BANK OF GREECE

EUROSYSTEM

SUMMARY
OF THE ANNUAL REPORT
2006

Presented to the General Meeting of Shareholders
by Governor Nicholas C. Garganas

APRIL 2007

BANK OF GREECE

Address
21, E. Venizelos Avenue
GR-102 50 Athens

Website
http://www.bankofgreece.gr

Telephone
+30 210 320.2392

Fax
+30 210 323.3025

*This is the English translation
of the Annual Report for 2006,
originally published in Greek.*

ISSN 1105 - 0527

GENERAL COUNCIL

Nicholas C. Garganas	***Chairman – Governor***	
Panayiotis A. Thomopoulos	***Deputy Governor***	
Nicholas D. Paleocrassas	***Deputy Governor***	
Georgios Akkas	*Member*	
Ioannis Gozadinos	»	*expiry of term of office* 2007*
Georgios Dimopoulos	»	
Georgios Kassimatis	»	*expiry of term of office* 2007*
Odysseas Kyriakopoulos	»	
Ioannis Papadakis**	»	
Georgios Oikonomou	»	
Christos Polyzogopoulos	»	
Michail Handris	»	
Eleftherios Foukas	*Government Commissioner*	

* The term of office of Mr. Ioannis Gozadinos and Mr. Georgios Kassimatis, who where appointed members of the General Council at the Annual General Meeting of 29 April 2004, according to article 21 of the Bank's Statute, expired at the Annual General Meeting of 2007.

** The term of office of Mr. Antonis Mantzavinos, who was appointed member of the Monetary Policy Council by a Presidential Decree dated 20 March 2001 (Government Gazette – Legal Persons in Public Law – No. 62/26 March 2001) for a six-year term, according to article 35A of the Bank's Statute, expired on 26 March 2007. He was replaced, according to the above article, for a six-year term by Mr. Ioannis Papadakis (Presidential Decree 30 March 2007, Government Gazette 148/5 April 2007).

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NICHOLAS C. GARGANAS

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I FINANCIAL RESULTS FOR 2006

The Bank's Profit and Loss Account for 2006 shows total net revenue of €830.9 million and total operating expenses including depreciation and provisions of €586.2 million. Net profit thus reached €244.6 million, compared with 228.5 million in 2005.

In accordance with Article 71 of the Bank's Statute regarding the appropriation of profit, the General Council, following its decision of 19 March 2007, proposes to the Meeting of Shareholders that €10.6 million, corresponding to 12% of the Bank's capital, be distributed as first dividend and that an amount of €35.5 million be distributed as additional dividend. This brings the total dividend proposed for distribution to €46.1 million, up from €38.1 million in 2005. The total dividend per share thus comes to €2.90, i.e. 20.8% more than in 2005. From the balance of net profits —after the allocation of €19.0 million to an extraordinary reserve and the deduction of income tax on distributed profits— an amount of €160.7 million shall be paid to the Government in accordance with Article 71 of the Bank's Statute, compared with €150.1 million in 2005.

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), registered an increase of €220.1 million or 36.0% relative to 2005, rising, as mentioned above, to €830.9 million.

Net interest income from claims on the Greek State and domestic or foreign credit institutions decreased by €6.3 million or 2.0%, relative to 2005. This is mainly attributed to the increase, over the previous year, in interest paid both on the balance of the Bank's liabilities arising from transactions with the ESCB, and on the required reserves held by credit institutions with the Bank of Greece. The combination of these two items more than offset the increase in interest receipts from transactions between the Bank of Greece and the Greek State and from claims on domestic or foreign credit institutions.

More specifically, net interest income from transactions with the Greek State increased by €10.6 million, after decreasing by €7.9 million in 2005. This increase stemmed from a €19.1 million increase in interest income from long-term loans extended by the Bank of Greece to the Greek State, owing to the substantial rise in euro area interest rates, but was partly offset by the €4.6 million decline in interest income from the Bank's holdings of government securities and by the €3.9 million increase in interest paid by the Bank of Greece to the Greek State (as a result of the significant rise in the interest rate).

The Bank's interest income from lending to credit institutions increased by €79.2 million, compared with an increase of €21.2 million in 2005. This increase is mainly attributed to the comparatively larger supply of liquidity in 2006 to credit institutions, chiefly through main refinancing operations, and to the rise in the remuneration rate. However, the interest paid by the Bank on credit institutions' required reserves also grew (by €35.9 million), mainly on account of the higher interest rate on the Eurosystem's main refinancing operations, but also because of the higher, relative to 2005, average reserve holdings with the Bank of Greece.

Interest paid on liabilities arising from intra-ESCB transactions also rose in 2006, increasing by €81.4 million to €333.5 million, from €252.1 million in 2005, as a result of the substantial rise in the remuneration rate (the minimum bid rate on main refinancing operations) on the Bank's net liabilities to the ESCB.

The Bank's financial operations in 2006 once again resulted in a net credit balance, which was substantially higher (+€228.7 million) than in 2005, rising to €362.2 million from €133.5 million. This performance stemmed almost exclusively from the €204.4 million in profits made on swap transactions, considering that net profits from transactions in foreign currency and securities remained almost unchanged relative to 2005.

Commission fees, income from participations and other income decreased by €2.3 million, on account of lower commissions, mainly on transactions with the State.

The Bank's total operating expenses — excluding provisions— increased by €35.5 million relative to 2005 and reached €358.6 million in 2006. More specifically, personnel outlays, excluding employer contributions, grew by €7.8 million or 5.9% relative to 2005. This increase was due to the pay rises given in compliance with the new sectoral and enterprise-level wage agreements, to the grade and pay advancement of the personnel and to higher compensation payments for the comparatively larger number of staff retirements. Administrative and other management expenses increased by €11.1 million in 2006 (+€2.0 million in 2005), owing mainly to the production costs for Greece's new passports (and which are counterbalanced by a corresponding rise in the Bank's income), to higher printing costs entailed by increased banknote production in 2006, relative to 2005, and to higher fees for outsourced monthly surveys and services. Depreciation increased by €4.6 million, after decreasing by €0.8 million in 2005, owing to the increased depreciation of euro banknote printing costs in previous years.

Finally, provisions for bad loans increased significantly in 2006, relative to 2005, thus affecting 2006 net profits. More specifically, provisions for asset valuation loss were raised to €23.2 million, from €14.2 million in 2005, while provisions for future obligations to personnel insurance funds were increased to €204.4 million, from €45.0 million in 2005.

In the course of 2006, the Bank of Greece recruited 81 employees (14 with post-graduate degrees in economics and finance, 45 for its security needs and 21 for its technical departments). Meanwhile, 217 employees retired. The Bank's staff therefore decreased further by 136 members to 2,766 at the end of 2006.

The year 2006 saw the Bank of Greece adopt further measures to improve its internal organisation and administration, involving the restructuring of certain units and the streamlining of operations, thus enabling the Bank to meet its increased responsibilities as a national central bank and a member of the Eurosystem.

The Bank's Statistics, Technical Services and Cash Departments all underwent significant restructuring, as warranted by present-day requirements.

Furthermore, in March 2007, in line with a broader restructuring plan designed to adapt the Bank's unit network to present-day conditions, the General Council, pursuant to a relevant agreement between the Administration and the Employees' Union, approved the following changes, which are to take place over the next five years:

(a) Ten of the Bank's branches will gradually cease operating, according to the following calendar:

- the Argostoli and Drama branches in 2007,
- the Piraeus, Agrinion and Xanthi branches in 2008,
- the Sparta and Florina branches in 2009,
- the Corfu and Rethymnon branches in 2010, and
- the Pyrgos branch in 2011.

Nine of the ten branches mentioned above (with the exception of the Piraeus branch, whose operations will be transferred to the Head Office in Athens) will be replaced by smaller units (counters), which will mainly handle transactions with the State and public organisations.

(b) Twenty-six of the Bank's total 67 agencies, at present located within the Internal Revenue Offices run by the Economy and Finance Ministry, will cease operating, as specified in a recent agreement between the Bank of Greece and the Ministry of Economy and Finance. In addition, all Bank of Greece tellers, previously dispatched to the Internal Revenue and Customs' Offices, will return to the units to which they belong.

(c) Eight sections at the Bank's Head Office will, together with their services, be merged into other sections with similar functions.

This restructuring will affect 351 employees, 50 of whom already qualify for retirement. Between 36 and 45 employees will staff the regional counters, once the relevant branches have ceased operating. The remaining employees will be transferred to other units of the Bank.

With regard to the staff that will be transferred to other units once their present units have been eliminated, measures have already been adopted to guarantee that they do not incur any financial loss and to ensure their smooth adaptation to new working conditions.

The Bank continued its personnel training programmes in 2006. With a view to improving the staff's professional and specialised skills, the Staff Training Section organised a number of highly-attended seminars, with particular emphasis on supervisory issues including market risk, solvency and International Accounting Standards. Special seminars on counterfeit detection were also held – both for its own personnel and for the personnel of other banks and organisations. Finally, in response to a request from the Ministry of Education, a series of lectures were given to inform secondary school pupils about the Bank's mission and its operation within the Eurosystem.

2006 saw the continuation of maintenance, remodelling and extension works on several of the Bank's premises, with a view to increasing the security of transactions and improving workplace functionality and ergonomics. More specifically, the remodeling of the Head Office's first floor, which now accommodates the Strategic Planning and Organisation Department, in addition to the Payment Systems Department, was completed, while the renovation of the Thessaloniki branch is in progress. The Head Office was equipped with fire escapes, so as to comply with the provisions in effect with regard to fire protection. In the field of information technology, the Bank's internal network was gradually renewed with the upgrading of the active equipment in the Bank's four main buildings, while the development and installation of a new software programme will enable the Bank to join the Interbank Electronic Cheque Clearing System.

In an effort to promote communication and cooperation between the Eurosystem and non-euro area Mediterranean central banks, the Bank of Greece, together with the European Central Bank, hosted the Third Euro-Mediterranean seminar in Nafplion in January 2006. Key speakers at the event were governors of Mediterranean central banks, and members of the Executive Board of the European Central Bank, who focused on recent economic and financial developments, capital account liberalisation and the reform of monetary policy instruments in Mediterranean countries.

Also, as part of the series of lectures established in honour and in memory of the former Bank of Greece governor Professor Xenophon Zolotas, Professor Alexandre Lamfalussy, former President of the International Monetary Institute, delivered a lecture at the Bank of Greece in September 2006 on the subject of "Monetary Policy and Systemic Risk Prevention – Challenges ahead for Central Banks"

The Bank of Greece, as a member of the Eurosystem, once again played an active part, with increasing effectiveness and experience, in implementing the single monetary policy, conducted by the ECB. At the same time, notable was the Bank's contribution in the sphere of its non-Eurosystem related tasks, i.e. as the authority responsible for the supervision of credit institutions and other enterprises of the financial sector, and being in charge of payment system supervision and management. The Bank also contributed decisively to the drafting of legislation for the transposition into national law of the Community Directives emanating from the Basle Agreement ("Basle II") on the revision of methods used to calculate credit institutions' capital adequacy. It goes without saying that the Bank could not have fulfilled these tasks so successfully without the zeal and dedication of its highly knowledgeable and skilled staff. I would therefore invite the General Meeting to join me in expressing our commendation to the entire staff.

In accordance with Article 35A of the Bank's Statute, the term of office of Monetary Policy Council member Mr. Antonios Mantzavinos came to an end on 26 March 2007 (after having been renewed on 26 March 2001), and Mr. Ioannis Papadakis was appointed in his place for a six-year term. Mr. Papadakis, Associate Professor of Economic Sciences at the University of Athens, is a distinguished academic and consulting economist, with profound knowledge and expertise in a vast array of monetary and central banking issues.

I wish to seize this opportunity to thank the departing Antonios Mantzavinos for his exceptional teamwork and invaluable contribution to the success of the Monetary Policy Council and the Bank of Greece in general, which he served, in his capacity as General Council member, with exemplary dedication.

At today's Annual General Meeting and in accordance with Article 21 of the Bank's Statute, the term of office of General Council members Georgios Kasimatis and Ioannis Gozadinos expires. The General Meeting will therefore be called upon to elect two new General Council members for a three-year term, i.e. until the Annual General Meeting of 2010.

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

II THE GREEK ECONOMY: DEVELOPMENTS, PROSPECTS AND POLICIES FOR ENHANCING POTENTIAL GROWTH

1 INTRODUCTION

The Greek economy in 2006 continued to grow at a high rate, reaching 4.3%. Gross domestic product is expected to continue to grow at a rate only slightly lower in the current year. This is the 14th successive year in which GDP has increased substantially, i.e. the longest period of continuous economic growth since the '50s and '60s. In the last ten years in particular, during which the average annual GDP growth rate has stood at 4.1% and that of *per capita* GDP at 3.7%, Greece's growth performance has been among the best in the euro area. This has resulted in substantial progress towards the convergence of living standards in Greece with the average level enjoyed in the more developed economies of the European Union.

The increase in domestic demand and in production capacity as a result of investment and structural reforms was the primary contributor to the high GDP growth rates in the 1997-2006 decade. Deregulation of the financial system in the 1990s and, thereafter, Greece's membership of the euro area led to a steep fall in borrowing costs, high credit expansion and, eventually, a rise in investment and consumption. At the same time, investment —primarily public, but also private investment— increased substantially in the run-up to the 2004 Olympic Games. In addition, the large inflow of resources from the European Union's Structural Funds boosted domestic demand and improved public infrastructure and total productivity, while certain structural measures have helped product and labour markets to operate more efficiently and enhanced productivity. Finally, over the same period, Greek exports to the new markets of Southeastern Europe expanded.

In addition to continued high growth rates, other significant positive developments were observed in 2006. Employment grew significantly, by 1.9%, while the unemployment rate dropped to 8.9% (from 9.9% in 2005 and 12.1% in 1999). Productivity increased by almost 2.5%, while inflation (based on the Harmonised Index of Consumer Prices) fell slightly to 3.3% (from 3.5% in 2005) despite the sharp rise in international oil prices. A particularly important factor was the improvement in fiscal aggregates, with the general government deficit falling to 2.6% of GDP (from 5.5% in 2005), i.e. below the reference value (3%) set by the Maastricht Treaty, while public debt decreased to 104.6% of GDP (from 107.5% in 2005).

The outlook for the current year is also positive, as the growth rate is forecast to remain high, about 4%, with inflation dipping slightly to around 3%.

However, the Greek economy still faces serious challenges. Over the last six years, inflation in Greece has remained higher than average inflation in the euro area and, more generally, in the country's trading partners. This has eroded incomes and led to a continuing decline in the international price competitiveness of the economy, thereby contributing to a widening of the current account deficit to 12.1% of GDP in 2006, from the already high level of 8.1% of GDP in 2005 and 7.4% of GDP on average in the five years 2001-2005. Improving international competitiveness is, therefore, a priority if account is taken of increasing competition internationally as a result of the current process of globalisation. To achieve this, price stability is a key prerequisite. Given that Greece's membership of the euro area ensures long-term monetary stability and that the single monetary policy is oriented towards ensuring price stability in the euro area as a whole rather than in individual countries, it is essential that appropriate policies be pursued at a national level. These policies include fiscal adjustment, a commitment —by the social partners— to wage rises and pricing policies consistent with price stability, as well as structural reforms which will improve competitive conditions in the markets and contribute to a further strengthening of productivity.

