (2003: €1,565 million, 2002: €1,111 million) in ordinary budget primary expenditure. Moreover, ordinary budget revenue fell short of budget forecasts by €1,585 million, compared with a shortfall of €1,169 million in 2003. A reversal of the downward trend was only witnessed in the case of investment budget revenue in 2004, where the marked downward trend of receipts, which had emerged since 2000, reversed in 2004.

The relaxation of fiscal policy between 2003 and 2004 is also indicated by the fact that the state budget, which had posted a surplus every year from 1991 to 2002, showed a primary deficit of 0.3% and 1.9% of GDP in 2003 and 2004 respectively, compared with a primary surplus of 2.7% of GDP in 2002 (see Chart VIII.1 and Table VIII.9).

As a result of the above developments, in May 2004 the Excessive Deficit Procedure was launched against Greece, which, following the ECOFIN Council decision of 17 February 2005, is at the stage referred to in Article 104, par. 9 of the Treaty. According to the same decision, in order to reach a close-to-balance or in-surplus budgetary position over the medium term, Greece has to reduce its deficit below 3% of GDP by the end of 2006 and then continue cutting it by at least 0.5% of GDP annually.[1] Meanwhile, the decision calls for the attainment of large primary surpluses to gradually cut public debt to 60% of GDP. Indeed, the new update of the Stability and Growth Programme, which was submitted to the European Commission on 21 March 2005, forecasts that the deficit will be brought below 3% of GDP by the end of 2006. On 12 April 2005 the ECOFIN Council examined the new Stability Programme, along with the measures announced on 29 March 2005, and concluded that no further steps under the Excessive Deficit Procedure are necessary for the time being.

Revenue

Ordinary budget revenue rose by 5.4% in 2004 to €42,035 million (see Table VIII.4). Considering that nominal GDP grew by 7.7% in 2004, this points to an income elasticity of revenue of only 0.7. Besides, since the actual revenue growth was lower compared to the budgeted[2] rate (9.4%), ordinary budget revenue in 2004 fell short of budget forecasts by €1,585 million, or almost 1.0% of GDP.

The bulk (€1,342 million or around 80%) of the shortfall is attributable to the shortfall in revenue from indirect taxes, while the remainder (€342 million) is due to the shortfall in non-tax revenue. By contrast, revenue from direct taxes overshot budget forecasts by €99 million. Also, an extra €400 million[3] was collected in 2004, as a result of the passing of Law 3259/2004 in July that year concerning: (i) the settlement of pending tax cases for the 2000-2002 period, (ii) the submission of overdue tax returns without imposition of penalty, (iii) the collection of tax arrears, and (iv) the repatriation of capital from abroad. Without these extraordinary receipts, the shortfall in revenue would have been bigger.

The rate of change in revenue from direct taxes accelerated to 7.1% in 2004 (2003: 3.9%), owing to increased revenue from personal income tax and —to a lesser degree— corporate income tax. By contrast, revenue from (i) tax on inheritances, gifts and parental donations, (ii) the taxation of interest income from deposits, and (iii) tax arrears declined, compared with 2003.

In more detail, revenue from personal income tax expanded by 11.7% (2003: 5.7%, 2002: 7.1%) to €7,785 million, thereby overshooting the budgeted target by €290 million,

1 After 2006, it is the *cyclically adjusted* deficit which will have to be reduced.
2 After the finalisation of the 2003 revenue (including tax refunds) at €39,881 million.
3 This estimate comes from the new update of the Stability and Growth Programme, p. 11.

TABLE VIII.4

ORDINARY BUDGET REVENUE[1]

(Million euro)

	Annual aggregates				Percentage changes		
	2001	2002	2003	2004*	2002/01	2003/02	2004*/03
I. DIRECT TAXES	13,585	14,813	15,397	16,484	9.0	3.9	7.1
1. Income tax	11,326	11,685	12,141	13,307	3.2	3.9	9.6
– Personal	6,156	6,595	6,969	7,785	7.1	5.7	11.7
– Corporate	4,172	4,191	4,341	4,724	0.5	3.6	8.8
– Special categories of income tax	998	899	831	798	–9.9	–7.6	–4.0
(tax on shipping)	(21)	(16)	(10)	(9)	(–23.8)	(–37.5)	(–10.0)
(tax on interest income from bonds, deposits, etc.)	(549)	(523)	(459)	(436)	(–4.7)	(–12.2)	(–5.0)
2. Wealth taxes	507	542	436	422	6.9	– 19.6	– 3.2
3. Direct taxes collected on behalf of third parties	2	1	1	1	–50.0	0.0	0.0
4. Tax arrears	840	1,610	1,671	1,569	91.7	3.8	– 6.1
5. Extraordinary and other direct taxes	910	975	1,148	1,185	7.1	17.7	3.2
II. INDIRECT TAXES	19,498	20,989	21,484	22,999	7.6	2.4	7.1
1. Customs duties and special contributions on imports-exports	205	203	222	277	–1.0	9.4	24.8
2. Consumption taxes on imports	1,965	2,049	2,257	2,624	4.3	10.2	16.3
– VAT (non-EU imports)	1,322	1,348	1,485	1,716	2.0	10.2	15.6
– Cars	603	659	726	852	9.3	10.2	17.4
– Special consumption tax	40	42	46	56	5.0	9.5	21.7
3. Consumption taxes on domestic products	15,089	16,439	16,856	18,168	8.9	2.5	7.8
– Turnover tax	207	221	245	269	6.8	10.9	9.8
– VAT	9,410	10,638	10,848	12,025	13.0	2.0	10.8
– Fuel	2,278	2,319	2,432	2,457	1.8	4.9	1.0
– Tobacco	1,941	2,125	2,248	2,242	9.5	5.8	– 0.3
– Road duties	753	629	554	693	–16.5	–11.9	25.1
– Special levies and contributions on cars	125	128	134	82	2.4	4.7	– 38.8
– Other[2]	375	379	395	400	1.1	4.2	1.3
4. Transaction taxes	1,849	1,440	1,490	1,514	–22.1	3.5	1.6
– Capital transfers	850	735	816	799	–13.5	11.0	– 2.1
– Stamp duties	877	618	592	624	–29.5	–4.2	5.4
– Banking transactions	32	0	0	0	–	–	–
– Licence fees for gambling	90	87	82	91	–3.3	–5.7	11.0
5. Other indirect taxes	390	858	659	416	120.0	–23.3	–36.8
III. TOTAL TAX REVENUE	33,083	35,802	36,881	39,483	8.2	3.0	7.1
Non-tax revenue	3,490	3,246	3,000	2,552	–7.0	–7.6	–14.9
IV. TOTAL ORDINARY BUDGET REVENUE	36,573	39,048	39,881	42,035	6.8	2.1	5.4

1 For comparability purposes, tax refunds have not been deducted from revenue.
2 Including the special consumption tax on domestic products.
* Provisional data.
Source: State General Accounting Office.

even though the effect of the 2003 tax reliefs (provided for by Laws 3052/2002 and 3091/2002) was completed in 2004. This expansion was exclusively due to receipts from taxes withheld at the source (wages and pensions), which grew by 16.6%, compared with 2.4% in 2003, chiefly as a result of wage increases and extraordinary compensation awarded to civil servants, as well as because of a pension rise (effective as of 1 January 2004).

Revenue from corporate income tax rose by 8.8%, having increased by 3.6% in 2003, and reached €4,724 million, approximately the budgeted amount.

Revenue from the taxation of interest income (from bonds, bank deposits, etc.) declined (–5%) for the fifth year in a row in 2004, despite the re-introduction of the tax on repo yields in 2002. This further drop is associated with the reduction (as of mid-2003) — and maintenance at minimal levels— of euro area deposit rates, as well as with the increasingly higher percentage of government paper held by non-residents, who are exempt from this tax.

Revenue from tax on inheritances, gifts and parental donations shrank by 9.6% and amounted to €233 million, compared with €257 million in 2003 and €370 million in 2002, as a result of tax reliefs, which had been introduced at the end of 2002 (Law 3091/2002) but affected the 2003 and 2004 revenue, and also because official real estate prices remain unchanged since 2001. Revenue from real property tax (presented in the same category of Table VIII.4 as the preceding item of this paragraph) increased by 5.7% and reached €189 million, against €179 million in 2003.

Despite the measures adopted by Law 3259/2004 in July concerning the settlement of pending tax cases and the collection of tax arrears, revenue from direct tax arrears dropped by 6.1% compared with 2003 and stood at €1,569 million. This amount was slightly smaller than the budgeted €1,610 million, even though the effects of the measures taken in July had, of course, not been taken into account in drafting the budget. As noted in a previous report,[1] the repeated settlements of pending tax cases have limited the possibility of raising additional revenue, while they encourage greater tax evasion in the long run.

An acceleration was recorded in indirect tax revenue, which increased by 7.1% in 2004, compared with 2.4% a year earlier, and amounted to €22,999 million. Notwithstanding this significant acceleration, indirect tax revenue fell short of the budgeted target by €1,342 million, chiefly owing to the shortfall in revenue from VAT on domestic products and services, and also because of a small shortfall in revenue from other indirect taxes.

The breakdown of indirect tax revenue shows that VAT revenue from goods and services which are imported from non-EU countries grew by 15.6% to €1,716 million, while similar increases were also recorded in all other taxes levied on these products and services, since the value of the respective imports[2] rose by about 10.9%.

Revenue from car registration fees[3] expanded by 17.4% in 2004, compared with 10.2% in 2003, and amounted to €852 million. This acceleration came from a 15.7%

1 Bank of Greece, *Annual Report 2003*, p. 211.
2 According to provisional trade data from the NSSG.
3 Formerly called “special consumption tax on cars”.

increase in new passenger car registrations in 2004, partly as a result of the renewal of the car fleet of car rental companies in anticipation of the Olympic Games, as well as because of the purchase of cars by “Athens 2004 S.A.”.

Revenue from VAT on domestic goods and services (including goods imported from EU countries) went up by 10.8% in 2004, compared with 2.0% in the previous year, and amounted to €12,025 million. This reflects a 6.2% upswing in the value of retail sales in 2004,[1] as well as the fact that (as of 1 January 2003) the frequency at which interim VAT returns are submitted changed from bimonthly to quarterly, which led to a “transfer” of VAT revenue in the order of €250 million from 2003 to 2004.[2] If the necessary adjustments for this transfer are made, the rate of increase in VAT revenue in 2004 drops to 6.3%, whereas that of 2003 increases to 4.2%. As already mentioned, VAT revenue, despite growing faster than in 2003, still fell considerably short of budget forecasts. Available data suggest that in drafting the 2004 budget the total VAT revenue *for 2003* had been overestimated[3] and that the actual amount collected was €947 million lower. Hence, as budget forecasts on the 2003 VAT revenue failed to realise, the actual VAT amount *for 2004* also fell short of the budgeted figure by €919 million.

Despite the growth of new passenger car registrations, receipts from the special consumption tax on liquid fuels rose by a mere 1% (2003: +4.9%) and amounted to €2,457 million. This slowdown may partly be explained by weaker diesel oil consumption (–2.8%), despite buoyant economic activity.[4] By contrast, petrol consumption picked up by 4%.

Revenue from road duties increased by 25.1% compared with the previous year, to €693 million, boosted by the rise in new passenger car registrations and a 15% increase (on average) in road duties for 2005 (effective in November 2004). The latter had a beneficial effect on 2004 revenue, as these duties were collected in December 2004.

While revenue from tobacco tax remained virtually unchanged compared with the previous year (2004: €2,242 million, 2003: €2,248 million), despite a 6.4% upswing in consumption, it fell short of the budgeted amount by a considerable €179 million, probably because of the substitution of cheap for expensive cigarettes.

Revenue from real estate transfer tax decreased by 3.5%, owing to a small downturn in the respective market, as well as because of the non-revision of the official real estate prices. By contrast, revenue from stock market transactions (which is presented, together with revenue from real estate transfer tax, under the category “capital transfers” of Table VIII.4) grew by 6.8%, against 18.7% in 2003, and amounted to €109 million. This improvement resulted from a 2.3% increase in the total annual value of stock market trading compared with 2003.

1 According to the relevant NSSG indicator.

2 See Bank of Greece, *Monetary Policy, Interim Report 2004*, Athens, October 2004, pp. 75-76.

2 The Introductory Report on the 2005 Budget (Table 3.3, p. 49) refers to total VAT revenue without distinguishing between domestic and imported goods and services and so does the Introductory Report on the 2004 Budget (p. 21).

4 The mismatch between developments in consumption and in economic activity is probably due to the extensive fuel smuggling and the substitution of heating oil (because of its cheaper price) for diesel.

Revenue from stamp duties rebounded by 5.4%, after having fallen by 4.2% in 2003, and stood at €642 million. This recovery stemmed from the fact that the negative effects of the reduction of stamp duties in 2002 had been exhausted in 2003 and therefore did not affect 2004.

Finally, non-tax revenue contracted by 14.9% for the third consecutive year, falling short of budget forecasts by €342 million. This shortfall was mainly accounted for by a drop in receipts from: (i) the Postal Savings Bank (–66.7%), because of the disbursement of interim dividends at the end of 2003, (ii) the Deposit and Loans Fund (–21.7%), (iii) the now predominantly privatised Hellenic Telecommunications Organisation – OTE (–63.4%) and (iv) rents (–38.9%).

Expenditure

The significant overrun in ordinary budget expenditure marked fiscal developments in 2004. Specifically, ordinary budget expenditure, which has been on an upward path in the last few years, grew considerably faster in 2004 (2004: 12.0%, 2003: 9.4%, 2002: 7.2%, see Table VIII.5). As a percentage of GDP, ordinary budget expenditure rose from 27.8% in 2002 to 28.1% in 2003 and 29.2% in 2004.

Following this large increase, ordinary budget expenditure (including tax refunds) came to €48,270 million (against €43,116 million in 2003), i.e. €3,520 million more than the budgeted amount (€44,750 million). This development was exclusively due to the overrun in ordinary budget primary expenditure, while interest payments were somewhat lower than budgeted.

Personnel outlays (including health care spending), which is the largest component of expenditure, continued to soar in 2004, at a rate of 13.4%, compared with 7.6% in 2003, and amounted to €18,737 million, thereby overshooting budget forecasts by €1,554 million (see Chart VIII.3). Accordingly, their share in total ordinary budget expenditure edged up from 38.3% in 2003 to 38.8% in 2004 (see Chart VIII.2). It should be noted that the 2004 figure for personnel outlays includes €336 million spent for extraordinary compensations related to the Olympic Games and to general and European Parliament elections. If this amount is excluded, the growth rate of personnel outlays drops to 11.3%, but still remains substantially higher than that of 2003 or the nominal growth rate of GDP. The considerable growth of personnel outlays for the third consecutive year stemmed from the introduction of the new salary scales (effective as of 1 January 2004), the increase (as of the same date) in pension payments and the retroactive payment of family allowances[1] and pension increases (awarded in 2003).[2] In addition, it is connected to further recruitments of 5-year term soldiers, primary and secondary education teachers,

1 In instalments as of 1 July 2002. Disbursements for family allowances totalled €85 million in 2004.

2 These account for €80 million.

TABLE VIII.5

OUTLAYS UNDER THE ORDINARY BUDGET AND THE PUBLIC INVESTMENT BUDGET

(Million euro)

	Annual aggregates				Percentage changes		
	2001	2002	2003	2004*	2002/01	2003/02	2004*/03
I. OUTLAYS UNDER THE ORDINARY BUDGET[1]	36,736	39,398	43,116	48,270	7.2	9.4	12.0
1. Personnel outlays	13,866	15,353	16,526	18,737	10.7	7.6	13.4
2. Interest payments[2]	9,711	9,134	9,416	9,466	–5.9	3.1	0.5
(*of which*: related to the national defence debt)[3]	(382)	(393)	–	–	(2.9)	–	–
3. Payments to the European Union	1,395	1,426	1,542	2,026	2.2	8.1	31.4
4. Restitution of revenue collected on behalf of third parties	2,970	3,051	3,512	3,788	2.7	15.1	7.9
5. Tax refunds	949	1,967	2,381	2,799	107.3	21.0	17.6
6. Interest rate subsidies	5	–	1	–	–	–	–
7. Subsidies to farmers	390	457	479	551	17.2	4.8	15.0
8. Grants[4]	5,342	5,612	6,862	8,449	5.1	22.3	23.1
9. Guarantees and foreign exchange valuation differences	7	4	1	6	–42.9	–69.5	376.0
10. Other[5]	2,101	2,394	2,396	2,448	13.9	0.1	2.2
II. OUTLAYS UNDER THE PUBLIC INVESTMENT BUDGET	7,842	7,014	8,435	9,515	–10.6	20.3	12.8
1. Project implementation	2,408	2,874	3,222	. . .	19.4	12.1	. . .
2. Grants	5,390	4,072	5,129	. . .	–24.5	26.7	. . .
3. Administration	45	68	55	. . .	51.1	–18.5	. . .
III. TOTAL I+II	44,578	46,412	51,551	57,785	4.1	11.1	12.1
Primary expenditure under the government budget	34,867	37,278	42,135	48,319	6.9	13.0	14.7
Primary expediture under the ordinary budget	27,025	30,264	33,700	38,804	12.0	11.4	15.1
Amortisation payments	12,777	20,860	21,615	20,356	63.3	3.6	–5.8
(amortisation payments related to the national defence debt)[3]	(935)	(425)	–	–	(–54.5)	–	–
Ministry of National Defence programmes for the procurement of military equipment	–	–	987	825	–	–	–16.4

1 Excluding amortisation payments. For 2003-2004, excluding additional expenditure for the implementation of Ministry of National Defence programmes for the procurement of military equipment.
2 Including “other expenditure” for public debt servicing.
3 For 2001-2002 only interest and amortisation payments effected by the Ministry of National Defence are included. Interest and amortisation payments related to the national defence debt and taken over by the Ministry of Economy and Finance are included in the main categories of the corresponding items. From 2003 onwards, interest and amortisation payments effected by the Ministry of National Defence are recorded in the off-budget item "Ministry of National Defence programmes for the procurement of military equipment". These payments affect the deficit on a national accounts basis.
4 Including social security subsidies.
5 Including preparation costs for the 2004 Olympic Games (2003: €82 million, 2004: €140 million).
* Provisional data.
Source: State General Accounting Office.

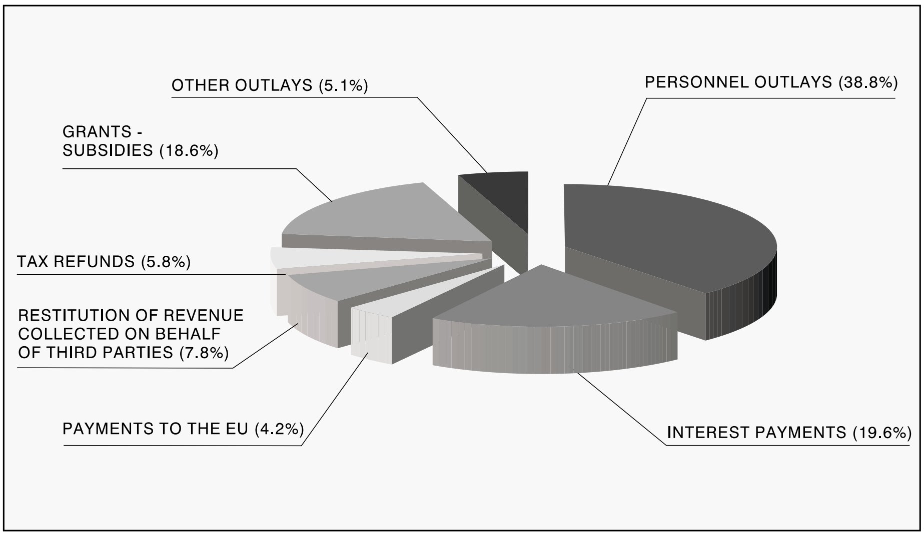
nurses, as well as civil servants in the broader public sector from the substitutes list derived from the 1998 competition of the Supreme Council for Personnel Selection (ASEP). Lastly, it reflects the extraordinary compensation payments referred to above.

Interest payments were contained to €9,466 million (up by 0.5% on a year earlier), against a budget forecast of €9,750 million. Thus, their share in total ordinary budget expenditure shrank further to 19.6% in 2004, from 21.8% in 2003 (see Chart VIII.2). As a percentage of GDP, interest payments continued their declining path, falling to 5.7% in 2004, from 6.1% in 2003 (see Chart VIII.4). Notwithstanding this drop, interest payments

CHART VIII.2

COMPOSITION OF OUTLAYS[1] UNDER THE ORDINARY BUDGET

(YEAR 2004*)



1 Excluding amortisation payments.
* Provisional data.

Source: State General Accounting Office.

are still higher than in any other EU Member State, reflecting the burden of servicing a large public debt. It should be noted that from 2003 onwards the interest payments which are serviced by the Ministry of National Defence are recorded under the off-ordinary budget expenditure component labelled "Ministry of National Defence programmes for the procurement of military equipment" (see Table VIII.5).

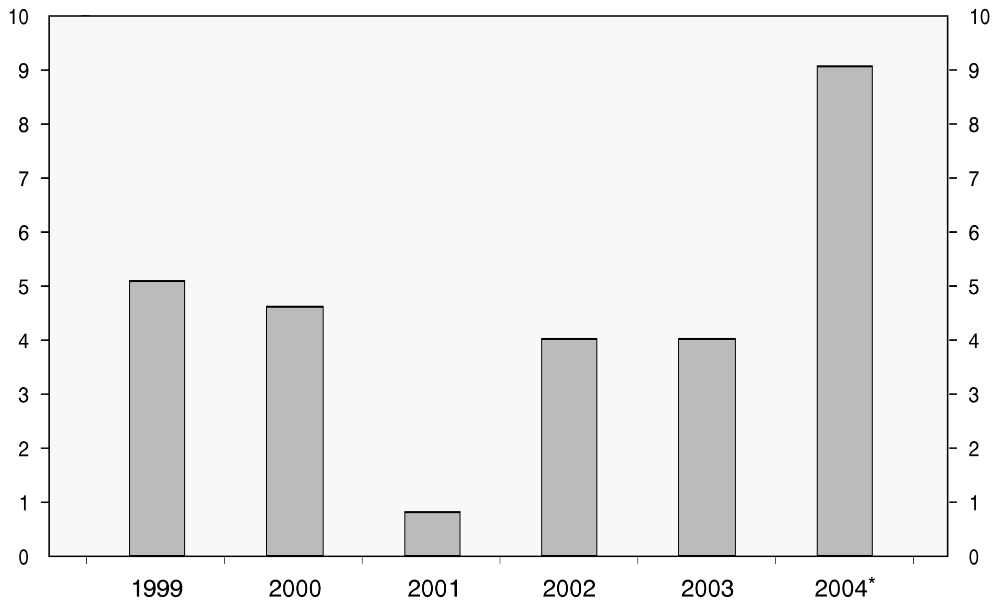
Payments to the European Union rose by 31.4% compared with the previous year and amounted to €2,026 million, owing to a change (as of 2002) in the calculation of Member State contributions to the EU and the introduction of a GDP-based contribution to be the main source of revenue for the Community Budget. According to the Ministry of Economy and Finance,[1] this change, combined with the faster-than-the-Community-average GDP growth in Greece, accounted for the substantial increase in these payments.

Restitution of revenue collected on behalf of third parties grew by 7.9% compared with the previous year and stood at €3,788 million. About two-thirds of this amount is paid over to local government (municipalities and prefectures) and the remainder to social security organisations.

Tax refunds[2] rose by 17.6% to €2,799 million in 2004, thereby exceeding the budgeted €2,200 million. This substantial overrun resulted from a simplification of proce-

CHART VIII.3

OVERRUN IN PERSONNEL OUTLAYS AS A PERCENTAGE OF THE BUDGETED AMOUNT



* Provisional data.

Source: State General Accounting Office.

dures,[3] the accelerated refunding of VAT to all exporting companies, as well as the repayment (in instalments) of delayed tax refunds from previous years. Besides, in 2004, Athens 2004 S.A received tax refunds amounting to approximately €150 million, while non-resi-

1 Ministry of Economy and Finance, *Introductory Report on the 2005 Budget*, Athens, 2004, p. 85.

2 For comparability purposes, these funds are recorded under expenditure and are not deducted from ordinary budget revenue, in line with the practice followed by the State General Accounting Office in the last three years.

3 Circular No. 1068229/4728/834/A0014/POL.1092/24 August 2004 of the Ministry of Economy and Finance concerning the refunding of VAT credit balances abolished the obligation to furnish banking documents, crossed cheques or other supporting documents (e.g. consignment notes, invoices, bills of lading etc.).

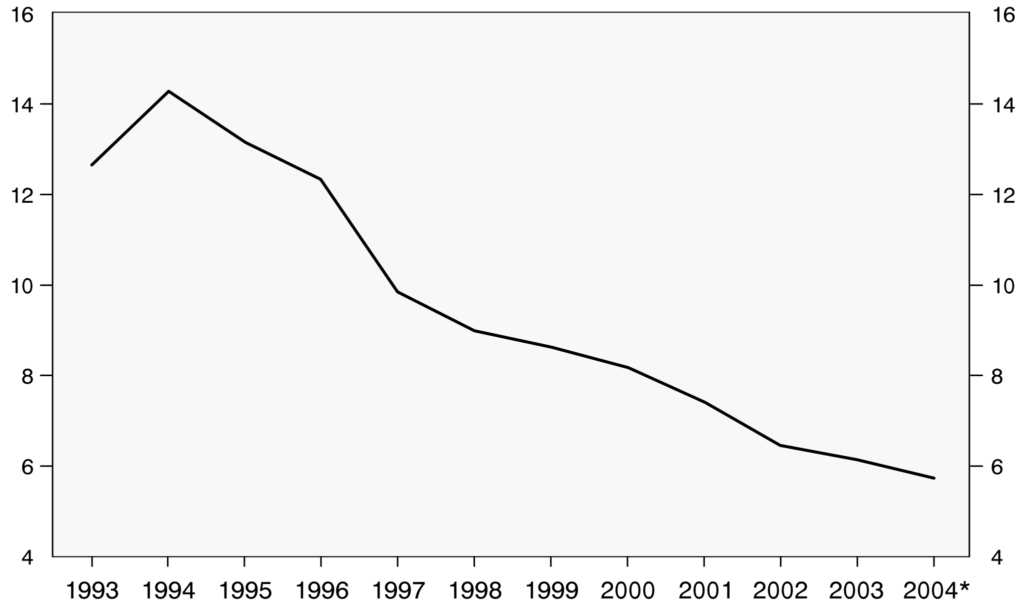
dent holders of Greek government bonds were refunded for tax withholdings on the interest income from these bonds.

Outlays for grants, the third largest component of ordinary budget expenditure grew by a hefty 23.1% to €8,449 million in 2004. Most of this increase was accounted for by grants to social security organisations, particularly OGA (Farmers' Insurance Fund) and NAT (Seamen's Insurance Fund), so as to cover the financing requirements arising from the increased[1] (as of 1 January 2004) pensions and —the also increased—

CHART VIII.4

INTEREST PAYMENTS[1] ON CENTRAL GOVERNMENT DEBT

(AS A PERCENTAGE OF GDP)



1 On an administrative basis. Including capitalised interest and other debt servicing outlays.
* Provisional data.

Source: State General Accounting Office.

EKAS (Pensioners' Social Solidarity Supplement) granted by these funds. Grants to public transport organisations (the Athens Urban Transport Organisation —OASA— and the Thessaloniki Urban Transport Organisation, OASTH) were also increased to finance their respective deficits.

1 On 1 January 2004, the minimum monthly pension paid by OGA and EKAS was increased by €30. Also, OGA and NAT received government backing to finance the health care spending of their respective members, and, additionally, in the case of NAT, the revised pensions of seamen.

Finally, "other outlays" grew by a modest 2.2% and stood at €2,448 million in 2004, slightly lower than the budgeted €2,472 million. It should be noted that the figure for 2004 includes an amount of €140 million spent on projects related to the Olympic Games.

The public investment budget

Public investment budget revenue, after steadily declining for four consecutive years, went up by 69.1% to €3,082 million, from €1,823 million in 2003 (see Table VIII.9), but still fell short of budget forecasts by €1,038 million. As already stated in the *Annual Report 2003*,[1] this shortfall was mainly due to delayed disbursements by different EU Funds, despite the timely submission of relevant applications in 2003. A large part of this revenue was collected in the first quarter of 2004, while further significant amounts, cumulatively totalling more than €2,000 million, were also collected in the remainder of the year.

Public investment budget payments increased by 12.8% on a year earlier and amounted to €9,515 million. This figure includes €2,250 million (compared with an initial forecast of €1,400 million) spent on transport and infrastructure projects required for the Olympic Games.[2] The resulting overrun (€850 million) was largely offset by cuts in other expenditure components of the public investment budget. Hence, the overrun in total investment expenditure was contained to €265 million.

2.2 Social security and welfare organisations

Not only the state budget, but also public entities and enterprises contributed to the worsening of public finances.

More specifically, according to data[3] from the Introductory Report on the 2005 Budget, as well as detailed data from the Ministry of Economy and Finance, the provisional financial results of the six major social security and welfare organisations for 2004 deteriorated considerably compared with 2003 (see Table VIII.6), as expenditure growth more than offset revenue growth.

In 2004, the total revenue of these organisations increased by 10.2%, having decreased by 0.6% in 2003, and amounted to €12,256 million. In more detail, the largest increases were recorded in the revenue of the Workers' Social Benefits Organisation – OEE (35.9%), the Workers' Housing Organisation – OEK (20.0%) and the Manpower Employment Organisation – OAED (30.1%), and the smallest in the revenue of the

1 P. 216.
2 A further €600 million —to be disbursed this year— was budgeted in the 2005 Budget for projects related to the Olympic Games.
3 On an administrative basis.

TABLE VIII.6

FINANCIAL RESULTS AND FINANCING OF SOCIAL SECURITY ORGANISATIONS[1]

(Million euro)

	2002	2003	2004*	Budget for 2005	Percentage changes 2003/02	2004*/03	2005/04*
A. Operating account							
1. Revenue	11,192	11,125	12,256	14,123	–0.6	10.2	15.2
2. Expenditure	14,765	15,044	17,954	20,109	1.9	19.3	12.0
3. Result (1 – 2)	–3,573	–3,919	–5,698	–5,986	9.7	45.4	5.1
B. Capital account							
4. Revenue	0	0	0	0	–	–	–
5. Expenditure	850	775	1,200	1,501	–8.8	54.8	25.1
(Investment)	(407)	(220)	(318)	(511)	(–45.9)	(44.5)	(60.7)
(Working capital)	(397)	(479)	(782)	(850)	(20.7)	(63.3)	(8.7)
(Other)	(46)	(76)	(100)	(140)	(65.2)	(31.6)	(40.0)
6. Result (4 – 5)	–850	–775	–1,200	–1,501	–8.8	54.8	25.1
7. Special resources	375	446	732	776	18.9	64.1	6.0
TOTAL RESULT (3+6+7)	–4,048	–4.248	–6,166	–6,711	4.9	45.2	8.8
Percentage of GDP	*2.9*	2.8	3.7	3.8			
FINANCING							
8. Grants	3,483	4,387	5,334	6,340	26.0	21.6	18.9
(Ordinary budget)	(3,190)	(4,124)	(4,981)	(5,987)	(29.3)	(20.8)	(20.2)
(Public investment budget–EU etc.)	(293)	(263)	(353)	(353)	(–10.2)	(34.2)	(0.0)
9. Depreciation	1	2	2	2	100.0	0.0	0.0
10. Net borrowing requirement	564	–141	830	369			–55.5
TOTAL FINANCING	4,048	4,248	6,166	6,711	4.9	45.2	8.8
11. Amortisation payments	...	...	...	...			
12. New suppliers' credit	...	...	...	...			
13. Gross borrowing requirement (10+11–12)	564	–141	830	369			–55.5

1 Comprising six social security organisations [Social Insurance Institute (IKA), Seamen's Insurance Fund (NAT), Farmers' Insurance Fund (OGA), Manpower Employment Organisation (OAED), Workers' Housing Organisation (OEK) and Workers' Social Benefits Organisation (EE)].