Despite the considerable reduction in the budget deficit and the appreciable decrease in the debt in 2006, public debt remains exceptionally high. It is, therefore, essential that fiscal adjustment be continued in order to achieve a fiscal surplus and a large reduction in public debt, especially when account is taken of the expected long-term increase in public spending on pensions and healthcare as a percentage of GDP owing to population ageing. Of course, prompt reform of the social security and healthcare systems is of crucial importance if the fiscal pressures arising from population ageing are to be tackled in a socially fair fashion that will not have a negative impact on the economy's growth prospects.

The unemployment rate has dropped significantly, but remains high, especially among young people and women. Although the economic growth rate is high, the increase in employment has been relatively moderate in recent years, despite the improvement recorded in 2006. In addition, income inequality and the poverty rate in Greece remain higher than the EU average and have not changed significantly in the last decade. There is strong evidence that these problems are associated with structural weaknesses in the product and labour markets as well as in the education and taxation systems.

As far as medium and long-term prospects are concerned, domestic demand and, especially, consumption, on which the economic growth of the last ten years has largely been based, cannot on their own support high growth rates in the long term. Therefore, structural reforms in a wide range of sectors of the economy must continue in order for future economic growth to be based on business investment and exports to a much greater extent than is the case at present. These reforms will make it possible to increase productivity, boost employment significantly, reduce the unemployment rate, limit income inequalities and offer opportunities to all to participate in a broad-based growth process. Progress with these essential reforms will be possible if social consensus is achieved on the basis of an open dialogue. This will lead to correct and acceptable decisions which will ensure that the cost of the necessary structural changes is divided fairly among social groups and generations. It will also lead to measures to support those social groups which may be adversely affected by such reforms.

2 THE INTERNATIONAL AND THE EUROPEAN ECONOMIC ENVIRONMENT[1]

2.1 OVERVIEW OF INTERNATIONAL DEVELOPMENTS

In 2006, the world economy continued to grow at a high rate, faster than in 2005, despite the historically high prices reached

1 Account has been taken primarily of the estimates of the International Monetary Fund (IMF, *World Economic Outlook,* April 2007) and of the European Commission (*Autumn Forecasts,* November 2006, and *Interim Forecast*, February 2007).

by crude oil and other commodities and the further increase in key rates by central banks in several major economies in order to reduce inflationary pressures. Positive aspects of economic developments last year were the higher than expected increase in GDP in the euro area and the containment of inflation in the advanced economies to lower levels than had been forecast. The outlook for 2007 is favourable, as the growth rate of global GDP should continue to be high, albeit slightly lower than in 2006, while inflation will generally remain at low levels.

The growth rate of world GDP accelerated to 5.4% in 2006, from 4.9% in 2005, remaining for the third consecutive year higher than the average figure for the period 1970-2006 (4.4%). Note that the growth rate of the global economy in 2006 was the best performance in the last 30 years. Despite the rise in short-term lending rates, real long-term rates remained low, while the main stock market indicators rose further. The continued favourable financial conditions, the increase in profitability and the further improvement in the financial condition of businesses were among the most important factors contributing to the maintenance of a favourable international economic environment in 2006.

Global economic expansion was more evenly distributed in geographical terms in 2006 as, in addition to the US, China and the other emerging Asian economies, a significant contribution was also made, for the first time after a number of years, by the euro area, where the GDP growth rate was the highest in the last six years.

In the advanced economies, the GDP growth rate accelerated to 3.1% in 2006, from 2.5% in 2005, chiefly as a result of developments in the euro area. In the emerging and developing economies, which account for around 48% of world output, the GDP growth rate also accelerated (to 7.9% in 2006, from 7.5% in 2005): the emerging economies of Asia continued to report the best performances, particularly China and India, as well as Russia and the other economies of the Commonwealth of Independent States, many of which continue to benefit from high fuel prices.

Despite the further large increase in the prices of oil and other commodities on the world market, inflation remained essentially unchanged. Consumer prices rose in the advanced economies by 2.3% in 2006, i.e. the same as in 2005, while in the other economies they increased by 5.3%, compared with 5.4% in 2005. The main reasons behind the relatively limited impact of the higher prices of oil and other commodities on domestic inflation are: (i) the fact that the higher prices of raw materials are frequently more than offset by the lower prices of intermediate and final products imported from countries with low production costs, chiefly the emerging Asian economies, (ii) the restrained wage rises in recent years and (iii) the fact that inflation expectations remain at low levels, chiefly owing to the consistent and credible pursuit of monetary policies oriented towards combatting inflation both in the advanced economies and in many developing and emerging economies.

The volume of international trade in goods and services at a global level is estimated to have increased by 9.2% in 2006 (2005: 7.4%). This increase is due to strong global demand and the ever greater deregulation of trade and, in general, to the internationalisation of production activities.

International crude oil prices continued to rise for the fifth consecutive year in 2006 to reach historically high levels in July-August, mainly on account of geopolitical tensions in the Middle East. Thereafter, however, prices fell markedly, with the result that the average international price of the main types of oil in US dollar terms showed an average annual increase of 20.5% in 2006, compared with 41.3% in 2005 (the total increase between 2002 and 2006 was 158%). Expressed in euro terms, the average annual price of Brent crude rose by 18.6% in 2006, while the total increase between 2002 and 2006 was 99.6%. In the first months of 2007, the downward trend in international oil prices halted, chiefly owing to the decisions taken by OPEC in November 2006 and February 2007 to cut down production. Since the end of March, oil prices have begun to rise again, implying greater uncertainty regarding future developments. Indeed, while the latest IMF report assumes that the average international US dollar price of the main types of crude oil will fall by 5.5% at average annual levels in 2007, the most recent developments on the forward markets imply that the average annual level will not change markedly in comparison with 2006. In addition, the prices of non-fuel commodities rose (in US dollars) at a higher rate in 2006 than in 2005 (28.4% compared with 10.3%), chiefly as a result of the sharp increase in international demand for metals, particularly on the part of China. For 2007, the IMF forecasts that non-fuel commodity prices (in dollars) will rise by 4.2%.

On the foreign exchange markets, the most important development in 2006 and the first months of 2007 was the further depreciation of the Japanese yen against the main international currencies, particularly the euro (see also Section 2.2 below). This development is linked with speculative borrowing in yen and subsequent purchases of high-yield currencies (the so-called "carry trade"). In addition, the US dollar, in terms of its average annual nominal effective exchange rate, depreciated by 0.8% in 2006 (against the euro it depreciated by 0.9%).

The prospects for 2007 are favourable, as the growth rate of global GDP is forecast to remain high (around 5%), and only slightly lower than in 2006. The economic policy mix pursued in the advanced economies is expected to be slightly restrictive but without any significant impact on economic activity or financial conditions, which are estimated to remain generally favourable. Specifically, the structural fiscal deficit as a percentage of GDP in the advanced economies as a whole is forecast to decrease in 2007 (according to the IMF), while the stance of monetary policy is expected to be neutral or slightly restrictive. Note that the policy challenges facing the major central banks differ, a reflection of differences in the cyclical position of the respective economies and in the intensity of inflationary pressures.[2] Thus, the Federal Reserve has kept its rates unchanged at 5.25% since June 2006, while ECB rates have been in an upward phase since December 2005, reaching 3.75% in March 2007. As for individual economies, the IMF forecasts that the GDP growth rate in the USA will decelerate markedly (to 2.2%, from 3.3% in 2006) and will remain essentially stable in

2 See IMF, *World Economic Outlook,* April 2007, page 27.

Japan (2.3%, compared with 2.2% in 2006). In the euro area, according to ECB staff macroeconomic projections, the GDP growth rate will be between 2.1% and 2.9% (compared with 2.7% in 2006). High GDP growth rates, though lower than in 2006, are expected —according to the IMF— in China (10%, compared with 10.7%), India (8.4%, against 9.2%) and Russia (6.4% against 6.7%).

There are, however, certain elements of uncertainty concerning prospects for the world economy associated chiefly with the likelihood of an abrupt correction of international macroeconomic imbalances, the possibility of a further increase in the international price of oil and the likelihood of the adoption of protectionist measures and a slowdown in the growth rate of world trade, particularly following the interruption of the multilateral Doha Round trade negotiations in July 2006.

2.2 ECONOMIC DEVELOPMENTS IN THE EURO AREA[3]

Economic activity in the euro area showed a strong recovery in 2006, with the GDP growth rate reaching 2.7% (compared with 1.4% in 2005), the highest rate since 2000. The increase in employment (by 1.4%) and the decrease in the unemployment rate (to 7.7%) were also notable. A positive characteristic of economic developments in the euro area in 2006 was the upturn in domestic demand, investment in particular, as well as in private consumption, while at the same time there was a faster increase in export volume. The upswing in investment (which was up by almost 5% in 2006, compared with 2.5% in 2005) and particularly the increase in business investment, due to improved profitability, the continued favourable monetary conditions and the improved levels of confidence, is a particularly encouraging element of the current economic situation in the euro area. In addition, private consumption was strengthened chiefly by the rise in employment and household disposable income and by greater consumer confidence as a result of the fall in the unemployment rate.

HICP inflation in the euro area fluctuated strongly in 2006, chiefly reflecting developments in fuel prices. Inflation remained above 2% (between 2.2% and 2.5%) up to and including August, while it fell thereafter (reflecting the reduction in fuel prices in comparison with the high level they had reached in the corresponding months in 2005) and stood at an average annual level of 2.2%, i.e. the same as in 2005. Inflation excluding energy and unprocessed food remained at 1.5% in 2006, as in 2005. In January and February 2007, inflation stood at 1.8% and in March reached 1.9%.

The gradual improvement in labour market conditions in the euro area in recent years continued at a faster pace in 2006. Employment rose by 1.4% and the average annual unemployment rate fell to 7.7% (from 8.6% in 2005). In January this year the unemployment rate fell further to 7.4%. The positive development of labour market conditions is due chiefly to increased economic activity and improved prospects for the euro area economies. It is also a reflection of the

3 At an institutional level, the admission of Slovenia into the euro area on 1 January 2007 should be noted (see Box V.1). This is the first enlargement of the euro area since Greece joined on 1 January 2001.

results of labour market reforms in several Member States in recent years.

Together with the rise in GDP, 2006 saw an acceleration in the growth rate of labour productivity to 1.2%, from 0.6% in 2005.

The fiscal position of the euro area as a whole improved in 2006, as the general government deficit is estimated to have fallen below 2% of GDP (1.6% according to the IMF) from 2.4% in 2005. A similar reduction was noted in the cyclically adjusted deficit. The general government debt also fell, to 69.3% of GDP from 70.5% in 2005. Fiscal developments were generally positive in the countries which are subject to the Excessive Deficit Procedure, with the exception of Italy. More specifically, in France, Germany and Greece, the fiscal deficit is estimated to have fallen below the 3% of GDP limit provided for by the Treaty, while in Portugal the deficit also narrowed, but remained significantly above 3%. According to forecasts by the European Commission, the fiscal deficit in France, Germany and Greece will remain below the 3% limit and will drop slightly below this figure in Italy.

The euro strengthened in 2006 against the major international currencies. Against the US dollar, it appreciated by 11.4% between December 2005 and December 2006, but by just 0.9% at average annual levels. In addition, the constant rise of the euro against the yen in recent years continued in 2006 and in the early months of 2007. The euro appreciated against the yen by 10.1% between December 2005 and December 2006 and by 6.7% at average annual levels. The broader index of the nominal effective exchange rate of the euro, at average annual levels, remained almost unchanged in comparison with 2005 (slight appreciation of 0.3%). The broader index of the real effective exchange rate of the euro based on the CPI showed a slight reduction of 0.3% at average annual levels, but increased by 4% between December 2005 and December 2006. The development of this index implies that the international price competitiveness of the euro area economy declined during the year.

The prospects of maintaining relatively high rates of economic activity in the euro area in 2007 are positive, reflecting the fact that, as early as 2006, the growth has been more broadly based and is now supported chiefly by domestic demand. However, the GDP growth rate is likely to be somewhat lower than in 2006 and closer to the growth rate of potential output. The increase in VAT rates in Germany is expected to slow down the euro area GDP growth rate in the first six months of the year. According to the above mentioned projections by ECB staff (March 2007) the euro area GDP growth rate is expected to be between 2.1% and 2.9% in 2007.

Inflation in the euro area is forecast to stand between 1.5% and 2.1% in 2007, according to ECB staff projections. In the medium term, inflation prospects are subject to risks associated, firstly, with the possibility of a further rise in oil prices and of increases in administratively determined prices and indirect taxes beyond those already announced. Most importantly, however, wage rises in excess of forecasts may pose a significant threat to price stability considering the high growth rates of economic activity in recent quarters. It is, therefore, essential that in wage negotiations and agreements account be taken of price competitiveness, the high unemployment rate in several economies and the development of productivity.

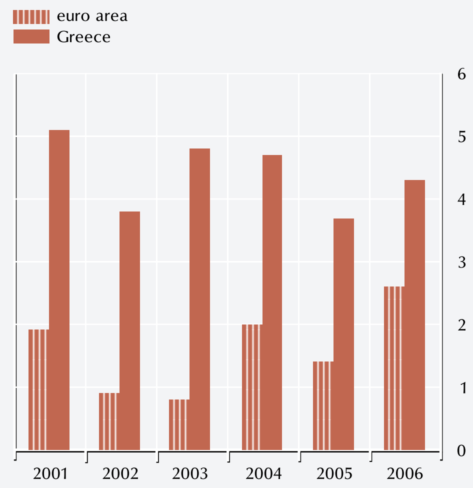
3 MACROECONOMIC DEVELOPMENTS IN GREECE IN 2006

3.1 ECONOMIC ACTIVITY

The growth rate of the Greek economy accelerated in 2006. More specifically, GDP rose by 4.3% (3.7% in 2005), exceeding the initial estimates and forecasts by international organisations, the Ministry of Economy and Finance and the Bank of Greece. Domestic demand was the prime driving factor behind this rise, while the change in the real external balance (on a national accounts basis) made a negative contribution to the GDP growth rate, compared with a positive one in 2005. Despite the increase in key ECB rates and the rise in the real effective[4] exchange rate of the euro, monetary and credit conditions remained favourable for economic activity and permitted further financing of household spending and business investment. A positive role was also played by the favourable international environment, particularly the increase in the volume of world trade, which supported the rise in goods exports. Moreover, structural interventions which have already been made —albeit at a pace which has still not reached the level required for a fast correction of structural weaknesses in the economy— also played a part in boosting production capacity and enabling markets to operate more efficiently, thereby contributing to a high GDP growth rate. Despite the existence of certain weaknesses, these favourable factors, together with an improved environment of macroeconomic stability and the emergence of positive prospects, fully offset the slowdown of economic activity caused by the significant rise in oil prices in the first eight months of 2006, which had a negative impact on business confidence and —to a limited extent— on the purchasing power of household income (although the average annual inflation rate fell in comparison with 2005).

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: Ministry of Economy and Finance, for the euro area: Eurostat.