* Estimates.

Source: Ministry of Economy and Finance.

Farmers' Insurance Fund – OGA (7.5%) and the Social Insurance Institute – IKA (7.6%). By contrast, the revenue of the Seamen's Insurance Fund (NAT) declined sharply (–17.7%).

Total operating expenditure grew by 19.3% in 2004, compared with 1.9% in 2003, and amounted to €17,954 million. The most spectacular increases were recorded in the expenditure of OEE (69.3%), OAED (54.6%), OGA (37.0%) and OEK (34.2%), while the expenditure of IKA rose by 7.6%. The sizeable increase in OGA expenditure was due to a €30 rise in farmers' monthly pensions, which took effect on 1 January 2004.

Capital account expenditure grew by 54.8% in 2004, compared with a decrease of 8.8% in 2003. This outcome is attributable to an impressive increase in working capital expenditure (2004: 63.3%, 2003: 20.7%). It also reflects a 44.5% increase in investment, which had decreased by 45.9% in 2003. By contrast, other expenditure grew by 31.6% in 2004, compared with a 65.2% rise in 2003.

As a result of the 54.8% rise in total capital account expenditure, the widening of the operating account deficit by 45.4% and a 64.1% increase in special resources, the total deficit in the consolidated operating and capital accounts of the six organisations grew by a substantial 45.2% to €6,166 million in 2004 (2003: €4,248 million), while as a percentage of GDP it rose from 2.8% in 2003 to 3.7% in 2004.

The bulk of the 2004 deficit was financed by the state budget as follows: 80.8% or €4,981 million came from ordinary budget grants, while another 5.7% was covered by investment budget grants, which grew by 34.2%, from €263 million in 2003 to €353 million in 2004.

The 45.2% increase in the total deficit raised the net borrowing requirement to €830 million (in contrast to a net repayment of liabilities amounting to €141 million in 2003). This occurred despite a 21.6% rise in state budget grants. Hence, 13.4% of the total deficit was financed through borrowing in 2004.

Data from the Introductory Report on the 2005 Budget show a deterioration in the financial results of the major social security and welfare organisations between 2002 and 2004, since their deficit widened from 2.9% of GDP in 2002 to 3.7% of GDP in 2004. No improvement is forecast for 2005, as the deficit is estimated to widen by a further 8.8%, reaching 3.8% of GDP (see Table VIII.6).

2.3 Public enterprises

According to data from the Introductory Report on the 2005 Budget, as well as from the Ministry of Economy and Finance, public enterprises showed a substantial operating surplus of €346 million in 2004 (compared with a surplus of €141 million in 2003), but, because of big investments in 2004, the consolidated balance of their operating and capital accounts remained negative, with the total deficit widening to €2,471 million, from €2,052 million in 2003. As a percentage of GDP, the consolidated 2004 deficit was 1.5%, up from 1.3% in 2003 (see Table VIII.7). It should be noted that from

TABLE VIII.7

FINANCIAL RESULTS AND FINANCING OF PUBLIC ENTERPRISES [1]

(Million euro)

	2002[2]	2003	2004*	Budget for 2005	Percentage changes		
					2003/02	2004*/03	2005/04*
A. Operating account							
1. Revenue	12,793	14,973	16,568	16,953	17.0	10.7	2.3
2. Expenditure	12,824	14,832	16,222	16,677	15.7	9.4	2.8
3. Result (1 – 2)	–31	141	346	276		145.4	–20.2
B. Capital account							
4. Revenue	0	0	0	0	–	–	–
5. Expenditure	3,126	3,907	4,213	3,997	25.0	7.8	–5.1
(Investment)	(2,256)	(2,421)	(2,652)	(2,757)	(7.3)	(9.5)	(4.0)
(Working capital)	(–98)	(149)	(209)	(–191)		(40.3)	
(Other)	(968)	(1,337)	(1,352)	(1,431)	(38.1)	(1.1)	(5.8)
6. Result (4 – 5)	–3,126	–3,907	–4,213	–3,997	25.0	7.8	–5.1
7. Special resources [3]	1,987	1,714	1,396	1,007	–13.7	–18.6	–27.9
TOTAL RESULT (3+6+7)	–1,170	–2,052	–2,471	–2,714	75.4	20.4	9.8
Percentage of GDP	0.8	1.3	1.5	1.5			
FINANCING							
8. Ordinary budget grants[4]	218	211	211	226	–3.2	0.0	7.1
9. Depreciation	1,030	1,169	1,222	1,229	13.5	4.5	0.6
10. Net borrowing requirement	–78	672	1,038	1,259		54.5	21.3
TOTAL FINANCING	1,170	2,052	2,471	2,714	75.4	20.4	9.8
11. Amortisation payments[5]	1,284	1,312	1,473	834	2.2	12.3	–43.4
12. Repayment of credit[5]	48	49	55	31	2.1	12.2	–43.6
13. New suppliers' credit	84	128	38	3	52.4	–70.3	–92.1
14. Gross borrowing requirement (10+11+12–13)	1,170	1,905	2,528	2,121	62.8	32.7	–16.1

1 The public enterprises mentioned in the Introductory Report on the 2005 Budget.
2 Excluding, from 2002 onwards, Olympic Airways, Olympic Aviation, KATH and AMEL.
3 Advances and participations by Public Power Corporation consumers, lump-sum payments by Hellenic Telecommunications Organisation subscribers, private sector participation in Water Supply and Sewerage Company projects, and own assets (from surpluses) of certain public enterprises. From 1997 onwards, grants through the Public Investment Budget and the EU have gradually taken the form of equity capital increases, leading to their gradual reclassification as "special resources" instead of "grants".
4 Grants from the ordinary budget to public enterprises which ran a deficit, minus collection of the surpluses of the other public enterprises.
5 Due to lack of data, the breakdown of the sum of amortisation payments and repayment of credit is an estimate.
* Estimates.
Source: Ministry of Economy and Finance.

2002 onwards the figures in Table VIII.7 do not include Olympic Airlines, Olympic Aviation, Thessaloniki Central Market Organisation (KATH) and Attiko Metro Operations Company S.A. (AMEL).

The total revenue of public enterprises grew by 10.7% in 2004, compared with 17% in 2003, and amounted to €16,568 million. An increase was recorded in the revenue of the Hellenic Post Office – ELTA (10.3%), the Hellenic Petroleum – ELPE (13.6%), the Public Gas Corporation – DEPA (4.9%), the Thessaloniki Port Authority – OLTH (14.9%), the Piraeus Port Authority – OLP (4.0%), the Water Supply and Sewerage Company of Thessaloniki – EYATH (15.1%) and the Public Power Corporation – DEH (4.2%). By contrast, the revenue of the Hellenic Railways Organisation (OSE), the Athens Urban Transport Organisation (OASA) and the Athens Water Supply and Sewerage Company (EYDAP) shrank by 3.2%, 1.0% and 3.2% respectively and that of the Hellenic Aerospace Industry (EAB) by 21.3%.

Operating expenditure rose by 9.4% in 2004, compared with a 15.7% increase in 2003, and amounted to €16,222 million. However, as a result of revenue expanding faster than expenditure, the operating surplus, as already mentioned, grew to €346 million.

Capital account expenditure grew by 7.8% in 2004, against 25.0% in 2003, and amounted to €4,213 million, reflecting an increase of 9.5%, 40.3% and 1.1% in investment, working capital and other expenditure, respectively. This, combined with the fact that receipts from special resources decreased by 18.6%, brought the total deficit of public enterprises to €2,471 million in 2004. Of this deficit, 8.5% was financed by ordinary budget grants, 49.5% by depreciation allowances and the remaining 42.0% by net borrowing.

Increased borrowing by public enterprises in the 2003-2004 period led to a near 48% rise in state-guaranteed loans between 2002 and 2004. Since most of these guarantees are being forfeit, the general government deficit and debt will increase in the future.[1]

2.4 Public debt

As a result of the revision of the 2004 fiscal data in the context of the fiscal audit, the debt[2]-to-GDP ratio rose to a level which is the highest in the EU. The revision of the debt figures consisted in the inclusion of the formerly excluded coupon liabilities, as well as the revision of the estimated intra-governmental debt.

Specifically, owing to the said revision, as well as because of substantial borrowing in 2004, the debt-to-GDP ratio rose by 1.2 percentage points to 110.5%, from 109.3% at the end of 2003 (see Table VIII.8). This rise occurred despite the receipt of privatisation proceeds amounting to €754 million.

1 On a national accounts basis.
2 Refers to the consolidated debt of general government, as defined in the Maastricht Treaty.

Following the revision of the deficit and debt figures, the "stock-flow-adjustment"[1] for the 1998-2003 period dropped to an average 3.7% of GDP (from a formerly estimated 5.2% of GDP) and declined further, especially between 2002 and 2003. Nonetheless, it bounced back to 3.1% of GDP in 2004, because of the reasons stated in the update of the Stability and Growth Programme[2] (see Table II.2). The fall in the "stock-flow-adjustment" may be explained by the inclusion in the revised deficit figures of expenditure components (such as defence expenditure), which were formerly excluded, even though they had affected debt levels.

The debt level is perhaps the most important macroeconomic imbalance; compounded with the renewed primary deficits, it makes the current fiscal position unsustain-

TABLE VIII.8

CONSOLIDATED DEBT OF GENERAL GOVERNMENT[1]

(Million euro)

	1999	2000	2001	2002	2003	2004*
Short-term liabilities	4,988	2,279	1,106	1,398	3,409	2,839
– securities	4,531	1,767	747	982	3,084	2,568
– loans	457	512	359	416	325	271
Long-term liabilities	121,415	136,302	149,391	156,972	163,859	179,342
– securities	99,843	109,923	117,442	126,514	134,394	156,969
– loans	21,572	26,379	31,949	30,458	29,465	22,373
Coin	155	178	198	515	454	521
Total	**126,558**	**138,759**	**150,695**	**158,885**	**167,722**	**182,702**
Percentage of GDP	**112.3**	**114.0**	**114.8**	**112.2**	**109.3**	**110.5**
– domestic debt[2]	96,643	105,431	142,195	154,188	164,340	180,199
(of which: debt to the Bank of Greece)	(12,290)	(12,472)	(10,985)	(9,561)	(9,018)	(8,488)
– external debt[2]	29,915	33,328	8,500	4,697	3,382	2,503

1 According to the definition in the Maastricht Treaty.
2 For 1999-2000, domestic debt includes euro-denominated securities held by non-residents, as well as Bank of Greece loans with a foreign currency clause. From 2001 onwards, domestic debt covers all liabilities in euro and external debt all liabilities in currencies other than the euro.
* Provisional data.
Sources: State General Accounting Office and Bank of Greece.

able, while setting back the potential growth of the Greek economy. Debt levels of over 100% of GDP persisted for years, despite the prevalence of particularly favourable conditions (primary surpluses, significantly reduced interest rates, privatisation proceeds and robust growth rates) from the end of the 1990s to 2004 inclusive.

1 The "stock-flow adjustment" refers to that part of the annual change in public debt which is not related to the primary balance (of the same year), nor to the combined effect of the interest rates and the growth rate, but to other factors (e.g. the assumption of debt, etc.)
2 P. 14-15.

The high debt is also a source of risk and uncertainty with respect to the achievement of fiscal goals, since a potential interest rate rise would trigger an increase in expenditure and deficit. Of course, Greece's reliability worldwide has been significantly enhanced —and its economy boosted— by its participation in the single currency and therefore the elimination of the exchange rate risk and the strengthening of monetary stability. Hence, while two of the three major rating agencies, Standard & Poor's and Fitch, downgraded, in the light of the revised fiscal data, Greece's credit rating in November and December 2004 respectively, this does not appear to have affected its borrowing costs.

For these reasons and given the substantial fiscal adjustment required by the relevant ECOFIN decision, as well as because of the fiscal problems that will arise from the ageing population, it is necessary to reduce the debt over the next decade, if possible below the reference value of 60% of GDP provided for in the Maastricht Treaty. A strong and sustained effort will therefore be needed, along with the attainment of primary surpluses in the order of 5-6% of GDP.

Considerable efforts have been made to extend average debt maturity in recent years. In 1990, around 45% of general government debt was in the form of Treasury bills, i.e. securities with a maximum maturity of one year. At the end of 2001, the outstanding balance of Treasury bills and other short-term securities had been reduced to 0.7% of general government debt. Treasury bill issues are no longer aimed at raising funds, but chiefly at ensuring that the Greek government is present as debt issuer all along the yield curve. At the end of 2004, short-term liabilities (Treasury bills and short-term loans) represented 1.6% of general government debt, while 98.4% was accounted for by medium and long-term liabilities (bonds, loans and coin) (see Table VIII.8).

Regarding debt negotiability, at the end of 2004, 87.3% of general government debt was made up of negotiable securities (mostly medium and long-term bonds), while the remainder consisted of loans that are not directly negotiable on the secondary market.

3. THE BUDGET FOR 2005

3.1 The state budget

Following the new update of the Stability and Growth Programme 2004-2007 submitted to the European Commission on 21 March 2005 and the subsequent enactment of additional fiscal —and other— measures on 29 March of the same year, the 2005 Budget, which was prepared in autumn 2004, when the 2004 deficit was estimated at 5.3% of GDP, is —to some extent— no longer valid.

The 2005 budget initially forecast that the general government deficit would be cut to 2.8% of GDP,[1] whereas in the new Stability Programme, in which the 2004 deficit is

1 This target had been set when the 2004 deficit was estimated at 5.3% of GDP.

estimated at 6.1% of GDP, the 2005 deficit is put at 3.5% of GDP. To attain this goal, a package of *ad hoc* fiscal measures was announced on 29 March 2005, which are believed to help narrow the deficit by 0.6% of GDP.

The 2005 budget forecasts that the deficit will be brought down to 2.8% of GDP, mainly by curbing spending. In more detail, state budget expenditure[1] is forecast to increase by a mere 0.8%, having risen by 12.1% in 2004 (see Table VIII.9). This will largely be made possible by a budgeted 15.4% decrease in public investment budget expenditure, after the completion of Olympic Games-related projects. By contrast, ordinary budget expenditure is forecast to grow by 4.0%, compared with 12.0% in 2004.

Turning to the individual components of ordinary budget expenditure, "operating expenditure" is the only one which is forecast to shrink appreciably (by 6.5%). By contrast, personnel outlays and grants to social security organisations are forecast to rise by 5.9% and 16.2% respectively. Interest payments are also expected to grow by 3.5%, even though they have been reduced by approximately €400 million (with a commensurate increase in amortisation payments), as a result of the inclusion of "new coupons" in the debt figures.[2]

On the revenue side, the 2005 budget forecasts that, without taking into account the effect of the new measures, ordinary budget revenue will expand by 10.2%, compared with a 5.4% increase in 2004 (see Table VIII.9). This may be a rather sanguine forecast, since economic growth is expected to weaken, while wage increases in the public sector are moderate.

The new measures announced on 29 March 2005 —which are not explicitly stated[3] in the update of the Stability and Growth Programme and which would help narrow the deficit by 0.6%— fall into three categories: (i) those aimed at increasing tax revenue, (ii) those aimed at cutting spending and (iii) those aimed at reducing tax evasion.

Revenue is estimated to expand by €765 million in 2005. Its growth will be fuelled by a one percentage point increase in VAT rates,[4] as well as by an increase in the tobacco tax (only for those cigarettes whose retail price is lower than "the most demanded price")[5] and, finally, in the tax on waterless spirit[6] (+20%). Expenditure will decrease by €95 million, which will be effected by limiting grants to transport operators, as well as civil servants' travel expenses. Finally, an estimated €125 million will come from reducing fuel tax evasion. In fact, tax increases are expected to help shrink the deficit by 78%, while the cut in expenditure and the reduction of tax evasion will push it further down by 22%.

As far as financial transactions between Greece and the EU are concerned, net receipts soared in 2004 compared with 2003 and amounted to €3,960 million, up by 29.3%

1 Including tax refunds.
2 According to the new update of the Stability and Growth Programme (p. 12), the resulting economies would amount to €425 million or 0.24% of GDP.
3 Although taken into account.
4 As of 1 April, the standard VAT rate was raised to 19%, the reduced rate to 9% and the special reduced rate to 4.5% from 18%, 8% and 4% respectively.
5 €2.70 per packet in 2004.
6 It refers to hard alcoholic drinks, not beer or wine.

TABLE VIII.9

REVENUE, EXPENDITURE AND DEFICIT UNDER THE OVERALL STATE BUDGET[1]

(Million euro)

	2001	2002	2003	2004*	Budget for 2005[5]	Percentage changes 2002/01	2003/02	2004*/03	Budget for 2005/04*
Revenue[2]	**39,368**	**41,051**	**41,704**	**45,117**	**49,710**	**4.3**	**1.6**	**8.2**	**10.2**
1. Ordinary budget	36,573	39,048	39,881	42,035	46,310	6.8	2.1	5.4	10.2
— Direct taxes	(13,585)	(14,813)	(15,397)	(16,484)	(18,145)	9.0	3.9	7.1	10.1
— Indirect taxes	(19,498)	(20,989)	(21,484)	(22,999)	(25,595)	7.6	2.4	7.1	11.3
— Other revenue	(3,490)	(3,246)	(3,000)	(2,552)	(2,570)	–7.0	–7.6	–14.9	0.7
2. Public investment budget	2,795	2,003	1,823	3,082	3,400	–28.3	–9.0	69.1	10.3
Expenditure[2]	**44,578**	**46,412**	**51,551**	**57,785**	**58,227**	**4.1**	**11.1**	**12.1**	**0.8**
1.1 Ordinary budget[3]	36,736	39,398	43,116	48,270	50,177	7.2	9.4	12.0	4.0
Interest payments[4]	(9,711)	(9,134)	(9,416)	(9,466)	(9,800)	–5.9	3.1	0.5	3.5
1.2 Primary ordinary budget expenditure	27,025	30,264	33,700	38,804	40,377	12.0	11.4	15.1	4.1
2. Public investment budget	7,842	7,014	8,435	9,515	8,050	–10.6	20.3	12.8	-15.4
Net deficit (–)/surplus (+)	**–5,210**	**–5,361**	**–9,847**	**–12,668**	**–8,517**				
Percentage of GDP	**–4.0**	**–3.8**	**–6.4**	**–7.7**	**–4.8**				
1. Ordinary budget	–163	–350	–3,235	–6,235	–3,867				
2. Public investment budget	–5,047	–5,011	–6,612	–6,433	–4,650				
Primary deficit (–)/surplus (+)	**4,501**	**3,773**	**–431**	**–3,202**	**1,283**				
Percentage of GDP	**3.4**	**2.7**	**–0.3**	**–1.9**	**0.7**				
ELEGEP (Revenue=Expenditure)	2,523	2,460	2,634	2,647	2,880	–2.5	7.1	0.5	8.8
Amortisation payments[4]	12,777	20,860	21,615	20,356	21,786	63.3	3.6	–5.8	7.0
Ministry of National Defence programmes for the procurement of military equipment			987	825	1600			–16.4	93.9

1 The extension of the fiscal year has been abolished since 2002.
2 For comparability purposes, tax refunds are included in expenditure and have not been deducted from revenue.
3 Excluding amortisation payments.
4 For 2001 and 2002 excluding interest and amortisation payments taken over by the Ministry of National Defence. From 2003 onwards, these payments are recorded in the off-budget item " Ministry of National Defence programmes for the procurement of military equipment".
5 The 2005 Budget does not include the effect (on revenue and expenditure) of the measures announced on 29 March 2005.
* Provisional data.
Source: State General Accounting Office.

TABLE VIII.10

FINANCIAL ACCOUNT OF GREECE WITH THE EUROPEAN UNION[1]

(Million euro)

	Annual aggregates					Percentage changes			
	2001	2002	2003	2004*	Budget for 2005	2002/01	2003/02	2004*/03	Budget for 2005/04*
A. Receipts from the European Union	*5,420*	*5,309*	*4,605*	*5,835*	*6,431*	*–2.0*	*–13.3*	*26.7*	*10.2*
1. 10% refund to cover cost of collecting the Union's "own resources"	20	45	52	66	56	125.0	15.6	26.9	–15.2
2. Social Fund	248	361	584	639	542	45.6	61.8	9.4	–15.2
3. EAGGF - Guidance Section	170	100	138	296	327	–41.2	38.0	114.5	10.5
4. Regional Fund	1,778	1,598	945	1,709	2,056	–10.1	–40.9	80.8	20.3
5. EAGGF - Guarantee Section	2,610	2,634	2,757	2,736	3,044	0.9	4.7	–0.8	11.3
6. Other receipts	9	9	18	8	8	0.0	100.0	–55.6	0.0
7. Cohesion Fund	575	549	63	348	362	–4.5	–88.5	452.4	4.0
8. Receipts from EFTA countries	7	13	7	4	6	85.7	–46.2	–42.9	50.0
9. Fisheries Fund	3	0	41	29	30	–100.0	–	–29.3	3.4
B. Payments to the European Union	*1,395*	*1,425*	*1,542*	*1,875*	*2,150*	*2.2*	*8.2*	*21.6*	*14.7*
1. Agricultural levies and duties	10	12	15	17	12	20.0	25.0	13.3	–29.4
2. Sugar levies	14	11	8	4	14	–21.4	–27.3	–50.0	250.0
3. Customs duties under the Common External Tariffs provision	178	173	185	242	198	–2.8	6.9	30.8	–18.2
4. Contribution on the basis of revenue from VAT	611	553	541	395	401	–9.5	–2.2	–27.0	1.5
5. Contribution on the basis of GDP	537	581	758	1,051	1,344	8.2	30.5	38.7	27.9
6. Other contributions	31	44	7	0	20	41.9	–84.1	–100.0	–
7. Contribution to the European Development Fund	10	19	27	29	31	90.0	42.1	7.4	6.9
8. Payments owing to unrealised projects	–	32	1	137	130	–	–	–	–
9. Contribution to the food aid programme	4	–	–	–	–	–	–	–	–
Net receipts from the European Union (A-B)	*4,025*	*3,884*	*3,063*	*3,960*	*4,281*	*–3.5*	*–21.1*	*29.3*	*8.1*

1 From 2002 onwards, data are provided on a cash basis.
* Provisional data and estimates.
Source: State General Accounting Office.

(see Table VIII.10). This development came as a result of increased inflows from Structural Funds, part of which were delayed 2003 payments collected in the first quarter of 2004. By contrast, the subsidisation of farmers under the Common Agricultural Policy – CAP (European Agricultural Guidance and Guarantee Fund – EAGGF, Guarantee Section) in nominal terms remained unchanged at 2003 levels.

Net inflows are forecast to grow by 8.1% in 2005. Receipts from the EU are expected to increase by 10.2% and payments to the EU by 14.7%. The considerable increase in payments to the EU in both 2004 and 2005 (see Table VIII.10) is connected to the change in the system of Member State contributions to the EU, as well as to the introduction of a GDP-based contribution to be the main source of revenue for the Community Budget.

3.2 The budget of public enterprises and social security and welfare organisations

According to the Introductory Report on the 2005 Budget, the financial results of the six major social security and welfare organisations, as reflected in the consolidated deficit of their operating and capital accounts, are expected to deteriorate further, since their total deficit is forecast to widen by €545 million and amount to €6,711 million (see Table VIII.6). As a percentage of GDP, however, the deficit will remain broadly unchanged at 3.8% and is forecast to be financed (to the extent of 89.2%) by increased ordinary budget grants.

The total deficit will widen by 8.8% as the operating and capital account deficits will rise by 5.1% and 25.1% respectively. Investment and other expenditure growth will be particularly high (60.7% and 40.0% respectively). By contrast, the rise in working capital appears to be much smaller (8.7%).

As regards public enterprises, their consolidated operating and capital account deficit is forecast to stabilise at 1.5% of GDP, as in 2004. In absolute terms, however, the total deficit seems to have risen by 9.8% and is estimated to reach €2,714 million in 2005, compared with €2,471 million in 2004 (see Table VIII.7).

The operating revenue of public enterprises is forecast to edge up by 2.3% compared with 2004. This, combined with the corresponding rise in operating expenditure (2.8%), will result in a primary operating surplus of €276 million, against €346 million in 2004. By contrast, total capital expenditure is forecast to decline by 5.1%, mainly because of the steep fall in working capital. This, coupled with the €276 million operating surplus referred to above and a projected decrease of 27.9% in special resources, will bring the total deficit of public enterprises to €2,714 million.

Of this deficit, 8.3% is forecast to be financed by ordinary budget and investment budget grants, 45.3% by depreciation allowances and the remaining 46.4% by net borrowing.

APPENDIX TO CHAPTER VIII

1. TAX POLICY MEASURES

The fiscal measures taken in 2004 can be divided into two categories: (i) measures that deal with fiscal problems and (ii) measures aimed at boosting private investment, raising the rate of economic growth and encouraging employment. In this context, the law passed in July concerning the settlement of pending tax cases and the collection of tax arrears seeks to increase budget revenue, in order to achieve the target of reducing the deficit below 3% of GDP by the end of 2006; in the same vein, the tax law passed last December will bring about by 2007 significant cuts in corporate taxes, which, along with the incentives given by the new development-conducive law, aim to encourage private investment.

In more detail, Law 3259/2004 re: "settlement of pending tax cases, collection of tax arrears and other provisions" offers taxpayers the opportunity to close their pending tax cases dating back to 2002 through objective procedures, as well as to achieve a very favourable settlement of their tax arrears to the government. Moreover, taxpayers (legal or natural persons) who have failed to submit their income tax, VAT or other tax return may submit it now without incurring any fine or other penalty. The law also gives natural or legal persons taxed in Greece the option to repatriate their funds from abroad, which will be taxed, however, at a rate of 3%. As this law was only finalised last December, the repatriation deadline was extended initially until 4 April 2005 and then until 4 May 2005. At the same time, the scope of the law itself was extended to cover —on the same terms and conditions— the repatriation of precious stones and metals.

In November, Article 57 of Law 3283/2004 raised road duties for 2005 (collected in December 2004) by 15% on average.

The tax and the development law passed in December 2004 aim to create a favourable business climate, boost investment and speed up economic growth. Specifically, the tax law (Law 3296/2004) brings about important changes in corporate and personal income tax and puts into place measures to stimulate the capital market.

In greater detail, between 2005 and 2007 the corporate income tax burden will be gradually reduced for all companies, since the tax rate on corporate profits will fall from 35% in 2004 to 32% in 2005, 29% in 2006 and 25% in 2007 (cumulative reduction of 10 percentage points) in the case of sociétés anonymes, limited companies (Ltds), joint ventures and "sociétés civiles de droit commun", and from 25% in 2004 to 24% in 2005, 22% in 2006 and 20% in 2007 in the case of general, limited or other partnerships. Moreover, the stamp duty on the profits of general and limited partnerships, Ltds and joint ventures is abolished.

The above tax law also provides tax incentives for companies to invest in staff training and technological research and development. Also, to promote entrepreneurship, it cuts by 50% the rate for advance tax payments made during the first three years after business start-up.

In addition, provision is made for ensuring the objectivity of fiscal controls, codifying tax-deductible expenses, cutting fines for tax violations and generally limiting the scope for arbitrary interpretations of tax law.

Furthermore, with a view to cutting the costs of stock market transactions and facilitating the recovery of the Stock Exchange, the tax on stock market transactions is reduced by 50%, from 3‰ to 1.5‰. Also, to attract new funds to the Stock Exchange, it is stipulated that 20% (up to a maximum €3,000) of the amount spent to purchase domestic equity-type and balanced-type mutual fund shares/units will be deducted from taxable income, provided that these fund shares/units are held for three years after purchase.

Also, by introducing a single 10% tax rate on repo yields and on interest income from deposits and bonds, the law puts into place a uniform system of taxation for all non-equity investment products, thereby leaving investment choices unaffected.

Moreover, Law 3296/2004 gives incentives to small and medium-sized enterprises to merge, by exempting merged companies from real-estate transfer tax, as well as any resulting surplus value from income tax, while it provides that the net profits of the company which is the product of the merger will be taxed at a rate reduced by 10 percentage points compared with the standard rate.

Regarding personal income tax, the most important change is that the non-taxable income of workers and pensioners is raised from €10,000 to €11,000 and from €8,400 to €9,500 in the other categories of taxpayers. Under the new tax scales, the threshold for applying the 40% maximum income tax rate decreases to €23,000 from €23,400. The new tax scales are presented in Tables VIII.A1 and VIII.A2.

The main characteristic of the new tax scales is that they are extremely compressed as their progressivity is confined to an income of €12,000,[1] while the threshold for applying the maximum income tax rate is €23,000, the lowest in the euro area.

The percentage of tax-deductible expenditure (e.g. interest payments for housing loans, health care or principal residence rent costs, etc.) is raised from 15% to 20%. The law also provides tax incentives for connecting to the natural gas net work, purchasing and holding fund shares/units, as well as incentives for young professionals to settle out of Athens. By contrast, the tax burden on workers and pensioners increases, as the €75 maximum tax deduction for family expenditure is abolished and the tax deduction for timely payment of tax is reduced from 2.5% to 1.5%.

As a result of the interplay between the new tax scales[2] and the 2005 wage increases,[3] on the one hand, and the abolition of the tax deduction for family expenditure and the reduction of the tax rebate for timely payment of tax, on the other, the tax burden on low-income (annual income: €13,072 or less) workers and pensioners with spouse (without income) and two children is reduced, while that on higher (taxable) incomes increases.

1 €10,000 for workers and pensioners with two children.
2 In which the level of non-taxable income has also been revised.
3 Income growth compared with 2004 was computed at 3.5%, roughly as much as the forecast increase in the regular salaries of civil servants for 2005 (see Chapter IV.2).

In addition, the new law provides for the introduction (as of 1 January 2006) of VAT on the purchase of newly built real property, with a parallel reduction of the real estate transfer tax.

On 29 March 2005, a package of measures, designed to increase revenue and reduce the general government deficit below 3% by the end of 2006, was announced and entered into effect on 1 April. Specifically, the standard VAT rate was raised from 18%

TABLE VIII.A1
EMPLOYEES AND PENSIONERS

Income bracket (in euro)	Tax rate (%)	Bracket tax (in euro)	Total income (in euro)	Total tax (in euro)
11,000	0	0	11,000	0
2,000	15	300	13,000	300
10,000	30	3,000	23,000	3,300
In excess	40			

TABLE VIII.A2
OTHER TAX-PAYERS

Income bracket (in euro)	Tax rate (%)	Bracket tax (in euro)	Total income (in euro)	Total tax (in euro)
9,500	0	0	9,500	0
3,500	15	525	13,000	525
10,000	30	3,000	23,000	3,525
In excess	40			

to 19%, the reduced VAT rate from 8% to 9% and the special reduced VAT rate from 4% to 4.5%. Also, a special consumption tax was imposed only on those cigarettes whose retail price was lower than "the most demanded price" in 2004. Finally, the special consumption tax on alcoholic beverages (other than wine and beer) was raised by 20%, except in the case of ouzo and tsipouro, where it was raised by 10%.

2. RECENT DEVELOPMENTS IN THE CONTEXT OF THE FISCAL AUDIT AND THE EXCESSIVE DEFICIT PROCEDURE

a. Fiscal audit

The fiscal audit began in March 2004 and its first stage was completed on 1 September of that year with the communication to Eurostat —in the context of the

Excessive Deficit Procedure— of the revised deficit and debt figures for the 2000-2004 period. A detailed account and discussion of these developments are available in Bank of Greece, *Monetary Policy, Interim Report 2004*, Athens, October 2004, pp. 73-80.

Following on from that, Eurostat initially issued an interim,[1] then a final, report on the revision of the Greek deficit and debt figures for the 1997-1999 period.[3] The revised figures from the latter report are presented in Table VIII.A3.

The deficit figures were revised to include grants to public enterprises, capitalised interest, as well as some expenditure for the purchase of defence equipment.[3] It should be noted that the inclusion in the deficit figures of expenditure for purchasing public enterprises' shares issued in capital increases is provided for by the stricter methodology (ESA 95) used for the compilation of the national accounts data from 2000 onwards, whereas under the former methodology (ESA 79) this expenditure component was considered as "financial transactions" and was almost entirely excluded from the calculation of deficit figures.

TABLE VIII.A3
REVISED DATA ON GENERAL GOVERNMENT DEFICIT
AND DEBT, 1997-1999
(As a percentage of GDP)

	1997	1998	1999
Deficit before the revision	4.0	2.5	1.8
Deficit after the revision	6.6	4.3	3.4
Debt before the revision	108.2	105.6	105.2
Debt after the revision	114.0	112.4	112.3

Source: Eurostat, *Report on the Revision of the Greek Government Deficit and Debt Figures*, 22 November 2004, p. 5.

The debt figures were revised owing to the inclusion of capitalised interest ("new coupons"), as well as because of the downward revision of the reserves of social security organisations and other general government agencies, which are invested in Greek government paper.

On 1 March 2005, Greece, according to the specified procedures, communicated to Eurostat the new deficit and debt figures, in which the deficit figures for the 2002-2004 period were revised upwards compared with those communicated in September 2004. The upward revision of the deficit figures reflected the inclusion of public hospitals' debt, the settlement of which began in January 2005 and is still ongoing. On a national accounts basis, however, the corresponding expenditure was shown in the respective years and

1 On 12 November 2004.
2 Eurostat, *Report by Eurostat on the Revision of the Greek Government Deficit and Debt Figures*, 22 November 2004.
3 Only the 1999 figure is significant.

amounted to €500 million in 2002, another €500 million in 2003 and €300 million in 2004. Notwithstanding that, the figures presented by Greece were not validated by Eurostat, given that €700 million of public hospital debt remains still unsettled, as well as because of differences in the recording of inflows from the EU Structural Funds.[1] Following this last communication, the general government deficit as a percentage of GDP was 4.1% in 2002, 5.2% in 2003 and 6.1% in 2004.

b. The Excessive Deficit Procedure

The European Commission initiated the Excessive Deficit Procedure against Greece in May 2004, as the 2003 deficit, as then estimated, had exceeded the reference value of 3% of GDP.[2] On 5 November, Greece sent the Commission a letter listing a range of measures taken to cope with its excessive deficit and reduce it below 3% of GDP by the end of 2005. Although these measures represented a step in the right direction, the European Commission considered them to be insufficient and therefore the Excessive Deficit Procedure progressed to the stage referred to in Article 104, par. 9 of the Maastricht Treaty. Thus, on 17 February 2005, the ECOFIN Council requested Greece to take fresh measures and, at the same time, extended the deadline for reducing the deficit below 3% until the end of 2006.

In response to the ECOFIN decision, Greece revised the update of its Stability and Growth Programme 2004-2007 and re-submitted[3] it to the European Commission on 21 March 2005. Also, on 29 March, a number of increases in indirect taxes (VAT rates, tobacco and spirit tax), as well as measures to cut ordinary budget spending and tax evasion, were announced. Overall, these measures are expected to contribute to reducing the deficit by €985 million or 0.6% of GDP in 2005 and by €1,655 million or 0.9% of GDP in 2006. It should be noted that in the new update of the Stability and Growth Programme the target for the 2005 general government deficit is revised to 3.5% of GDP.

Finally, the new Stability and Growth Programme of Greece was examined by the European Commission on 6 April 2005 and by the ECOFIN Council on 12 April 2005. Pursuant to the Opinion issued by the latter, the measures taken by the Greek government to redress fiscal imbalances and its respective commitment on 29 March are in line with the recommendations of the ECOFIN Council Decision of 17 February and "thus no further steps under the Excessive Deficit Procedure are necessary for the time being". In October 2005, Greece will present new data for a re-assessment of the situation.

1 Eurostat, Press release 39/18 March 2005.
2 On developments in the context of the Excessive Deficit Procedure from May 2004 to February 2005, see Bank of Greece, *Monetary Policy 2004-2005*, February 2005, pp. 131-134, Box VI.1.
3 The original submission had been made in December 2004.

IX. BALANCE OF PAYMENTS

1. CURRENT ACCOUNT

The current account deficit stood at €6,411 million in 2004, a significant €2,235 million less than in 2003. The decrease was due to the spectacular growth not only of the services surplus, that resulted from increased shipping receipts, but also of the transfers

TABLE IX.1
BALANCE OF PAYMENTS
(Million euro)

	January – December			Percentage changes	
	2002	2003	2004*	2003/02	2004*/03
I. Current account balance (I.A+I.B+I.C+I.D)	**–8,571.3**	**–8,646.3**	**–6,411.0**		
I.A Trade balance (I.A.1–I.A.2)	**–22,708.7**	**–22,643.5**	**–25,435.7**		
Non–oil **trade balance**	**–19,203.7**	**–18,607.7**	**–20,960.8**		
Oil **trade balance**	**–3,505.0**	**–4,035.8**	**–4,475.0**		
I.A.1 Exports of goods	10,433.6	11,113.6	12,653.3	6.5	13.9
I.A.2 Imports of goods	33,142.3	33,757.1	38,089.0	1.9	12.8
I.B Services balance (I.B.1–I.B.2)	**10,755.3**	**11,506.4**	**15,467.0**		
I.B.1 Receipts	21,131.4	21,430.3	26,742.5	1.4	24.8
I.B.2 Payments	10,376.1	9,923.9	11,275.5	–4.4	13.6
I.C Income balance (I.C.1–I.C.2)	**–2,073.4**	**–2,597.4**	**–2,457.5**		
I.C.1 Receipts	1,626.5	1,569.1	1,686.5	–3.5	7.5
I.C.2 Payments	3,699.9	4,166.5	4,144.0	12.6	–0.6
I.D Transfers balance (I.D.1–I.D.2)	**5,455.4**	**5,088.1**	**6,015.1**		
I.D.1 Receipts	7,801.4	7,817.4	8,974.3	0.2	14.8
I.D.2 Payments	2,346.0	2,729.3	2,959.2	16.3	8.4
II. Financial account balance	**10,310.4**	**9,663.7**	**7,834.0**		
III. Errors and omissions	**–1,739.0**	**–1,017.4**	**–1,423.0**		
Reserve assets (end of period)[1]	**9,014.0**	**4,605.0**	**1,994.0**		

1 Since Greece entered the euro area in January 2001, reserve assets, as defined by the European Central Bank, include only monetary gold, the "reserve position" in the IMF, "Special Drawing Rights" and Bank of Greece's claims in foreign currency on residents of non-euro area countries. Conversely, reserve assets do not include claims in euro on residents of non-euro area countries, claims in foreign currency or in euro on residents of euro area countries and the Bank of Greece participation in the capital and the reserve assets of the ECB.
* Provisional data.
Source: Bank of Greece.

surplus. These favourable developments, together with the slight drop in the income account deficit, more than offset the considerable widening of the trade deficit. In any event, despite the substantial decrease in the current account deficit in 2004 (to 3.9% of GDP, from an average of 6.2% of GDP during 2000-2003), its structure reveals, to a large extent, the intrinsic shortcomings of the Greek economy, which have led to the loss of competitiveness in the exportable goods and services. Specifically, the reduced price competitiveness of Greek products is evidenced by the fact that the euro effective exchange rate index, weighted on the basis of unit labour costs in manufacturing, rose by almost 6.5% in 2004, following an equally remarkable 5.5% rise in 2003.

With regard to the trade balance, the significant increase in payments for imports of goods in 2004 more than offset the rise in export receipts, thus leading to a widening of both the oil and the non-oil trade deficits. Increased payments for non-oil imports are largely associated with the completion of infrastructure projects for the Olympic Games, as well as with chronic problems, such as the failure to promote dynamic industrial activity.

The increase in freight rates for sea transport and the rise in world sea trade volume, owing to the high growth rates of the Chinese and US economies, led to the large increase in net transport receipts and, hence, in the services surplus. Finally, the increase in the transfers surplus is attributable to the rise in net EU transfers to general government, following the pickup in the rate of absorption of Structural Funds resources.

1.1 Trade balance

The total trade deficit increased by €2,792 million relative to 2003. Specifically, the large increase in the non-oil import bill more than offset the rise in non-oil export receipts. At the same time, the growth of the net oil import bill, which has been observed since 2000, continued in 2004, as a result of the steep rise in crude oil prices on the global market (21.5% in euro terms).

The significant increase (of €3,629 million or 12.8%) in the non-oil import bill, which accounts for most of the rise in the trade deficit, followed the relative slack of imports during the three years 2001-2003 (despite the rapid growth of economic activity over the same period).[1]

Detailed data on the composition of the import bill by product indicate a rise in payments in most categories (see Table IX.2), which was mainly due to the rise in import volume, given the relative stability of the prices of imported goods (according to the NSSG wholesale price index for imported goods). The category "means of transport" (including both passenger cars and other transport equipment) made the largest contribution to the total increase in import payments. This development is largely associated with the increased needs for means of transport during the Olympic Games. A slack was observed only in imports of machinery and appliances included in the subcategories of capital goods and consumer durables. According to provisional NSSG data for 2004, the geographical breakdown of imports remained broadly unchanged (see Table IX.3).

1 According to the NSSG, the value of non-oil imports increased at an average annual rate of 13.4% in 2004 (the value of total imports of goods increased by 11.3%).

TABLE IX.2
BREAKDOWN OF GREECE'S NON-OIL EXTERNAL TRADE BY PRODUCT CATEGORY

A. Export receipts

	Percentage share of each product category in total export receipts			Percentage change in export receipts	
	2002	2003	2004*	2003/2002	2004*/2003
Agricultural products	19.3	22.0	17.1	20.0	–12.3
Chemicals, plastics[1]	11.0	12.4	11.6	19.3	5.7
Metallurgy	8.6	7.9	9.7	–3.3	38.7
Machinery, appliances	5.4	7.3	5.5	42.2	–14.9
Means of transport	0.7	3.7	13.7	445.1	323.2
Ships	0.4	3.0	12.4	702.7	369.8
Other manufacturing industries[1]	19.2	20.1	17.8	10.8	0.1
Unclassified goods[2]	35.8	26.6	24.6	–21.4	4.4
Total	100.0	100.0	100.0	5.6	13.0
Total (excl. ships)				*2.9*	*2.0*

B. Import bill

	Percentage share of each product category in total import bill			Percentage change in import bill	
	2002	2003	2004*	2003/2002	2004*/2003
Agricultural products	14.7	14.4	13.7	–2.6	7.7
Chemicals, plastics	16.7	15.8	14.2	–5.2	1.1
Metallurgy	8.1	8.8	9.2	8.5	18.0
Machinery, appliances	21.4	21.2	19.3	–1.4	2.5
Consumer durables	3.5	3.6	3.2	1.7	–0.9
Capital goods	13.0	13.2	11.7	1.6	0.0
PCs	2.3	1.9	2.0	–16.1	15.9
Fixed-voice and mobile telephony	2.6	2.4	2.4	–7.6	10.6
Means of transport	12.8	15.0	18.4	16.7	38.1
Passenger cars	6.2	7.1	7.9	14.2	24.8
Other manufacturing industries[1]	21.9	21.9	20.7	0.1	6.3
Other goods	0.4	0.3	0.4	–13.6	36.7
Unclassified goods[2]	4.0	2.5	4.2	–37.2	84.8
Total	100.0	100.0	100.0	–0.3	12.8

1 Including raw materials used.
2 Products for which no code number has been reported.
* Provisional data.
Source: Bank of Greece.

TABLE IX.3

BREAKDOWN OF GREECE'S EXTERNAL TRADE BY GEOGRAPHICAL AREA*

A. Exports

	Percentage shares in total export value				Percentage change in export value		
	2001	2002	2003	2004	2002/2001	2003/2002	2004/2003
European Union-15	42.0	43.5	46.7	47.8	–3.3	16.4	6.3
Euro area	32.3	35.2	37.8	38.8	1.6	16.6	6.7
New Member States[1]	9.5	8.8	8.5	7.6	–13.5	4.4	–7.2
OECD[2]	12.9	12.3	14.3	13.3	–10.6	25.9	–3.1
USA	5.5	5.3	6.6	5.3	–9.3	33.1	–15.9
Balkan countries[3]	18.4	16.6	16.4	17.0	–15.6	6.9	7.7
Commonwealth of Independent States	4.3	4.3	3.5	3.0	–5.8	–10.5	–12.3
Northern Africa & Middle East countries[4]	6.7	7.1	5.5	6.4	–1.2	–16.0	20.9
China and Southeastern Asia[5]	1.9	2.1	1.6	2.0	4.9	–20.1	32.1
Other countries	4.5	5.2	3.6	3.0	8.6	–25.1	–13.4
Total	100.0	100.0	100.0	100.0	–6.7	8.5	3.9

B. Imports

	Percentage shares in total import value				Percentage change in import value		
	2001	2002	2003	2004	2002/2001	2003/2002	2004/2003
European Union-15	54.5	52.2	54.5	53.7	–0.5	25.6	5.1
Euro area	47.3	46.3	48.3	47.2	1.6	25.5	4.2
New Member States[1]	2.0	2.0	1.8	2.1	4.0	9.1	19.3
OECD[2]	13.8	17.9	18.9	15.9	35.1	26.9	–10.3
USA	3.5	4.7	5.0	4.4	40.3	28.2	–5.3
Balkan countries[3]	3.6	2.7	2.7	3.1	–21.2	17.7	23.1
Commonwealth of Independent States	6.8	9.3	7.3	6.4	42.5	–6.1	–6.6
Northern Africa & Middle East countries[4]	10.4	7.0	7.2	8.8	–30.6	24.0	30.6
China and Southeastern Asia[5]	5.2	5.0	4.7	5.1	1.0	12.4	16.5
Other countries	3.7	3.8	2.8	5.0	7.7	–11.3	87.0
Total	100.0	100.0	100.0	100.0	3.9	20.1	6.8

1 Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Cyprus, Malta.
2 The OECD Member States not included in any other category.
3 Albania, Bulgaria, Romania and former Yugoslavia countries (Bosnia, Croatia, FYROM and New Yugoslavia).
4 Greece's major trading partners in Northern Africa and the Middle East.
5 Greece's major trading partners in Southeastern Asia.
* Provisional data.
Source: NSSG.

As regards non-oil exports, the trend that had been observed since the beginning of the year continued. Specifically, non-oil export receipts recorded a noticeable growth (of €1,276 million or 13.0%) relative to 2003. It should be underlined, however, that this rise was almost entirely due to sales (exports) of second-hand ships for the renewal of the country's commercial fleet. Non-oil export receipts from other goods registered a very small increase (2.0%),[1] which, as already noted, is the net result of two countervailing effects: on the one hand, the acceleration of the growth rate of world trade (to 9.9%, from 4.9% in 2003), with positive effects on exports, and, on the other hand, the deterioration of the price competitiveness of Greek exports, which have been negatively affected to almost the same extent.

According to detailed data on the composition of (non-oil) exports by product category, an increase was recorded in receipts from exports of metallurgical products, means of transport (mainly second-hand ships) and chemicals-plastics (see Table IX.2). By contrast, a decrease was registered in receipts from exports of agricultural products and machinery-appliances.[2] As regards the geographical breakdown of exports, the latest available detailed NSSG data show that the share of exports to EU-15 countries displayed an upward trend in 2001-2004, although it remained almost unchanged in 2004 relative to 2003 (see Table IX.3).

1 Provisional NSSG data show a slight increase (of 1.9%) in the value of non-oil exports in 2004 (and a 2.6% increase in total exports of goods). Differences between the Bank of Greece and the NSSG trade data are due to a number of reasons, the most important one being that the former data refer to receipts and payments mainly through the domestic banking system, while the latter are based on customs data on transactions with non-EU countries and on tax data (INTRASTAT) on transactions with the EU and remain provisional for a long period of time.

2 It should be noted that deflating export receipts on the basis of the respective NSSG wholesale price index shows that changes in export receipts in most product categories are mainly due to changes in export volume.

BOX IX.1

The role of China in Greece's foreign trade

The emergence of China as a dynamic economy and major commercial power was one of the most important developments in the last few decades. Its extremely large population and its very significant growth potential enable it to influence the world economy to a great extent. The expansion of its foreign trade is one of the most remarkable features of its rapidly growing economy. In fact, according to World Trade Organisation (WTO) data, in 2003 China was the fourth exporting power in the world and ranked third in imports of goods, while it ranked ninth and eighth in exports and imports of services, respectively.

Trade between China and the EU-25 doubled between 1999 and 2003 and mainly focused on manufacturing products. Characteristically, in 2003 China was the third destination of EU-25 exports and the second, in terms of size, source of EU-25 imports (Eurostat data). About two-thirds of EU-25 exports to China are made up of "machinery and means of transport", while almost half of EU-25 imports from China consist of "machinery and means of transport" and the remainder of "other industrial products". →

→ Greece's trade with China represents a small proportion of the two countries' total trade, although it has been growing rapidly over the last five years. Specifically, the value of Greek exports to China does not exceed 0.5% of total Greek exports, while the value of imports from China stands at about 3.5% of total Greek imports. Exports to China increased from €18.4 million in 1999 to €58.3 million in 2004, while, over the same period, imports increased from €524 million to €1,419 million. As a result, the trade deficit with China rose from €506 million in 1999 to €1,361 million in 2004.

The composition of exports to China is very different from that of imports (see the first table in this box). Specifically, Greek exports represent low value added and consist mainly of

BREAKDOWN OF GREECE-CHINA TRADE BY PRODUCT CATEGORY
(Percentage share by product category)

A. Greece's exports to China

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Agricultural products	2.2	0.5	0.9	0.4	2.3	1.7	2.0	1.8	2.7	3.4
Raw materials (except fuel)	4.4	15.5	5.2	5.5	16.8	30.5	35.5	27.1	69.9	55.5
Fuel	3.5	0.4	1.0	5.1	1.6	2.8	1.0	0.4	0.3	1.5
Chemical products	73.0	56.0	72.9	33.6	44.1	44.6	23.7	19.1	10.5	3.3
Machinery and means of transport	1.8	5.3	1.7	4.1	6.1	5.7	28.4	45.6	8.1	12.9
Miscellaneous industrial goods	15.2	22.3	18.3	51.0	28.8	14.7	9.3	6.0	8.2	23.4
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
China's percentage share in total Greek exports	*0.2*	*0.4*	*0.5*	*0.2*	*0.2*	*0.3*	*0.4*	*0.6*	*0.5*	*0.5*

B. Greece's imports from China

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Agricultural products	0.9	1.0	2.1	1.6	1.1	1.4	1.2	1.3	1.5	1.3
Raw materials (except fuel)	0.8	0.8	0.6	0.6	1.2	1.6	1.3	1.0	0.8	1.0
Fuel	0.0	0.0	0.0	0.1	0.9	0.6	1.3	0.1	0.0	0.4
Chemical products	3.1	2.1	2.1	2.3	2.3	2.1	1.9	2.6	2.5	2.3
Machinery and means of transport	21.8	22.2	19.5	32.7	24.1	30.5	39.9	35.9	39.6	34.7
Miscellaneous industrial goods	73.5	73.9	75.8	62.7	70.4	63.9	54.4	59.0	55.6	60.4
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
China's percentage share in total Greek imports	*1.3*	*1.6*	*1.8*	*2.0*	*1.8*	*2.1*	*3.0*	*3.1*	*3.1*	*3.5*

Source: NSSG.

raw materials with a limited degree of processing, while the proportion of industrial products is relatively small. Among the raw materials exported to China, the most important is unprocessed marble, while cotton was added in 2003, owing to increased demand by the rapidly growing Chinese textile industry. Among industrial products, the main exports over a series of years have been chemical fertilisers, although they have decreased in the last few years. The share of raw materials and chemical products in total exports declined in 2004, while the share of industrial products (mainly accessories for assembly in China) increased substantially.[1] It should be →

1 The shares of some categories of products in total Greek exports to China are very volatile. It is therefore not certain whether they reflect long-term trends or temporary developments.

➔ noted that increased demand for raw materials, such as steel and aluminium, in the Chinese market has benefited many Greek firms, although it has caused a rise in the prices of raw materials (including oil), with rather unfavourable consequences for the Greek economy in general.

Imports from China consist almost exclusively of industrial products, some of which are highly competitive compared with domestic products, such as ready-made clothes, toys and various small appliances and tools. Specifically, imports from China adversely affect the textile industry, especially firms making ready-made clothes, which form a traditional section of Greek manufacturing, accounting for a significant part of total employment and a large share in the country's exports.

Special reference should be made to the textile industry, given that it faces strong competition from cheap Chinese products not only in Greece but also in other EU and non-EU countries, where it represents a significant sector of the domestic economy. Owing to its size, the Chinese market interests textile and clothing exporters, but China has become perhaps the largest exporter of textile products in the world, because of the extremely low prices of its products. Competition from Chinese products has intensified since 1 January 2005, when quotas on imports of textile products were abolished, as required by the WTO Agreement on Textiles and Clothing of 1995.[1]

In the EU, countries with significant textile and clothing industries (Italy, Spain, France) have a comparative advantage over China, mainly based on "brands" and high quality. In Greece, however, the textile/clothing sector's comparative advantage was initially based on low production cost, which has been substantially reduced, both because of the rise in labour costs and because of the entry of Eastern European countries into the European market. With China's entry into the global market, the textile and clothing manufacturers in Greece face increased pressures, which are concentrated in small and medium-sized firms making "non-brand" products, mainly in ready-made clothing.[2] "Brand" products seem to face less intense competition and, as a result, they control a growing part of retail trade in the sector. In the framework of the effort to boost the competitiveness of the sector's products, steps are already being taken to modernise production methods, in order to cut costs, improve product quality and promote Greek products in foreign markets.

According to balance of payments statistics, the share of China in Greece's total receipts from, and payments for, services remains very low (see the second table in the box). Both receipts and payments are mainly associated with transport, specifically sea transport. China has significantly increased its demand for sea transport in the last five years, since it has become ➔

1 Quotas were abolished rather abruptly, since 83% of them were still in force at the end of 2004, both in the EU and the US. This move was aimed at boosting the exports of many developing countries (in SE Asia and Africa), where textiles account for over 50% of exports and a substantial percentage of employment. However, it seems that the benefits from the abolition of quotas tend to be distributed unevenly, at the expense of less competitive countries, while China is expected to gain the most. However, already before the lifting of quotas, textile organisations all over the world had requested the extension of this regime or the creation of an alternative one, in order to restrict the expansion of Chinese exports, while pressure was exerted on China to abandon unfair competition practices. Under such pressure, China decided to impose duties on textile exports, both to avoid friction with the countries that import its products and to reorganise its production. Thus, it also counterbalances the practice of putting obstacles to imports of foreign products from other countries.

2 The spread of illegal trade has caused major problems in the last few years, mainly to domestic production and trade in clothing. This phenomenon is being gradually restricted by intensified controls, but it seems that legitimate importers as well continue to be significant competitors for domestic products, owing to the low cost of imported goods.

➔ one of the major consumers of raw materials and semi-processed products and one of the major producers of goods carried by sea. This increased demand, in conjunction with the distance between China and the markets for its products (USA, Europe), exerts upward pressure on international freight rates. For Greece in particular, receipts from sea transport in 2004 reached approximately 55% of total receipts from services exported by Greece to China. In addition, China's demand for transport services is expected to increase in the medium term, since the explosive growth of its economy is further supported by preparations for the 2008 Olympic Games.

It should be noted that Greece's net receipts from China for travel and other services have been rising in the last five years, although their significance for Greece's total services balance is still very small. It would be useful to explore the Chinese market potential for Greek tourism, because China may become the origin of a considerable number of tourists, as restrictions on Chinese citizens' travel abroad are gradually being lifted. Specifically, according to estimates by the WTO, Chinese tourists who will visit Greece in 2014 are expected to increase to 280 thousand, from 15 thousand in 2004. Given that Greece is a distant destination for Chinese tourists, measures should be taken to attract them and facilitate their visit. In particular, Greek tourism agencies should be established at the places of origin of most Chinese tourists (Beijing, Shanghai) and the air connection between the two countries should be improved. Finally, Greece can become an important reception gate for Chinese products in the Balkans and SE Europe and can benefit by exploiting the transit route of such products.[1]

GREECE-CHINA TRADE IN SERVICES
(Percentage share in total trade with China)

A. Greece's receipts						
	1999	2000	2001	2002	2003	2004
Sea transport	70.6	75.3	28.5	28.8	76.1	54.6
Travel services	23.7	4.2	27.8	65.3	9.6	20.8
Other services	5.7	20.6	43.7	5.8	14.4	24.6
	100.0	100.0	100.0	100.0	100.0	100.0
China's percentage share in total Greek receipts from services exports	*0.02*	*0.01*	*0.01*	*0.10*	*0.12*	*0.13*
B. Greece's payments						
	1999	2000	2001	2002	2003	2004
Sea transport	56.2	88.0	87.5	80.1	68.9	72.0
Travel services	24.3	5.3	4.2	8.6	23.0	18.9
Other services	19.5	6.8	8.4	11.3	8.1	9.1
	100.0	100.0	100.0	100.0	100.0	100.0
China's percentage share in total Greek import bill for services	*0.13*	*0.22*	*0.26*	*0.36*	*0.59*	*0.69*

Source: Bank of Greece.

1 The port of Thessaloniki has begun offering important services in this field, owing to the direct connection with China and Taiwan.

1.2 Services balance

The services surplus grew by €3,961 million in 2004 (or 34.4% against 2003) to €15,467 million, financing 61% of the trade deficit (50.8% in 2003). This rise is attributable to the considerable increase in net inflows, mainly from transport services and, to a lesser extent, from travel services (see Table IX.4).

TABLE IX.4

BALANCES ON SERVICES, INCOME AND TRANSFERS

(Million euro)

	2002	2003	2004*	2003/2002	2004*/2003
Services balance	**10,755.4**	**11,506.5**	**15,467.0**	**7.0**	**34.4**
Receipts	**21,131.4**	**21,430.3**	**26,742.5**	**1.4**	**24.8**
Travel	10,284.7	9,495.3	10,347.8	–7.7	9.0
Transport	8,523.4	9,569.8	13,307.0	12.3	39.1
Other services	2,323.3	2,365.3	3,087.7	1.8	30.5
Payments	**10,376.1**	**9,923.9**	**11,275.5**	**–4.4**	**13.6**
Travel	2,548.7	2,136.0	2,310.4	–16.2	8.2
Transport	5,029.7	4,923.6	5,728.2	–2.1	16.3
Other services	2,797.7	2,864.3	3,236.9	2.4	13.0
Net receipts	**10,755.4**	**11,506.5**	**15,467.0**	**7.0**	**34.4**
Travel	7,736.0	7,359.3	8,037.4	–4.9	9.2
Transport	3,493.7	4,646.2	7,578.8	33.0	63.1
Other services	–474.4	–499.0	–149.2	5.2	–70.1
Income balance	**–2,073.4**	**–2,597.4**	**–2,457.4**	**25.3**	**–5.4**
Receipts	**1,626.5**	**1,569.1**	**1,686.5**	**–3.5**	**7.5**
Wages, salaries	509.6	337.2	280.0	–33.8	–17.0
Interest, dividends, profits	1,116.9	1,231.9	1,406.5	10.3	14.2
Payments	**3,699.9**	**4,166.5**	**4,144.0**	**12.6**	**–0.5**
Wages, salaries	240.4	169.9	188.9	–29.3	11.2
Interest, dividends, profits	3,459.5	3,996.6	3,955.1	15.5	–1.0
Transfers balance	**5,455.4**	**5,088.1**	**6,015.1**	**–6.7**	**18.2**
Receipts	**7,801.4**	**7,817.4**	**8,974.3**	**0.2**	**14.8**
General government (EU transfers)	5,458.0	5,375.0	6,544.2	–1.5	21.8
Other sectors (emigrants' remittances etc.)	2,343.4	2,442.4	2,430.1	4.2	–0.5
Payments	**2,346.0**	**2,729.3**	**2,959.2**	**16.3**	**8.4**
General government (mainly payments to the EU)	1,695.7	2,169.3	2,286.6	27.9	5.4
Other sectors	650.3	560.0	672.6	–13.9	20.1

* Provisional data.
Source: Bank of Greece.

More specifically, net receipts from travel services amounted to €8,037 million, i.e. they increased by €678 million (or 9.2%) relative to 2003. The easing of broader geopolitical tensions and the positive economic performance of the tourists' countries of origin have led to a spectacular rise in international tourism (12%). However, despite the successful holding of the Olympic Games, tourism in Greece does not seem to have been substantially affected as regards the total volume of arrivals[1] or overnight stays of foreign tourists. In fact, arrivals declined by 1.5%, accompanied by a decrease in overnight stays per trip. Many attribute these developments to fears for potential terrorist acts during the Games, as well as to the view that accommodation was hard to find. The fact remains, however, that the prices of travel services offered in Greece are considered high, following the appreciation of the euro, while the generous advertising and promotion of emerging and cheap destinations (Turkey, Bulgaria, Croatia, Egypt) and new EU members (Malta, Cyprus, Slovenia, Czech Republic) should also be taken into consideration.

Nevertheless, receipts per overnight stay in 2004 increased significantly, mainly from July to September, while a rise was also observed in *per capita* inflows (10% approximately), which was probably due in part to the increased prices charged for tourism services during the Olympic Games.

Net transport receipts registered a rise of 63% to €7,579 million, reflecting a pick-up in world trade volume and high growth rates of Asian markets, especially China. Thus, the significant increase in the demand for transport services raised freight rates to historically high levels, both for ore & bulk ships and tankers. Although the world merchant fleet responded to market pressure with a 5% increase in capacity,[2] strong demand for raw materials (oil, iron ore and coal) by Asian countries, especially China, in conjunction with the limited port capacity of China, increased freight rates both at the beginning and at the end of 2004. Specifically, ore & bulk rates, as expressed by the BDI (Baltic Dry Index), increased by 71.6%[3] and came to a historical peak (6,208 points) on 6 December 2004, higher than the level recorded on 4 February 2004 (5,681 points). At the same time, tanker freight rates rose by 33%[4] and reached an all-time high (3,194 points) on 17 November 2004.

1 Specifically, arrivals from EU countries declined by 4.5%, with the exception of Italy, Austria, Spain and Ireland, while arrivals from the US and the UK remained unchanged.
2 This increase was also due to the decrease in the number of laid-up ships and the postponement of demolition of old ships until the date of entry into force of the new environmental protection regulations.
3 On the basis of the average level of the index in 2004, compared with the corresponding average of 2003.
4 See previous footnote.

BOX IX.2

Developments in Greek shipping and its contribution to the national economy

The year under review was an important one for Greek merchant shipping. Specifically, according to the latest available data, its direct contribution to the country's GDP in 2004 came to 4.8% and net inflows from sea transport covered 31% of the trade deficit. In addition, receipts from sea transport increased by 38.4% and relevant payments by 17.5%. Therefore, net inflows from shipping rose by 53.9% compared with 2003 (see the first table in this box). →

➔ Greek shipping companies enjoyed noticeable activity in US stock markets —NASDAQ, New York Stock Exchange (NYSE) and American Exchange (AMEX)— supported by the strongly upward trends in international freight markets. Specifically, during the year, Greek shipping companies raised, through either initial public offerings or capital increases, funds amounting to $550 million from US stock markets. This strong activity continued in the first quarter of 2005, when more than $600 million were raised.

The activity of Greek shipowners in purchasing and selling second-hand ships and building new ones has helped both to expand the fleet (in terms of deadweight tonnage) and reduce the average age of the Greek-owned fleet.