In 2006, the Greek economy, together with the economies of Ireland, Finland and Luxembourg, was one of the fastest growing economies among the 15 more developed Member States of the European Union (i.e. the EU-15), growing at a rate which exceeded by a significant margin GDP growth rate in the euro area as a whole (see Chart II.1). However, despite the progress achieved in

4 Based on Greece's external trade.

terms of real convergence, *per capita* GDP in Greece (in purchasing power standards) continued to lag behind, and in 2006 it was 21.5% below the EU-15 average.

According to the latest estimates by the Ministry of Economy and Finance on a national accounts basis,[5] private consumption continued to rise at a high rate, which accelerated to 3.9% from 3.4% in 2005 and was the main driving force behind domestic demand. The faster increase in salaried employment and average real disposable income of wage earners contributed to this development, as did the high growth rate of social transfers to economically weaker population groups, which display a high propensity to consume. The annual rate of increase in the outstanding balance of consumer loans, despite falling to 23.9% in December 2006 from 28.7% in December 2005, remained high and fuelled consumption expenditure. Moreover, the market value of households' assets increased: this is evident from the fact that house prices, the most important household asset in Greece, continued to rise, as did the value of shares on the Athens Exchange. An important role in maintaining the relatively high rate of increase in private consumption in recent years (regardless of short-term fluctuations in disposable income) was played by the significant fall in interest rates following Greece's entry into the euro area, together with the deregulation of the financial system, since the easier access of households to consumer credit allows them to take decisions on consumption expenditure without depending solely on current income.

Public consumption grew by 0.6% in 2006 (1.0% in 2005), chiefly owing to increased employment in central government.

Total gross fixed capital formation recovered in 2006 with a growth rate of 12.7%, following a small downturn in 2005 caused chiefly by the drastic reduction in public investment as part of the fiscal adjustment. In 2006, public investment increased by 7.6%, while the growth rate of business investment accelerated significantly (to 8.6% from 1.5% in 2005), although investment by public enterprises decreased. The positive development expected in domestic and international demand for the products (goods and services) of certain sectors of production played a key role in encouraging new business initiatives, while the favourable financial position of businesses, the satisfactory profitability of a number of dynamic sectors of the economy and the easier access to bank credit supported an increase in fixed capital formation by companies. According to data from the Ministry of Economy and Finance, an appreciable number of investment plans, chiefly in manufacturing and tourism, have taken advantage of the provisions of the development law.

Residential investment was one of the most dynamic elements of domestic demand in 2006. Following the marginal decline noted in 2004 and 2005, 2006 saw a drastic upturn, with a 32.3% rate of increase. The substantial growth of residential investment is directly associated with the announcement —in the last months of 2005— of administrative and tax reforms (for the imposition of VAT on new buildings and the adjustment of objective real estate prices. Moreover, housing credit (the annual growth rate of the outstanding balance of housing loans was 25.8%

5 April 2007. The estimates were made on the basis of the old series of national accounts.

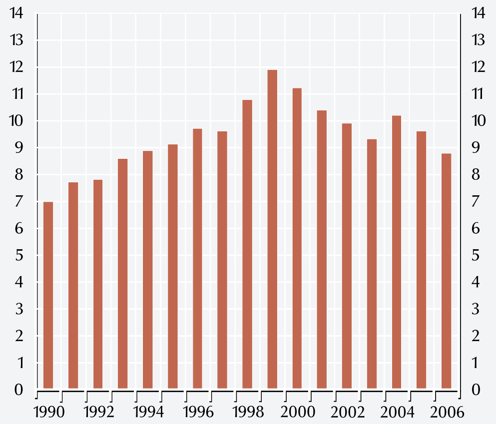
in December 2006, compared with 33.5% in December 2005) and the faster increase in household disposable income supported the increase in residential investment.

The high growth rate of private consumption, together with strong investment activity in the business sector, resulted in a drastic recovery in imports of goods and services, which grew by 9.8%, following the small fall recorded in 2005. This rise exceeded by approximately 4 percentage points the rate of increase in final domestic demand. The rate of increase in exports of goods at constant prices accelerated to 11%, from 8.2% in 2005, overshooting the growth rate of international demand and thereby boosting the market share of Greek exports. This increase would have been still greater —with a beneficial effect on the real external balance and, by extension, on activity— had the accumulated losses of competitiveness in recent years been kept smaller. On a national accounts basis, exports of services recovered slightly in 2006 at constant prices (1.4% compared with –0.1% in 2005), as the growth rate of receipts from merchant shipping and tourism remained slightly higher than the inflation rate. As a result of these developments, the real external balance on a national accounts basis made a negative contribution of 2.0 percentage points on GDP growth in 2006, following the positive contribution (of 1.1 percentage points) it made in 2005.

Services, which have been playing a progressively greater role in domestic production in recent years, supported the rise in GDP in 2006. The financial sector, telecommunications, real estate management and trade recorded a particularly satisfactory performance. By contrast, the gross value added of agriculture (at constant prices) decreased by 8.4%.

Chart II.2 Total unemployment rate

(percentage of the labour force)



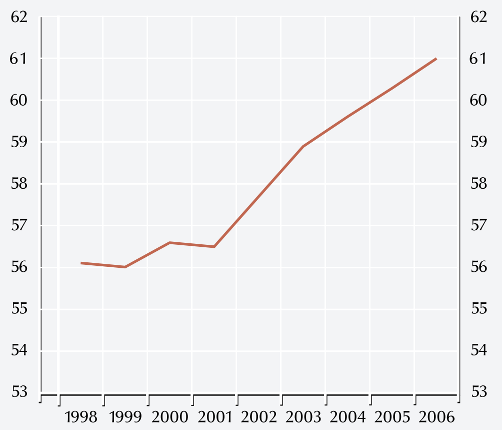
Source: NSSG, second-quarter data for each year.

3.2 EMPLOYMENT – UNEMPLOYMENT

The increase in economic activity in 2006 was accompanied by a significant rise of 1.9% in employment, according to data from the Labour Force Survey (LFS), and by a reduction in the unemployment rate to 8.9%, from 9.9% in 2005 (see Chart II.2).

The increase in employment in 2006 was considerable and much higher than that recorded in the period 2000-2005, when the average annual rate of GDP growth (4.4%) was accompanied by an average annual increase of about 1.3% in employment. The increase in the number of employed people led to a rise in the employment rate to 61% in 2006 for those in the 15-64 age group, from 58.1% on average in the period 2000-2005 (see Chart II.3). This change occurred due to the increase

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 after the adjustment of survey results on the basis of the 2001 National Census.

in employment among those belonging to the 25-64 age group, which was faster than the increase in the population in this age group and higher among women than among men.[6] By contrast, the employment rate for people aged 15-24 dropped, as employment fell faster than the population in this age group.

The increase in employment was due chiefly to the tertiary sector (services) and it should be noted that —according to the LFS— increased employment in public administration played a significant part in this development.[7] By contrast, a drop in employment was recorded in the primary sector, continuing the downward trend observed in recent years, while in the secondary sector (manufacturing, electricity-gas-water supply and construction) as a whole a marginal increase was recorded.

In the non-agricultural sector of the economy, average weekly working hours fell marginally (-0.2%), despite the existence of certain differences among individual branches. The rate of change in labour productivity in the whole economy (calculated either on the basis of GDP per employed person or on the basis of GDP per hour worked) reached 2.3%-2.5%. Certain differences are observed across branches, with a significant increase in productivity in some of them (e.g. retail trade) and a fall in others (e.g. electricity, natural gas and water supply).[8]

As regards types of employment, approximately 18% of "new entrants" in the labour market[9] work on a part-time basis. This development contributed to a rise in the percentage of part-time employees (5.7% of those employed in 2006, from 5.0% in 2005). At the same time, an increase was recorded in the number of employees who combine work with education (either within or outside the official education system).

Data from the NSSG (LFS) and OAED —the Greek Manpower Employment Organisation — indicate that the number of jobless fell sig-

6 In particular, the employment rate for women aged 15-64 rose from 43.6% on average in the period 2000-2005 to 47.4% in 2006, while the employment rate for men increased from 72.7% to 74.6%.
7 The chief contributor to the annual increase in employment in 2006 was the tertiary sector (2.0 percentage points), with only a marginal contribution by the secondary sector (by 0.1 percentage point), while the primary sector made a negative contribution of 0.2 percentage point. At the branch level, contributors to the increase in total employment include public administration (0.7 percentage point), education (0.4 p.p.) and healthcare (0.2 p.p.); services in the business sector (trade, hotels and restaurants, financial intermediaries, transport and communications, other business activities, etc.) contributed 0.7 percentage point.
8 These estimates are supported by data from retail sales volume and production indicators and by data concerning employment derived from the LFS or other special surveys carried out by the NSSG.
9 "New entrants" are those who got a job in 2006, but were either jobless or economically inactive in the previous year.

nificantly in comparison with 2005. According to the definition and data of the LFS, the average number of those out of work in 2006 was 434,000 (unemployment rate: 8.9%), i.e. about 43,000 fewer than in 2005 (unemployment rate: 9.9%). The decline in the average number of jobless in 2006 chiefly reflects the drop in the number of people made redundant during the year.

The picture of the labour market in 2006 on the basis of the LFS data is clearly better than it was in 2005. However, the employment rate (61% in 2006, compared with 65.9% in the EU-15[10]) is still relatively low, while the unemployment rate (8.9% for 2006, compared with 7.8% in the EU-15) is high. The duration of unemployment is also high, as shown by the high percentage of long-term unemployed people (56%, compared with approximately 42% in the EU-15). The situation concerning women and young people (i.e. those aged 15-24) is particularly unfavourable: the employment rate for these groups was 47.4% and 24.2% respectively, against 58.3% and 40.1% in the EU-15. Moreover, the unemployment rate in 2006 for these two groups was 13.6% and 25.2% respectively, against 8.7% and 16.2% in the EU-15.

The short-term outlook for employment was positive in the first quarter of 2007 according to assessments by businesses in all sectors of economic activity. However, given the considerable increase in employment recorded in 2006, there may be a small slowdown in the rate of increase in employment this year.

Long-term prospects for employment depend on expanding the production capacity of the economy and particularly, among other things, on the effectiveness of the measures being taken to improve the business environment, the operation of the labour market and the diffusion of new technologies and to attract foreign investment. A positive element (as far as prospects for the productivity of the economy are concerned) is the fact that young employees are of a higher educational level than those already employed. These educational qualifications, however, must be supplemented by vocational training.[11] On the other hand, the fact that the average age of employees rose from approximately 40 in 2000 to 40.7 in 2006, while the average retirement age *fell* marginally during the same period from 60.9 to 60.8, is a cause for concern.

The rise in employment will, to some degree, reduce the number of people out of work. However, such a reduction is hindered by the facts that (i) a high percentage of those out of work (56%) are long-term unemployed people, whose chances of finding work are gradually diminishing, and (ii) mismatching —to some degree— of the skills demanded by companies and those taught by the education system is observed.[12] To overcome both these obstacles, the government is considering implementing measures to improve the effectiveness of active employment policies regarding the matching of labour supply and demand (e.g. by modernising the existing Employment Promotion Centres so that their services may be used both by the unemployed and by employers) and to tackle

10 The data for the EU-15 concern the nine months January-September 2006.
11 OAED programmes aimed both at employees and the self-employed already exist to satisfy this requirement.
12 This is indicated by, *inter alia*, the data concerning job vacancies in certain sectors and by statements of the Federation of Industries of Northern Greece (SBBE) and the Association of Greek Tourist Enterprises (SETE).

unemployment before its duration exceeds six months. At the same time, care is being taken to boost income for those out of work via the establishment of the Social Solidarity Fund and increases in the unemployment benefit (for the active and passive employment-boosting policies see Chapter III.4).

3.3 INFLATION

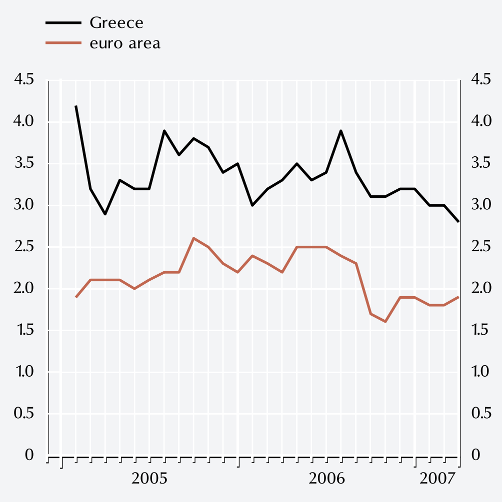
Average annual inflation in Greece based on the Harmonised Index of Consumer Prices (HICP) fell slightly to 3.3% in 2006, from 3.5% in 2005. The average annual level of core inflation, as measured on the basis of the HICP excluding energy and unprocessed food, fell to 2.9%, from 3.2% in 2005. However, core inflation increased to 3.4% in the final quarter of 2006 (from 3.0% in the final quarter of 2005).

The limited fall in inflation in 2006 reflects the fact that the favourable effects of certain factors were to a large degree offset by the adverse impact of others. In particular, inflation was favourably affected by (i) the gradual elimination (from April 2006 onwards) of the effect that the increase in indirect tax rates (since April 2005) had on the annual rate of increase in consumer prices, (ii) the significant deceleration of the average annual rate of increase in crude oil prices and domestic retail fuel prices, (iii) to some extent, fiscal policy, and (iv) the strengthening of competition in the retail trade sector. Inflation would have been higher if rises in public utility rates had fully reflected cost increases (see Table IV.2). Inflation was negatively affected by the large acceleration of the rise in non-fuel commodity prices on the world market and in the prices of imported goods (again with the exception of fuel) as well as the fact that the prices of fresh fruit and vegetables rose in 2006, whereas in 2005 they had fallen. The significantly faster rise in unit labour costs compared with 2005 also had a negative impact; this acceleration is attributable, *inter alia*, to the fact that excess demand in the economy continued to generate inflationary pressures.

Given that HICP inflation and core inflation in the euro area remained unchanged in 2006 (at 2.2% and 1.5% respectively), the differential between inflation in Greece and the corresponding rate in the euro area as a whole narrowed to 1.1 percentage points (from 1.3 percentage points in 2005) and the differential of core inflation was reduced to 1.4 percentage points (from 1.7 percentage points in 2005 – see Charts II.4 and II.5). As in previous years, the differential of the annual increase in unit labour costs between Greece and the euro area (2.4 percentage points) was greater than the inflation rate differential. The inflation differential entails a significant drop in international price competi-

Chart II.4 Harmonised index of consumer prices: Greece and the euro area

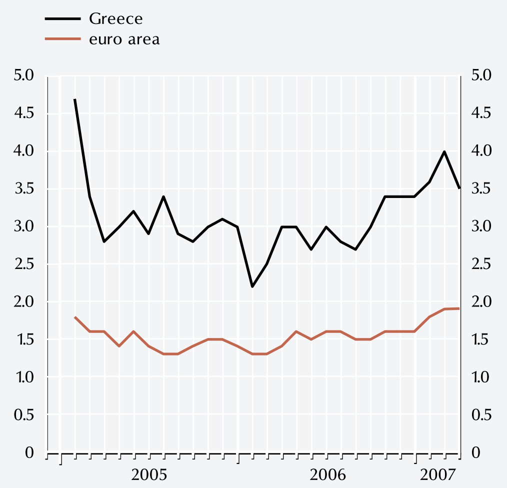
(percentage changes over same month of previous year)



Source: Bank of Greece.

Chart II.5 Harmonised index of consumer prices excluding energy and unprocessed food: Greece and the euro area

(percentage changes over same month of previous year)



Sources: NSSG and ECB.

tiveness, which is partly reflected in the widening current account deficit and the fact that the unemployment rate, despite having fallen, remains relatively high.

To some extent, the positive differential of inflation in Greece vis-á-vis that of the euro area as a whole is due to the convergence of prices and incomes in Greece towards the euro area average. In the main, however, the persistence of core inflation at relatively high levels and its positive differential over inflation in the euro area are due to more permanent macroeconomic factors associated with excess demand, i.e. with the fact that the GDP growth rate continues to exceed the potential growth rate of the economy and the "output gap"[13] is positive, whereas it is negative in the euro area, as well as with the high rates of increase in production costs. The latter rates are partly affected by excess demand and are higher than the corresponding rates in the euro area. The persistence of high inflation rates and the positive differential between the Greek and the euro area inflation rate are also due to unsatisfactory competitive conditions in certain markets, which increases the ability of businesses to influence price levels. In a more general sense, price levels are adversely affected, depending on the case, by developments in production costs, excess demand and price inelasticity of demand (for some products) and by the fact that a number of companies take advantage of their dominant market position and that there is collusion among certain enterprises. In addition, unsatisfactory competitive conditions and elements of rigidity in product and labour markets increase the inflationary impact of possible exogenous shocks.

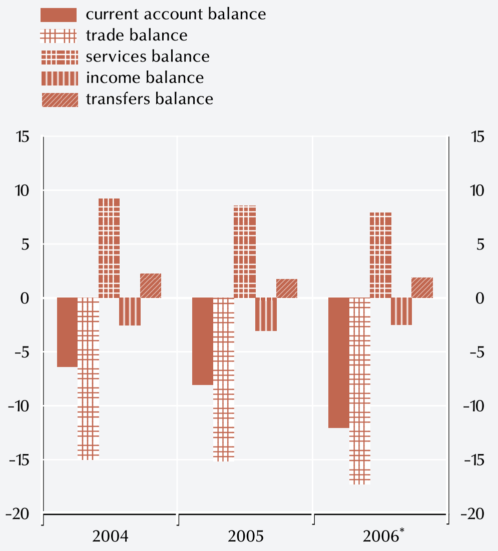
3.4 BALANCE OF PAYMENTS

According to Bank of Greece balance of payments statistics, in 2006 the current account deficit increased considerably to 12.1% of GDP (see Chart II.6), compared with the already high level of 8.1% of GDP in 2005 and 7.4% on average during 2001-2005. (On a national accounts basis, the current account deficit stood at 10.7% of GDP in 2006, compared with 9.2% of GDP in 2005 and 9.5% on average during 2001-2005.) The high current account deficit in recent years reflects the significant shortfall of national savings against domestic investment (for reasons stated below). At the same time, it is due to the low level of structural competitiveness and the continuous decline —owing to inflation differential— in the international price competitiveness of the Greek economy.

13 I.e. the difference between the level of current output (GDP) and the country's production potential (level of potential GDP) as a percentage of the level of potential GDP.

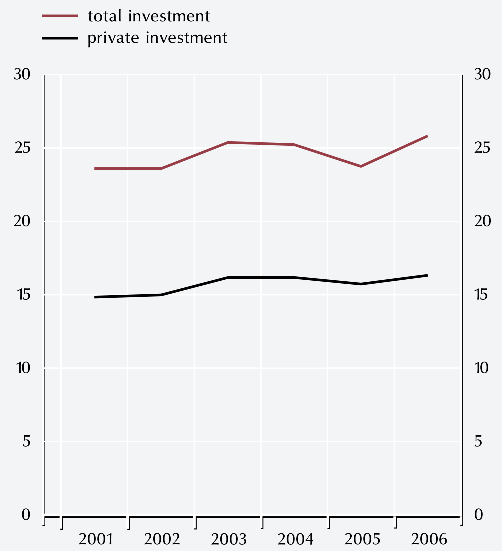
Chart II.6 Current account balance

(percentage of GDP)



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

Chart II.7 Gross fixed capital formation as a percentage of GDP



Source: Ministry of Economy and Finance (old national accounts series at current prices).

It should be noted that the rise in investment (as a percentage of GDP – see Chart II.7) reflects the improvement in the macroeconomic outlook, as well as the more comfortable conditions for financing infrastructure projects; the decrease in savings is related to the sizeable fiscal deficits and the increase in household borrowing. In 2006, gross fixed capital formation rose to 25.7% of GDP, from 23.7% of GDP in 2005, while total savings came to 15.9% of GDP, from 15.1% in 2005.

Moreover, as for Greece's interrnational price competitiveness, it is estimated that the real effective exchange rate (vis-á-vis the 28 major trading partners of Greece) based on consumer prices (i.e. relative consumer prices expressed in a common currency) recorded a cumulative increase of 13% in 2000-2006, while relative unit labour costs in manufacturing, expressed in a common currency, increased cumulatively by 34.7% and relative unit labour costs in the economy as a whole, also in a common currency, increased in total by 15.2% (see Table IX.2). These increases —to which contributed the cumulative increase of 8.4% in the *nominal* effective exchange rate of the euro over the same period— are equivalent to corresponding competitiveness losses.

Of course, the increase in the current account deficit in 2006 is partly due to special factors: by 29.6% to the rise in net payments for the purchase of ships, by 23.6% to the increase in the oil trade deficit and by 15.7% to the rise in net interest payments. However, even excluding net payments for the purchase of ships and oil, the current account deficit increased to 5.9% of GDP in 2006, from 4.5% on average in 2001-2005 and 4.0% in 2005.

Nevertheless, it should be noted that the expenditure for the renewal of the merchant fleet[14] (see Box IX.1) is largely an investment, as it creates a positive medium-term outlook for a rise in net receipts from shipping services and, consequently, a narrowing of the current account deficit and easier servicing of external debt.[15]

Furthermore, the increase in the net oil import bill[16] was significant in 2006, as the price elasticity of oil demand was low (in conjunction with high economic growth rates), but it seems it was only temporary, given that from August onwards world prices fell. In a more general sense, however, it should be taken into account that both gross unit energy consumption and the energy dependence of the economy (as measured by the ratio of net energy imports to energy consumption) remain among the highest in Europe.[17]

Even though thanks to Greece's participation in the euro area there is no problem regarding the financing of the current account deficit and the external debt, the widening of the deficit limits the rate of economic growth. Given that approximately 3/4 of the current account deficit are serviced by external borrowing, the gross external debt of the public and the private sector has increased considerably and exceeded 125% of GDP in 2006. The servicing of this debt absorbs domestic resources, with adverse repercussions on growth, employment and, thus, living standards.

Apart from the aforementioned extraordinary factors, the main underlying cause of the high level of the current account deficit is the persistent trade deficit, which reflects macroeconomic factors in conjunction with structural weaknesses in the economy, although there exist some encouraging indications.

In particular, following the acceleration of external demand growth, receipts from exports (excluding oil and ships) have recorded a considerable increase over the last two years, largely due to the increase in exports of technology-intensive and skilled-labour-intensive manufacturing products. These product categories are the only ones that have increased their share in world markets. Specifically, according to a recent study,[18] technology-intensive products have increased their share in total Greek exports, from 5.8% in 1988 to 22.3% in 2005, with an average annual growth rate of 14.5%. Over the same period, skilled-labour-intensive products have raised their share from 9.3% to 13.8%, with an average annual growth rate of 7.2%. This performance places these two product categories in the second and fourth place, respectively, as regards their contribution to total exports. However, these figures are very low compared with the corresponding euro area averages.[19] In addi-

14 According to the new specifications set out in Community Regulation 417/2002.

15 The fleet under construction numbers 364 ships and corresponds to 11% of the existing Greek-owned fleet, 1/3 of which is registered under the Greek flag. It is worth noting that in the next three years the world fleet is projected to increase at a rate higher than 5%.

16 It is estimated that for every 10 dollars paid for oil product imports, the Greek economy receives 2 dollars from exports of derivatives (see Panhellenic Exporters Association (PSE), "Petroleum: Greece's Trade", *Episimanseis* No. 32, November 2006). This limits —to some extent— the net oil import bill and the adverse effects from increases in oil prices.

17 According to Eurostat, in 2004 gross unit energy consumption in Greece was the highest in the EU-15 (after that of Finland). Moreover, in 2005 the ratio of net energy imports to the corresponding consumption exceeded the EU-15 and EU-25 averages (70.8% against 58.4% and 56.2%), while in 2004 the ratio of net crude oil and oil product imports to the corresponding consumption (104.8%) was the highest in the EU-25.

18 I. Chalikias, *Changes in the composition of Greek exports in the period 1988-2005 (in Greek), PSE-KEEM,* February 2007.

19 See Bank of Greece, *Annual Report 2005,* April 2006, Box IX.2 ("Review of changes in the structure of Greek external trade"), pp. 285-91.

tion, the good export performance of the Greek economy in recent years is largely due to export activity towards the Balkans, the former Soviet Union and the Middle East. In this case, the competitiveness problems usually faced by Greek exports are offset by geographical location (proximity) and/or the fact that Greek exporters are familiar with the conditions prevailing in these markets.

At the same time, however, the strengthening of private consumption, which is associated with the improvement in expectations of households about their future income and with the growth in consumer credit, as well as the ongoing increase in investment (for reasons already stated), entail a rise in expenditure for imports of consumer and investment goods at high rates, even higher than those of export receipts (as in 2006). As a result, and given that imports exceed exports in absolute terms, the trade deficit is constantly widening. This is due, among other things, to the fact that the composition of domestic output —precisely because of the low structural competitiveness of the economy— does not adequately match the composition of domestic consumer and investment demand. Of course, as in the case of net payments for the purchase of ships, that part of the deficit which is due to the increase in imports of capital goods does not cause problems with regard to the sustainability of the external debt, because the rise in investment strengthens productivity and competitiveness and contributes, through output growth, to the servicing of external obligations.

As a general remark, the Greek economy faces a serious "competitiveness deficit"[20] and has not managed to sufficiently take advantage of the opportunities created by globalised markets. The situation is exacerbated by substantial weaknesses with regard to the regulatory framework and market operation; hence, foreign direct investment, which could play a decisive role in boosting the outward orientation of the economy, is discouraged. These weaknesses include[21] provisions which hinder competition and flexibility in labour and product markets, the high costs of doing business, largely due to bureaucratic hindrances to business start-ups (see Box III.1) and relatively high taxation (including social security contributions), as well as inadequate infrastructures, particularly regarding new technologies. Furthermore, due to weaknesses in the education system (including vocational training), there is a significant mismatch of skills on offer and those in demand in the labour market, while working age population falls behind the EU-25 in terms of education and vocational training.[22]

Under these circumstances, it is natural for the economy to rely mainly on services exports and net current transfers in order to finance the trade deficit. Given that in the long run the contribution of current transfers to the financing of the deficit is expected to

20 The same remark is made in a recent study of the International Monetary Fund. See International Monetary Fund, *Greece-Selected Issues,* Chapter I "Greece's Competitiveness Deficit: How big is it and how could it be unwound?", January 2007.

21 See also Bank of Greece, *Monetary Policy – Interim Report 2006*, October 2006, Box IV.1 ("Foreign direct investment"), pp. 128-134, as well as MPC Task Force, "Competitiveness and the Export Performance of the Euro Area", ECB Occasional Paper No. 30, June 2005.

22 Indeed, the percentage of the population at working age (15-64 years old) with a low education level is higher than the EU-25 average, while the percentages with a medium and high education level are lower (see European Commission, *Employment in Europe 2006,* November 2006, Table 10).

decrease,[23] dependence on services exports makes the Greek balance of payments vulnerable to exogenous factors because of which the volatility of the respective inflows is high. For example, although Greek merchant shipping is particularly competitive in the world market, the relative normalisation of conditions in the sea-transport market and the evolution of freights led to a significant slowdown in the growth rate of transport receipts over the last two years. Moreover, the economy has not managed to fully exploit the benefits from the successful organisation of the Olympic Games, due to inefficiencies in tourist infrastructure: in this sense, tourism (travel services) also faces a "competitiveness deficit".

Eliminating the "competitiveness deficit" takes time and requires multi-sided efforts; also, it presupposes that the increase in production costs is contained, the outward orientation of the economy is enhanced through greater exports, and fiscal consolidation and structural reforms are continued in order to improve productivity and competitiveness and attract foreign direct investment.

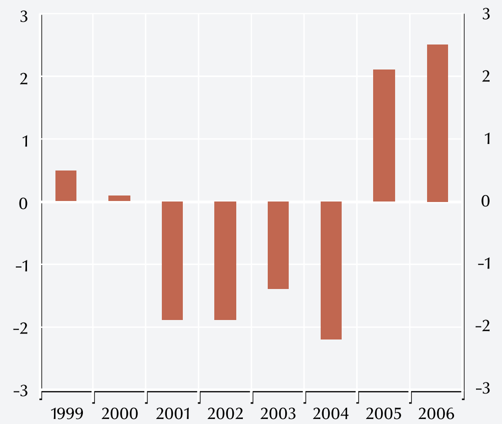
4 FISCAL DEVELOPMENTS AND PROSPECTS

4.1 DEFICIT REDUCTION

In 2006, fiscal policy remained particularly restrictive for the second consecutive year. Specifically, the cyclically adjusted primary balance, changes in which imply the fiscal policy stance, evolved as follows: the deficit of 2.8% of GDP in 2004 narrowed to 0.7% of GDP in 2005 and turned into a cyclically adjusted primary surplus of 1.8% of GDP in 2006 (see Chart II.8). The (non-cyclically-adjusted) primary surplus in 2006 came to 2.0% of GDP, compared with a primary deficit of 0.6% in 2005 (see Chart II.9). It is estimated that in the primary surplus in 2006 the cyclical component, which reflects the beneficial effect of high growth on the budget, corresponds to 0.2% of GDP; this is

Chart II.8 Fiscal policy stance: annual changes in the cyclicaly adjusted primary balance[1]

(percentage of GDP)



1 Positive values indicate a restrictive fiscal policy, negative values an expansionary policy and zero values a neutral policy.
Source: Bank of Greece estimates on the basis of the ECB model.

23 With regard to the short-term and medium-term outlook of EU-transfers, it should be noted that: (i) Total net (current and capital) transfers of EU funds are projected to exceed €5 billion both in 2007 and in 2008, excluding advance payments of the National Strategic Reference Framework (CSF IV) 2007-2013. This amount represents approximately 2.2-2.4% of GDP. (ii) For the fiscal period 2007-2013, Greece has secured EU funding of €24.3 billion from Structural Funds and the Cohesion Fund for the implementation of the NSRF, while it seems that grants in the context of the Common Agricultural Policy will remain unchanged until 2013. (iii) The recent revision of Greek GDP implies increased transfers to the Community Budget as of 2007 (the exact amounts and the way the contributions to the Community Budget —to be increased retroactively— will be paid have not yet been determined), while it will not affect the already agreed upon amounts to be transferred from the EU in 2007-2013. However, the eligibility of all Member States will be reassessed in 2010 on the basis of EU-27 economic data and Greece may lose €1.4 billion (out of a budgeted total of €3.3 billion for the whole seven-year period).