Specifically, in the last few years, there has been a visible improvement in the age of Greek-owned ships. According to data from the Lloyd's Register-Fairplay, on the basis of the

KEY MACROECONOMIC AGGREGATES RELATING TO SHIPPING RECEIPTS
(Million euro)

	2002	2003	2004
GDP (at current prices)	141,668.7	153,472.1	165,280.5
Trade balance	–22,708.7	–22,643.5	–25,435.8
of which: sale of ships	36.5	293.0	1,376.5
Services balance	10,755.3	11,506.5	15,467.0
Sea transport receipts	8,002.8	8,961.1	12,404.2
Sea transport bill	4,015.4	3,817.9	4,486.0
Net receipts from sea transport	3,987.4	5,143.3	7,918.3
– As a percentage of GDP	2.81	3.35	4.79
– As a percentage of the services balance	37.07	44.70	51.19
– As a percentage of the trade deficit	17.56	22.71	31.13
Annual percentage change in net receipts from sea transport	–3.21	28.99	53.95

Sources: Bank of Greece and Eurostat.

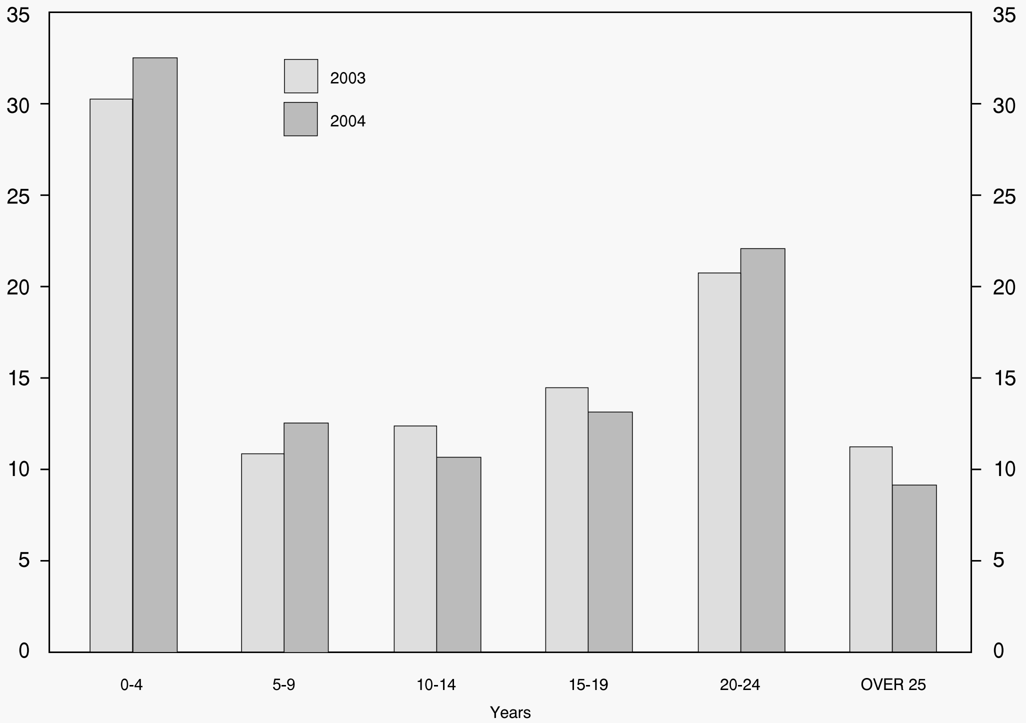
deadweight tonnage of the fleet under Greek management, ships aged less than 10 years increased their share in the whole fleet, while the respective share of ships aged over 10 years declined (see the first chart in this box). This renewal was effected through the building of new ships and the sale of older ones. This is also evidenced by Bank of Greece data, according to which in 2004 Greece's ship exports came to 12.4% of total exports of goods, compared with 3.0% in 2003.

This effort led to a 5% increase in the deadweight tonnage of the Greek-owned fleet, which thus rose to 18% of the world fleet (in dwt terms) and numbers 3,370 ships. Greek shipowners seem to prefer oil tankers and ore & bulk carriers (see the second chart in this box). ➔

→ The increase in freight rates was also impressive for both oil tankers and ore & bulk vessels. The rise in the volume of sea trade in ore & bulk is estimated at 4.5% in 2004, compared with 3.8% in 2003. This pickup in the transport volume of ore & bulk ships was reflected in the respective freight rates, which (according to the Baltic Dry Index-BDI) recorded an average annual increase of 70% and registered historically high levels in December 2004, beating the record attained in February 2004 (see the third chart in this box). This increase is attributable to the following factors:

AGE DISTRIBUTION OF THE GREEK-FLAG FLEET

(PERCENTAGES) (Based on dwt)



Source: Lloyd's Register - Fairplay.

1. *Imports of raw materials by China:* Owing to China's high growth rate, its imports of raw materials (mainly iron ore and coal) increased. In the course of 2004, the increase in steel production (which requires the use of iron ore and coal) in China exceeded 23%, compared with a mere 2.3% in the rest of Asia (see the second table in this box).

2. *China's energy requirements:* China's increased energy requirements reduced exports of thermal coal to neighbouring countries. Consequently, the latter had to import coal from more distant countries.

3. *Congestion of ports:* Increased waiting times in both loading and unloading ports (in China and the USA).

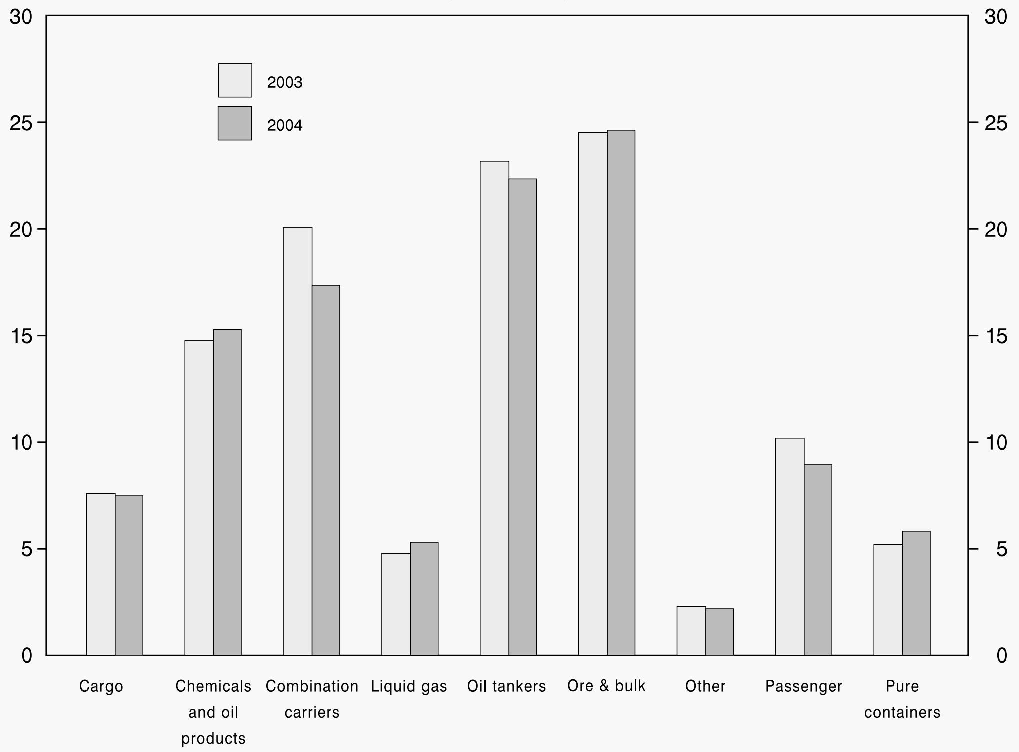
4. *Coal stocks:* Owing to the extremely high temperatures in the summer of 2003, which contributed to the increased consumption of electric power, mainly because of the intensive →

➔ operation of air conditioners, European power generating companies were forced to consume larger quantities of coal to meet production requirements. They were therefore unable to stock up the quantities of coal needed for the winter. Hence, in late 2003 and early 2004, Australian and South African coalmines were faced with increased demand.

5. *Transport of grains:* While the transported quantities of grains did not change substantially, an increase was registered in the transport (in terms of distance covered) of grains by

GREEK-FLAG FLEET AS A PERCENTAGE OF THE WORLD FLEET

(Based on dwt)



Source: Lloyd's Register - Fairplay.

traditional exporters, such as the USA, owing to increased demand from Asia and low production in the EU and the former Soviet Union countries.

Oil tanker freight rates, as reflected in the Baltic Dirty Tanker Index (BDTI), registered a significant increase in early 2004, which was contained in the spring of the same year. However, a further rise was registered from mid-summer onwards and these rates reached historically high levels in November 2004 (see the third chart in this box). This rise is attributable to the increased demand for oil, mainly by China and other Asian countries. Oil consumption in China grew by 16% in 2004, against 11% in 2003. Moreover, broader geopolitical conditions forced importing countries to obtain oil from more distant sources. ➔

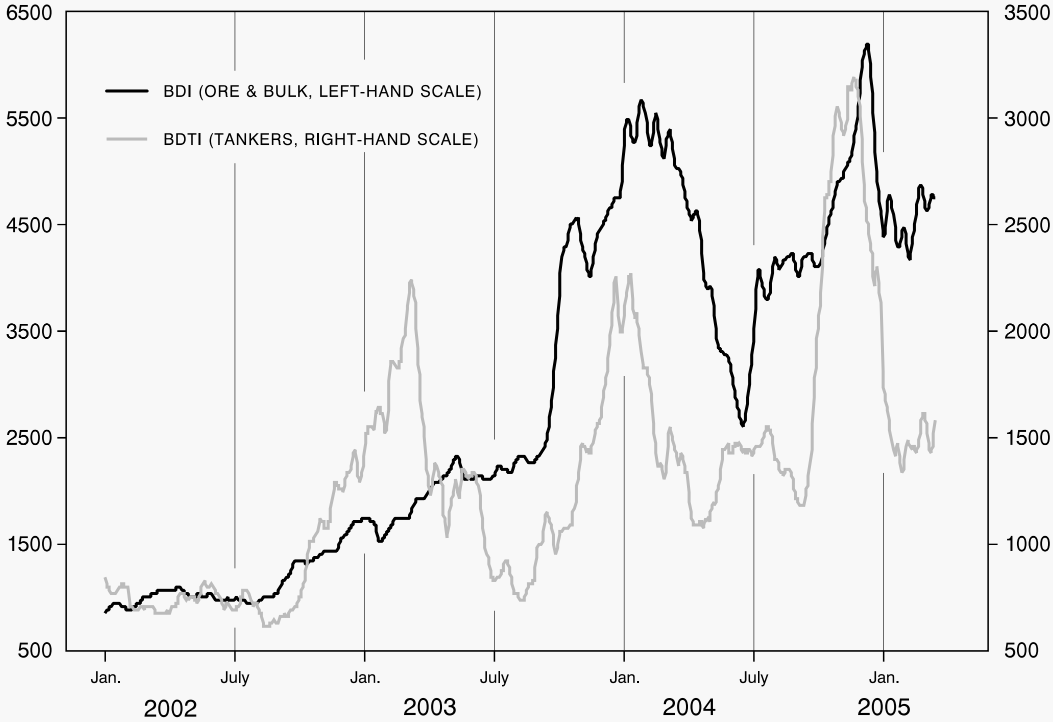
STEEL PRODUCTION

	Production shares (%)			Annual increase in production (%)	
	2002	2003	2004	2003/02	2004/03
EU–15	17.6	16.9	16.3	1.1	5.0
Other European countries	5.3	5.1	5.1	0.6	8.9
Commonwealth of Independent States	11.2	11.2	10.8	5.1	5.3
North America	13.6	13.3	12.8	2.8	5.4
Asia	43.7	45.1	46.8	8.7	13.1
of which: China	20.1	23.3	26.3	21.7	23.2
Other countries	8.6	8.5	8.2	3.9	3.9
Total	**100.0**	**100.0**	**100.0**	**5.3**	**8.9**

Source: Calculations based on data from the International Iron & Steel Institute.

➔ It is estimated that freight rates in 2005 will remain at average 2004 levels. However, in the second half of the year, it is expected that deliveries of new ships will offset the demolition of old ones —owing to the new arrangements that are being put into force by the International Maritime Organisation (IMO)— and might lead to a small-scale adjustment of freight rates.

FREIGHT RATE INDICATORS FOR ORE & BULK VESSELS AND OIL TANKERS



Source: Bloomberg.

1.3 Income account

The income account deficit consists, for the most part, of interest payments on Greek government bonds, which are associated with the increase in non-residents' holdings of such securities. In 2004, the deficit stood at €2,457 million, i.e. it registered a slight decrease of 5.4% compared with 2003. This development is due to the rise in interest, dividend and profit receipts, mainly because of residents' growing portfolio investments abroad, while respective payments remained unchanged.

1.4 Transfers balance

The transfers surplus rose to €6,015 million, from €5,088 million in 2003. This development is almost exclusively attributable to the considerable increase in net EU transfers (receipts minus payments), which amounted to €4,258 million in 2004, compared with €3,206 million in 2003. By contrast,the net receipts of the other sectors (i.e. excluding EU transfers) declined to €1,758 million, from €1,882 million in 2003. It should be noted that emigrants' remittances, which form part of the other sectors' receipts, have been declining since 2000 and fell to 29% of the receipts of the other sectors in 2004 (from 63% in 2000).

The rise in net transfers is exclusively due to the faster absorption of Structural Fund resources under CSF III,[1] taking into account that receipts from the Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) under the Common Agricultural Policy (CAP) remain at roughly the same level each year. For 2005, EU transfers are expected to increase further, given that in December 2004 the European Commission approved the "mid-term review" of CSF III (2000-2006). At the same time, the foundations were laid at the national level for the implementation of the necessary organisational and institutional improvements, while simplifications of the relevant procedures are under way, aiming at the more effective utilisation of EU resources and at preventing the loss of such resources, while strengthening Greece's bargaining position in demanding CSF IV funds.

It should be borne in mind that EU transfers to Greece are secured until the end of 2006 on the basis of the applicable "EU financial perspectives" for the period 2000-2006 and are not affected by the EU enlargement with 10 new Member States since May 2004. Concerning the period beyond 2006, transfers will be phased out over a long transitional period. (For the outlook regarding future transfers – i.e. CSF IV covering the period 2007-2013 – see Box IX.3.)

1 By end-December 2004, the rate of absorption of Structural Fund resources under CSF III stood, on a cash basis, at approximately 33% of the total EU contribution, compared with 22% in December 2003.

BOX IX.3

Transfers from the European Union after the enlargement: developments and prospects at national and Community level

EU financial perspectives: 2007-2013

Transfers to Greece from the Structural Funds and the Cohesion Fund under the 3rd Community Support Framework (CSF III), as well as the Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) under the Common Agricultural Policy (CAP), are secured until end-2006 on the basis of the current "EU financial perspectives" for the period 2000-2006.[1]

In February 2004 the European Commission published its proposals for the financial perspectives of the EU for the period 2007-2013,[2] which will be the basis for the preparation of the CSFs for the 25 and, later on, the 27 Member States.[3] The goal is to finalise the new financial perspectives at the European Council in June 2005 under Luxembourg presidency, so as to devote the remaining time to negotiations with the Member States and commence the implementation of the new programmes in early 2007.[4]

The financial framework 2007-2013 fulfils the main policy priorities for the enlarged EU (promoting sustainable development, giving full content to European citizenship and supporting the EU as a global partner) and is associated with the new structure of the economic and social cohesion policy.[5]

The new objectives can be met in the European Union of 27 Member States if the ceiling on own resources of the Community Budget (CB) during the period 2007-2013 remains unchanged, at 1.24% of the EU Gross National Income (GNI).[6] However, the average level of "payment appropriations" should, according to the Commission's proposals, be raised to 1.14% of the EU's GNI, from the current 1.09%.[7] These limits have been questioned by the six "net contributors" (Germany, France, UK, Sweden, Austria, Netherlands). →

1 EU enlargement with the accession of ten new Member States in May 2004 does not burden, for the period up to 2006, the 15 old Member States, mainly because of the transitional arrangements for the implementation of the CAP for the new Member States.

2 See European Commission, "Building Our Common Future – Policy challenges and budgetary means of the enlarged Union 2007-2013", COM(2004) 101 final, 10 February 2004.

3 Accession negotiations with Bulgaria and Romania were completed in the course of 2004, the plan for these countries being to sign the Accession Treaty in 2005 and fully accede in 2007.

4 According to statements by the Greek Prime Minister (18 April 2005), "Greece supports the Commission proposal" on the financial perspectives 2007-2013, because "it is a balanced proposal that both ensures the success of the enlargement and deals with the problems and challenges stemming from the different levels of development of the 25 Member States".

5 See European Commission, *Third report on economic and social cohesion*, COM(2004) 107 final, 18 February 2004.

6 In the course of the policy period 2000-2006, the ceiling on own resources declined from 1.27% of the EU's Gross Domestic Product (GDP) to 1.24% of the EU's GNI, in order to maintain unchanged the amount of financial resources put at the disposal of Member States, following the technical adjustment in the framework of implementation of the new statistical system ESA 95 (see Council Resolution 2000/597 on the system of European Communities' own resources, *Official Journal* L 253, 7 October 2000, and European Commission, Communication on the adaptation of the ceiling on own resources, COM(2001) 801 final, 28 December 2001).

7 In practice, the Community budget's "payment appropriations" are far from the own resources ceiling, mainly due to pressures exerted by "net contributors".

EUROPEAN COMMISSION PROPOSALS FOR THE EU'S
FINANCIAL PERSPECTIVES 2007-2013
(Million euro, 2004 constant prices)

Commitment appropriations[1]	2006	% share in the total	2013	% share in the total	2007-2013	% share in the total
1. Sustainable growth	**47,582**	**39**	**76,785**	**48**	**477,665**	**47**
1a. Competitiveness for growth and employment	8,791	7	25,825	16	132,755	13
1b. Cohesion for growth and employment	38,791	32	50,960	32	344,910	34
2. Preservation and management of natural resources	**56,015**	**47**	**57,805**	**37**	**404,655**	**39**
out of which:						
Agriculture – market-related expenditure and direct payments	43,735	36	42,293	27	301,074	29
3. Citizenship, freedom, security and justice	**1,381**	**1**	**3,620**	**2**	**18,505**	**2**
4. The EU as a global partner	**11,232**	**9**	**15,740**	**10**	**95,590**	**9**
5. Administration	**3,436**	**3**	**4,500**	**3**	**28,620**	**3**
Compensations	**1,041**	**1**		**0**		**0**
Total appropriations for commitments (1+2+3+4+5)[2]	**120,688**	**100**	**158,450**	**100**	**1,025,035**	**100**
Total appropriations for payments[3]	114,740		143,100		928,700	
Appropriations for payments as a percentage of GNI	1.09%		1.15%		1.14%	
Margin available	0.15%		0.09%		0.10%	
Own resources ceiling as a percentage of GNI	1.24%		1.24%		1.24%	

1 For comparability purposes, expenditure for 2006 has been broken down according to the proposed new nomenclature which will be applied during 2007-2013. It should be recalled that, in the framework of the financial perspectives for 2000-2006, total appropriations for commitments amount to €687,524 million (EU-25, at 1999 constant prices).
2 Appropriations for commitments cover, during the current year, liabilities related to actions whose implementation will take more than one fiscal year.
3 Appropriations for payments cover expenditure from liabilities incurred in the current or previous fiscal years but paid within the current year.

Source: Calculations based on the European Commission's "Building our common Future – Policy challenges and budgetary means of the enlarged Union 2007-2013", COM(2004) 101 final, 10 February 2004.

→ In the framework of the new financial perspectives, the financing system of the CB will undergo a general revision by 1 January 2006. Proposals include modifications in the structure of "own resources" by the creation of a new autonomous "own resource" and the introduction of a generalised correction mechanism for "negative budgetary imbalances"[1] in order to avoid excessive budgetary burdens on "net contributors".[2]

The total resources of the cohesion policy (structural actions) for the period 2007-2013 amount, according to the Commission's proposals, to €336.1 billion and correspond to approximately one-third of the CB and 0.41% of the EU's GNI (see the table in this box). Resources for agriculture in the framework of the revised CAP, specifically expenditure relating to the common market organisation and direct payments, remain, on average, unchanged from the previous period, being restricted as a percentage of the CB to the benefit of structural expenditure (corresponding to approximately 30.0% of the total). It should be noted that the financial framework 2007-2013 implements a new classification of CB expenditure in five main fields, reflecting the new economic and political objectives of the enlarged EU. Therefore, expenditure for the new period is not entirely comparable with that based on the previous financial perspectives.

Revision of the operation of Structural Funds

The enlarged EU and the new approach have made it necessary to radically revise the operation of Structural Funds. The European Commission has issued five proposals for new Regulations. They include a general Regulation, establishing a common set of rules for the three financial instruments, a specific Regulation for each of the three instruments, i.e. the Cohesion Fund, the European Regional Development Fund (ERDF) and the European Social Fund (ESF), and finally a Regulation relating to the creation of a "European Grouping of Cross-border Cooperation".[3] The proposed reform maintains the basic principles of structural actions, such as multiannual programming, co-financing based on the principle of additionality of Community assistance and national funding and the assessment of performance and quality in different stages of the procedure. However, it introduces a series of important innovations, aiming at improving the efficiency of cohesion policy and simplifying the community resources management procedures, while greater reliance is afforded to national control systems.

The main points of the review are the decrease in the number of cohesion financial instruments and the change in the priority goals of the Funds. Specifically, the Cohesion Fund is included in Structural Funds and is now subject to the same rules as they are, while the →

1 According to the current system, the Community budget's sources of financing are: (a) traditional own resources (mainly customs duties collected by Member States on behalf of the EU), (b) the resource based on value added tax (VAT) and (c) the GNI-based resource. A specific mechanism for correcting the budgetary imbalance of the United Kingdom is also part of the current system.

2 See European Commission, "Financing the European Union", COM(2004) 505 final, 14 July 2004.

3 See the relevant proposals for Council Regulations in COM(2004) 492 final, COM(2004) 495 final, COM(2004) 493 final and COM(2004) 496 final, 14 July 2004.

➔ Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) and the Financial Instrument for Fisheries Guidance (FIFG) are abolished and their goals are incorporated into the new European Agricultural Fund for Rural Development (EAFRD) and the European Fisheries Fund (EFF), respectively.[1] The operational programmes will be financed by one fund only (the ERDF or the ESF), with the exception of programmes relating to infrastructures, where the ERDF and the Cohesion Fund participate jointly. "Community initiatives" will be incorporated into the operational programmes.

The three current priority objectives of the Funds ("Objective 1": regions whose development is lagging behind, "Objective 2": regions under economic and social restructuring and "Objective 3": education and employment systems) will be replaced in 2007 by the following objectives:

– "Convergence" objective (ERDF, ESF, Cohesion Fund): similar to the current Objective 1, aiming at accelerating the economic convergence of less developed regions.

– "Regional Competitiveness and Employment" objective (ERDF, ESF).

– "European Territorial Cooperation" objective (ERDF): it aims at strengthening cross-border cooperation through common programmes.

The "Convergence" objective concerns regions whose *per capita* GDP, calculated on the basis of available data for the last three years, is less than 75.0% of the enlarged EU average – which mainly holds true for most new Member States. For regions exceeding the percentage of 75.0% owing to the "statistical effect" of the enlargement,[2] a transitional period and special support are provided for, which will be phased out by 2013.

All regions that are not covered by the "Convergence" objective will be able to benefit from the "Regional Competitiveness and Employment" objective.[3] The regions of current Objective 1 which, in 2007, will not be eligible for the "Convergence" objective owing to their economic growth, will receive, in the framework of the "Regional Competitiveness and Employment" objective, special and transitional support, to be phased out by 2013.

As was mentioned above, the total resources of the cohesion policy during 2007-2013 amount to €336.1 billion and correspond to approximately 1/3 of the CB. Of these resources, €264 billion, i.e. 78.54% of the Funds' resources, will be allocated to the "Convergence" objective, compared with the current 75.0%. Specifically, resources will be allocated as follows:

– 67.34% for regions with *per capita* GDP lower than 75.0% of the enlarged EU average,

– 8.38% for regions affected by the "statistical effect" of the enlargement,

– 23.86% for Member States benefiting from the Cohesion Fund,

– 0.42% for extremely remote regions. ➔

1 See the relevant proposals for Council Regulations in COM(2004) 490 final and COM(2004) 497 final, 14 July 2004.

2 It is clear that, with the accession of the new Member States, the *per capita* GDP average decreases, in which case some regions of Greece and of other current Member States will not be eligible for inclusion in Objective 1 owing to this statistical effect alone, although they have not completed the process of economic convergence.

3 It should be recalled that, in the current period 2000-2006, 1/3 of the resources of Structural Funds is directed towards regions which are not eligible for inclusion in Objective 1.

→ The interventions of the Cohesion Fund will continue to apply to Member States with *per capita* GDP lying below 90% of the Community average.[1] In the EU-15, this criterion was initially met by Greece, Ireland, Spain and Portugal. After the enlargement, the Cohesion Fund covers the three Member States that remained eligible (Greece, Portugal, Spain),[2] as well as the ten new Member States. As mentioned above, in the new programming period the Cohesion Fund will be included in the Structural Funds and will be subject to the same rules, such as the rule of automatic decommitment of any unused part of Community funds, two years after their commitment (n+2 rule). However, a special feature of the Cohesion Fund, also included in the proposal for the new Regulation, is that assistance is conditioned to the fulfilment of the Treaty requirements for convergence programmes and excessive deficits by the Member States participating in the economic and monetary union.[3]

The share of the various Funds in the overall public expenditure (national and Community one) for projects and programmes covered thereby has the following ceilings:

– 85.0% for the Cohesion Fund,

– 75.0% for the ERDF or the ESF with regard to the "Convergence" objective and, exceptionally, up to 80.0% for Member States benefiting from the Cohesion Fund,

– 50.0% for the ERDF or the ESF regarding the "Regional Competitiveness and Employment" objective,

– 75.0% for the ERDF as regards the "European Territorial Cooperation" objective.

Same as before, in the period 2007-2013 the European Commission will make a "payment on account" (advance payment) of 7.0% of the total contribution of Structural Funds and 10.5% of the contribution of the Cohesion Fund at the beginning of the programming period. Moreover, the "performance reserve" is maintained, henceforth to be called "quality and performance reserve"; it will correspond to 9.0% of the resources paid by the ERDF and the ESF for the "Convergence" and "Regional Competitiveness and Employment" programmes and will reward the progress made in accordance with specific criteria.

Community Support Framework 2007-2013: perspectives for Greece

The above points reveal the overall environment in which negotiations are held concerning the size and allocation of the next CSF. →

1 The Protocol on Economic and Social Cohesion, appended to the Maastricht Treaty, provided for the establishment of the Cohesion Fund before the end of 1993 in order to finance programmes aiming at the protection of the environment and the development of trans-European networks in Member States whose *per capita* GDP was less than 90.0% of the Community average (the Cohesion Fund was established by Regulation (EC) 1164/94, which was subsequently supplemented by Regulations (EC) 1264/99 and (EC) 1265/99).

2 Since 2004, Ireland has ceased to be eligible for the Cohesion Fund, because it exceeded the GDP threshold (see European Commission, COM(2004) 191 final, 24 March 2004), while Spain will cease to be eligible in the new programming period.

3 Specifically, in the event that the Council finds, according to Article 104 of the EC Treaty, that an excessive budgetary deficit exists in a Member State and such Member State does not take effective measures to reduce it, the whole or part of economic support will be suspended from 1 January of the following year.

→ At the national level, procedures for drafting the Greek "National Strategic Development Plan" (NSDP) were initiated in the first half of 2004, with the establishment of the relevant planning and coordination committees, staffed with government officials and representatives of other economic agents and of the social partners.[1] The whole process will last two years and is divided into two phases: the growth prospects of the country must be identified by end-May 2005 and the planning be completed by end-May 2006. The NSDP will describe the main growth objectives of the country at national, sectoral and regional levels,[2] which should be in line with the Community's "Strategic Guidelines for Cohesion".[3]

Greece's receipts from the next CSF will depend, first, on the total amount to be allocated from the Community budget to the cohesion policy and, second, on the allocation of the funds among the regions of the 25 Member States. If the Commission proposals, supported by Greece and "small countries", are accepted, it is estimated that Greece will be in a position to demand a maximum amount of €22.0-23.0 billion[4] (against €26.0 billion of the CSF for the current period 2000-2006).

The final amount will mainly depend on the exact number of the country's regions that will not be included in the "Convergence" objective, either for actual or for statistical reasons, but will continue to be financed beyond 2007 with smaller amounts that will be phased out. It should be recalled that, in the current period 2000-2006, Greece is the only country among the 15 Member States all the regions of which are included in Objective 1.

Assuming that the eligible regions for the "Convergence" objective in the programming period 2007-2013 will be determined on the basis of the average Community *per capita* GDP of the period 2000-2002,[5] two regions of Greece (Central Greece and South Aegean Islands) are not included in the "Convergence" objective owing to "actual convergence" and three other regions (Central Macedonia, West Macedonia and Attica) owing to "statistical convergence". The other regions (Eastern Macedonia – Thrace, Thessaly, Epirus, Ionian Islands, Western Greece, →

1 Specifically, in December 2004 the Ministry of Economy and Finance issued the 2nd Circular on the planning of the NSDP 2007-2013 (the 1st was issued in June 2004). Moreover:
- The commissioning of the "General Study on Greece's Growth Prospects" is under way.
- A "roadmap" was prepared for the next planning and programming phases and steps of the NSDP.
- Progress is being made in the establishment of the bodies responsible for planning and preparing the action plan, i.e. the "Coordination and Policy Formulation Committee" and the "Drafting Group", which supports the above committee in cooperation with the "Ministry and Regional Authority Planning Groups".

2 See Ministry of Economy and Finance, Conclusions of the 5th and 6th CSF Monitoring Committee, June and December 2004 respectively.

3 The "Strategic Guidelines on Cohesion" define, at the Community level, the guidelines on economic and social cohesion. Their content and method of adoption are included in Articles 23 and 24 of the General Regulation COM(2004) 492 final, 14 July 2004. The relevant proposals of the European Commission will be made public by June 2005. According to Articles 25 and 26 of the above Regulation, the NSDP determines the relations between Community priorities, on the one hand, and national and regional priorities on the other.

4 See, *inter alia*, Bradley *et al.* (2004), *A study of the Macroeconomic Impact of the Reform of the EU Cohesion Policy*, The Economic and Social Research Institute, October 2004, commissioned by the European Commission. According to this study, in Greece the CSF 2007-2013 public expenditure (Community and national one) will contribute to an annual GDP growth of 1.36% on average. This general conclusion is subject to the limitations and assumptions of the econometric model used, while it also depends on the proposals of the European Commission on the size and allocation of Community resources per Member State for the period 2007-2013.

5 For the relevant calculations, *per capita* GDP is expressed in purchasing power standards.

➔ Peloponnese, North Aegean Islands and Crete) have a regional *per capita* GDP below 75% of the respective Community average and, as a result, they continue to meet the criteria for inclusion in the "Convergence" objective.[1] The exclusion of certain regions from the "Convergence" objective does not result in automatic and full discontinuation of Community fund receipts. By contrast, as mentioned above, a transitional period is stipulated for regions disqualified owing to the "statistical" effect of the enlargement, during which Community financing will be phased out, while regions disqualified owing to "actual convergence" will receive transitional support (also to be phased out) in the framework of the "Regional Competitiveness and Employment" objective.