Table II.1 Fiscal deficits[1]

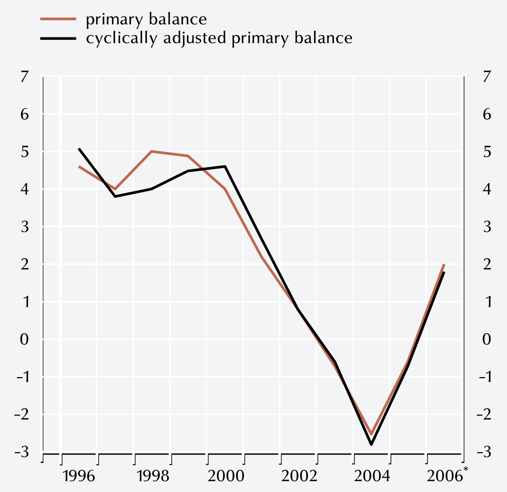
(million euro)

	2004	2005	Budget 2006	Outcome 2006*	Budget 2007	Percentage changes 2005/2004	2006*/2005	Budget 2007/2006*
Central government (administrative basis)								
Revenue[2]	**44,949**	**47,446**	**52,240[7]**	**52,399**	**55,260**	**5.6**	**10.4**	**5.5**
% of GDP	26.7	26.2	26.9	26.8	26.4			
1. Ordinary budget	42,055	44,760	48,750[7]	48,685	51,370	6.4	8.8	5.5
2. Public investment budget	2,894	2,686	3,490	3,714	3,890	–7.2	38.3	4.7
Expenditure[2]	**57,810**	**58,763**	**60,790**	**60,770**	**64,310**	**1.6**	**3.4**	**5.8**
% of GDP	34.3	32.4	31.2	31.1	30.7			
1. Ordinary budget[3]	48,288	51,239	52,390	52,586	55,560	6.1	2.6	5.7
1.1 Interest payments	9,464	9,774	9,600	9,589	9,750	3.3	–1.9	1.7
1.2 Ordinary budget primary expenditure	38,824	41,465	42,790	42,997	45,810	6.8	3.7	6.5
% of GDP	23.1	22.9	22.0	22.0	21.9			–0.6
2. Public investment budget	9,522	7,524	8,400	8,184	8,750	–21.0	8.8	6.9
Net deficit (–)[3]	**–12,861[5]**	**–11,317[6]**	**–8,550[7]**	**–8,371**	**–9,050**			
% of GDP	**–7.6**	**–6.2**	**–4.4**	**–4.3**	**–4.3**			
General government (national accounts basis)								
Deficit[4] (% of GDP)	**–7.9**	**–5.5**	**–2.6**	**–2.6**	**–2.4**			
Primary deficit(–)/surplus(+)[4]								
(% of GDP)	**–2.5**	**–0.6**	**2.0**	**2.0**	**2.0**			

1 It should be noted that by the "fiscal audit" the general government deficit on a national accounts basis was revised, whereas the central government deficit on an administrative basis was not revised.
2 For comparability purposes, tax refunds have been recorded in expenditure and have not been deducted from revenue.
3 Excluding amortisation payments.
4 Deficit and primary deficit as notified to the European Commission in the context of the Excessive Deficit Procedure.
5 Including the subsidisation of OTE's personnel insurance fund (TAP-OTE) with €220 million.
6 Including the subsidisation of TAP-OTE (€330 million) and the repayment of government debt (€349 million) to the Agricultural Bank of Greece.
7 Including extraordinary revenue of €1,100 million from dividends, the sale of concession rights, and the settlement of revenue collected by the National Telecommunications and Post Commission.
* Provisional data.
Source: Ministry of Economy and Finance – State General Accounting Office and NSSG.

Chart II.9 General government primary balance and cyclically adjusted primary balance

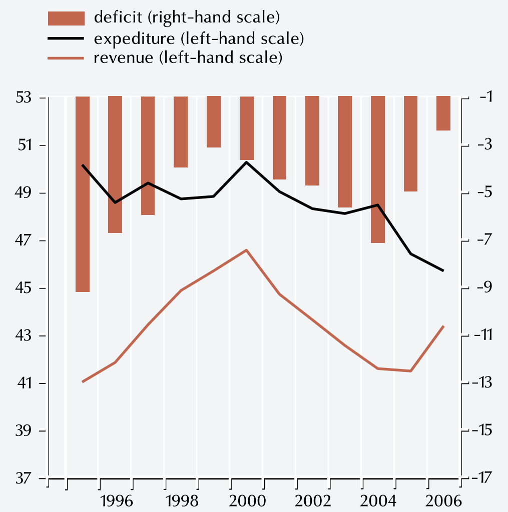
(percentage of GDP)



* Provisional data.
Sources: Primary balance: Ministry of Economy and Finance. Cyclically adjusted primary balance: Bank of Greece estimates on the basis of the ECB model.

Chart II.10 General government revenue, expenditure and deficit[1]

(percentage of GDP)



1 Deficit according to the Excessive Deficit Procedure definition.
Source: Ministry of Economy and Finance, Macroeconomic Analysis and Forecasts Department.

why the cyclically adjusted primary surplus falls to 1.8% of GDP. The continuation of fiscal consolidation was necessary in order to reduce fiscal imbalances and bring the general government deficit below 3% of GDP so that Greece meets its obligations under the ECOFIN Council decision of 17 February 2005 with regard to excessive deficit. As a result of these efforts, the objective to lower the deficit to 2.6% of GDP, from 5.5% of GDP in 2005, was achieved. Following the halving of the deficit in 2006 and its projected further narrowing in 2007, conditions are forming for Greece's exit from the Excessive Deficit Procedure (in accordance with article 104 of the Treaty on European Union).

The reduction in the general government deficit stemmed mainly from the state budget, the deficit of which narrowed by 1.9 percentage points of GDP (based on administrative data – see Table II.1). This development is primarily due to the good performance of revenue in both the ordinary and the public investment budget. It is also due to the containment of ordinary budget expenditure close to budget forecasts, as well as to the curtailment of public investment expenditure (see Chart II.10).

In more detail, ordinary budget revenue increased by 8.8% and came to €48,685 million. The measures taken on 29 March 2005, the planned increase in the special consumption tax on fuels (1 July 2006) and the three sets of additional measures[24] introduced in the course of the year to boost revenue have all been the main driving forces behind this development. On account of

24 The first set of tax measures was announced in January 2006; on 27 July the minimum excise duty on tobacco and the mobile telephony tax were raised, while in November the one-off taxation of bank reserves was imposed.

these arrangements, ordinary budget revenue includes extraordinary revenue of €1,539 million[25] or 0.8% of GDP.

Looking at individual categories of revenue, a significant contribution was made by revenue from indirect taxes (10.8% increase), particularly VAT, the real property transfer tax, road duties and the tax on stock exchange transactions. By contrast, receipts from direct taxes (which include revenue from the taxation of bank reserves and the rise in the advance payment of corporate income tax) recorded a small increase of 1.8%. The limited contribution of direct taxes is due to the reduction of the corporate income tax rates, as well as to the quadrupling of the tax-free amount and other favourable tax measures regarding inheritances, donations and parental gifts. The modest contribution of direct taxes can also be attributed to the unwinding of the effect of the measures taken in July 2004 for the settlement of pending tax cases and the collection of tax arrears.

Another factor that contributed to the narrowing of the deficit was the containment at 2.6% of the increase in ordinary budget expenditure,[26] which came to €52,586 million. Primary expenditure increased by 3.7%[27] and exceeded budget forecasts by €207 million, while interest payments fell by 1.9%. The moderate rise in expenditure, whose rate of increase (2.6%) fell significantly below the rate of increase in nominal GDP (7.8%), reflects the strong efforts being made to contain expenditure.

The deficit was also reduced thanks to the public investment budget, whose deficit eventually was €440 million lower than the 2006 budget forecast. Thus, the smaller deficit in the public investment budget more than offset the slight overrun in the ordinary budget deficit. The containment of the public investment deficit below the budgeted limit was the result of increased receipts from EU structural funds and the curtailment of investment expenditure. Specifically, revenue exceeded budget forecasts by €224 million, while expenditure was cut by €216 million.

Apart from the state budget, another factor that contributed to the decrease in the general government deficit was the increased surplus recorded by both social security organisations (2005: €2,071 million, 2006: €3,528 million) and legal persons in public law (2005: €340 million, 2006: €600 million).[28]

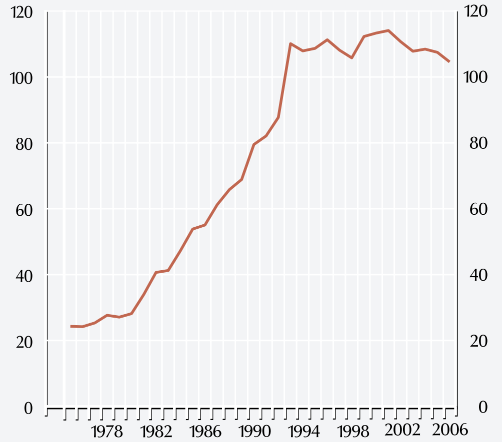
4.2 THE EVOLUTION OF PUBLIC DEBT

The considerable fiscal adjustment contributed, *inter alia,* to the appreciable decrease in public debt. According to the latest data,[29] the consolidated debt of general government fell to 104.6% of GDP in 2006, from 107.5% in 2005 (see Chart II.11 and Table II.2). Nevertheless, despite its significant fall in 2006, the debt remains the second highest among the 25 countries of the European

25 Extraordinary revenue consists of non-tax revenue of €773 million and of tax revenue of €766 million. Extraordinary tax revenue stems from the rise in the advance payment of corporate income tax (€450 million) and from the one-off taxation of bank reserves (€316 million).
26 Including tax refunds.
27 Excluding tax refunds, the increase in primary expenditure tallies with the budgeted figure (4.4%).
28 According to the Updated Stability and Growth Programme (USGP) covering the period 2006-2009 (p. 12) the increased surplus of social security funds "... includes €1,157 million of deposits made by the auxiliary pension funds of several banks to the newly established auxiliary pension fund of bank employees (ETAT)". According to Law 3455/2006, these banks were Emporiki Bank and Piraeus Bank, which will pay this amount in 10 equal instalments.
29 Ministry of Economy and Finance.

Chart II.11 Consolidated debt of general government, 1975-2006

(percentage of GDP)



Source: Ministry of Economy and Finance.

Table II.2 Consolidated debt of general government

(percentage of GDP)

1990	79.6
1991	82.2
1992	87.8
1993	110.1
1994	107.9
1995	108.7
1996	111.3
1997	108.2
1998	105.8
1999	112.3
2000	113.3
2001	114.1
2002	110.7
2003	107.8
2004	108.5
2005	107.5
2006	104.6

Source: Ministry of Economy and Finance.

Union,[30] at almost twice the Maastricht Treaty reference value (60% of GDP).

Over the last decade, the decline in the debt-to-GDP ratio was slow, on average less than one percentage point per annum. At this rate it will take more than four decades to reduce the debt to 60% of GDP. Even if we take into account only the decrease in the debt in 2006 and the declines projected in the 2006-2009 USGP for 2007-2009,[31] at end-2015 debt will still stand at approximately 68% of GDP.[32]

It should be noted that, over the last decade, conditions for the reduction of the debt were particularly favourable. Not only high growth rates were achieved, but also interest rates on government borrowing stood at historically low levels. Furthermore, high primary surpluses were recorded[33] and significant amounts of revenue were raised through privatisation. Nevertheless, Greece did not take advantage of these favourable conditions to reduce public debt faster.

4.3 THE EXCESSIVE DEFICIT PROCEDURE

In the context of the Excessive Deficit Procedure, on 31 March 2007 Greece submitted to Eurostat the required statistical data. According to these data, the general government deficit stood at 2.6% of GDP in 2006, while according to the budget and the 2006-2009 USGP it is projected to fall to 2.4% of GDP in 2007. The European Commission will assess these data, also taking into account its spring forecasts, and submit a proposal to the ECOFIN Council regarding

30 The highest debt is that of Italy (107.6% of GDP in 2006).
31 The fall in 2006 and the forecasts for 2007-2009 lead to an average decline per annum of 4.05% of GDP for 2006-2009. It is assumed that this rate will be maintained until 2015.
32 This is why out of all euro area countries Greece and Portugal are seen by the European Commission as "high-risk countries" as regards the sustainability of public finances. See European Commission, *Quarterly Report on the Euro Area,* December 2006, p. 46, and European Commission-Directorate General Economic and Financial Affairs, *Economic Assessment of the Stability Programme of Greece (Update of December 2006),* 27 February 2007, p. 47.
33 In 1996-2000 general government primary surpluses stood between 4% and 5% per annum.

the continuation or termination of the Excessive Deficit Procedure to which Greece has been subject since July 2004.

According to the existing EU provisions, the reduction of the deficit to 2.6% of GDP in 2006 and the forecast further fall to 2.4% of GDP in 2007 meet the main conditions for the termination of the Excessive Deficit Procedure for Greece.

4.4 THE UPDATED STABILITY AND GROWTH PROGRAMME (USGP) 2006-2009

In December 2006, Greece submitted to the European Commission its Updated Stability and Growth Programme (USGP) covering the period 2006-2009. The "baseline scenario" forecasts a further reduction of the public deficit throughout the three-year period 2007-2009 (to 1.2% of GDP in 2009). The medium-term goal of the Programme is a budgetary position close to balance or in surplus, but it is set for 2012.

The forecast fiscal adjustment for the three-year period 2007-2009 is based on both a curtailment of current expenditure by 0.7% of GDP and an increase of 0.5% of GDP in general government revenue. The reduction of expenditure will be accounted for, *inter alia*, by a significant decrease in interest payments (by 0.5% of GDP), personnel outlays and "other current expenditure" (as a percentage of GDP). By contrast, social transfers are projected to rise by 1.1% of GDP, while investment expenditure is forecast to remain virtually unchanged at approximately 3.5% of GDP. Finally, the primary surplus is expected to grow gradually from 2% of GDP in 2006 to 2.9% in 2009. Turning to revenue, the increase lies in receipts from indirect taxes (0.7%), while revenue from direct taxes will remain unchanged, at 9% of GDP.

In 2006 strong efforts were made to reduce the deficit by 2.9 percentage points of GDP to 2.6%. This decrease is one of the biggest achieved in a single year and is an important step in Greece's overall fiscal consolidation efforts. However, the magnitude of the fiscal problem in Greece (including the pressure to be exerted on public finances by population ageing) calls for the continuation and intensification of efforts to achieve a sustainable fiscal position.

The forecast deficit reduction in the three-year period 2007-2009 entails only a small increase in the primary surplus (from 2.0% in 2006 to 2.9% in 2009), because 1/3 of the adjustment is achieved through a reduction in interest payments. Should the primary surplus remain at this level after 2009, it will not be enough for the timely reduction of the debt to 60% of GDP by 2015 – the year in which substantial increases in expenditure for pensions and healthcare are expected to commence due to population ageing. Moreover, by the end of the Programme (2009) Greece will not have met the "medium-term budgetary objective" of the Stability and Growth Pact for a "budget close to balance or in surplus".[34] The current fiscal position does not ensure that in case of deteriorating macro-

34 It should be recalled that, according to the SGP as amended in 2005, (i) the "medium-term budgetary objective" (in cyclically adjusted terms and net of one-off or temporary measures) for euro area countries with high public debt is a budgetary position close to balance or in surplus, (ii) euro area countries that have not achieved the medium-term budgetary objective are required to reduce their deficit by 0.5% of GDP per annum, also in cyclically adjusted terms and net of one-off or temporary measures (see *Monetary Policy – Interim Report 2005*, October 2005, Box VI.1).

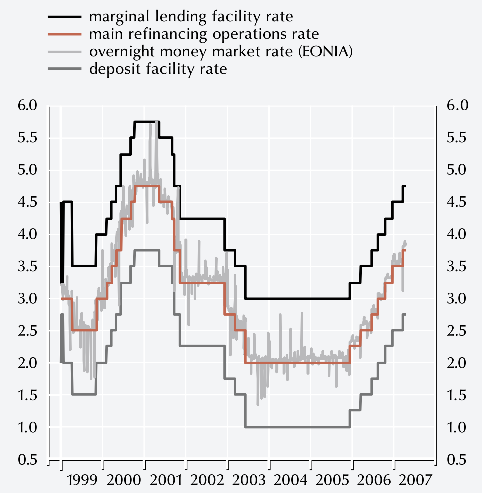
economic developments (e.g. economic slowdown, further rise in interest rates etc.) the deficit will remain below 3.0% of GDP. Besides, it would be advisable for a country with fiscal problems such as those of Greece to set more ambitious budgetary objectives than those of the 2006-2009 USGP. It is worth noting that many EU countries are forming reserves in order to cope with fiscal problems related to population ageing, even though they expect a weaker impact of these problems than in Greece. Therefore, it is advisable to continue and intensify fiscal adjustment efforts and to seek to achieve the "medium-term budgetary objective"[35] in order to ensure the timely reduction of the debt-to-GDP ratio. Moreover, reforms are required in the social security and healthcare systems so as to reduce the expected fiscal burden due to population ageing.

5 MONETARY AND FINANCIAL DEVELOPMENTS IN THE EURO AREA – ANALYSIS OF THE ECB MONETARY POLICY

The stance of the ECB monetary policy changed in December 2005: key interest rates were raised six times until end-2006,[36] by a total of 150 basis points. A further increase (by 25 basis points) in key ECB rates was decided on 8 March this year and the minimum bid rate on the main refinancing operations rose to 3.75%, from 2.25% in January 2006 (see Chart II.12). Increases in key ECB rates were deemed necessary, in order to prevent risks to price stability in the euro area, which were identified through the economic and monetary analysis (conducted by the ECB). The Governing Council has repeatedly stressed that it will monitor closely all economic and

Chart II.12 ECB interest rates and the overnight money market rate (EONIA)

(percentages per annum, daily data)



Source: ECB.

monetary developments so as to act in a firm and timely manner in order to ensure that inflationary expectations remain at a level consistent with price stability (i.e. inflation rate below but close to 2% over the medium term). Thus, the single monetary policy, apart from maintaining low inflation rates, continued to support economic growth and job creation in the euro area. After the 8 March decision, given the favourable economic environment, the ECB monetary policy continues to support economic activity, as real interest rates remain relatively low, while monetary and credit expansion remains high and liquidity is ample in the euro area.

Economic analysis showed that economic recovery in the euro area was stronger and

35 See previous footnote.
36 On 1 December 2005 and on 2 March, 8 June, 3 August, 5 October and 7 December 2006.

more broadly based in 2006, as investment activity increased and private consumption grew faster than in 2005. The annual growth rate of GDP (2.7%) stood at the highest level since 2000. Inflation exceeded 2% until the end of August 2006, but in the following months it fell below 2%, owing to a significant decline in oil prices. Throughout 2006, the Governing Council of the ECB continued to identify risks to price stability, which were mostly associated with possible wage increases higher than expected (due to increased employment and capacity utilisation in general), as well as with a probable further increase in oil prices and a pass-through of previous increases in oil prices to consumer goods prices.

Monetary analysis confirms the prevailing inflationary risks, as there is still ample liquidity in the euro area. Monetary expansion accelerated almost continuously during 2006 and reached historically high levels, while credit expansion to the private sector, after accelerating strongly in the first half of the year, stabilised at very high levels. These developments may be attributed, to a large extent, to the recovery of economic activity and the fact that real interest rates, despite rising, still remain low. The increase in money market interest rates did not halt the acceleration of the M3 growth rate observed since mid-2004. In contrast, it mostly caused shifts of funds within M3, from overnight deposits and deposits redeemable at notice up to three months, the interest rates on which recorded a relatively small increase, to deposits with an agreed maturity of up to two years, the interest rates on which followed the general upward course. Moreover, investors turned to debt securities with a maturity of up to two years and a floating rate, which are included in M3.

The main counterpart of M3 was credit expansion to the private sector. The accelerating growth rate of loans to the private sector is attributed to the recovery of economic activity and the improvement in credit standards (apart from interest rates), which more than offset the effect of rising interest rates. Indeed, there was strong demand for business loans, owing to increased investment activity, while demand for housing loans to households was also strong in the first half of the year, owing to pronounced demand in the housing markets. However, in the second half of the year, the growth of housing loans to households decelerated, partly because of the decline in dwelling prices in certain euro area countries.

The rise in the level of interest rates recorded in 2006 continued into this year. In particular, interest rates in the euro area money market rose, in parallel with the increase in ECB rates. Long-term government bond yields fluctuated during the year, but stood generally at higher levels than those observed in previous years, as the outlook for economic activity improved, causing an increase in real interest rates. In contrast, inflation expectations did not change significantly during the year, while the risk premium incorporated into long-term securities, after some fluctuation, remains low. Bank deposit and lending rates also rose, but there were differences among categories, reflecting the corresponding increase in the money and capital market rates.

Share prices on the euro area stock markets (as in the USA and Japan) followed an upward course during 2006 (except for the May-June period), which continued into the first two months of 2007. Underlying this development was the improved outlook for economic recovery in the euro area, which supported expectations that the already high corporate profitability would be maintained. Towards the end of February there was a sharp but temporary fall in stock market prices.

6 MONEY, CREDIT AND CAPITAL MARKETS IN GREECE

6.1 MONETARY DEVELOPMENTS AND INTEREST RATES

The annual growth rate of the Greek contribution to the euro area M3 (excluding currency in circulation) accelerated during 2006 (fourth quarter of 2006: 10.6%, fourth quarter of 2005: 6.9%). This trend continued in the first two months of this year. Since the second quarter of 2006, this rate has been exceeding the corresponding euro area rate. In 2006, after the ECB increased its key rates, short-term interest rates rose more than long-term ones, which led to shifts out of M3 (such as bond-type mutual funds) to assets included in M3 (particularly to deposits with an agreed maturity of up to two years).

A shift of funds was also observed within M3, as savers turned from high liquidity deposits (such as savings deposits) to time deposits with an agreed maturity of up to two years, the interest rates on which rose much faster. The growth rate of time deposits, though decelerating, remained high, while the rate of change in overnight deposits fell significantly. The growth rate of total deposits included in M3 decelerated to 12.1% in the fourth quarter of 2006 (from 20.7% in the fourth quarter of 2005) and remained at this level during the January-February 2007 period. In addition, holdings of money market fund units (after falling for more than two years) grew in 2006, due to their increased yields, while repo holdings decreased.

Deposit rates in Greece tended to rise in 2006, as they were influenced by the gradual increase in key ECB rates since December 2005. In the euro area, the increase in interest rates on overnight deposits followed a similar course. As a result, the positive differential in favour of Greek interest rates remained at almost the same level at the end of the year (22 basis points), while the rise in interest rates on time deposits with an agreed maturity of up to one year in the euro area was slightly stronger, thus somewhat limiting (to 20 basis points) the positive differential between Greek and euro area rates. During the January-February 2007 period, the deposit rate differential between Greece and the euro area decreased further for both these categories.

Interest rates in most bank lending categories in Greece rose, following to a significant degree the course of key ECB rates. Average rates on corporate loans recorded the largest increase, which was more than triple that of the average rate on loans to households. However, increased competition between banks operating in Greece contributed to containing the rise in interest rates on most loan categories (compared with the increase in corresponding rates in the euro area) in 2006, or even caused interest rates on certain consumer or housing loans to decline. Thus, the positive differential between Greek interest rates and the corresponding euro area rates fell as regards business loans, while it became negative (Greek rates are now lower) in the largest category of fixed-term consumer loans (loans with a floating rate or an initial rate fixation of up to one year, the interest rate on which fell by 96 basis points in 2006). Moreover, interest rates on the two most significant categories of housing loans (loans with a floating rate or an initial rate fixation of up to one year and loans with an initial rate fixation of over one and up to five years) stood at lower levels than the corresponding euro area rates, reflecting either a decline in Greek rates or a smaller increase than that in the corresponding euro area rates. In particular, interest rate differentials between Greece and the euro area as regards the first of the above categories of housing loans stood at –49 basis points at the end of 2006 and grew to –103 basis points in February 2007. During this month, Greece recorded the lowest interest rate in the euro area. In contrast, the interest rate differential was positive, and even rose, in two significant categories of consumer loans, i.e. loans without a defined maturity (including loans through credit cards) and loans with an initial rate fixation of over one and up to five years. At end-2006 this differential was 377 and 285 basis points, respectively, while it fell in both consumer loan categories in the first two months of 2007.

The interest rate spread, i.e. the difference between the weighted average interest rate on new bank loans and the corresponding rate on new bank deposits, remained almost constant in Greece during 2006 and stood at 4.42% in December (while there was a total decline of 364 basis points from December 1998 to December 2005). This spread decreased further in the first two months of this year (February 2007: 4.27%). In contrast, the corresponding spread in the euro area widened, both in 2006 (by 33 basis points to 2.89% in December) and in the first two months of 2007 (by 8 basis points). These developments show that interest rates in Greece are generally converging towards the corresponding euro area rates. However, the interest rate spread remains higher in Greece than in the euro area, reflecting the effect of certain factors (noted in previous Bank of Greece Reports and examined in detail in Box VI.2), including the different structure of deposits and loans in Greece compared with the euro area.

6.2 CREDIT DEVELOPMENTS

The annual growth rate of the total financing of the economy[37] by Monetary Financial Institutions (MFIs, i.e. banks and money market funds) operating in Greece accelerated during 2006, although there was a deceleration in the last few months of the year (fourth quarter 2006: 15.3%, fourth quarter 2005: 14.0%). The strongest contribution to this development came from MFI credit to enterprises and households, while the growth of financing of general government decelerated. In detail, the annual growth rate of general government financing during the January-September 2006 period was positive, but it turned negative again in October (fourth quarter 2006: –1.8%, fourth quarter 2005: –0.7%). In contrast, the annual growth rate of credit to enterprises and households sped up to 21.3% in the last quarter of 2006, from 20.1% in the corresponding quarter in 2005.

37 Total financing of the economy by MFIs comprises MFI loans (after extraordinary write-offs and securitised loans are taken into account, see Chapter VI) as well as government securities and corporate bonds held by MFIs.

In particular, credit expansion to enterprises accelerated significantly, while that to households decelerated. In the first two months of this year, the annual growth rate of total credit to the economy decelerated and stood at 13.0% in February 2007.

The annual growth rate of total credit to enterprises[38] accelerated considerably during 2006 (fourth quarter 2006: 16.8%, fourth quarter 2005: 12.7%), while a small deceleration was recorded in the first two months of 2007 (February: 15.9%). Developments in 2006 were mostly attributed to continued corporate bond issues,[39] causing MFI holdings of corporate bonds to stand at 15.0% of total bank lending to enterprises (December 2005: 12.0%). As regards credit to enterprises by type of economic activity, an acceleration was recorded across all sectors, excluding trade and shipping.

The annual growth rate of credit to households, which receive more than half of total MFI credit expansion to the private sector (including securitised loans and write-offs) decelerated, though remaining at high levels (fourth quarter 2006: 26.7%, fourth quarter 2005: 30.6%). This trend was maintained in the first two months of 2007 (February: 24.2%). The slowdown reflects a deceleration in the growth rate of housing loans (fourth quarter 2006: 28.0%, fourth quarter 2005: 31.5%), as well as an even stronger deceleration in the growth rate of consumer loans (fourth quarter 2006: 23.7%, fourth quarter 2005: 30.4%). The drop in the growth rate of both housing and consumer loans continued into the first two months of this year and the corresponding annual rates of change stood at 25.2% and 21.9% in February 2007. Due to the high rate of credit expansion to households, their total liabilities against MFIs (including securitised loans) rose to 44.0% of GDP by the end of the year (December 2005: 38.0%). Excluding securitised loans, by the end of 2006 this rate stood at 41.1% in Greece, compared with 54.3% on average in the euro area.

6.3 CAPITAL MARKETS

In 2006, capital markets were marked by the upward course of government bond yields, particularly short-term bond yields, a sustained improvement in stock market performance and a decline in the mutual funds market.

Greek government bond yields were generally in line with the yields of corresponding securities in the euro area, as these markets are now almost fully integrated. In particular, the increase in yields, which started after the historically low levels of September 2005, continued during the first half of 2006, due to an optimistic outlook for the euro area economy, indications of stronger inflationary pressures as well as increases in key ECB interest rates. However, in the second half of the year, a containment of inflationary pressures, as well as estimates of a deceleration in US economic growth, led to a decline in long-term bond yields, while short-term bond yields kept rising. At end-2006, government bond yields as a whole stood at appreciably higher levels than at end-2005 (although long-term bond yields remained

38 Including bank loans (together with extraordinary write-offs and securitised loans, see Chapter VI), as well as corporate bonds held by MFIs.
39 According to the legal framework of corporate bond issuance (Law 3156/2003), corporate bonds are exempt from the contributions (0.6% of the outstanding amount of the loan) levied on bank loans under Law 128/1975.

relatively low), while the yield curve flattened noticeably, reflecting the increases in key ECB interest rates and expectations that these rates would rise further. In the first quarter of 2007, government bond yields recorded a slight increase.

The 10-year Greek government bond yield rose to 4.19% at end-December 2006, i.e. 68 basis points higher than at end-2005. The yield differential between the Greek 10-year bond and the corresponding German one reached 27 basis points by the end of December 2006, from 21 basis points at end-December 2005, which is mainly due to different maturity dates.

Transactions in the Electronic Secondary Market for Securities (HDAT) remained at high levels, although their average daily value fell slightly, compared with the previous year, and stood at €2.5 billion in 2006, from €2.9 billion in 2005. Transactions mostly concerned long-term instruments, in particular 10-year bonds, which accounted for almost 3/4 of the total value of transactions. Besides, the average daily value of transactions in the Electronic Securities System (SAT) of the Bank of Greece reached €22.1 billion in 2006 (€25.8 billion in 2005).[40]

Activity in the primary market for Greek government securities in 2006 was marked by a decline, for the second consecutive year, of the amount of capital raised, an increase in interest rates compared with the low levels of the previous year, as well as investors' strong demand for Greek government issues, which was among the highest in the euro area. Fund raising was effected through new issues and re-openings of past issues, chiefly through syndicated loans and, to a lesser extent, through auctions.