The prospects of transfers to the agricultural sector

Concerning the prospects of transfers to the agricultural sector of Greece and other Members States, it should be noted in principle that, despite the gradual decrease in CB expenditure subsidising the prices of agricultural products, the CAP remains the most important category of expenditure in the current period 2000-2006. According to the classification in force, it represents over 40.0% of the total, while structural resources correspond to 30.0% of the total. Similarly, about 40.0-45.0% of Greece's receipts originate from the Guarantee Section of the EAGGF, according to the CAP arrangements. By 2006, Greece and the other EU-15 Member States will receive the amounts agreed for the agricultural sector at the Berlin European Council (March 1999). Transitional arrangements will be applicable to new Member States.[2]

For the period beyond 2006, the level and the composition of transfers to the agricultural sector are associated with the specific resolutions made in the framework of the "mid-term review" of the CAP in June 2003. According to these resolutions, financing for the 15 old Member States has been secured at about the current level up to 2013 (financial neutrality). Equal treatment of Mediterranean and other products has also been secured regarding the principles and methods to be applied during the revision.[3] ➔

1 See Statistical Office of the European Communities (Eurostat), "Regional GDP p.c. in the EU-25", 25 January 2005 (and revision on 7 April 2005), as well as Announcement by the EU Regional Policy Commissioner Mrs. D. Hubner, IP/05/107, 28 January 2005.

2 Specifically, in 2004 the ten new Member States will receive 25.0% of the subsidies that they would normally receive, in 2005 30.0%, in 2006 35.0% and in 2007 40.0%. Additional 10% annual increases will be made subsequently, in order to ensure that in 2013 they will reach the level of support then applicable to the current 15 Member States (European Council Resolutions of Brussels and Copenhagen).

3 The Common Agricultural Policy (CAP) is the oldest and most integrated common policy of the European Union. Its general objectives and principles were determined in the Rome Convention (1960), when its mechanisms were approved by the 6 founding Member States of the European Communities (EC), and it was put in force in 1962. By the Maastricht Treaty (1992), the Amsterdam Treaty (1997) and the "Agenda 2000" action plan (1999), its operation was linked to the economic and social cohesion policy and the promotion of sustainable growth. The "Agenda 2000" action plan, in view of the enlargement, provided, *inter alia*, for a new revision of the CAP in the framework of the financial perspectives of the period 2000-2006. The general guidelines of the revision were confirmed by the European Council at Gothenburg (June 2001) and incorporated into the proposals for the so-called "mid-term review" of the CAP, which were approved in June 2003 (*Official Journal* L 270, 21 October 2003). The second phase of the revision, which covers the Mediterranean products, was approved in April 2004 (Regulations (EC) 864/2004 on tobacco, cotton and hops and 865/2004 on olive oil (*Official Journal* L 161, 30 April 2004).

→ These trends are reflected in the proposals for the new financial perspectives, where expenditure for agriculture approaches, on average, the levels of the previous period, limited of course as a percentage of GDP in favour of structural expenditure (see the table in this box). This is due to the fact that the saving of resources from changes in the intervention measures for agricultural products offsets the effects of the new arrangements on Community support to producers.[1] Therefore, the budgetary effects of the review seem to be rather limited for the whole EU agricultural sector, with some deviations depending on product categories and regions.

The implementation of the new CAP in Greece will begin in 2006. Given that, for the calculation of Community support to Member States, according to the new CAP arrangements, the historical data of the period 2000-2002[2] will be taken into consideration as a reference point, it is estimated that Greece will continue to receive €2.7 million per annum in the new programming period (including the amounts to be paid for agricultural development). However, in the current phase, no overall conclusions can be drawn concerning the effects of the "mid-term review" on Greece because (i) the review incorporates many and extensive changes, some of which will be carried out over a long period of time, (ii) an assessment should be made of the contribution of the proposed measures to the attainment of the objectives of the revision and (iii) the composition of the agricultural sector and the specific features of each product market should be taken into account.

From the above points, it is clear that, in the enlarged EU for the period beyond 2006, if the proposals of the European Commission are adopted, overall EU transfers to Greece (structural actions and inflows to the agricultural sector) will continue to represent a significant part of GNI,[3] although they will be phased out in the course of a long transitional period. They need to be put into effective use in order to maximise the benefits stemming from the enlargement.

1 A basic direction of the "mid-term review" is the rural development strategy as the second pillar of the CAP. The main points of the review are:
- Decoupling of direct production aids, which will be replaced by a single (lump sum) income payment per holding.
- Progressive reduction of single direct aids, with the exception of small producers who will receive up to €5,000 per holding (modulation). For large holdings, the reduction will be 3.0% per annum, aiming at achieving a total reduction of 20.0% within seven years (by 2011). The resources saved through these reductions will be transferred to the "second pillar", i.e. to rural development projects.
- Linking of payments to the observance of certain standards and rules concerning the environment, food safety etc. (cross-compliance), and implementation of a new system of farm auditing for the proper application of the above arrangements.

These proposals aim at gradually creating a "multifunctional" agriculture, where farmers should carry out other functions besides producing agricultural products in order to qualify for subsidisation.

2 See the respective Regulations in footnote 3 on the previous page.

3 According to European Commission estimates, the "net financial benefit" (receipts minus payments) will correspond to approximately 2.2% of GNI on average in the period 2007-2013 (see European Commission, "Financing the EU", COM(2004) 505 final, 14 July 2004).

2. FINANCIAL ACCOUNT

Net financial inflows to the Greek economy in 2004 more than offset the current account deficit.[1] It should be pointed out, however, that this deficit is financed by the inflow of funds for the purchase of Greek government bonds by foreign investors, while the share of direct investment remains small.

Indeed, total financial investment, i.e. the sum of total direct investment, portfolio investment and "other" investment, showed a net inflow of €5,223 million, compared with €5,255 million in 2003 (see Table IX.5). It should be noted, however, that this development is mainly attributable to a net inflow of €13,727 million under "portfolio investment" (2003: €12,334 million), while inflows under "direct investment" amounted to €600 million (2003: €545 million). These inflows were largely offset by a net outflow of €9,104 million under "other investment" (2003: €7,624 million).

TABLE IX.5
FINANCIAL ACCOUNT BALANCE
(Million euro)

	2002	2003	2004*
Financial account balance (I+II+III+IV)	**10,310.4**	**9,663.7**	**7,834.0**
I. Direct investment	**–643.0**	**544.7**	**599.6**
Abroad by residents	–696.3	–41.2	–488.8
In Greece by non-residents	53.4	585.9	1,088.4
II. Portfolio investment	**10,937.8**	**12,334.0**	**13,727.5**
Assets	–2,230.0	–8,737.9	11,489.4
Liabilities	13,167.8	21,071.8	25,216.9
III. Other investment	**1,998.6**	**–7,623.9**	**–9,104.1**
Assets	–7,481.9	–4,034.5	–6,215.7
Liabilities	9,480.5	–3,589.4	–2,888.4
(General government borrowing)	–4,510.1	–2,618.4	–1,027.4
IV. Reserve asset changes	**–1,983.0**	**4,409.0**	**2,611.0**

* Provisional data.
Source: Bank of Greece.

1 Net financial flows, consisting of the sum of total financial investment and the change in reserve assets, amounted to €7.8 billion in 2004, against €9.7 billion in 2003 (see Table IX.5).

2.1 Direct investment

Inflows for direct investment, although still at low levels, increased further in 2004, despite the decline of foreign direct investment worldwide. Specifically, non-residents' investment in Greece amounted to €1,088 million in 2004, i.e. it almost doubled relative to 2003 (€586 million). Moreover, residents' investment abroad rose to €489 million, from a mere €41 million in 2003.

According to the country breakdown of direct investment, non-residents' investment in Greece originated almost exclusively from OECD countries, mainly EU

TABLE IX.6
REGION BREAKDOWN OF FOREIGN DIRECT
INVESTMENT IN GREECE

	Million euro	
	2003	2004*
OECD[1]	672	1,091
EU-15	701	916
Euro area	206	301
Balkan countries[2]	1.0	–1.3
Central Europe and former USSR[3]	0.0	3.1
Middle East and the Mediterranean[4]	12	24
Other countries	–99	–29
Total	586	1,088

1 Twenty-four OECD countries except Mexico, South Korea, the Czech Republic, Poland and Hungary.
2 Albania, Bulgaria, Romania and former Yugoslavia countries (Slovenia, Bosnia, Croatia, FYROM and New Yugoslavia).
3 Poland, Hungary, the Czech Republic, Slovakia and former USSR countries.
4 Greece's major trading partners in the Middle East and the Mediterranean.
* Provisional data.
Source: Bank of Greece.

Member States (see Table IX.6). The most important non-residents' direct investment in Greece concerns the following acquisitions: (i) of Panafon AEET by Vodafone (which was realised partly in 2003 and was completed in January and February 2004), (ii) of Geniki Bank by Société Générale (in March), (iii) of "Delta Singular Outsourcing Services" (subsidiary of "Delta Singular") by the US company "First Data" (in July) and (iv) of Kotsovolos S.A. by Dixons (in September). Lastly, a significant inflow was due to the larger stake acquired by Paneuropean Oil S.A. in Hellenic Petroleum S.A. (in August).

The bulk of residents' direct foreign investment was also directed towards OECD countries, mainly the EU, and, to a lesser extent, towards Balkan countries (see Table IX.7). Greek investment activity in the Balkans registered a substantial decline relative to 2003. Important investments included the acquisition of an Uzbek mobile telephony company by "Germanos S.A." (in September) and of Bulgaria's UBB Bank by the National Bank of Greece (July).

TABLE IX.7
REGION BREAKDOWN OF GREEK RESIDENTS' DIRECT INVESTMENT ABROAD*

	Million euro	
	2003	2004*
OECD[1]	293	390
EU-15	263	278
Euro area	137	204
Balkan countries[2]	298	71
Central Europe and former USSR[3]	11	3
Middle East and the Mediterranean[4]	–622	7
Other countries	61	17
Total	41	489

1 Twenty-four OECD countries except Mexico, South Korea, the Czech Republic, Poland and Hungary.
2 Albania, Bulgaria, Romania and former Yugoslavia countries (Slovenia, Bosnia, Croatia, FYROM and New Yugoslavia).
3 Poland, Hungary, the Czech Republic, Slovakia and former USSR countries.
4 Greece's major trading partners in the Middle East and the Mediterranean.
* Provisional data.
Source: Bank of Greece.

2.2 Portfolio investment

Inflows under portfolio investment remained at very high levels in 2004, reaching €25.2 billion (€21.1 billion in 2003). The purchase of Greek government bonds by foreign investors continues to be the main source of considerable inflows for portfolio investment. Specifically, non-residents' investment in Greek bonds stood at €21.6 billion in 2004 (2003: €18.8 billion). Purchases of shares by foreign investors also increased significantly to €3.4 billion in 2004 (2003: €2.2 billion).

Greek residents' portfolio investment abroad was also substantial (2004: €11.5 billion, 2003: €8.7 billion), mainly concerning investment in foreign bonds (€10.3 billion), which grew relative to 2003 (€8.3 billion). As mentioned in previous Bank of Greece

Reports, a large part of Greek residents' investment in foreign bonds is made up of bonds issued in other euro area countries, which are purchased by the Bank of Greece, with a corresponding reduction of its reserve assets (see next section). Investment by domestic credit institutions and private individuals is also noteworthy.[1]

2.3 Other investment

The significant net outflow under "other investment" (€9,104 million) reflects both a €6,216 million increase in residents' external assets and a €2,888 million decrease in their external liabilities. The increase in assets in 2004 is exclusively due to higher deposits and repo holdings by residents, mainly credit institutions (€6.3 billion, against €4.1 billion in 2003). On the other hand, the decrease in liabilities was mainly due to loan repayments (2004: €2.2 billion, 2003: €3.9 billion) and, to a lesser extent, to reduced (by €0.7 billion) deposits and repo holdings by non-residents.

Finally, Greece's reserve assets stood at €2.0 billion at end-2004, against €4.6 billion at end-2003 (see Tables IX.1 and IX.8). It should be recalled that, already from the first months of 2003, the Bank of Greece started restructuring its portfolio by reducing its holdings in non-euro area currencies (which are included in reserve assets). At the same time, it increased its holdings of assets which have higher yields or are expressed in euro — primarily euro area government bonds, which are not included in reserve assets (as already mentioned, these holdings are registered as residents' portfolio investment). Given that there is less need to maintain large foreign currency reserves,[2] by the above restructuring the Bank of Greece has improved the return on its investments.

3. INTERNATIONAL INVESTMENT POSITION

In 2004, Greece's negative international investment position deteriorated further to €–110 billion at the end of the year, from €–9.2 billion at end-2003. As a result, despite the considerable growth of GDP, the country's negative investment position rose from 60.1% of GDP in 2003 to 66.8% in 2004 (see Table IX.8).

The deterioration of the country's international investment position reflects the negative effect primarily of portfolio investment and secondarily of direct investment,

1 Bank of Greece investment in euro area countries' bonds amounted to €3.6 billion in 2004, against €2.7 billion in 2003.

2 It has been repeatedly noted that, since Greece's entry into the euro area in January 2001, reserve assets, as defined by the European Central Bank, include only monetary gold, special drawing rights and the reserve position of the Bank of Greece in the International Monetary Fund, as well as Bank of Greece claims on non-euro area residents denominated in foreign currency. By contrast, they do not include claims on non-euro area residents denominated in euro, claims on euro area residents denominated in euro or in foreign currency, and Bank of Greece participation in the capital and the reserve assets of the ECB.

whereas “other investment” had a small favourable effect. The negative impact of portfolio investment is exclusively due to the considerable increase in liabilities, mainly reflecting the sale of Greek government bonds to non-residents. At the same time, assets from

TABLE IX.8
INTERNATIONAL INVESTMENT POSITION
(Million euro)

	2002*	2003*	2004**
1. Direct investment	**–6,255**	**–8,159**	**–10,394**
Abroad by residents	8,583	8,934	9,586
In Greece by non-residents	14,838	17,083	19,980
2. Portfolio investment	**–57,738**	**–69,062**	**–84,767**
Assets	17,139	27,685	38,504
Liabilities	74,877	96,747	123,271
3. Financial derivatives	**300**	**258**	**603**
4. Other investment	**–21,639**	**–19,932**	**–17,787**
Assets	45,056	47,734	50,095
Liabilities	66,695	67,666	67,882
5. Reserve assets[1]	**9,014**	**4,605**	**1,994**
Net international investment position (1+2+3+4+5)	**–76,318**	**–92,290**	**–110,351**
GDP	141,669	153,472	165,280
% of GDP	**–53.9**	**–60.1**	**–66.8**

1 The decrease in reserve assets in 2003 and 2004 is largely associated with the restructuring of the Bank of Greece’s portfolio.
* It should be noted that data for 2002 and 2003 have been revised and thus differ from those stated in *Annual Report 2003*.
** Provisional estimates.
Source: Bank of Greece.

residents’ investment in foreign bonds increased considerably. The negative impact of foreign direct investment is associated with non-residents’ investment in Greece. Finally, the small favourable effect of “other” investment was due to the increase in assets, while liabilities remained almost unchanged.

X. THE BANKING SYSTEM AND ITS SUPERVISION

1. INTRODUCTION

Developments in the Greek banking system continued to be favourable in 2004. After deteriorating considerably in 2002, Greek banks' operating profitability was satisfactory for the second consecutive year. Underlying this was continued strong credit expansion, notably in the area of consumer credit. However, extraordinary factors, such as the implementation of employee voluntary retirement plans and increased provisioning for doubtful loans, weighed heavily on the results of certain banks, leading to a decline in net profits and therefore in the return on assets (ROA) and return on equity (ROE) of those banks, as well as of the banking sector as a whole.

Despite increased competition and narrower interest rate margins, net interest income as a proportion of average assets remained virtually unchanged in 2004. This reflected the growing share of loans, notably consumer loans, which involve both larger profit margins and higher risk, and the declining share of Greek government bonds in banks' assets.

As regards the capital adequacy of credit institutions, there was a marked increase in the overall capital adequacy ratio (CAR), which reached relatively high levels both on a solo basis and on a consolidated basis.

The European and, more generally, the global environment within which Greek banks operate has been characterised in recent years by further financial integration, continued merger and acquisition activity, albeit at a slower pace, introduction of new products and services, internationalisation and a shift to retail banking, against a background of increasing competition and historically low interest rates.

The first quarter of 2005 saw rather subdued growth rates in Europe, varying across geographical regions. The rise in the profitability of EU banks during 2004 —mainly as a result of lower provisions and cost-saving efforts— may not continue in 2005, owing to heightened uncertainty about the future path of oil prices and a potential economic slowdown. Greek credit institutions further increased their activity and cross-border claims in the Balkan region, which shows a high growth potential. As regards the domestic market, given the positive relation between economic activity and credit expansion, a potential slowdown in economic activity may affect not only credit expansion and banks' profitability, but also the amount of doubtful loans (of both households and firms), which are underestimated in the upward phase of the business cycle. This factor was taken into account by the Bank of Greece in its recent decision to increase the provisioning coefficients for specific loan categories. At the same time, the Bank of Greece's policy aiming at the enhancement of banks' internal control and risk management systems, in conjunction with banks' increased risk awareness and risk-adjusted pricing policies, led to a further strengthening of the stability of the banking system.

The timely preparation of Greek credit institutions for the new Basel Capital Accord ("Basel II") should contribute to the same direction. Furthermore, the application of the International Accounting Standards (IAS), especially of IAS 19, which requires the recognition of liabilities arising from employee defined-benefit schemes on banks' balance sheets, is expected to affect considerably the CAR of a small number of credit institutions, which have already decided to increase their capital, while the revaluation of assets on the basis of the IAS will offset —in certain cases— the decrease in own funds.

Overall, the outlook for the Greek banking system in 2005 is favourable, provided that credit expansion, notably in the area of consumer credit, is combined with the successful completion of certain banking groups' restructuring plans, mainly aimed at controlling operating costs, more effective —at least in certain cases— pricing of risks, expansion to new revenue-generating activities (e.g. asset management) and strengthening of cross-selling (e.g. bankassurance products).

For its part, the Bank of Greece is continuously adjusting its supervisory methodology, also encouraging adjustments undertaken by credit institutions on their own initiative with a view to ensuring that:

— The profitability of banking activities will take more into account the relevant risks involved, especially in an environment of intensifying competition over market shares. Increased risk-taking should be considered in the light of the factors that affect the overall macroeconomic environment and their impact on specific categories of borrowers, such as small and medium-sized enterprises and households, which are typically more vulnerable to cyclical developments, notably economic downturns.

— Implementation of standardised stress tests under alternative risk scenarios (including interest rate, exchange rate and equity risks); such tests are vital for the calculation and incorporation into risk management policies of the impact on banks' capital adequacy and profitability from such scenarios, so that there is an adequate cushion for absorbing any economic slowdown or financial shocks.

— A dynamic evaluation of banks' capital adequacy; given the procyclicality of doubtful loans, this would involve an assessment of the impact from changes in the macroeconomic environment, in order to ensure an adequate margin for addressing future risks.

In this context, the Bank of Greece has amended recently the supervisory framework for the liquidity of Greek credit institutions, imposing compulsory minimum liquid assets and mismatch ratios.

2. DEVELOPMENTS IN BANKS' KEY BALANCE SHEET AGGREGATES

The assets of all the credit institutions operating in the Greek market rose by 9.4% in 2004 (see Table X.1) and at end-2004 stood at 139.5% of GDP, compared with 137.4% in 2003. The rise in off-balance-sheet items was considerably higher (25.5%); as a result, total on- and off-balance-sheet items increased to 402.3% of GDP in 2004, from 362.9%

in 2003. Specifically, the assets of Greek commercial banks grew by 7.3% in 2004, compared with 5.8% in 2003. The assets of foreign banks rose by 20.2% in 2004 and the highest rates of growth were recorded by the banks with the largest market shares. The assets of cooperative banks grew strongly in 2004 too (by 26.9%). A substantial increase was also observed in the assets of Specialised Credit Institutions[1] (2004: 16.6%, 2003: 5.1%).

As in 2003, in 2004 total bank lending[2] increased strongly by 17.0%, i.e. much faster than assets. A similar pattern was observed in lending by Greek commercial banks, which rose by 17.9% in 2004 (2003: 14.9%), bringing the outstanding amount of their loans to 62.7% of their assets in 2004, compared with 57.1% in 2003. This development is mainly attributable to the Greek economy's high growth rates, as well as a bank portfolio restructuring and marked shift to household lending, favoured by the deregulation of consumer credit and the fall in interest rates.

TABLE X.1

BANKS' KEY BALANCE SHEET AGGREGATES

(Percentage changes over previous year)

	All banks		Greek commercial banks	
	2003	2004	2003	2004
Loans	14.2	17.0	14.9	17.9
Own funds	7.6	4.7	9.4	4.3
Deposits	9.6	14.0	9.5	12.0
Deposits and repos	3.9	10.5	2.9	8.0
Total assets	**6.3**	**9.4**	**5.8**	**7.3**
Off-balance sheet items	20.4	25.5	19.0	22.9

Sources: Bank of Greece (data from financial statements) and banks' balance sheets.

Credit institutions' total own funds (as reported in their annual accounts) increased by 4.7% in 2004, compared with 7.6% in 2003. Specifically, Greek commercial banks' own funds rose by 4.3% in 2004 (2003: 9.4%), i.e. slower than assets, to reach 6.7% of assets in 2004, compared with 6.9% in 2003. It should be noted that available data for EU banks[3] suggest that, as a percentage of assets, European commercial banks' own funds (2003: 6.0%) are lower than those of Greek commercial banks.

Total deposits with credit institutions grew by 14.0% in 2004, compared with 9.6% in 2003. Adding repurchase agreements (repos), which are essentially similar to deposits,

1 These currently comprise the Postal Savings Bank and the Deposits and Loans Fund. For comparability purposes, the Investment Bank, which was absorbed by Emporiki Bank at the end of 2004, is classified under commercial banks in 2003.

2 Credit developments are discussed in more detail in Chapter VI of this report.

3 Data from the Bankscope database for EU commercial banks with a similar size to Greek banks. Comparison is made with 2003 data, because the 2004 data available so far are insufficient.

the growth rate is reduced to 10.5%. Deposits held with Greek commercial banks increased by 12% (or 8% including repos).

3. THE BANKING SYSTEM: STRUCTURE AND COMPETITION

An examination of the structure of the Greek banking system (see Table X.2) reveals that in 2004 the market share of Greek commercial banks showed a small decline on the basis of total assets (2004: 80.9%, 2003: 82.1%) and deposits (2004: 81.8%, 2003: 82.6%) and a slight increase on the basis of loans (2004: 85.1%, 2003: 84.5%).

TABLE X.2
STRUCTURE OF THE GREEK CREDIT SYSTEM

A. Market shares (%) in balance sheet key aggregates

	Assets		Loans		Deposits	
	2003	2004	2003	2004	2003	2004
Greek commercial banks	82.1	80.9	84.5	85.1	82.6	81.8
Foreign banks	9.3	10.0	9.4	8.8	7.3	8.2
Cooperative banks	0.6	0.7	0.9	1.0	0.7	0.8
Specialised Credit Institutions	8.0	8.4	5.2	5.1	9.4	9.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

B. Number of banks, branches and employees

	Banks		Branches		Employees	
	2003	2004	2003	2004	2003	2004
Greek commercial banks	22	21	2,876	2,953	53,809	51,741
Foreign banks	20	23	205	223	4,851	5,133
Cooperative banks	15	16	80	87	681	781
Specialised Credit Institutions	2	2	139	140	1,733	1,682
Total	**59**	**62**	**3,300**	**3,403**	**61,074**	**59,337**

Source: Bank of Greece (data from financial statements).

By contrast, in 2004 the market share of foreign banks rose on the basis of total assets (2004: 10.0%, 2003: 9.3%) and deposits (2004: 8.2%, 2003: 7.3%) and decreased on the basis of loans (2004: 8.8%, 2003: 9.4%).

Cooperative banks continued to improve slightly their market shares in 2004, which, however, remain small (not exceeding 1%). Their share in total assets rose to 0.7% in 2004, from 0.6% in 2003, in loans to 1.0% in 2004, from 0.9% in 2003, and in deposits to 0.8% in 2004, from 0.7% in 2003.

Specialised credit institutions showed a small increase in their market shares on the basis of total assets (2004: 8.4%, 2003: 8.0%) and a small decline on the basis of loans (2004: 5.1%, 2003: 5.2%) and deposits (2004: 9.2%, 2003: 9.4%).

Concentration in the Greek banking system, as measured by the market shares of the five largest banks, increased marginally in 2004 for the second consecutive year in terms of loans and declined slightly in terms of total assets or deposits. Specifically, the five largest banks' market share in loans rose from 66.1% in 2003 to 66.3% in 2004. The concentration ratio fell by around two percentage points in terms of assets (2004: 65.0%, 2003: 66.9%) and by one percentage point in terms of deposits (2004: 66.5%, 2003: 67.6%).

After increasing considerably in the late 1990s, concentration in EU banking systems showed a further small rise at the beginning of this decade. Specifically, between 2000 and 2003, average concentration in the EU, on the basis of the assets of the five largest banks per country, increased by two percentage points (2000: 51%, 2003: 53%).[1] This is the case with all countries except for Spain and Sweden, where concentration declined slightly. In Greece, while the rise observed until 2002 seems to have been reversed, concentration remains relatively high, but is well below the corresponding figures (over 80%) recorded in three other euro area countries (Finland, Belgium, Netherlands). Similar estimates of concentration in the Greek credit system relative to other EU countries and the EU average are derived using the Herfindahl index, which takes into account the market shares of all banks.[2]

The size of Greek banks continues to be small by international standards: six Greek banks are included in the 150 largest EU banks, only two of them in the top 100 and no Greek bank ranks among the world's 100 largest banks and only one is among the top 150. This is not surprising given the relatively small size and limited internationalisation of the domestic financial market. However, it signals the existence of a considerable scope over the medium term; actually, Greek banks seek to establish themselves as strong regional banks in the Balkans and consolidate their position in major international financial centres.

The number of credit institutions in Greece rose in 2004, mainly as a result of new entrants coming from other EU countries, and generally has shown a slight upward trend in recent years, with small fluctuations. By contrast, a declining trend prevails in most EU countries, reflecting international merger and acquisition activity, as well as efforts made in EU countries to rationalise and adapt structures to the new environment implied by the creation of EMU. Specifically, in the 2000-2003 period, the number of credit institutions operating in the EU Member States decreased by about 1,000 (2000: 8,433, 2003: 7,444).[3] However, it should be pointed out that half of this decline is accounted for by developments in Germany, which mostly concern local cooperative and saving banks.

1 ECB, "Review of structural developments in the EU banking sector, Year 2003", November 2004.

2 The Herfindahl index is calculated as the sum of the squares of the market shares of each individual firm in the industry. In 2003, this index was 1,130 for Greece, compared with 540 for the EU.

3 See footnote 1.

The number of bank branches in Greece continues to rise (2004: 3,403, 2003: 3,300), albeit at a slower pace in the last two years. As already mentioned, in most EU Member States the number of branches has dropped, although there have been some increases, mainly in the European South. In the EU as a whole, the number of branches fell by about 11,500 between 2000 and 2003 (2000: 197,513, 2003: 186,009).[1] However, to evaluate correctly this decline, it should be taken into account that in one country (Germany) the number of branches fell by around 9,500 during the above period.

Alternative distribution channels, such as the internet, phone banking and automatic teller machines (ATMs), are increasingly being used in Greece. The number of ATMs rose from 5,468 in 2003 to 5,787 in 2004. Still, these channels are supplementary to branches, which retain their key role as points of sale. In the current competitive environment, attracting new customers and maintaining the existing ones is a main strategic choice for banks and this can be achieved more effectively through personal contact at branches, where the sale of more than one products to the same customer can also be pursued. Besides, the expansion of retail banking in recent years requires an extensive branch network with satisfactory geographical coverage. However, there is a trend towards a new branch model, as modern technologies enable banks to centralise their back office functions and to focus on product promotion and advice-intensive services.

Branch density relative to population is lower in Greece than the European average. In 2003 there were 30 branches per 100,000 inhabitants in Greece (2002: 31), compared with 49 in the EU. However, GDP per branch, which is usually a better measure of demand for banking services, is not much different from the EU (Greece: €46.5 million, EU: €50 million).

The number of staff of credit institutions operating in Greece fell in 2004 (2003: 61,074, 2004: 59,337), as the rise in employment in new and smaller banks, which are expanding their business and networks, was lower than the reduction in the staff of certain large banks that implemented voluntary retirement plans. On the basis of 2003 data, the number of staff per branch in Greece (19) remains higher than the corresponding EU average (15 employees). However, there are marked differences across EU countries, in terms of both branch size (on the basis of the number of staff) and network density, which are partly attributable to the different stages of maturity of individual credit systems, as well as to strategic choices dictated by country-specific factors.

The worldwide dominance of universal banking and the ongoing process of disintermediation have led banks to broaden the scope of services provided by them either directly or through subsidiaries. However, in the current competitive environment, banking groups are trying to cut their operating costs, take advantage of economies of scope and possibly economies of scale, and to achieve better coordination of their operations. In this context, over the last two years in Greece parent banks have been absorbing their financial (mainly investment and securities) subsidiaries.

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1 See footnote 1 on page 269.

Greek credit institutions continue their efforts to expand their business in the area of bankassurance. Banks either have insurance subsidiaries or cooperate with insurance companies, in order to take advantage of joint distribution networks, promote cross-selling and offer more sophisticated deposit or investment products linked with pension plans. It should be noted that Greek banks control around 37% of the domestic insurance market through their subsidiaries, the capital adequacy of which they have repeatedly enhanced. Besides, banks worldwide are trying to take advantage of the restructuring of public pension systems and of the gradual shift towards private supplementary insurance. The Greek insurance market was also affected by the unfavourable economic developments in the first years of this decade, but has shown signs of recovery since 2003. According to data from the Association of Insurance Companies-Greece, premiums as a percentage of GDP rose slightly in 2003 (to 2.12%) in comparison with 2002 (2.05%). However, Greece lags well behind the EU, where insurance premiums were 8.7% of GDP in 2002.

Greek banks have further expanded their cross-border activity, notably in the Balkan countries, in a quest for new sources of income, in line with global trends. In 2004, after cost-cutting efforts in the domestic context, Greek credit institutions reconsidered their activities abroad. Thus, Greek banks are tending to withdraw from markets where they have been active for years with only marginal profitability and expand to countries that offer better profitability prospects and a higher growth potential. In this context, during 2004 and in early 2005, Greek banks showed particular interest in the Balkans, by new acquisitions (Serbia, Bulgaria), by increasing their qualifying holdings in their subsidiaries or by further developing their networks. Therefore, in the years to come it is likely that the Balkan and Eastern European countries will continue to be a major area of expansion for Greek banks.

4. THE PROFITABILITY OF GREEK BANKS

The recovery of the profitability of Greek banks observed in 2003 after a decline in the 2000-2002 period continued in 2004. The net profits of Greek commercial banks rose by 7.6% in 2004 in comparison with 2003 (or by 20.5% at the group level). However, increased provisioning and extraordinary expenses associated with the implementation of employee voluntary retirement plans weighed heavily on the results of banks and banking groups.

4.1 Banks

An examination of the results of Greek commercial banks in 2004 (see Table X.3) shows that the increase in their operating profits stemmed from a faster rise in gross income (6.2%) than in operating costs (5.4%). Specifically, the growth of gross income is mainly accounted for by a 7.1% rise in net interest income and, to a lesser extent, a 3.5% increase in non-interest income.