Share prices on the Athens Exchange (Athex) maintained a generally upward course, partly reflecting developments in other euro area stock markets. Between end-December 2005 and end-December 2006 the Athex composite share price index rose by 19.9%, an increase similar to that of the Dow Jones Euro Stoxx broad index for the euro area. The average daily value of transactions in shares rose appreciably by 64% in 2006, while the bulk of transactions concerned shares included in the large capitalisation index. Note that foreign investors made a significant contribution to this development. The positive course of both the composite share price index and the Dow Jones Euro Stoxx index continued into the first quarter of 2007. Moreover, total funds raised through the stock market in 2006 also increased, which is attributable solely to funds raised by banks.

Favourable stock market developments are largely associated with the positive macroeconomic environment of the Greek economy in recent years, the high profitability of companies listed on the Athex, higher participation of foreign investors in the Athex, and successful business agreements concerning various Athex sectors. Moreover, during the last few months of 2006 the electronic interlinking of (stock and bond) markets of the Athex with those of the Cyprus Stock Exchange was put into practice. This development boosts liquidity and broadens transaction opportunities in both markets.

On the basis of developments in stock prices and corporate earnings, it is estimated that

40 Transactions in SAT include transactions in HDAT, as well as over-the-counter transactions between banks and their customers.

the price to earnings per share ratio of shares included in the Athex composite share price index fell slightly in 2006 compared with the previous year, though remaining higher than the corresponding ratio of the Dow Jones Euro Stoxx index.

The mutual funds market weakened for the second consecutive year in 2006, as shown by the 15.1% drop in their total assets, owing to a decline in the number of mutual fund units which more than offset the rise in their prices. This drop in the assets of mutual funds is primarily due to the steep fall in the assets of bond-type mutual funds and, on a secondary level, to the decline in the assets of balanced-type mutual funds. In contrast, the assets of other categories grew, particularly those of funds of funds, whose assets more than doubled in 2006, compared with 2005. As regards equity-type mutual funds, their assets increased less than stock prices.

7 BANKING SYSTEM STABILITY

The economic and social importance of a stable and well-functioning financial system is obvious, as it contributes to effective intermediation, efficient allocation of financial resources, business risk dispersion and management, and smooth carrying-out of payments. The orderly operation and credibility of the Greek financial system hinge in effect on the stability of the banking system, given the predominant role of banking intermediation and banks' decisive participation in payment systems and money and capital markets. The analysis that follows focuses on the evaluation of the stability of the banking system. This evaluation consists of an examination of, on the one hand, the nature and magnitude of the risks assumed by banks in relation to possible developments in the economic environment and, on the other hand, those quantitative and qualitative characteristics of banks —such as profitability, lending policy, provisioning policy and capital adequacy— that determine their ability to absorb possible shocks without disruptions.

The profitability and capital adequacy of Greek banks remain at levels that provide a margin for ensuring the stability of the Greek banking system and, coupled with more effective banking risk management, enhance the soundness of the banking system across time, as well as depositors' and investors' confidence.

7.1 PROFITABILITY AND EFFICIENCY

The profitability of Greek banks and banking groups remained satisfactory in 2006, for the fourth consecutive year, assisted by the benign domestic macroeconomic environment, continuing credit expansion, the favourable conjuncture in the stock exchange, the increasing positive contribution of banks' subsidiaries in the South-eastern Europe markets and the containment of operating costs. However, certain banks' substantial provisioning limited pre-tax profits growth at the banking system level in comparison with the figures observed both in the first three quarters of 2006 and in 2005. In addition, after-tax profits were affected by the one-off taxation of banks' reserves. Banking groups' profitability improved in the euro area, despite weaker economic growth and credit expansion than in Greece, mainly owing to increases in net interest and commission income, as well as in profits from financial operations.[41]

Specifically, Greek banks' and banking groups' pre-tax profits grew by 22.3% and 25.9% respectively in 2006, clearly slower than during the January-September 2006 period. Underlying this were certain banks'/banking groups' non-recurring profits, mainly in the first quarter of 2006, as well as increased provisioning (banks: +29.3%, banking groups: +31.5%) at the end of the year. However, after-tax profits were affected by the one-off taxation of banks' reserves (about €300 million at banking system level) and rose by 6% (banks) and 16.6% (banking groups).

Banks' and banking groups' total income grew by 18% and 20.6% respectively in 2006. A considerable increase was observed in net interest income (banks: 14.5%, banking groups: 19.7%), as a result of the expansion of the loan portfolio, in particular with respect to housing and consumer credit, which offset a small contraction in the net interest rate margin[42] for both banks (2006: 2.7%, 2005: 2.8%) and banking groups (2006: 3.0%, 2005: 3.1%). The decline in this margin is explained by growing competition, as a result of which lending rates in Greece converged with the euro area average,[43] and by the higher cost of interbank market financing, owing to the ECB's interest rate hikes and the faster growth of lending than deposits.

Net interest income continues to make up the bulk of Greek banks' income (3/4 of total income, which is considerably higher than for medium-sized banking groups in the EU: 63.1% in 2005). This fact is positive as, to the extent that banks price properly their credit risk and the volatility of impairment losses and profitability is reduced, it is important for banking system stability that banks draw a relatively large part of their income from fairly stable sources. Net commission income also improved (banks: +12.1%, banking groups: +20.1%), accounting for about 1/5 of banks' total income. Finally, income from financial operations and other income also grew considerably, partly owing to the sale of banks' participations and the generation of added value from certain banks' participation in mergers.

Banks seem to have continued to rationalise their costs, despite increased expenditure owing to their cross-border expansion; as a result, the ratio of operating costs to assets declined slightly both for banks (2006: 1.9%, 2005: 2%) and for banking groups (2006: 2.4%, 2005: 2.5%), but remained higher than for medium-sized banking groups in the EU (2005: 1.5%).

Despite the relatively strong growth of personnel outlays, the rate of increase in operating costs[44] (banks: 12.4%, banking groups: 15.1%) was slower than the rate of increase in operating income, hence the efficiency ratio[45] improved by around 2.5 percentage points in comparison with 2005 (banks: 52.3%, banking groups: 54.2%); as a result,

41 In this section, comparative data for the EU countries are drawn from the following ECB publications: *EU Banking Sector Stability*, November 2006; *EU Banking Structures,* October 2006; and *Monthly Bulletin*, March 2007.

42 Calculated as the ratio of net interest income to total average assets.

43 In certain loan categories, such as housing loans, interest rates are now lower than the euro area average.

44 Personnel outlays: 11.9% at bank and 14.5% at banking group level; general administrative costs: 12.7% and 12.5% respectively; depreciation allowances: -5% and 6% respectively.

45 Operating costs to operating income.

it stands at a better level than for medium-sized banks in the EU (2005: 58.4%).

The flow of provisions[46] also grew considerably (banks: 29.3%, banking groups: 31.5%) as a result of certain banks' substantial provisioning.

These developments kept after-tax return on equity (ROE) (excluding the impact from the one-off taxation of reserves) at a satisfactory level both for banks (2006: 14.5%, 2005: 16.2%) and for banking groups (2006: 15.4%, 2005: 17%), close to the EU banking groups' average (2005: 15.3%).[47]

7.2 CAPITAL ADEQUACY

In 2006, Greek banks' capital adequacy strengthened, while that of Greek banking groups decreased slightly, but remained considerably higher than the supervisory minimum (8%). This decline is mainly attributable to an increase in risk-weighted assets, as a result of fast credit growth in Greece and the expansion of Greek banks' business abroad (representing 8.2% of their total weighted assets).

Specifically, banks' Capital Adequacy Ratio (CAR) and Tier I Ratio reached 13.6% and 9.5% respectively in 2006, compared with 13.3% and 8.7% respectively in 2005. However, at banking group level, which is more representative, there was a decline in both the CAR (2006: 12.2%, 2005: 13.2%) and the Tier I Ratio (2006: 9.9%, 2005: 10.9%). Nevertheless, these figures are marginally higher than for medium-sized banking groups in the EU, while the quality of Greek banking groups' capital remained virtually unchanged, as the share of core capital in total capital remained roughly the same (2006: 79.1%, 2005: 80.9%).

7.3 BANKING RISKS

Credit risk is the most important risk factor for the Greek banking system, as lending to customers made up 62% of Greek banks' assets in 2006, in comparison with 49.7% for EU banking groups in 2005. The low starting base owing to the relatively recent full liberalisation of housing and consumer credit in the Greek banking market and the favourable macroeconomic environment for several years have contributed to strong credit expansion, mainly to households, the indebtedness of which —as a percentage of GDP— has risen (2006: 44%, 2005: 38%), but is still lower than the euro area average (first half of 2006: 58.3%, 2005: 57%).

It is a fact that the increase in the outstanding balance of housing and consumer loans during the last five years has boosted Greek banks' profitability. However, a slowdown trend is observed in credit expansion to households, which is expected to continue, in particular with respect to consumer credit, where profit margins are higher. In addition, the growth rate of loan disbursements has weakened considerably, affecting commission income from retail banking. Moreover, although a shift to fixed-rate loans has been observed recently in borrowers' preferences, especially in housing credit, a large part of total loans has been concluded at floating rates and, as a result, servicing costs have

46 In the terminology of the international accounting standards, the flow of provisions is defined as impairment losses.
47 Since the available data on EU banks concern banking groups, comparison with Greek banks can only be made at banking group level.

risen considerably owing to the ECB's key rate hikes since December 2005.

In consumer credit, the non-performing loans (NPLs) to total loans ratio improved (2006: 6.9%, 2005: 7.8%), mainly as a result of increased consumer loan write-offs by certain banks in 2006. Higher write-offs were a result of, *inter alia,* the Bank of Greece policy, on the one hand providing incentives for loan write-offs[48] and on the other hand requesting banks to write off consumer loans overdue by more than one year. At the same time, there was a small decline in the NPLs ratio for housing loans (2006: 3.4%, 2005: 3.6%). However, despite the improvement in the NPLs ratios for loans to households, these ratios are more than double than in the EU and may be further affected by the ECB interest rate increases and a possible further slowdown in credit expansion.

Credit expansion to businesses sped up in 2006, but continues to fall short considerably of credit expansion to households, and in the current economic conjuncture it does not seem to be a potential factor of higher credit risk. Besides, the quality of the corporate loan portfolio has improved, as the NPLs to total loans ratio in this category has declined (2006: 6%, 2005: 7.1%). However, any risk concentration in specific branches or corporations that face difficulties and have unfavourable prospects should not be overlooked.

The financial condition of non-financial corporations[49] is considered satisfactory, as pre-tax profits grew by 15.9% in 2006 over 2005 and ROE improved (2006: 16.8%, 2005: 15.2%). However, the leverage ratio declined (2006: 0.84, 2005: 0.91) and the ratio of financial costs to gross profits rose (2006: 7.4%, 2005: 5.8%), suggesting a possible increase in credit risk. Moreover, a mixed picture is given by credit registry data compiled by the Greek credit bureau "Tiresias S.A." and associated with banks' credit risk.[50]

Overall, the quality of banks' loan portfolio has improved, as the NPLs to total loans ratio dropped from 6.3% in 2005 to 5.4% in 2006, mainly as a result of considerable write-offs by certain banks. Hence, NPLs ratios (net of provisions) improved, for both total loans (2006: 2.1%, 2005: 2.4%) and supervisory capital (2006: 15.5%, 2005: 19.2%), although they are still higher than the corresponding ratios for medium-sized banks in the EU. Besides, despite write-offs of doubtful loans, the coverage ratio of provisions to NPLs remained virtually unchanged (2006: 61.6%, 2005: 61.9%) and lower than in the EU (2005: 72.2%).

The Bank of Greece, taking into account continuing strong credit expansion and the above risk sources, considers that further improving banks' portfolio and increasing the coverage ratio of provisions to NPLs is particularly important in order to prevent wide fluctuations in the CAR, in view of the implementation of the new supervisory framework (Basel II), in particular Pillar 2. Specifically, the Bank of Greece has requested credit institutions with relatively high NPLs ratios to for-

48 Bank of Greece Governor's Act 2565/11 October 2005.
49 The figures concern a sample of 472 corporations monitored by the Bank of Greece. For a more extensive analysis see Chapter IV.3.
50 Specifically, in 2006 bankruptcy petitions and the value of payment orders rose (by 24.8% and 64% respectively), while, on the positive side, the value of unpaid cheques declined (by 17.9%). These data typically show high volatility and are subject to frequent revisions.

mulate a policy that will lead to a reduction in the NPLs to total loans ratio to 3.5%; at the same time, the ratio of net NPLs (i.e. NPLs overdue by more than 90 days minus cumulative provisions) to supervisory capital should not exceed 10%. Credit institutions' credit policy should include factors such as loan approval percentages, credit risk pricing, NPLs recovery procedures, loan-loss provisioning and write-offs.

In addition, since limited data are available on borrowers' behaviour across the business cycle and on loan recovery in periods where the probability of default is increased, it is necessary to adopt a more conservative risk management policy. Against this background, banks are required to carry out regular stress tests in order to estimate the impact from possible unfavourable developments on their profitability and capital adequacy. At the same time, households should evaluate carefully their debt servicing capacity by taking into account, *inter alia,* their economic prospects and the possibility of further interest rate hikes.

Market-risk-weighted assets, despite rising considerably by 57.8% in 2006, still account for a small percentage (4.3%) of total credit- and market-risk-weighted assets. This development reflects the expansion of certain banks' investment positions in shares, debt securities and other investment products with interest rate-sensitive prices, as well as the increasing use of innovative products. The impact from these factors more than offset the decline in banks' exposure to foreign exchange risk and the effect of lower market volatility. However, one should not underestimate the possible impact from market risks on certain banks that do not have in place adequately developed mechanisms for managing these risks.

Finally, the liquidity of the Greek banking system is satisfactory, on the basis of the two liquidity ratios established by the Bank of Greece. Specifically, in 2006 the liquid asset ratio and the asset/liability maturity mismatch ratio rose to 25% and 0.14% respectively, in comparison with regulatory minimums of 20% and -20% respectively. Moreover, the loan-to-deposit ratio, despite rising to 98.2% in 2006, from 94.5% in 2005, is still considerably lower than the EU average (2005: 128.2%). The rise in the loan-to-deposit ratio implies that the strong credit expansion has been financed to a considerable extent by interbank lending and the issuance of bank bonds and bond loans.

7.4 THE STRUCTURE OF THE BANKING SYSTEM AND THE PROVISION OF BANKING SERVICES

The structure of the banking system showed little change in 2006 in comparison with 2005. Greek commercial banks[51] maintained their predominant role, as at end-2006 their market share (in terms of assets) was 86.5%, up from 85.1% in 2005. The market shares of the branches of foreign banks[52] and cooperative banks remained unchanged (10.1% and 0.8% respectively), while the share of specialised credit institutions narrowed (2006: 2.6%, 2005: 4%).

51 As from April 2006, the Postal Savings Bank, which was included in specialised credit institutions up to (and including) 2005, is considered a commercial bank. However, for comparability reasons, data for 2005 have been adjusted as well.