Interest income grew by 7%, while interest expenses rose at a slightly weaker pace (6.9%); the latter, however, are much lower than the former in absolute terms. The main factor underlying the rise in interest income was continued strong credit expansion, chiefly to households and firms, which more than offset a small fall in the average lending rate in 2004. By contrast, the considerable decline in banks' holdings of debt securities had a downward impact on interest income. The fact that the increase in interest payments was smaller than the growth of deposits and repos (8% in 2004) is mainly attributable to a decline in repos, which are remunerated at higher rates than deposits of comparable

TABLE X.3

GREEK COMMERCIAL BANKS' AND BANKING GROUPS' INCOME STATEMENTS

(Percentage change over the previous year)

	Banks		Banking groups	
	2003	2004	2003	2004
Interest income	–2.1	7.0	–2.4	9.4
Interest expenses	–19.7	6.9	–19.2	8.5
Net interest income	17.3	7.1	15.1	10.2
Income from other operations	9.3	3.5	24.1	13.7
Fees and commissions	8.2	7.7	14.4	9.7
Income from financial operations	25.1	–28.7	52.7	11.0
Other income	–1.2	24.0	52.8	33.6
Gross income	15.1	6.2	17.7	11.2
Operating expenses	3.7	5.4	8.5	6.1
Net income	40.6	7.6	39.0	20.5
Provisions	32.7	28.7	32.4	29.1
Pre-tax profits[1]	47.3	–11.5	42.6	9.9
Pre-tax profits (excl. voluntary retirement costs)	*47.3*	*–2.0*	*42.6*	*18.5*

1 In 2004, pre-tax profits were affected heavily by the cost of implementation of voluntary retirement plans by certain banks.
Source: Bank of Greece calculations based on income statement data.

maturities. These developments did not affect the net interest rate margin,[1] which remained at 2.8%.

Fees and commissions (net) rose appreciably (by 7.7%), reflecting Greek credit institutions' effort to expand their business in investment and personal banking. A stronger increase of 24% was seen in "other" income, mainly stemming from considerably higher investment in shares and other equity. By contrast, income from financial operations declined by 28.7%, owing to disinvestment of securities, as well as to the apprecia-

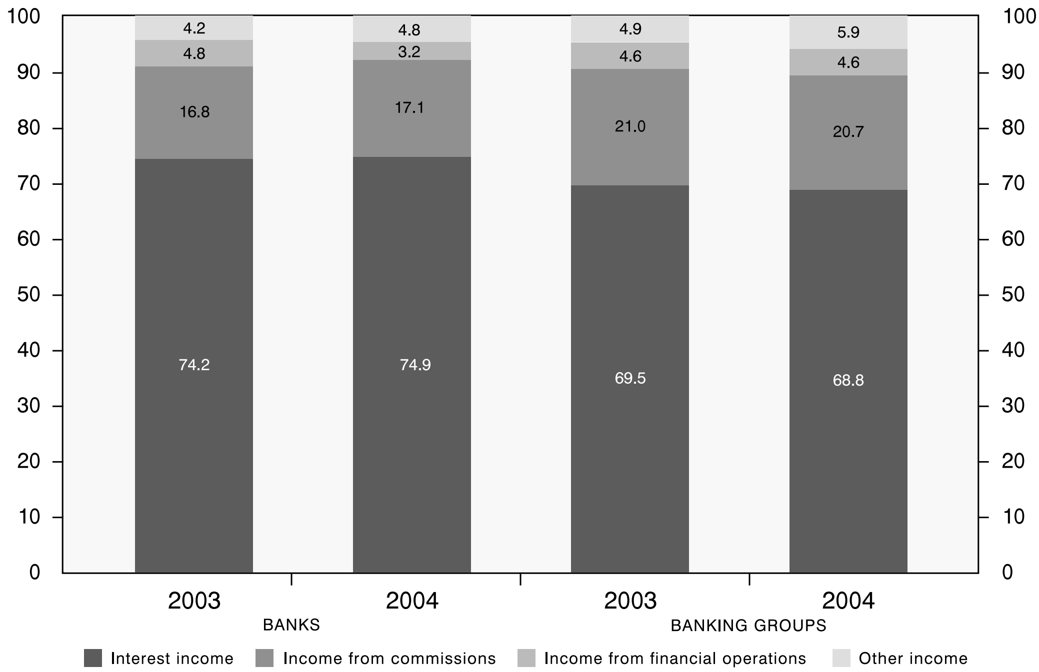
1 Calculated as the ratio of net interest income to average total assets.

tion of the euro against other currencies, notably the US dollar. It should be pointed out, however, that the last two income categories have a small share in banks' gross income.

These developments led to relatively little change in the income structure (see Chart X.1). Specifically, there were small rises in the shares of interest income (2004: 74.9%, 2003: 74.2%), income from commissions (2004: 17.1%, 2003: 16.8%) and "other" income (2004: 4.8%, 2003: 4.2%) in operating income. By contrast, the share of income from financial operations declined (2004: 3.2%, 2003: 4.8%).

CHART X.1

INCOME STRUCTURE OF GREEK COMMERCIAL BANKS AND BANKING GROUPS
(IN PERCENTAGES)



Source: Bank of Greece calculations based on income statement data.

Operating costs grew moderately by 5.4%. Staff costs rose by 6.8%, coming to 59.1% of operating costs, up from 58.3% in 2003. Smaller increases were recorded by depreciation expenses (2.1%) and "other" expenses (3.8%); as a result, their share in operating costs declined slightly. These developments led to a small improvement in the cost-to-income ratio, which fell to 61.8%, from 62.3% in 2003. It should be noted that this ratio for EU banks of a similar size[1] was 64.4% in 2003, implying lower efficiency relative to Greek banks.

1 See footnote 3 on page 267.

Gross provisions increased substantially by 28.7%, reaching 0.6% of total assets and 1% of average outstanding loans (2003: 0.5% and 0.9% respectively). This was largely attributable to certain banks' increased provisioning, higher profitability and risks assumed in the current phase of the business cycle. However, this strong rise in provisions is welcome and it would be highly desirable if banks were to build up buffers against potential risks far and above the current tax incentive (provisions corresponding to 1% of lending are tax-deductible).

TABLE X.4

GREEK COMMERCIAL BANKS' AND BANKING GROUPS' INCOME STATEMENTS

(Percentage of average assets)

	Banks		Banking groups	
	2003	2004	2003	2004
Interest income	4.9	4.9	5.1	5.2
Interest expenses	2.1	2.1	2.1	2.2
Net interest income	2.8	2.8	2.9	3.0
Non-interest income	1.0	0.9	1.3	1.4
Operating expenses	2.3	2.3	2.7	2.7
Net income	1.4	1.4	1.5	1.7
Provisions	0.5	0.6	0.5	0.7
Pre-tax profits (ROA)	0.9	0.7	1.0	1.0
Pre-tax profits as a percentage of own funds (ROE)	*13.0*	*10.8*	*16.5*	*16.1*

Source: Bank of Greece calculations based on income statement data.

Pre-tax profits dropped by 11.5% in comparison with 2003 (see Table X.3) or by only 2% if the cost of voluntary retirement plans is not included. As a result, pre-tax return on average assets (ROA) of commercial banks as a whole declined to 0.7% in 2004, from 0.9% in 2003 (see Table X.4), compared with an EU average of 0.7% in 2003. Pre-tax return on equity (ROE) fell by more than two percentage points (to 10.8% in 2004, from 13.0% in 2003), compared with an EU average of 11.1% in 2003.

4.2 Banking groups

The results of banking groups were better than those of banks, as pre-tax profits rose by 9.9%, reflecting the generally stronger performance of subsidiaries. Operating costs grew at a markedly slower pace than operating income (6.1% and 11.2% respectively); as a result, the cost-to-income ratio improved to 61.5%, from 64.4% in 2003. It should be noted that the corresponding ratio of EU banking groups was 62.9% in 2003, i.e. better than in Greece.

The net interest rate margin of banking groups rose slightly in comparison with 2003 and was higher than that for banks (2004: 3.0%, 2003: 2.9%). Both their pre-tax ROA (2004: 1.0%, 2003: 1.0%) and ROE (2004: 16.1%, 2003: 16.5%) were also higher than those of banks. It should be noted than in the EU pre-tax ROA was 0.8% and pre-tax ROE was 13.7% in 2003.

5. BANKING RISKS

5.1 Credit risk

As already mentioned, strong credit expansion boosted credit institutions' operating profitability in 2004, but has also increased the credit risk exposure. It should be noted, in this connection, that non-performing loans (defined as loans more than three months overdue) rose considerably faster than in 2003 (by 16.4% in 2004, compared with 9.7% in 2003), while the growth rate of lending was only slightly higher than in 2003 (2004: 15.5%, 2003: 15.1%).

5.1.1 Quality of the loan portfolio and evolution of provisioning

In 2004, the ratio of non-performing loans to total loans stood at 7% (5.4% excluding one bank), remaining virtually unchanged from 2003. Specifically, excluding rescheduled loans, for reasons of international comparability, individual non-performing loans as a percentage of total loans of all Greek commercial banks were 4.6% for housing loans (down 0.2 percentage point from 2003), 7.2% for consumer loans (up 0.8 percentage point) and 7.8% for corporate loans (down 0.4 percentage point – see Chart X.2). It should be pointed out, however, that the decline in the non-performing loans ratio in retail banking also reflects the strong growth of retail lending business in 2004.

The rise in the ratio of non-performing business loans to total corporate loans is also reflected in the migration matrix data reported by commercial banks to the Bank of Greece in 2004. These data reveal that, of the total number of borrowers and the total loans rated, (a) 81.0% and 74.4% respectively had unchanged credit ratings; (b) 10.8% and 16.3% respectively were downgraded; and (c) 8.2% and 9.3% were upgraded. These data are an additional indication of increased credit risk, as for total corporate loans downgradings outnumber upgradings by 7.0%.

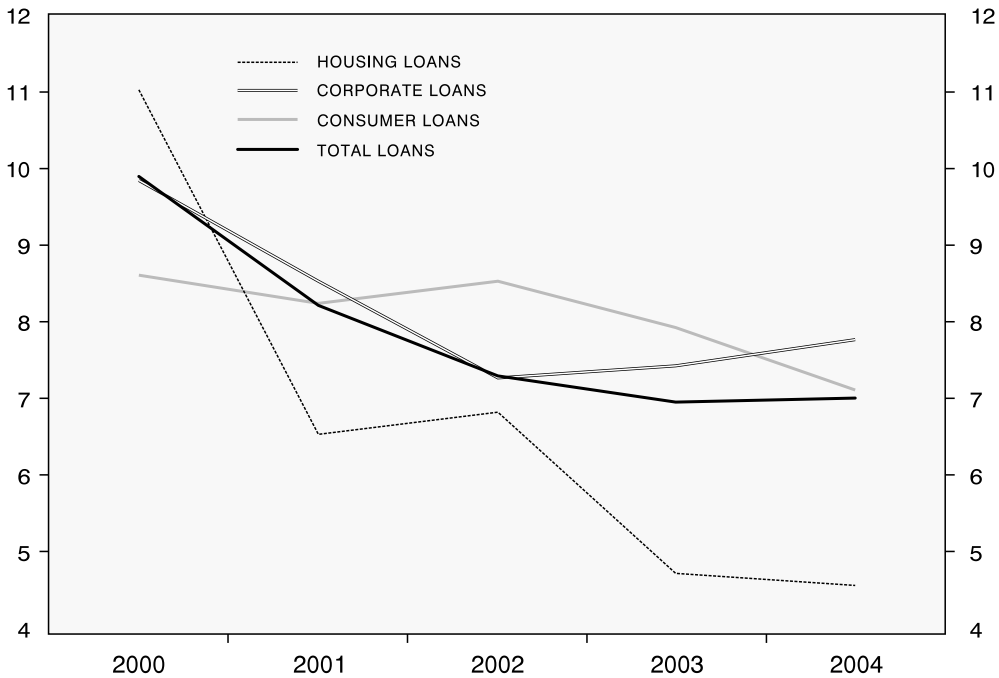
Although the overall non-performing loan ratio stabilised (at 7%, or 5.4% excluding one bank), the increased aggregate provisions of Greek commercial banks drove the ratio of net non-performing loans (i.e. non-performing loans minus provisions) overdue more than three months down to 3.4% in 2004 (or 2.2% excluding one bank), from 3.5% (2.1% excluding one bank) in 2003 (see Chart X.3). These levels do not reflect the accurate size of potential loan loss, as this depends on the value of collateral, which is not taken into account in the calculation of the ratio. However, the Bank of Greece attaches particular importance to a further reduction of the net non-performing loan ratios of certain banks, as currently for banks that account for 70% of total assets of commercial banks the ratio of net non-performing loans more than three months overdue to total loans exceeds 2%.

The coverage of provisions for loans overdue for more than three months and more than one year improved further from 57.7% and 81.4% in 2003 to 58.6% and 88.2% in 2004 respectively (except for one bank), while for banks as a whole it rose to 51.1% and

CHART X.2

NON-PERFORMING LOANS BY CATEGORY OF LOAN GRANTED BY GREEK COMMERCIAL BANKS

(PERCENTAGE POINTS)



Source: Bank of Greece.

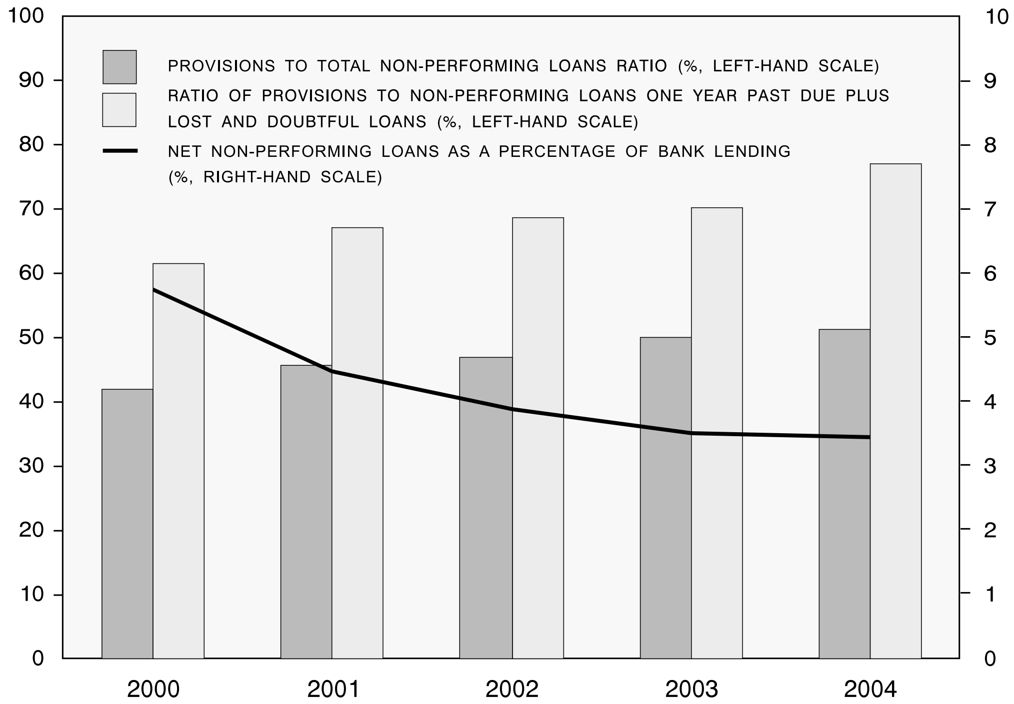
77.0% in 2004, from 49.9% and 70.3% in 2003 respectively (see Chart X3). It is expected that, in the course of 2005, the settlement of the so-called “compound interest issue” and the planned capital increase of this particular bank will enable it, *inter alia*, to write-off claims related to compound interest, improve its provisioning coverage of non-performing loans and converge with other banks.

It should be noted that three banks have a provisioning coverage ratio of less than 45% for loans overdue for more than three months and five banks have a ratio of less than 60% for loans overdue for more than one year. This, apart from potential loan loss considerations, also raises competition concerns.

The Bank of Greece, judging that consumer loans, most importantly those overdue by more than one year, entail increased credit risk, has recently decided to raise the relevant provisioning coefficients. The purpose of this measure was to encourage banks to write off doubtful loans. However, the Bank of Greece acknowledges that the generally applicable provisioning framework may incorporate the impact of the macroeconomic environment, but does not substitute for banks' obligation to regularly review their credit standards, improve their credit risk management systems and adjust their loan loss provisions accordingly.

CHART X.3

PROVISIONS TO NON-PERFORMING BANK LOANS RATIO AND NET NON-PERFORMING LOANS (LESS PROVISIONS) AS A PERCENTAGE OF TOTAL BANK LENDING



Source: Bank of Greece.

5.1.2 Credit risk transfer

Credit risk transfer through securitisation of loans continued in 2004. In the course of the year, an additional €750 million of mortgage loans were securitised (2003: €250 million), thus raising the total stock of securitised loans of Greek banks to €1 billion

(0.5% of total assets). In the EU, housing loans of €138.47 billion were securitised in 2004, rising by 15.8% over 2003. The share of Greek banks in total housing loan securitisation in the EU increased to 0.54% in 2004, from 0.2% in 2003.

In addition to serving as a credit risk transfer tool, securitisation also improved asset allocation and functioned as an alternative source of funding. A considerable number of banks showed keen interest in securitisation in 2004 and more banks are expected to follow in 2005, in line with the trend towards diversification of funding sources and credit risk transfer.

The Bank of Greece attaches particular importance to the monitoring of risks entailed by the use of credit derivatives in bank portfolios, although the amounts involved are still low. In this context, it issued Administration's Circular 2004/2, laying down the supervisory treatment of credit derivatives held by banks. At end-2004, the outstanding amount of protection buying through credit derivatives was €168.7 million (0.09% of total assets, compared with 0.3-10% of total assets in the EU).

5.1.3 Household loans' credit risk

As already mentioned, credit expansion outpaced GDP growth in 2004. As a result, at-end 2004, total bank lending to households rose to 31.2% of GDP, from 26.2% at end-2003, in any case remaining considerably lower than the euro area average (50.4% at end-2004). Specifically, mortgages rose to 20% of GDP in 2004, from 17.3% in 2003, while consumer and "other" loans to households increased to 11.2% of GDP in 2004, from 8.9% in 2003.[1]

Households' interest payments rose in 2004 over 2003. Specifically, households' total interest payments on housing and consumer loans as a percentage of their disposable income[2] are estimated at 2.8% in 2004, up from 2.5% in 2003, still relatively low in comparison with the euro area average (4.7% in 2003).

5.1.4 Corporate loans' credit risk

As regards developments in the financial position of enterprises, on the basis of a sample of 554 non-financial corporations,[3] profits fell slightly (by 1.2%) in comparison with 2003. Specifically, profits dropped in the construction, transport, telecommunications and healthcare sectors, while the textiles industry recorded substantial losses. As a result,

1 Including securitised mortgage loans (€925 million in 2004), total housing loans reached 20.6% of GDP and total loans to households 31.8% of GDP in 2004.

2 Gross disposable income, as derived from National Accounts data.

3 In 2004, the data compiled by the Bank of Greece concerned a sample of 554 non-financial corporations from various sectors, of which 256 are listed on the Athens Exchange.

both ROE and ROA declined in 2004. It should be noted, however, that in 2004 corporate profitability was affected by substantial extraordinary expenses, notably in the telecommunications sector. Excluding extraordinary revenue and expenses (i.e. non-operating results), profits showed a small rise (1.6%) in 2004, compared with a large increase in 2003.

Firms' debt repayment is considered to be overall satisfactory, as their net pre-tax profits as a proportion of total liabilities exceeds 10%. Developments in 2004 were overall positive, since the percentage of firms that were below this limit declined to 41.1%, from 45.3% in 2003. However, in certain sectors, especially those that recorded lower profits, the percentage of firms below the 10% limit showed increases, ranging between 4 percentage points in the already afflicted textiles industry and 17 percentage points in the construction sector.

Reflecting a 2.6% decrease in financial costs, their ratio to gross profits (financial vulnerability index – FVI) improved slightly (2004: 5.3%, 2003: 5.7%), despite some deterioration in certain sectors, such as textiles and, to a lesser extent, hotels, healthcare and information technology. It should be noted that this index overall stands at a very low level. Exceptions are the textiles and transport sectors (29.4% and 28.2% respectively), where it is relatively high, suggesting greater sensitivity to interest rate changes.

The own and borrowed funds of the sample firms grew in 2004 at almost the same rate (3.5% and 3.4% respectively), implying almost no change in the gearing ratio, which stood at 1.02 in 2004. This is still high compared with the 1997-2001 average of 0.75, on the basis of ICAP's sample of about 25,000 firms, but lower than the corresponding euro area average (2000: 1.46).[1] This difference in firms' capital structure between Greece and the euro area is partly explained by the relatively small size of Greek firms (since small firms typically have high gearing ratios), but also reflects an underdeveloped stock market.

Bank borrowing by the sample firms showed a small drop (1.1%) in 2004. However, it accounts for 24.8% of total funds (compared with an average of 16.5% in the euro area),[2] suggesting the importance of this source of funding for Greek firms. Finally, it should be pointed out that, for the sample firms as a whole, the liquidity ratio (i.e. the ratio of outstanding and disposable funds to short-term liabilities) fell to 1.27 in 2004, from 1.30 in 2003, but is considered to be satisfactory. This small decline mainly stemmed from the services and "other" activities sectors (2004: 1.21, 2003: 1.32), while liquidity improved slightly in manufacturing (2004: 1.38, 2003: 1.34) and trade (2004: 1.20, 2003: 1.19).

To sum up, the overall picture of the sample firms did not improve in 2004 over 2003. Profits, even if extraordinary results are excluded, remained virtually stagnant (rising by only 1.6%), despite a considerable increase in sales (of 11.1%); as a result, profit margins narrowed (2004: 8.4%, 2003: 9.5%) and ROE and ROA fell (from 13.5% and 6.8% respectively in 2003 to 12.9% and 6.5% in 2004). However, it should be noted that

1 Calculations based on data from ECB, *Report on financial structure*, October 2002, p. 35.

2 See previous footnote.

the financial position of certain sectors, such as construction (owing to the completion of projects connected with the Olympic Games), textiles (due to competition from low-cost countries) and transport (as a result of higher oil prices), deteriorated considerably in 2004.

The worsening of firms' financial condition is also reflected in data from "Tiresias S.A.". As shown in Table X.5, bankruptcy petitions rose by 4.6%, the amount of payment

TABLE X.5

ANNUAL PERCENTAGE CHANGES IN BAD CREDIT RECORD DATA[1]

	2001	2002	2003	2004
1 Bankruptcy petitions	22.2	–68.5	199.1[2]	4.6
2 Payment orders	–20.9	–47.0	73.2	59.5
3 Unpaid cheques	—14.4	28.6	22.2	33.2

1 Changes in the relative amounts.
2 2/3 of the total increase concerns 10 enterprises.
Source: Tiresias S.A.

orders by 59.5% and the value of unpaid cheques by 33.2%, pointing to increased credit risk. These data cover firms as a whole, not only the largest ones that are included in the sample. However, as small enterprises do not have easy access to bank credit, it is likely that this development has not affected significantly banks' credit risk. Supporting this view, non-performing loans as a percentage of total bank loans to businesses rose only slightly in 2004 over 2003 (from 7.4% to 7.8%).

5.2 Market risk

The total value of the banking groups' trading book for the on-balance sheet assets (mainly bonds and shares) as at 31 December 2004 was €28.3 billion (12.2% of banking groups' assets), compared with €39.3 billion in 2003.

The nominal value of off-balance-sheet assets, referring to derivatives of the trading book, amounted to €41.8 billion in 2004. For the most part they are interest rate swaps (69.8%), while foreign exchange swaps have a share of 29.8% and equity derivatives have a share of a mere 0.4%.

The capital requirement against market risk for the banking system as a whole was €518 million on 31 December 2004, compared with €711 million at end-2003. The share of market risk in total risk declined from 7.8% in 2003 to 5.3% in 2004.

Stress testing of market risk factors confirms the reduced relative importance of market risk. According to stress tests, market risk for the banking system as a whole is under control, as the impact on capital adequacy is relatively small and not a source of concern for any individual bank.

5.2.1 Value-at-risk models

Despite the widespread use of value-at-risk (VaR) models by Greek banks, in 2004 none of them applied for recognition of such models as market risk measurement tools. However, some Greek banks have signalled their intention to do so in the course of financial year 2005. The Bank of Greece has allowed banks to use value-at-risk models to calculate capital requirements for foreign exchange and trading book risks (only one bank makes use of this option). The recognition of such models by the Bank of Greece and their use by credit institutions will help give a clearer picture of the market risk of both individual banks and the credit system as a whole and improve the management of these risks.

5.3 Liquidity

The liquidity of the Greek banking system has shown a small deterioration over time, as strong credit expansion (295% between 1998 and 2004) has not been accompanied by a commensurate increase in deposits (169%). This has led to a considerable increase in the loan-to-deposit ratio (including repos), which rose from 49.3% in 1998 to 86.1% in 2004, but is still well below the EU average (2003: 121%), and to a corresponding decrease in the liquid assets[1] to deposits ratio from 53.3% in 1998 to 29.1% in 2004.

This fall in banks' liquidity ratio (liquid assets to deposits) points to increased competition in fund-raising and, as a result, a greater reliance on the interbank market or on refinancing by the Eurosystem, as credit expansion is increasingly financed by interbank lending, subordinated loans and bank bond issuance. It should be noted, in this connection, that the amount of funds raised by Greek credit institutions through bonds and subordinated loans rose to €12.2 billion in 2004, from €5.8 billion in 2003, corresponding to 7.9% of deposits and repos, compared with 4.3% in 2003. Furthermore, such forms of funding have an impact not only on liquidity, but also on banks' profitability, as they are typically a costlier source of funding than deposits.

Similar conclusions can be drawn from the declining path over time of the ''Total Liquidity Index'' compiled by the Bank of Greece.

With a view to bringing its regulatory framework for monitoring credit institutions' liquidity in line with the prevailing liquidity conditions and international best practices, the Bank of Greece issued Governor's Act 2560/1 April 2005. This Act, which will come into force on 1 July 2005, established compulsory ratios (referring to liquid assets and maturity mismatches between assets and liabilities) in the form of minimum limits (20% and –20% respectively). To facilitate credit institutions' adjustment to the new framework, the Act provides for a transitional period from 1 July 2005 to 30 September 2005, during

1 Liquid assets = cash + balances with banks + Treasury bills + bonds and other fixed-income securities.

which lower limits will apply. These compulsory ratios currently stand at satisfactory levels on average, although certain banks are estimated to fall considerably short of the relevant requirement.

5.4 Concentration risk

5.4.1 Large exposures to groups or individual firms

Prudential returns on credit institutions' large exposures (i.e. exposures over 10% of their supervisory own funds) as at 31 December 2004 show that the aggregate net large exposures of Greek banks to individual borrowers or to associated groups of borrowers as a percentage of their supervisory own funds fell to 123.7%, from 190.8% at end-2003, reflecting a 22% decrease in large exposures and a 15% increase in supervisory own funds.

Furthermore, the distribution of these percentages across individual banks indicates a considerable shift in concentration to the lower bands. Moreover, no credit institution has large exposures of over 500% (the upper limit being 800%). This shift signals that concentration risk is increasingly being factored in by banks within their risk management systems.

5.4.2 Large exposures to specific sectors

Although no ceilings on sectoral exposures have been imposed, sectoral concentration and the adjustment of exposures to the prevailing conditions should be an integral part of banks' risk management systems and are assessed separately by the Bank of Greece.

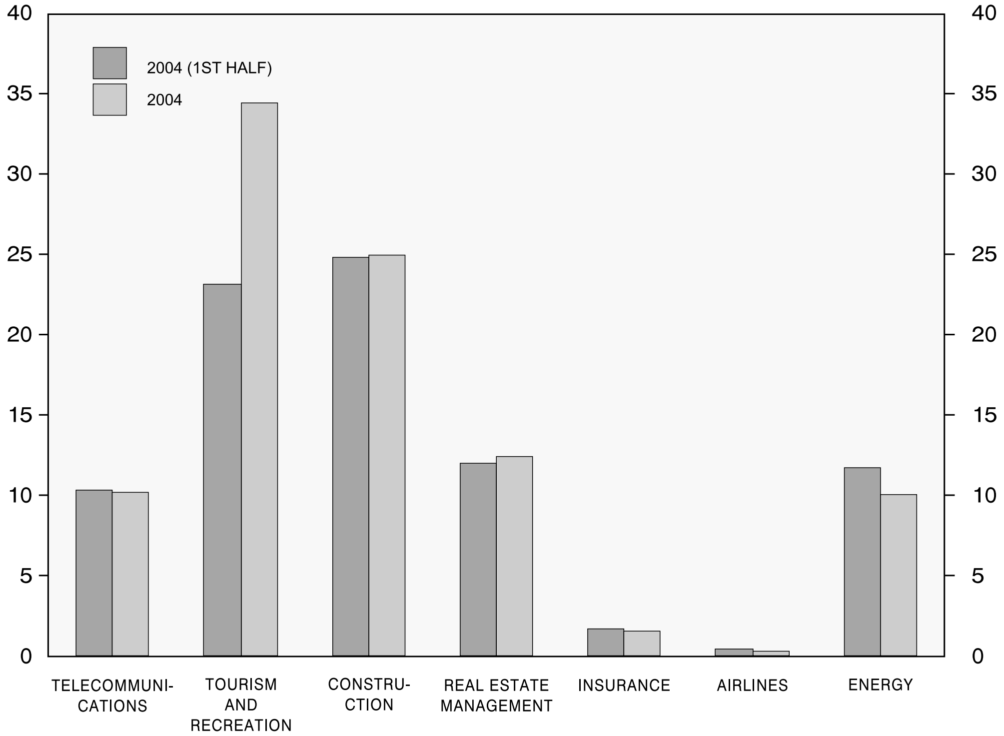
According to data reported by banks regarding loans over €1.5 million during 2004, Greek commercial banks have substantial exposures to two sectors of economic activity, i.e. construction and tourism (see Chart X.4). In the construction sector, banks' exposures[1] stabilised after the completion of infrastructure projects associated with the Olympic Games and reached 24.7% of banks' supervisory own funds at end-2004, compared with 24.5% in the first half of 2004. On the other hand, the prospects of the sector may be affected unfavourably by the curtailment of the public investment programme, although reported data do not show any increase in the non-performing loans to total loans ratio (3.25% at end-2004, from 3.28% in the first half of 2004). Greek commercial banks' exposures to the tourism sector rose to 34% of their own funds at end-2004, from 22% in the first half of 2004, and non-performing loans also increased significantly. In addition, there is a slight increase in the non-performing loans to total loans ratio in the

1 Total exposures to the construction sector do not include the amount of guarantees, which dropped considerably owing to the slowdown in construction activity after the end of the Olympic Games.

ICT sector, although exposures to this sector as a percentage of credit institutions' own funds remained almost unchanged (10.1% at end-2004, from 10.2% in the first half of 2004). The adjustment of exposures indicates that credit institutions respond to sectoral developments in a timely manner.

CHART X.4

FINANCIAL EXPOSURES OF GREEK COMMERCIAL BANKS BY SECTOR OF ECONOMIC ACTIVITY AS A PERCENTAGE OF THEIR OWN FUNDS



Source: Bank of Greece.

5.4.3 Exposures to non-residents

Given the increasing internationalisation of the Greek financial system, the Bank of Greece monitors regularly Greek commercial banks' exposures to non-residents (on a consolidated basis), as well as the nature and concentration of the risks entailed. Under Bank of Greece Governor's Act 2520/10 February 2003, exposures to non-residents (foreign claims) are understood as follows:

1. Cross-border claims, i.e. claims of a Greek credit institution on non-residents, as well as the claims in a foreign country of its branches abroad (other than in the specific countries).

2. Local claims in non-local currency, i.e. claims in non-local currency of the branches of credit institutions established in a foreign country on its residents.

3. Net local claims in local currency, i.e. claims in local currency of the branches of credit institutions, provided that they are not covered by liabilities in local currency. Such claims involve sovereign risk (i.e. the risk related to the inability or unwillingness of the counterparty country's government to fulfil its direct and indirect financial liabilities abroad) and country transfer risk (i.e. the risk of the counterparty/non-resident being unable to obtain the amount of foreign exchange required for fulfilling its liabilities).

The above claims include on-balance-sheet items, such as deposits and holdings in credit institutions, positions in money market instruments, loans and other financing instruments, fixed- and variable-yield securities and other equity (other than participations in subsidiary credit institutions or credit institutions subject to consolidation), as well as off-balance-sheet items, such as guarantees, binding credit facilities extended to customers, credit derivatives and over-the-counter financial products. It should be noted that intra-group claims (i.e. claims on or between non-resident branches of the same credit institution) are excluded.

Both claims on a contractual basis and claims on an ultimate risk basis (i.e. after adjusting for any cross-border risk transfer) are monitored separately. Where risk is transferred to Greece, country claims are reduced accordingly.

Calculations using consolidated data (including only subsidiaries which are credit institutions) on Greek commercial banks' ultimate claims on non-residents as at 31 December 2004 show that:

– Ultimate claims[1] amounted to €24,165 million (4% down from 2003) and accounted for 162% of supervisory own funds and 13% of assets of Greek commercial banks.

– Cross-border claims make up the bulk (70%) of claims, while local claims in non-local currency and net local claims in local currency have a share of 25% and 5% respectively.

– Ultimate claims are broken down as follows: €13,715 million or 57% on Developed Countries and Multilateral Banks, €7,330 million or 30% on Developing Europe (i.e. Eastern and Central Europe, the Balkans, Cyprus and Malta) and €1,328 million or 6% on Offshore Centres. These three geographical zones account for 93% of ultimate claims. As a percentage of own funds, claims are broken down as follows: about 92% on Developed Countries, 49% on Developing Europe and 9% on Offshore Centres (see Chart X.5).

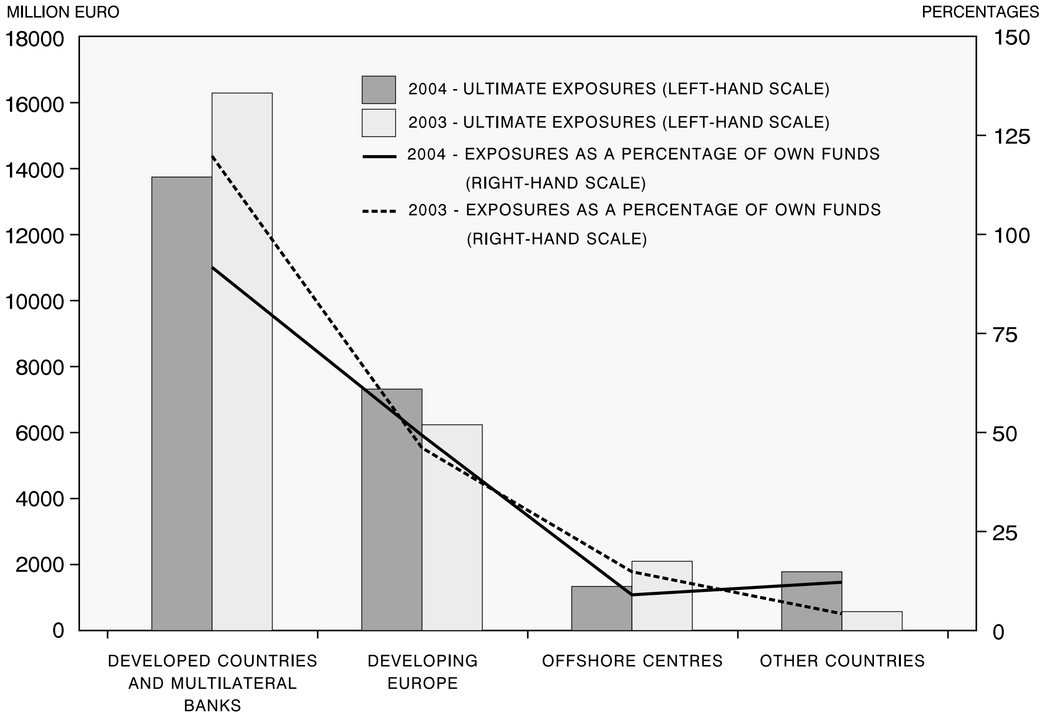
– Of particular interest are claims on Balkan countries, which amounted to €4,115 million (17% of ultimate claims), having risen by 30% relative to 2003 and accounting for 28% of banks' own funds (2003: 23%), while local claims in non-local currency made up 80%. However, in certain cases they exceed 50% of own funds, which calls for vigilance.

1 That is, the sum of cross-border claims, local claims in non-local currency (including subsidiaries and branches) and net local claims in local currency.

These developments in foreign claims are primarily addressed by credit institutions in the context of their risk management and provisioning policies. As far as prudential supervision is concerned, the Bank of Greece attaches particular importance to the specialised and accurate measurement of country risk and contagion risk and encourages adequate provisioning, notably when ultimate claims on a country or a geographical area

CHART X.5

BANKS' ULTIMATE EXPOSURES BY CATEGORY AND GEOGRAPHICAL AREA AND AS A PERCENTAGE OF THEIR OWN FUNDS



Source: Bank of Greece.

exceed a reasonable level of a credit institution's own funds. This level should be calculated on a bank-specific basis, taking into account the overall quality of the bank's risk management mechanism.

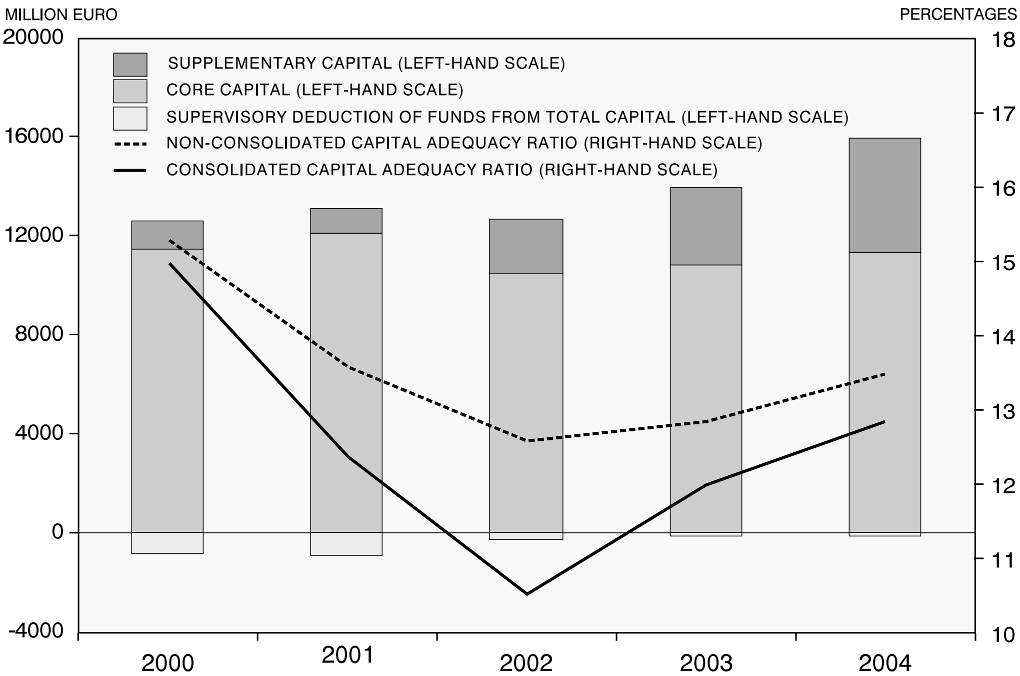
6. CAPITAL ADEQUACY

The growth of supervisory own funds (15.24%) over 2003 outpaced that of risk-weighted assets (9.86%) in 2004; as a result, the capital adequacy ratio (CAR) of Greek commercial banks as a whole rose appreciably to 13.46% on a non-consolidated basis in

2004, from 12.84% in 2003 (compared with 12.35% in the EU-15[1]) (see Chart X.6). Calculated with respect to core (Tier I) capital only, the CAR on a non-consolidated basis remained relatively high (9.63%,[2] down from 10.11% in 2003, in comparison with 8.79% in the EU-15 in 2003). Specifically, core (Tier I) capital rose by 4.58% in 2004 in comparison with 2003, whereas supplementary (Tier II) capital grew faster (by 50.81%). This

CHART X.6

GREEK COMMERCIAL BANKS' TOTAL CAPITAL ADEQUACY



Source: Bank of Greece.

drove down the share of core (Tier I) capital in total supervisory own funds from 79% in 2003 to 72% in 2004, which is now close to the EU average (71% in 2003). Moreover, even if the shortfall of accounting provisions against supervisory provisions[3] is taken into account, the CAR of commercial banks as a whole rose to 12.93% in 2004 (from 12.19% in 2003).

1 ECB, "EU Banking Sector Stability 2004", November 2004.

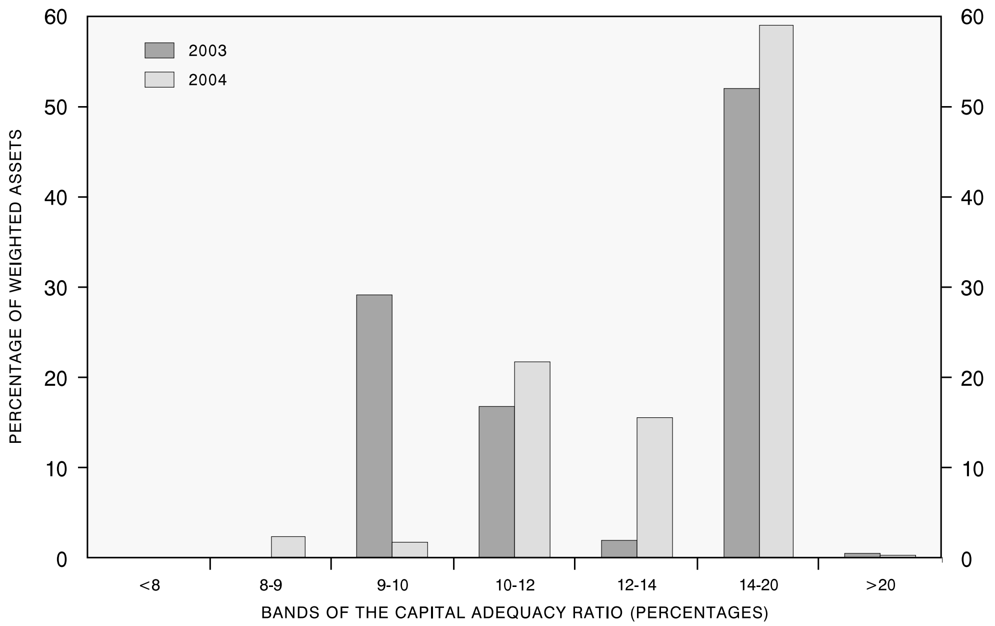
2 0.6% of this ratio is accounted for by capitalisation of fixed asset revaluation surpluses under Law 3229/2004. The Bank of Greece is currently holding a consultation with banks on the inclusion of such surpluses in core or supplementary capital.

3 That is, the difference between the minimum provisions laid down by the Bank of Greece and banks' accounting provisions.

The on- and off-balance-sheet risk-weighted assets on a non-consolidated basis, including notional assets[1] corresponding to capital requirements for market risk, rose from 58% in 2003 to 60% of total assets in 2004 and reached €117 billion. Specifically, credit-risk-weighted assets including off-balance-sheet accounts grew by 12.5% in 2004 in comparison with 2003, which points to increased credit risk. By contrast, market-risk-weighted balance sheet items fell to €5.2 billion in 2004, from €7.2 billion in 2003, and

CHART X.7

PERCENTAGES OF WEIGHTED ASSETS RELATED TO THE BANDS OF THE CAPITAL ADEQUACY RATIO



Source: Bank of Greece.

now make up 4.4% of total weighted assets, compared with 6.7% in 2003. This decrease was broadly based across market risk components (i.e. foreign exchange risk, interest rate and specific risk, and counterparty risk).

At end-2004, only one bank had a CAR of below 9% (which is considered as a relatively satisfactory level, compared with a minimum requirement of 8%) and has planned

1 The concept of notional assets is used for the calculation of capital adequacy for market risks of any nature from on- and off-balance-sheet items (notional assets = total capital requirements for these items x 12.5 (= 1/0.08), i.e. the inverse of 8%).

a capital increase for 2005. Furthermore, the share of the weighted assets of banks with a CAR (on a non-consolidated basis) lower than 10% in the total weighted assets of banks fell to 3.9% in 2004, from 29.2% in 2003 (see Chart X.7). This shows that credit institutions have largely created adequate capital buffers for absorbing shocks; this is especially the case with small and medium-sized banks, which are more vulnerable to intensifying competition.

On a consolidated basis, the CAR reached 12.83% in 2004, from 11.97% at end-2003, mainly as a result of an 18% increase in supervisory own funds, including hybrid capital. Calculated only on the basis of core (Tier I) capital, the CAR rose to 10.02%, from 9.80% in 2003, while the share of hybrid capital in this increase is estimated at one percentage point.

The CAR of cooperative banks fell to 20.93% in 2004, from 23.67% at end-2003 (compared with a minimum requirement of 10%), as their total risk-weighted assets rose by 28%, whereas supervisory own funds grew quite slower (by 13.2%).

7. OTHER SUPERVISORY ISSUES

7.1 Transparency of transactions

In the light of the experience gained in 2003, the first full year of implementation of Bank of Greece Governor's Act 2501/2002 on customer information, and on the basis of data reported by banks and the review of customer complaints submitted to the Bank of Greece, the Banking and Credit Committee issued Decision 178/3/2004 and provided clarifications where appropriate.

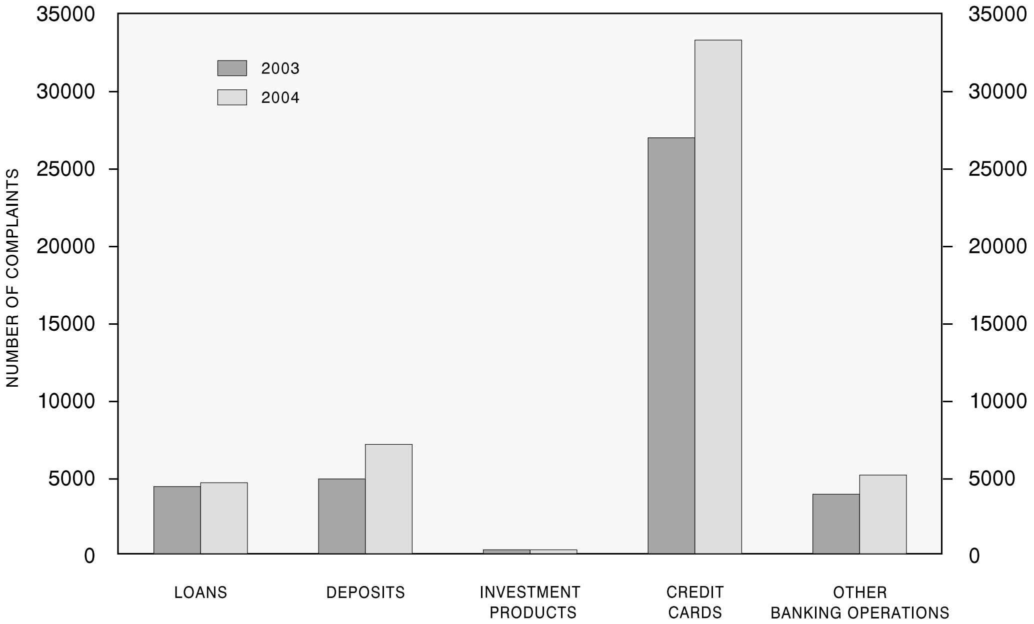
Clarifications referred to issues such as the free determination of bank rates and how conditions of loan agreements, especially when a floating rate is involved, should be formulated. In view of the widespread use of such agreements, chiefly in housing loans, the purpose is to ensure thorough customer information, so that customers can evaluate their future liabilities in relation to their income and the potential consequences in the event of an interest rate rise.

Furthermore, the Bank of Greece cooperates with other competent authorities on issues concerning consumer credit in general and participates in an ad hoc working group established at the Ministry of Development with the task of examining contentious bank-consumer relations, so as to ensure effective protection of customers.

Besides, as reported by banks' units responsible for dealing with customer complaints, the number of complaints has risen, notably in the area of consumer loans and credit cards (see Chart X.8). This can be partly attributed to the improved recording of complaints, the enhanced efficiency and reliability of such services, as well as banks' stronger focus on this area in 2004.

CHART X.8

BANK CUSTOMER COMPLAINTS PER CATEGORY



Source: Bank of Greece.

7.2 On-site inspections

On-site inspections – sanctions

The effective supervision of credit and financial institutions relies on the following tools: (a) analysis and assessment of reported supervisory data; (b) meetings with senior executives and risk management/internal control officers; and (c) on-site inspections to verify the accuracy of reported data and the appropriateness of banks' risk management and internal control mechanisms with respect to their overall policies and risk profiles.

In exercising its supervisory tasks, the Bank of Greece uses all three tools. In 2004, it carried out both general and specific inspections to evaluate all types of risks, with special emphasis on credit risk, which is currently the major risk facing banks. This does not imply that the Bank underrates the other risks, including operational risk that is entailed by banking business. Specifically, in 2004 the Bank of Greece conducted 457 inspections (237 of which through its branches), including:

(a) General and specific inspections at commercial and cooperative banks, including their subsidiaries and branches abroad, to assess the quality of the loan portfolio, evaluate internal control systems over a wide range of activities, as well as risks associated with corporate governance and loans to affiliated firms and/or shareholders. It should be noted that such loans should not be subject to privileged terms.

(b) Inspections to evaluate the adequacy of banks' and financial institutions' information systems.

(c) Inspections to verify credit and financial institutions' compliance with the anti-money laundering and counterfeit prevention framework, chiefly in commercial bank branches.

In 2004, significant resources were devoted by the Bank of Greece to dealing with about 800 bank customer complaints referred to it by banks. These had to do with transparency issues that fell within its scope of authority, but in most cases fell within the wider scope of the Bank's responsibilities as banking regulator and supervisor and as custodian of the reputation and reliability of the credit system.

About 600 complaints were resolved in 2004, of which: (a) 55% concerned credit cards (mostly problems arising from credit card providers that ceased operation); and (b) 22.5% concerned the implementation of Law 2912/2001 on the settlement of compound interest debts.

Regarding the outcome of complaints, 80% of the cases were not found to constitute non-compliance on the part of banks, and in some instances the delays were not unreasonable in view of the required legal procedures, especially for the former category of issues. The remaining complaints (about 20%) were either referred to the competent Bank of Greece Committee to consider imposing sanctions on banks or did not concern violations, but were customers' suggestions for banks to take measures for settlement.

The Bank of Greece monitors developments in the credit system and constantly adjusts its supervisory methodology accordingly. In this respect, on-site inspections enable it to evaluate bank-specific risks and the measures and procedures applied by banks for safeguarding their own reliability and reputation.

Also, work is underway for the formulation of specific instructions on risk evaluation. These instructions will be addressed to banks and to the Bank of Greece supervisors and should be complied with by all banks, not only by those which will adopt the sophisticated methodologies of the new capital adequacy Directive.

Sanctions

In 2004, sanctions were imposed on 21 banks, in the form of non-remunerated deposits with the Bank of Greece (€16.7 million), fines in favour of the Greek State (€163 thousand) or warnings. Sanctions concerned violations of provisions of laws (Article 42 of Law 2912/2001) and/or Bank of Greece decisions, inadequate compliance with euro banknote authentication procedures or violations of the Underwriting Regulation by credit institutions supervised by the Bank of Greece, in which case the Bank of

Greece has the power to impose sanctions upon a recommendation from the Capital Market Commission.

7.3 Prevention and suppression of money laundering and the financing of terrorism

In 2004, the Financial Action Task Force – FATF, an intergovernmental body housed at the OECD and devoted to the prevention and suppression of money laundering and the financing of terrorism, issued “Special Recommendation IX”: Cash couriers.

At the EU level, a new Directive is being prepared, intended to replace Directive 2001/97/EC of the European Parliament and the Council, which had amended Council Directive 91/308/EEC. The new Directive will incorporate the revised Forty Recommendations on the prevention of money laundering and the Nine Special Recommendations on the financing of terrorism issued by FATF.

The Bank of Greece issued Administration’s Circular 16/2 August 2004, which is a consolidated version of guidelines to credit and financial institutions aimed at the prevention and suppression of money laundering.

Moreover, the Bank of Greece is involved in the drafting of a bill that will amend Law 2331/1995 by implementing Directive 2001/97/EC of the European Parliament and the Council. The new bill, among other things, (a) broadens the definition of “credit institutions” and “financial organisations”; (b) expands the scope of the legislative power of the Bank of Greece as the Competent Authority under Article 4(9) of Law 2331/1995; (c) states that postal companies shall be supervised by the Bank of Greece, provided that they act as intermediaries in fund transfers; and (d) lays down a framework for wire transfers, in accordance with FATF’s Seventh Special Recommendation.

7.4 International Accounting Standards

7.4.1 European and international developments

During 2004 and in early 2005, the European Commission adopted a new set of International Financial Reporting Standards (IFRS), revised versions of existing International Accounting Standards (IAS), and related Interpretations issued by the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC) respectively. Specifically, by six Commission Regulations, the following were introduced in the EU: (a) IFRS 1, 2, 3, 4 and 5; (b) revisions of IAS 1, 2, 8, 10, 16, 17, 21, 24, 27, 28, 31, 33, 36, 38, 39 and 40; and (d) IFRIC Interpretation 1.

As regards the disputed IAS 39 – Financial Instruments: Recognition and Measurement, some points of which had been criticised by national banking supervisors and the European Central Bank (ECB), this Standard was finally adopted by the European Commission with two exceptions ("carve outs") on: (a) the use of the full fair value option; and (b) hedge accounting. However, it should be mentioned that negotiations for bridging the gap between IAS 39 and the original IASB Standard are continuing and are expected to lead to a mutually acceptable solution.

7.4.2 The adoption of the IAS in Greece

Law 3301/2004 amended earlier legislation that had introduced the IAS as compulsory for the financial statements (consolidated or otherwise) of Athens Exchange listed firms and their unconsolidated subsidiaries. Specifically:

– Law 2190/1920 and Presidential Decree 360/1985, as currently in force, were amended with respect to the preparation of annual and interim financial statements, respectively, by firms that apply the IAS;

– the non-listed subsidiaries of firms required to apply the IAS were exempted from the requirement to apply the IAS, provided that their total turnover or assets or financial results do not exceed 5% of the corresponding aggregates of the parent company;

– firms subject to the IAS were given the option, as an alternative to IAS-based book-keeping, to continue to apply the existing rules of tax legislation and then adapt the resulting financial statements to the IAS requirements; and

– with respect to certain important issues affecting banks, the provisions of tax legislation were harmonised with the IAS provisions.

Credit institutions and other legal entities supervised by the Bank of Greece (effectively the vast majority of the banking industry) will be applying the IAS as from 1 January 2005. The implementation of the IAS is expected to bring about changes –important ones, in certain cases– in the financial statements of these institutions, and also in the relevant regulatory ratios such as the capital requirements for credit and market risks. With a view to mitigating some of these effects, notably those exclusively attributable to fundamental changes in accounting practices, the central banks and banking supervisors of the EU are taking concrete measures. In this context, the Bank of Greece issued a consultation document recommending the following adjustments to the accounting data resulting from the implementation of the IAS in the calculation of the CAR:

(a) the current definition of supervisory own funds should be maintained, namely recognition of certain hybrid securities as supervisory own funds regardless of their recognition in net worth or liabilities;

(b) for certain assets, non-recognition or only partial recognition in supervisory own funds of valuation differences resulting from fair value accounting; and

(c) restriction of the scope of accounting consolidation of banks' financial subsidiaries in connection with the calculation of the CAR on a consolidated basis.

Similar adjustments are made to the data reported to the Bank of Greece for the calculation of capital adequacy (supervisory own funds and credit-risk-weighted data). These adjustments, as well as the use by credit institutions of the options provided for by IFRS 1, mainly with respect to the revaluation of their fixed assets at fair value, should reduce considerably the impact on their capital adequacy from the implementation of the IAS. However, if the problem of financing the actuarial deficits of certain banks' pension plans is not solved, this will affect their capital adequacy, as their cumulative outstanding net liabilities under these plans as at 1 January 2005 will equally reduce their supervisory own funds.

8. EUROPEAN AND INTERNATIONAL DEVELOPMENTS

8.1 Activation of the Committee of European Banking Supervisors (CEBS)

2004 was a landmark year for the decision-making process on banking supervision issues in the EU, as it saw the activation of the Committee of European Banking Supervisors (CEBS), bringing together all the EU banking supervisory authorities. CEBS functions as a "level 3" body under the Lamfalussy process,[1] which is aimed at more effective financial regulation at the EU level, faster response to technological change and market developments and greater convergence of supervisory practices across Member States.

In implementation of this process, a directive of the European Parliament and the Council[2] is expected to be adopted. This, among other things, will grant regulatory powers to the European Banking Committee (EBC). The EBC was established as an advisory body by a Decision of the European Commission,[3] which will come into effect as soon as the proposed directive is adopted. The Committee of European Banking Supervisors (CEBS) was also established by a Decision of the European Commission[4] and is the successor of a pre-existing committee with advisory mandate under Community Directives. The Bank of Greece, as the authority responsible for banking supervision in Greece, participates in the CEBS through a high-level official representative.

According to the Commission Decision establishing the CEBS, its tasks include advising the Commission on banking regulation; promoting the consistent application of EU directives and the convergence of supervisory practices throughout the Community; and enhancing supervisory cooperation, also through extensive and open consultations.

In practice, the CEBS advises, through the European Banking Committee (EBC), the European Commission on legislative initiatives in the banking sector (adoption of a new

1 Named after Alexandre Lamfalussy, chairman of the "Committee of Wise Men on the Regulation of European Securities Markets".

2 Proposal for a Directive of the European Parliament and the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure (COM/2003/0659).

3 Commission Decision 2004/10/EC of 5 November 2003 establishing the European Banking Committee.

4 Commission Decision 2004/5/EC of 5 November 2003 establishing the Committee of European Banking Supervisors.

directive or amendment to an existing one etc.). In addition to its involvement in the introduction of common rules, the CEBS fosters the uniform implementation of such rules at the national level by the member supervising authorities. Furthermore, the CEBS strives for the establishment of effective common procedures that facilitate supervisory cooperation, especially where this cooperation is explicitly required by EU banking law (see also Section 8.2).

8.2 Developments in the reform of the capital adequacy framework (CAD III)

As regards the reform of the capital adequacy framework for credit institutions, the European Commission finalised its relevant preparatory work in July 2004 and presented its proposal for the recasting of Directives 2000/12/EC and 93/6/EEC. The new directives were debated at the European Parliament and (following brief consultations and minor changes) were approved by the ECOFIN Council in December 2004. In March 2005, the European Parliament Committee on Economic and Monetary Affairs delivered an opinion.

Concurrently with consultations within the Council and the European Parliament and given that no major changes in the draft directives are expected, the CEBS is actively pursuing the strongest possible convergence of supervisory practices relating to the implementation of the above directives. Large cross-border groups are also pressing in this direction, requesting convergence across national supervisory practices so as to ensure harmonised reporting and lower compliance costs.

Specifically, the new capital adequacy framework provides for a number of national discretions, which allow for country-specific regulatory approaches. Although it is a commonly shared belief that it is not possible or desirable to eliminate national discretions, differences in their application could cause competition problems to credit institutions that face different supervisory regimes. Therefore, the CEBS undertook to review the national discretions provided for in the two directives and to identify any unnecessary ones. A first set of 13 discretions were identified, which will be addressed in the same way by all the supervisory authorities of Member States and, following CEBS's recommendation to the European Council, they were removed from the draft directives. A second set of discretions were identified as calling for convergence as a matter of priority and efforts are being made to this end. Full convergence will continue to be the ultimate goal, which, once attained, will make national discretions unnecessary.

Another important strand of CEBS work refers to the harmonised treatment of certain issues, each being dealt with by special CEBS working groups: (a) supervisory recognition and validation of the more advanced approaches for calculating capital requirements against credit risk (internal ratings-based approach) and operational risk (advanced measurement methods), including partial use of the approaches, data collection, certification and corporate governance; (b) measurement of capital requirements for operational risk; and (c) the recognition of External Credit Assessment Institutions (ECAIs), specifically the recognition process, the implementation of the recognition criteria under the new directive and the criteria for the "mapping" of external credit assessment to the credit quality steps of the directive.

The CEBS is also preparing EU-wide guidelines on cooperation between home and host supervisory authorities and harmonised application of the Supervision Review Process under "Pillar 2".

Bank of Greece actions

The Bank of Greece, recognising the complexity of the new framework and the need for credit institutions to adapt their systems and internal procedures in a timely manner, has put out five "Consultation Documents" communicating its broad positions on the discretions it intends to exercise or allow, interpreting certain points of the draft directive and seeking feedback from credit institutions. The five Consultation Documents correspond to key aspects of the directive, namely:

– standardised approach;
– the internal ratings-based (IRB) approach;
– credit risk mitigation techniques;
– securitisation; and
– key requirements for the development of the IRB approach.

Of course, pending the finalisation of the directive, the Bank's views cannot be but tentative. What is for sure is that any final position will take into account not only the views of the banking industry, but also the choices of other banking supervisors in the EU or non-EU countries where Greek credit institutions have established branches.

In the selection of specific discretions, ensuring a level playing field could take second place to the need to adopt the best practices appropriate for the circumstances and the degree of development of risk management mechanisms and parameters.

Consultations with credit institutions will continue both on a collective and a bilateral basis, in particular in the context of the pre-evaluation of their systems, which has already started for banks that intend to apply the more advanced approaches.

Cooperation between the home and host supervisors is crucial for the effective implementation of the new framework. The Bank of Greece has initiated contacts with the supervisory authorities of countries where branches of Greek credit institutions have been established, so as to put cooperation structures in place for more effective information exchange and more harmonised supervisory treatment.

8.3 Cooperation with foreign supervisory authorities

After the successful completion of the EU enlargement process in June 2004, the central banks and banking supervisors of the new Member States agreed to adhere to two

Memorandums of Understanding which had already been signed by the other EU central banks and banking supervisors in 2001 on the oversight of payment systems and in 2003 on cooperation among central banks and banking supervisors in the area of crisis management, respectively.

In the context of international cooperation, meetings were held in Athens with representatives of the supervisory authorities of the United Kingdom (FSA) in April 2004, China in September 2004 and Serbia in January 2005. Issues concerning the supervision of credit institutions that are active in the respective countries were discussed and there was an exchange of views on the supervisory procedures applied.

9. DOMESTIC DEVELOPMENTS IN BANKING REGULATION

During 2004 and in early 2005, the Bank of Greece, in the context of its regulatory powers, took a number of measures to adapt the rules of supervision of credit institutions and laid down rules of operation and supervision of new types of financial corporations. Specifically:

By authority of Law 3148/2003, stating that money transfer intermediaries must have the legal form of sociétés anonymes with a minimum capital of €150,000 and are subject to supervision by the Bank of Greece, the Bank of Greece issued Governor's Act 2536/4 February 2004 laying down requirements for granting authorisation to, and rules for the supervision of, such companies. Six money transfer intermediaries have already been authorised and have come under supervision by the Bank of Greece.

Bank of Greece Governor's Act 2540/27 February 2004 (subsequently amended by decision 190/3/26 January 2005 of the Banking and Credit Committee) laid down rules for the supervision of the company "Credit Guarantee Fund of Small and Very Small Enterprises S.A." (TEMPME S.A.) and the supervisory treatment of credit institutions' claims carrying the explicit guarantee of TEMPME S.A. The company was established by Law 3066/2002 (subsequently amended by Article 14 of Law 3190/2003 and Article 9 of Law 3297/2004) and its purpose is to guarantee part of the debt of small and very small enterprises to credit or financial institutions; its capital currently amounts to €200 million, paid up by the EU (67%) and the Greek State (33%). Following an opinion from the Bank of Greece, a joint decision of the Minister of Economy and Finance and the Minister of Development approved the Regulation of Guarantees and Operation of TEMPME S.A. The same law assigns the supervision of TEMPME S.A. to the Bank of Greece and provides for all the other issues relating to the operation of the company (capital increases, governance, asset management etc.), except for those that are responsibilities of the Ministry of Economy and Finance and/or the Ministry of Development.

Bank of Greece Governor's Act 2541/27 February 2004 codified into a single text its earlier decisions issued by authority of Law 2515/1997 concerning the authorisation and operation of bureaux de change. Furthermore, the relevant framework was updated in view of recent changes in the foreign exchange regime (introduction of the euro, liberalisation of capital movements and of the current account) and was brought in line with the framework governing similar corporations of the financial sector.

By Bank of Greece Governor's Act 2552/23 June 2004, the ceiling on borrowing from credit institutions and members of the Athens Exchange for conducting stock exchange transactions was raised to €1 million per customer, following a proposal from the Capital Market Commission, in accordance with the provisions of Law 2843/2000. That ceiling had initially been set at €150,000 by Bank of Greece Governor's Act 2474/2001.

By decision 178/1/19 July 2004 of the Banking and Credit Committee, credit institutions that are not members of the Athens Exchange were allowed to finance legal persons conducting stock exchange transactions, in accordance with the terms and conditions of Bank of Greece Governor's Act 2474/31 May 2001, as currently in force, which apply to loans to natural persons.

By its decision 178/3/19 July 2004, the Banking and Credit Committee clarified certain provisions of earlier Bank of Greece Governor's Acts concerning the interest rates charged by credit institutions and the information provided to credit institutions' customers.

Under decision 178/7/19 July 2004 of the Banking and Credit Committee, hybrid securities that fulfil the minimum requirements of Bank of Greece Administration's Circular 21/2004 (which replaced Administration's Circular 17/2002) and are included in core capital as Lower Tier 1 capital may be up to 30% of core capital, or 15% in the case of stepped-up call options.

Administration's Circular 16/2 August 2004 codified into a single text the provisions on the obligations of credit and financial institutions in connection with the prevention and suppression of money laundering. This codification was considered necessary in view of the implementation of the revised Forty (40) Recommendations and the Eight (8) Special Recommendations of FATF.

The Banking and Credit Committee, by decision 185/2/23 November 2004, amended its decision 595/2/27 June 1997 on the imposition of sanctions on credit institutions in the event of delayed or inaccurate or incomplete reporting of supervisory data, providing greater flexibility in the determination of penalties.

Bank of Greece Governor's Act 2557/26 January 2005 increased the provisioning ratios on claims from consumer loans as follows: (i) from 70% to 90% for non-performing loans one year past due or in permanent arrears; and (ii) from 84% to 100% for doubtful loans. At the same time, the provisioning ratio on performing loans backed by residential mortgages was lowered from 0.7% to 0.5%, provided that the amount of the loan does not exceed 70% of the taxable value of the residential property.

Decision 193/1/11 March 2005 of the Banking and Credit Committee amended the provisions of Bank of Greece Governor's Act 2438/6 August 1998 on the operating framework and assessment criteria concerning credit institutions' internal control systems and on the powers of internal control bodies. Specifically, credit institutions were required to record in detail the standards and procedures applying to the extension of credit to, or participations in, associated legal entities. This arrangement was warranted in order to

(a) ensure that credit institutions do not deviate from their standard credit policies when lending to related entities; and (b) further enhance the framework governing the approval of credit to associated companies. The aforementioned decision also laid down the basic principles to be observed by credit institutions with total assets over €100 million for the safe and effective operation of IT systems, so as to prevent and manage operational risk, while the Department for the Supervision of Credit and Financial Institutions was authorised to determine the scope of compliance with these principles by credit institutions with total assets of less than €100 million.

Finally, Bank of Greece Governor's Act 2560/1 April 2005 amended the framework for monitoring credit institutions' liquidity adequacy by establishing minimum compulsory ratios, the Liquid Asset Ratio and the Asset/Liability Mismatch Ratio. In addition to Greek-based credit institutions, foreign credit institutions' branches in Greece are also required to comply with these provisions. However, branches of EU credit institutions may be exempted by the Bank of Greece, on an *ad hoc* basis, provided that adequate liquidity is ensured by parent banks.

10. PAYMENT SYSTEMS

10.1 Retail payment systems

In 2004, the number of cheques processed through the two clearing systems operating in Greece (the Athens Clearing Office and the DIAS S.A. Interbanking Cheque Clearing System) rose by 1.8% to 16.7 million, while their total value increased by 2.6% to €273 billion.

It should be noted that the share of cheques in the total volume of payments through all instruments, whether settled through one of these systems or through banks' own networks, dropped slightly to 22.6% in 2004, from 23.8% in 2003. This suggests the increasing use of payment instruments that are based on modern ICT technologies, in particular credit cards.

Total payment traffic in all the subsystems of DIAS S.A. increased considerably in comparison with 2003, rising by 4.5% to 28 million in volume terms and by 15.7% to €92.7 billion in value terms. The volume of payments through the credit transfer subsystem rose to 565,000 (up 26.4%) and their value grew to €1.2 billion (up 82.8%). The expansion of the use of this subsystem by credit institutions is a positive development, as the automated processing of a larger number of payments should eventually lead to reduced cost of retail payment services.

The total volume of electronic payments through the internet rose from 3.3 million in 2003 to 5 million in 2004 and their total value increased from €11 billion to €17.7 billion. Therefore, internet payments are growing rapidly, although not all banks support such transactions. The use of the internet is expected to rise in the coming years, as customers are becoming familiar with this option and, under pressure from competition, more banks are to offer e-banking services.

10.2 The HERMES payment system

The HERMES payment system continued to operate smoothly in 2004, having a significant contribution to financial stability.

Payment traffic in the HERMES system increased by 3% to 1.36 million in volume terms and 10.6% to €3,697.2 billion in value terms in comparison with 2003. However, this increase did not change the share of HERMES in TARGET transactions either in volume or in value terms (1.97% and 0.83% respectively), which remained subdued close to the 2003 levels (1.99% and 0.79%).

TABLE X.6
TRANSACTIONS THROUGH THE HERMES AND THE TARGET SYSTEMS

Payment orders	2003		2004	
	Number of transactions	Value of transactions (million euro)	Number of transactions	Value of transactions (million euro)
1. Domestic	**984,492**	**1,723,429**	**1,024,108**	**1,675,300**
– customer payments	651,953	387,639	695,493	331,823
– interbank payments[1]	332,539	1,335,790	328,615	1,343,477
2. Cross-border	**340,330**	**1,620,873**	**340,427**	**2,021,865**
– customer payments	218,414	8,560	213,135	10,196
– interbank payments	121,916	1,612,313	127,292	2,011,669
HERMES total	**1,324,822**	**3,344,302**	**1,364,535**	**3,697,165**
TARGET total	**66,608,000**	**420,749,000**	**69,213,498**	**443,993,000**

1 They include the debiting of the following clearing systems: the Book-Entry Securities System, the Athens Clearing Office and DIAS S.A. (13,529 payment orders amounting to €321,085 million for 2003 and 13,415 orders amounting to €382,809 million for 2004).
Sources: Bank of Greece and ECB.

Cross-border payments grew considerably in value terms in 2004 (by 24.8%), but remained unchanged in volume terms. Within this category, interbank payments rose in volume, while customer payments dropped. This development reflected increasing activity by credit institutions in the single European market.

The smooth flow of payments was supported by the sufficient intraday liquidity provided by the Bank of Greece. Analysis of data shows that the value of deposited collateral was well in excess of the payment system's collateral requirements throughout 2004. Specifically, the average daily amount of collateral was €1,547.6 million, while the average value of intraday credit was €411.6 million, providing an adequate buffer against possible increases in liquidity needs.

The availability of the HERMES system remained high in 2004, with the annual average availability rate coming to 99.8% due to five short failures attributable to technical reasons, which were addressed by upgrading the system's equipment.

The Bank of Greece proceeded to the necessary technical adjustments so that the processing of payment orders and other messages of HERMES, along with other IT applications, be effected in the new environment (SWIFTNet) developed by SWIFT. The migration to SWIFTNet is very important, because many operations of the new TARGET2 payment system are supported by services of the new environment.

The development of TARGET2 continued at a fast pace in 2004. After the ECB Governing Council approved the general specifications of the new system in July 2004, the Eurosystem is elaborating detailed specifications, which should be finalised by April 2005, thus allowing credit institutions to proceed to the organisational and technical adjustments required to participate in the system's testing and trial phase during 2006.

APPENDIX TO CHAPTER X

BANK OF GREECE DECISIONS CONCERNING THE ESTABLISHMENT AND OPERATION OF CREDIT INSTITUTIONS

16 January 2004

The Bank of Greece approves the merger of the Investment Bank of Greece and Marfin Hellenic Securities S.A. (through the absorption of the latter by the former).

20 January 2004

In implementation of ECB decisions, the Bank of Greece sets a framework for the reproduction of euro banknotes.

21 January 2004

The rules governing credit institutions' statistical reporting to the Bank of Greece of all transactions (capital movements and current transactions) in euro and foreign exchange between Greek residents and non-residents are amended and codified into a single text.

4 February 2004

Under authorisation by Law 3148/2003, the Bank of Greece specifies the terms and conditions for granting authorisation to, and the rules for the supervision of, money transfer intermediaries.

11 February 2004

With a view to providing more thorough information to the Bank of Greece for compiling the balance of payments and the international investment position, credit institutions shall submit, on a monthly basis, detailed lists of the securities they either hold for their own account or keep in custody/manage on behalf of their customers.

27 February 2004

— In the framework of Law 3066/2002 establishing the "Credit Guarantee Fund of Small and Very Small Enterprises S.A." (TEMPME S.A.), the Bank of Greece lays down supervisory rules governing TEMPME's capital adequacy, liquidity and investment of its funds.

— The provisions relating to the authorisation of bureaux de change in Greece and the rules for their supervision by the Bank of Greece are codified into a single text and updated.

— The bank “Societé Générale S.A.” is authorised to acquire the majority of the share capital of General (Geniki) Bank.

23 March 2004

The Tirana-based “American Bank of Albania” is authorised to establish and operate a branch in Greece.

18 June 2004

Credit institutions are required to report to the Bank of Greece quarterly data on their open positions in foreign exchange on both a solo and a consolidated basis. Thus, the frequency of reporting is harmonised with that for overall capital adequacy data.

23 June 2004

The ceiling on borrowing from credit institutions and members of the Athens Exchange for conducting stock exchange transactions is raised from €150,000 per customer to €1,000,000, following a proposal by the Hellenic Capital Market Commission, in accordance with the provisions of Law 2843/2000.

19 July 2004

— Credit institutions which are not members of the Athens Exchange are allowed to finance legal persons for conducting stock exchange transactions.

— To achieve correct and consistent implementation of the relevant provisions, the Bank of Greece clarifies some of its decisions referring to the interest rates charged by credit institutions and to the information provided to credit institution customers.

— The “Christoforos K. Varvias & Associates S.A. – Financial Services” is authorised to operate as a money transfer intermediary.

— The “Advanced Chronocash Financial – Electronic Fund Transfer S.A.” is authorised to operate as a money transfer intermediary.

— Ceilings are set on the amount of hybrid securities issued by credit institutions that may be included in their core (Tier I) capital.

27 July 2004

The Bank of Greece withdraws the authorisation of the “Arab Bank plc” branch operating in Greece.

4 August 2004

– "CBN Greece S.A." is authorised to operate as a money transfer intermediary.

– "Manilink – S.A." is authorised to operate as a money transfer intermediary.

9 September 2004

– The Bank of Greece approves the merger of "Emporiki Bank" with several of its subsidiaries ("Emporiki Investment Bank" inclusive) of the financial sector. The merger will be effected through absorption of the above firms by "Emporiki Bank".

– "Smith & Smith Hellas S.A." is authorised to operate as a money transfer intermediary.

10 November 2004

"Athens Tourism Enterprises S.A." is authorised to operate as a money transfer intermediary.

23 November 2004

– Piraeus Bank is authorised to establish and operate seven new branches in Bulgaria.

– Commercial Value S.A. is authorised to acquire a special holding in the share capital of Aspis Bank S.A.

21 December 2004

The ceiling on Postal Savings Bank (PSB) financing of natural persons for the purchase of goods and for covering other personal needs is set at 15% of PSB's own funds, on condition that its provisions for doubtful loans will at least equal the amount provided for by Law 2238/94 (1% of the amounts lent).

19 January 2005

Alpha Bank is authorised to acquire 100% of the share capital of the Belgrade-based "Jubanka a.d. Beograd".

26 January 2005

– The provisioning ratios on claims (i) from non-performing consumer loans one year past due or in permanent arrears and (ii) from doubtful consumer loans are increased, respectively, from 70% to 90% and from 84% to 100%. At the same time, the provisioning ratio on performing loans backed by residential mortgages is lowered from 0.7% to 0.5%, provided that the amount of the loan does not exceed 70% of the objective value of the residential property.

– The provisioning ratios applying to the part of the outstanding guarantees of the Credit Guarantee Fund of Small and Very Small Enterprises that is secured by the European Investment Fund are set at 20% of the respective general minimum provisioning ratios.

25 February 2005

– The National Bank of Greece is authorised to establish and operate 15 new branches in Serbia-Montenegro.

– Alpha Bank is authorised to establish and operate one new branch in Albania.

11 March 2005

– The operating framework and the assessment criteria concerning credit institutions' internal audit systems are amended and specified, while the powers of the bodies responsible for internal audit are defined.

– Piraeus Bank is authorised to acquire the majority of the share capital of the Sofia-based "Eurobank a.d."

23 March 2005

"Famanet Hellas S.A. Financial Information Services" is authorised to operate as a money transfer intermediary.

1 April 2005

The Bank of Greece supervisory framework for the liquidity adequacy of credit institutions is amended and minimum compulsory ratios are set.

GLOSSARY

Community Support Framework (CSF): compiled by the Commission of the European Communities in co-operation with the EU Member State concerned and approved by the Commission. It includes the country's growth strategy, activity priorities and financing resources (Community funding, national public expenditure, private funding).

Deposit facility: a *standing facility* of the *Eurosystem* which counterparties may use to make overnight deposits, remunerated at a pre-specified interest rate, at a national central bank.

Deposits redeemable at notice: this instrument comprises savings deposits which the depositor may withdraw once he has given notification thereof within a predetermined time period. At some instances, it is possible to withdraw part of the amount deposited at notice or before, subject to penalty. Deposits redeemable at notice of up to three months pertain to M2 (hence to M3). Longer-term deposits redeemable at notice pertain to (non-monetary) longer-term financial liabilities of monetary financial institutions (MFIs).

Deposits with an agreed maturity: deposits with a fixed maturity, which, according to the national practice, are either not convertible into cash before their maturity or are convertible into cash subject to penalty. They include some non-negotiable instruments, such as non-negotiable certificates of (private) deposit. Deposits with an agreed maturity of up to two years pertain to M2 (hence to M3). Longer-term deposits with an agreed maturity pertain to (non-monetary) longer-term financial liabilities of monetary financial institutions (MFIs).

Effective (nominal/real) exchange rates: nominal effective exchange rates are weighted averages of bilateral exchange rates. Real effective exchange rates are nominal effective exchange rates deflated by a weighted average of foreign, relative to domestic, prices or costs. They are, thus, measures of price and cost competitiveness.

EONIA (euro overnight index average): a measure of the interest rate prevailing in the euro interbank overnight market, based on transactions.

EURIBOR (euro interbank offered rate): the rate at which a prime bank is willing to lend funds in euro to another prime bank, computed daily for interbank deposits with different maturities of up to 12 months.

Euro area: the area encompassing those Member States in which the euro has been adopted as the single currency in accordance with the Treaty and in which a single monetary policy is conducted under the responsibility of the *Governing Council* of the ECB. The euro area currently comprises: Austria, Belgium, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

European Central Bank (ECB): the ECB lies at the centre of the *European System of Central Banks* (ESCB) and the *Eurosystem* and has legal personality under Community law. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the national central banks, pursuant to the Statute of the ESCB and of the ECB. The ECB is governed by the *Governing Council* and the *Executive Board*, and, as a third decision-making body, by the *General Council*.

European System of Central Banks (ESCB): composed of the ECB and the national central banks of all 25 EU Member States, i.e. it includes, in addition to the members of the *Eurosystem*, the national central banks of those Member States that have not yet adopted the euro. The ESCB is governed by the *Governing Council* and the *Executive Board*, and, as a third decision-making body, by the *General Council*.

Eurosystem: comprises the ECB and the national central banks of those Member States that have adopted the euro. There are currently 12 national central banks in the Eurosystem. The Eurosystem is governed by the *Governing Council* and the *Executive Board* of the ECB.

Executive Board: one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and four other members appointed by common accord by the Heads of State or Government of the countries that have adopted the euro.

General Council: one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and the governors of the 25 EU national central banks.

General government: as defined in the European System of Accounts 1995 (ESA 95), comprises central, state and local government and social security funds.

Governing Council: one of the decision-making bodies of the ECB. It comprises all the members of the *Executive Board* and the governors of the national central banks of the countries that have adopted the euro.

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices which is compiled by Eurostat and harmonised for all EU countries.

Key ECB interest rates: the interest rates, set by the *ECB*, which reflect the monetary policy stance of the ECB. Currently, key ECB interest rates are the minimum bid rate on the *main refinancing operations*, the interest rate on the *marginal lending facility* and the interest rate on the *deposit facility*.

Main refinancing operation: a weekly open market operation conducted by the *Eurosystem*. The operations are conducted as variable rate tenders with a pre-announced minimum bid rate and have a matu-rity of one week.

Marginal lending facility: a *standing facility* of the *Eurosystem,* which counterparties may use to receive overnight credit from a national central bank at a pre-specified interest rate against eligible assets.

Monetary aggregates: a monetary aggregate is the sum total of currency in circulation plus the overdue amounts of certain liabilities of MFIs and central governments which have a high degree of "moneyness" (or liquidity in a broad sense). The narrow monetary aggregate M1, as defined by the *Eurosystem*, comprises currency in circulation plus *overnight deposits* which non-MFI *euro area* residents (other than central government) keep with *euro area* institutions that issue money. The monetary aggregate M2 comprises M1 plus *deposits with an agreed maturity* of up to two years plus *deposits redeemable at* a period of *notice* of up to three months. The broad monetary aggregate M3 comprises M2 and repurchase agreements (repos), money market fund shares/units, money market paper and debt securities with a maturity of up to two years.

MFI net external assets: the external assets of the euro area *MFI* sector (such as gold, foreign currency banknotes and coins, securities issued by non-euro area residents and loans granted to non-euro area residents) minus the external liabilities of the euro area MFI sector (such as non-euro area residents' deposits and repurchase agreements, as well as their holdings of money market fund shares/units and debt securities issued by *MFIs* with a maturity of up to and including two years).

Monetary Financial Institutions (MFIs): financial institutions forming the money-issuing sector of the euro area. They include the ECB, the NCBs of the euro area countries, and credit institutions and money market funds located in the euro area.

Overnight deposits: deposits due on the next working day. This instrument comprises both fully transferable (through cheques etc.) and non-transferable deposits convertible into cash upon request or until the end of the next working day. Particularly for Greece, this instrument includes sight deposits, deposits in current accounts and savings deposits.

Standing facility: a national central bank facility available to counterparties on their own initiative. The *Eurosystem* offers two overnight standing facilities: the *marginal lending facility* and the *deposit facility*.

Supervisory own funds: the ones defined in Bank of Greece Governor's Act 2053/8 March 1992, incorporating Directive 89/299 (EEC) into Greek law. This Directive was later repealed and its content was incorporated into Directive 2000/12 (EC).

TARGET System (Trans-European Automated Real-time Gross settlement Express Transfer system): a decentralised system consisting of 15 national RTGS (Real-Time Gross Settlement) systems (one in each of the 15 EU Member States) and the ECB payment mechanism. These are interconnected by common procedures (Interlinking Mechanism) to allow cross-border fund transfers throughout the EU at real time.

ANNUAL ACCOUNTS
OF THE BANK OF GREECE

BALANCE SHEET AS AT

(in euro)

ASSETS	2004	2003
1. Gold and gold receivables	**1,430,796,271**	**1,466,081,069**
2. Claims on non-euro area residents denominated in foreign currency	**902,461,999**	**3,441,044,109**
2.1 Receivables from the IMF	334,351,329	421,272,697
2.2 Balances with banks and security investments, external loans and other external assets	568,110,670	3,019,771,412
3. Claims on euro area residents denominated in foreign currency	**1,382,733,073**	**2,441,720,904**
3.1 General government	1,224,358,075	1,313,176,558
3.2 Other claims	158,374,998	1,128,544,346
4. Claims on non-euro area residents denominated in euro	**1,196,029,735**	**520,803,599**
4.1 Balances with banks, security investments and loans	1,196,029,735	520,803,599
4.2 Claims arising from the credit facility under ERM II	0	0
5. Lending to euro area credit institutions related to monetary policy operations denominated in euro	**201,368,044**	**4,342,500,000**
5.1 Main refinancing operations	48,000,000	4,342,500,000
5.2 Longer-term refinancing operations	153,368,044	0
6. Other claims on euro area credit institutions denominated in euro	**767,244,745**	**98,885,665**
7. Securities of euro area residents denominated in euro	**6,443,828,060**	**3,460,870,091**
8. General government debt denominated in euro	**9,254,374,380**	**9,848,680,442**
8.1 Long-term debt	1,668,806,532	1,853,871,728
8.2 Loans for participation in the IMF	726,634,375	774,878,742
8.3 Long-term loans and securities in euro	6,858,933,473	7,219,929,972
9. Intra-Eurosystem claims	**1,449,244,341**	**1,425,018,195**
9.1 Participating interest in the ECB	393,403,998	388,614,874
9.2 Claims equivalent to the transfer of foreign reserves to the ECB	1,055,840,343	1,028,200,000
9.3 Claims related to promissory notes backing the issuance of ECB debt certificates	0	0
9.4 Net claims related to the allocation of euro banknotes within the Eurosystem	0	0
9.5 Net claims related to the TARGET account	0	0
9.6 Other claims within the Eurosystem (net)	0	8,203,321
10. Items in course of settlement	**389,343**	**5,461,849**
11. Other assets	**6,618,040,175**	**5,758,944,185**
11.1 Coins of euro area	33,287,864	36,198,747
11.2 Tangible and intangible fixed assets	758,842,518	264,620,992
11.3 Other financial assets	4,864,714,102	4,571,873,748
11.4 Accruals and prepaid expenses	577,929,305	535,044,528
11.5 Sundry	383,266,386	351,206,170
TOTAL ASSETS	**29,646,510,166**	**32,810,010,108**

OFF-BALANCE-SHEET ITEMS	2004	2003
1. Investment in Greek government securities on behalf of public entities (legal persons in public law, social security funds in public and private law)	15,218,519,470	12,388,376,153
2. Investment in Greek government securities and other debt securities on behalf of public entities, social security funds and private agents	8,723,342,399	7,824,960,029
3. Other off-balance-sheet items	2,606,875,223	6,830,752,773
TOTAL OFF-BALANCE-SHEET ITEMS	**26,548,737,092**	**27,044,088,955**

NOTES:

1. Under Article 54A of the Bank's Statute, the balance sheet was drawn up in compliance with the rules and accounting practices determined by the European Central Bank (ECB) and applying to the members of the European System of Central Banks (ESCB).
2. Claims/liabilities denominated in euro or foreign currencies are broken down into claims on/liabilities to euro area residents and non-euro area residents.
3. Account balances related to monetary policy operations are shown under separate items.
4. The value of gold has been calculated on the basis of the euro price of the gold ounce (€321.562), according to the ECB's foreign exchange rate list of 31 December 2004.
5. Claims and liabilites in foreign currencies have been converted into euro on the basis of the exchange rates published in the ECB's foreign exchange rate list of 31 December 2004.

31 DECEMBER 2004

LIABILITIES	2004	2003
1. Banknotes in circulation	**12,238,189,655**	**10,079,150,900**
2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**5,234,280,080**	**2,403,901,409**
2.1 Current accounts (covering the minimum reserve system)	5,233,450,080	2,399,726,409
2.2 Deposit facility	830,000	4,175,000
3. Other liabilities to euro area credit institutions denominated in euro	**0**	**198,000**
4. Liabilities to other euro area residents denominated in euro	**1,211,444,873**	**367,598,758**
4.1 General government	1,196,313,972	351,027,564
4.2 Other liabilities	15,130,901	16,571,194
5. Liabilities to non-euro area residents denominated in euro	**648,506,465**	**604,726,683**
6. Liabilities to euro area residents denominated in foreign currency	**127,832,903**	**207,530,978**
7. Liabilities to non-euro area residents denominated in foreign currency	**536,364,014**	**551,060,434**
7.1 Deposits and other liabilities	536,364,014	551,060,434
7.2 Liabilities arising from the credit facility under ERM II	0	0
8. Counterpart of special drawing rights allocated by the IMF	**117,993,482**	**121,971,446**
9. Intra-Eurosystem liabilities	**6,966,258,551**	**16,069,321,621**
9.1 Liabilities related to promissory notes backing the issuance of ECB debt certificates	0	0
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	416,930,960	716,252,165
9.3 Net liabilities related to the TARGET account	6,545,889,704	15,353,069,456
9.4 Other intra-Eurosystem liabilities (net)	3,437,887	0
10. Items in course of settlement	**20,769,508**	**30,810,822**
11. Other liabilities	**973,095,264**	**1,126,362,505**
11.1 Accruals and income collected in advance	133,340,775	191,115,949
11.2 Sundry	839,754,489	935,246,556
12. Provisions	**821,921,817**	**181,436,025**
13. Revaluation accounts	**123,871,662**	**374,327,194**
14. Capital and reserves	**625,981,892**	**691,613,333**
14.1 Capital	66,746,019	66,746,019
14.2 Ordinary reserve	66,746,019	66,746,019
14.3 Special reserve from the revaluation of real estate under Law 3229/2004	492,267,534	0
14.4 Special reserves	222,320	558,121,295
TOTAL LIABILITIES	**29,646,510,166**	**32,810,010,108**

6. The value of securities has been calculated on the basis of their prices as at 31 December 2004, except for the securities included in asset item 11.3 “Other financial assets”, which have been valuated at acquisition cost. The Greek government debt securities and part of the debt securities of euro area countries, which are fixed investment to be held until their maturity date, have been transferred from asset item 7 “Securities of euro area residents denominated in euro” to the above item 11.3. To ensure comparability, the corresponding items of financial year 2003 have been reclassified accordingly.
7. In financial year 2004, the undepreciated value of the Bank’s real estate was adjusted, under Article 15 of Law 3229/2004, at its fair (market) value, as determined by independent appraisers. The resulting surplus value of €492,267,534 was transferred to the “Special reserve from the revaluation of real estate under Law 3229/2004” item. In previous years, real estate was valuated at acquisition cost, as adjusted under Law 2065/92.
8. The subscription key of the Bank of Greece to the ECB’s capital —following the two adjustments in 2004— was set at 1.8974%, from 2.0564% in 2003 and the weighted subscription key of the Bank of Greece to the ECB’s capital fully paid by the 12 National Central Banks of the Eurosystem was set at 2.65405%, from 2.53894% in 2003.

PROFIT AND LOSS ACCOUNT

(in euro)

DEBIT	2004	2003
STAFF COSTS	**238,376,244**	**226,542,368**
Wages and salaries	126,350,375	121,887,566
Employer's contributions and other levies		
To the Health Insurance Fund	12,246,167	11,208,669
To the Pension Fund	29,739,637	29,596,749
To the Supplementary Pension Fund	12,186,812	12,186,041
Contributions to other insurance funds and other charges	11,290,889	9,143,215
Pensions and benefits	46,562,364	42,520,128
ADMINISTRATIVE AND OTHER EXPENSES	**37,552,145**	**43,131,840**
DEPRECIATION OF TANGIBLE AND INTANGIBLE FIXED ASSETS	**34,613,846**	**19,700,525**
OPERATING PROVISIONS	**82,476,430**	**21,716,267**
Provision under Article 71 of the Statute	11,152,473	11,487,360
Provision for the Bank's future liabilities to the Personnel's		
Social Security Funds	35,000,000	10,000,000
Provision, against monetary income, for the Bank's participation		
in the coverage of the ECB's loss for financial year 2004	36,095,050	0
Sundry provisions	228,907	228,907
	393,018,665	**311,091,000**
NET PROFIT	**205,605,304**	**218,259,837**
	598,623,969	**529,350,837**

FOR THE YEAR 2004

SEVENTY-SEVENTH YEAR

CREDIT	2004	2003
NET INTEREST INCOME	325,922,104	270,809,782
NET RESULT OF FINANCIAL OPERATIONS	3,873,348	27,898,860
NET INCOME FROM FEES AND COMMISSIONS	141,630,119	117,786,711
INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS	2,459,420	2,689,516
NET RESULT OF THE POOLING OF MONETARY INCOME	10,795,758	21,729,366
OTHER INCOME	113,943,220	88,436,602
	598,623,969	529,350,837

DISTRIBUTION OF NET PROFIT

(Article 71 of the Statute)

(in euro)

	2004	2003
Dividend on capital, €0.67 per share on 11,918,932 shares	7,985,684	7,985,684
Additional dividend, €2.18 per share on 11,918,932 shares*	25,983,272	21,811,646
Tax payment (Law 3296/2004, Article 6)	18,290,976	16,044,716
To the Government	153,345,372	172,417,791
	205,605,304	**218,259,837**

* The dividend on capital and the additional dividend for the year 2003 were €0.67 and €1.83 per share, respectively (in total €2.50)

Athens, 18 March 2005

THE GOVERNOR

NICHOLAS C. GARGANAS

THE DIRECTOR OF THE ACCOUNTS DEPARTMENT

DIMITRIOS E. MATSIMANIS

AUDITORS REPORT

FOR THE YEAR 2004

TO THE GENERAL MEETING OF SHAREHOLDERS

OF THE

BANK OF GREECE

We have audited the attached financial statements of "BANK OF GREECE S.A." for the year ended 31 December 2004. The management of BANK OF GREECE S.A. is responsible for the preparation of the above financial statements. Our responsibility is to express an opinion upon these financial statements, based on our audit.

We conducted our audit in accordance with the audit procedures we considered appropriate on the basis of the auditing principles and rules promulgated by the Greek Institute of Certified Auditors – Accountants. These auditing principles require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit, also, includes assessing the accounting principles used and significant estimations made by the Bank's management as well as evaluating the overall Financial Statement Presentation. We believe that our audit provides a reasonable basis for our opinion.

Based on our audit we noted that in the year ended 31 December 2004 the Bank increased the provision for future liabilities to Employee Funds by €593 million, out of which €35 million were charged to the Income Statement and €558 million were transferred from transition reserves. Consequently, the recorded provision amounts to €660 million, but we cannot assess its adequacy.

In our opinion, except for the above finding, the attached Financial Statements give a true and fair view of the financial position of BANK OF GREECE S.A. as at 31 December 2004, and the results for the year then ended, on the basis of the accounting principles determined by the European Central Bank as they have been adopted by the Bank in Article 54A of its Statute and Codified Law 2190/1920, and are consistent with those applied by the Bank in the preceding year, apart from note 7 made by the Bank.

Athens, 18 March 2005

The Auditors

ERNST & YOUNG S.A.		SOL S.A.
N. Moustakis	D. Xenaki	C. Stathakis
(ICPA Reg. No. 13971)	(ICPA Reg. No. 14161)	(ICPA Reg. No. 12251)

ERNST & YOUNG