52 Only the data for branches of foreign banks are included. Foreign banks' subsidiaries located in Greece are included in Greek commercial banks.

Measured by the market share of the five largest banks in total assets (2006: 66.4%, 2005: 64.8%), the degree of concentration of the Greek banking system showed a small increase. A similar trend is also observed in the EU,[53] where small countries show comparatively higher concentration ratios. However, contrary to the EU, the number of branches in Greece continued to increase (albeit at a slower pace than in the past), which is explained by both Greek banks' focus on retail banking and the preference of their customers (especially the elderly) for transactions through branches.

Nevertheless, branch density relative to population is lower in Greece (33 branches per 100,000 inhabitants) than in the euro area (2005: 54) and the EU (2005: 44). The number of employees per branch in Greece, despite having declined to 17 at end-2006, is still considerably higher than the corresponding EU average (15). During 2006, despite expanding their branch networks, banks continued to develop alternative distribution channels. Specifically, they increased the number of automatic teller machines (ATMs) by 7% (2006: 6,667, 2005: 6,230) and expanded the range of transactions that can be supported by ATMs, at the same time improving their e-banking services. Moreover, they enhanced their cooperation with retail chains (e.g. department stores, car sales agencies) and professional groups (e.g. manufacturers) in order to promote banking products, while also placing more emphasis on direct marketing.

8 THE ECONOMIC OUTLOOK FOR 2007

In 2006 the Greek economy grew at a rate of 4.3%, slightly exceeding the average figure for the last decade (4.1%). In 2007, the economy is expected to maintain its strong growth performance. Based on the information available, the evidence provided by the leading indicators and the fact that the factors which supported the growth of the Greek economy in recent years will continue to have a favourable effect, the Bank of Greece estimates that the GDP growth rate in 2007 will stand at approximately 4% or slightly higher.

The forecast high growth rate of economic activity in 2007 and the improved conditions of operation of the labour market are expected to contribute to an increase in employment and a further fall in unemployment.

The growth rate of domestic demand is forecast to decelerate slightly in 2007 in comparison with 2006 but will, nevertheless, remain at a high level and will be the major driving force behind economic growth, while the foreign sector will continue to make a negative contribution.

Private consumption will continue to grow at a high rate, supported by the forecast rise in salaried employment, the maintenance of the growth rate of real incomes at levels at least equal to those of 2006 and the cumulative impact of the increase in the market value of households' assets. A significant contribution to the rise in private consumption in 2007 will be made by the continued credit expansion, although its rate is expected to be lower than in 2006. By contrast, the growth rate of public consumption

53 References to the EU concern the EU-25. Data are drawn from the ECB's *EU Banking Sector Stability*, November 2006, and *EU Banking Structures*, October 2006.

will remain low, as forecast in the Updated Stability and Growth Programme.

The rate of increase in total gross fixed capital formation is forecast to decelerate in 2007, chiefly due to the significant drop in the growth rate of housing investment in comparison with the exceptionally high levels recorded in 2006. By contrast, the growth rate of business investment is forecast to accelerate. The favourable outlook for demand (domestic and international) for the products of many branches of production, combined with low leverage in many companies and adequate liquidity, are the principal determinants of increased business investment. An increase in business investment is also indicated, first, by the considerable number of investment plans brought under the provisions of the development law, and, second, by the activation of the legal framework of public-private partnerships.

The growth rate of exports of goods and services on a national accounts basis is forecast to remain at 2006 levels, albeit with a limited slowdown in the growth rate of goods exports, which will be offset by a small acceleration in the growth rate of services exports. The forecast of a lower growth rate of goods exports takes into account both the expected slowdown in the growth of world trade volume, which will, nevertheless, remain high, and the cumulative decline (in recent years) in the international price competitiveness of the Greek economy. Moreover, the growth rate of goods imports on a national accounts basis is expected to decelerate slightly more than that of final demand.

It is forecast that the current account deficit will remain at exceptionally high levels in 2007 as well. This forecast is based on the assumptions that the average annual level of the dollar price of crude oil will fall or remain more or less unchanged in 2007. It also takes into account the previously mentioned forecasts concerning the growth of imports and exports and the assessment that the renewal of the merchant fleet will continue, interest payments will keep rising and surpluses in current and capital transfers balances will remain effectively unchanged.

The average annual HICP inflation rate is forecast to slow down to around 3% in 2007, from 3.3% in 2006, chiefly due to the expected drop in the price of crude oil (in the first quarter of 2007, HICP inflation stood at 2.9%). By contrast, core inflation (which excludes energy and unprocessed food prices) is expected to accelerate from 2.9% in 2006 to 3.5% in 2007, i.e. close to the average level for the six years 2001-2006 (3.4%). In the first quarter of 2007, core inflation stood at 3.7%. The forecast rise in core inflation reflects the lagged effect on the general level of prices of the sharp increase in the prices of crude oil and other commodities on international markets until the third quarter of 2006. This effect is expected to weaken somewhat during the year, as there will be a limited slowdown in the growth rate of unit labour costs, while total demand conditions will remain virtually unchanged. Nevertheless, it is estimated that the considerable increase in ECB interest rates from December 2005 to date and the fiscal policy being pursued are helping to contain inflationary expectations at lower levels. As usual, the inflation forecast is marked by a degree of uncertainty, to the extent that it depends on the accuracy of assumptions concerning the international prices of oil and other raw materials, the exchange rate of the euro and the prices of fresh fruit and vegetables.

9 THE ECONOMIC OUTLOOK AND POLICIES FOR RAISING THE POTENTIAL GROWTH RATE

9.1 MEDIUM TO LONG-TERM GROWTH PROSPECTS

The achievement of impressive growth rates in the last ten years (4.1% per annum on average in the 1997-2006 decade) has allowed for significant progress towards real convergence of the Greek economy with the more advanced economies of the EU. However, Greece still lags considerably behind the EU-15 in terms of the level of economic development and social welfare. *Per capita* GDP (in purchasing power parity terms) was 21.5% behind that of the EU-15 in 2006, while unemployment, poverty and income inequality indicators continue to be worse. In addition, the Greek economy displays serious macroeconomic imbalances and structural weaknesses, which undermine long-term growth prospects, while the expected population ageing and the globalisation process could have serious repercussions on the fiscal position and the international competitiveness of the economy, respectively. However, these problems can be dealt with in time if consensus among the social partners is achieved and an appropriate economic policy framework is formulated.

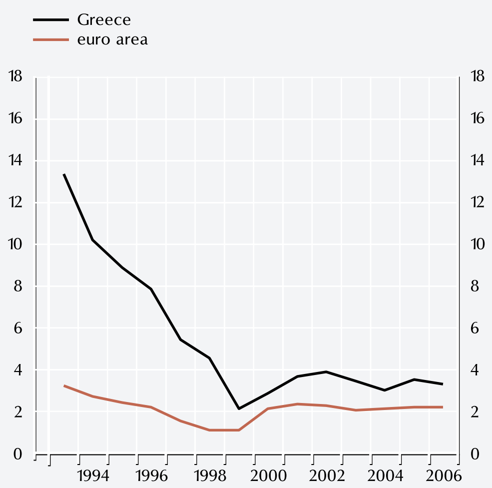
The rapid growth of the Greek economy in the last ten years was based on rising domestic demand and enhanced productive capacity through investment and structural reforms (as well as an increase in the labour force). The improvement in the macroeconomic environment (chiefly as a consequence of the introduction of the euro), the associated reduction in borrowing costs and the deregulation of the credit system have contributed to an increase in household spending on consumption and housing investment and strengthened business investment. In addition, the large inflow of resources from the European Union's Structural Funds has increased domestic demand and public infrastructure as well as overall productivity, while a number of structural measures have helped product and labour markets to operate more efficiently and have improved productivity.

At the same time, however, the current account deficit, as measured on the basis of the Bank of Greece's balance of payments statistics, grew significantly to 12.1% of GDP in 2006, from the already high level of 7.4% of GDP on average in the five years 2001-2005. On a national accounts basis it reached 10.7% of GDP in 2006, compared with 9.5% of GDP on average from 2001 to 2005 (see Section 3.4 above). The high levels of the balance of payments deficit in recent years reflect by definition the significant shortfall in national savings with respect to domestic investment. More specifically, savings fell as a percentage of GDP (to 15.0% on average in the period 2001-2006, compared with 16.9% on average in the period 1995-2000) due to the increase in household borrowing, which contributed to an increase in private consumption, but also because of considerable fiscal deficits, while at the same time investment increased. It should also be noted that national savings as a percentage of GDP are 6-6.5 percentage points lower in Greece than in the euro area, while investment as a percentage of GDP is 4 percentage points higher (partly owing to the higher level of investment in housing in Greece[54]). Moreover, the rise in the current account deficit to high levels in the six years 2001-2006 led to a significant deterioration of the negative international investment position of Greece (i.e. the net financial liabilities of the private and the public sector to non-residents) from 44% of GDP at the end of 2000 to 92.2% of GDP at the end of 2006.[55]

As far as the future is concerned, the growth of domestic demand will tend to decelerate gradually in the coming years. This will occur because the high rates of credit expansion supporting private consumption and housing investment will inevitably fall, as total household borrowing as a percentage of GDP, which is still significantly lower than the euro area average, will tend to stabilise. A steeper deceleration could be caused by the upward trend in interest rates or by an unfavourable change in real estate market conditions. In addition, the large current account deficit — to the extent that it reflects high levels of private consumption and housing investment rather than investment in production— leads to an increase in the external debt without any parallel strengthening of productive and export capacity and, consequently, without any corresponding improvement in the economy's capacity to service its debt. Thus —although, due to Greece's participation in monetary union and the absence of exchange rate risks, deficits can be funded comfortably and on much more favourable terms than would have been possible without the adoption of the euro— an increased share of national income will be absorbed by interest payments on the external debt. This will have negative consequences for investment, growth prospects and, as a result, living standards. In addition, the continued relatively high rates of inflation (see Chart II.13) have already led, in the last six years, to a cumulative deterioration of the economy's international price competitiveness (see Section 3.4 above). This fall in competitiveness is one of the largest in the euro area and, if it is not tackled, it could act as a constraint on the domestic production of internationally marketable products, thereby also contributing to a slowdown of the growth rate.

Chart II.13 Harmonised index of consumer prices: Greece and the euro area, annual data

(annual percentage changes)



Sources: NSSG and Eurostat.

The foregoing analysis suggests that, to ensure high growth rates on a sustainable basis, the Greek economy will need to be restructured so that its future growth can be

54 Business investment as a percentage of GDP is 2-2.5 percentage points higher in Greece than in the euro area.
55 This development chiefly reflects the increased debt of the public and the private sector held by non-residents and, to a much lesser degree, the increase in the net inflow of foreign direct investment.

based on exports and business investment far more than at present. This is the only way in which a steady rise in employment, real earnings and living standards can be guaranteed. This will require expansion of the production base and greater flexibility within the economy to enable the production of goods of higher quality and greater value added, which will be competitive on international markets. The present production base of the Greek economy is not sufficiently broad or dynamic, nor sufficiently flexible to allow a smooth and rapid transfer of productive resources to the export sector. Specifically, the labour and product markets continue to suffer from rigidities, despite the progress made. The agricultural sector has retained its traditional character to a large extent. The manufacturing sector is relatively stagnant as far as production is concerned, while its structure is changing, as more dynamic sectors are growing stronger (a development which is reflected in improved export performance – see Section 3.4 above), but not to the degree required to deal effectively with the challenge of globalisation and to strengthen the position of the Greek economy within the international division of labour. Finally, in the services sector only a few trades display dynamism (such as financial services, telecommunications and merchant shipping).

Transforming the economy will require, first of all, a correction of macroeconomic imbalances. Obvious symptoms of these imbalances are the high levels of inflation and of the current account deficit. Of course, as has been stressed repeatedly, the single monetary policy is determined on the basis of economic conditions in the euro area as a whole rather than those in individual countries. Moreover, as inflation in Greece is higher, the single monetary policy means that real interest rates in Greece are lower and thus monetary conditions are more relaxed. For this reason, reducing inflationary pressures depends on the contribution of fiscal policy, the determination of wage increases consistent with price stability, and structural reforms which will strengthen competition and improve supply conditions.

As analysed more extensively in Section 9.2, fiscal adjustment is particularly important. Fiscal deficits narrowed significantly in 2005-2006, but continued fiscal adjustment is essential in order to contain inflationary pressures and ensure fiscal stability in the long term. Public debt remains exceptionally high (104.6% of GDP in 2006, the second highest in the EU), while the expected ageing of the population will place a heavy burden on public expenditure for pensions and healthcare, particularly after 2015. If fiscal adjustment leads to large primary surpluses and a reduction in public debt to 60% of GDP by 2015, it will make a major contribution to tackling these problems. Moreover, if the scale of fiscal adjustment is sufficiently great, it will enable fiscal policy to support those social groups which are likely to be affected by the necessary structural reforms (as explained below). It is obvious that a timely reform of the pension system will make it possible to avoid laying a very large tax burden on coming generations in order to finance the pension system.

In the new economic environment resulting from the adoption of the euro, the social partners can make a permanent contribution to the achievement of price stability, both via collective bargaining on wage increases and via the pricing policies of enterprises. Indeed, it will be beneficial for all if wage agreements are reached taking into account price competitiveness, unemployment levels and the evolution of productivity, as, in this way, nominal wage increases will not be eroded by inflation, nor will they undermine prospects for growth and employment. Of course, improved productivity will also help contain the rise in unit labour costs. At the same time, there is substantial scope for stronger competition in product markets, which will permit price developments to be compatible with the development of production costs and with profit margins that do not undermine price stability and the improvement of competitiveness.

Transforming the Greek economy will also require the correction of its structural weaknesses, which are evidenced by high unemployment, the fact that economic growth and productivity in Greece are lagging behind compared with the more advanced economies of the EU, and the large current account deficit (which, as noted previously, is *also* evidence of macroeconomic imbalances). The process of globalisation on the one hand presents a challenge to the Greek economy, as international markets are being flooded with exports from countries (chiefly in Southeastern Asia, but also in Central and Eastern Europe) where production costs, particularly labour costs, are low and, on the other hand, it offers an opportunity for domestic exporters, owing to the rapid increase in the size of international markets. As analysed more extensively in Section 9.3 below, this challenge may be faced and the opportunity exploited if reforms are made over a broad range of sectors of the economy, aimed at reducing labour and product market rigidities, upgrading human capital, improving the efficiency of the public sector and, finally, restructuring the economy's production base.

Progress with these essential reforms will require broadly based social consensus. As the experience of other European countries has shown, consensus presupposes an open dialogue concerning both the major benefits of structural reforms, which are frequently long-term and spread out widely throughout the economy, and the costs of such reforms, which are usually encountered in the short term and burden small population groups. Such dialogue will allow correct and acceptable decisions to be made that will ensure that the costs of the necessary structural reforms are divided fairly among social groups and generations. It will also allow the introduction of measures for targeted support to those social groups which are likely to be adversely affected by such reforms. As stated previously, creating fiscal margins to permit the adoption of social support measures will be a further positive consequence of fiscal adjustment.

9.2 FISCAL CONSOLIDATION AND REFORM OF THE PENSION SYSTEM

9.2.1 Fiscal consolidation

Fiscal consolidation will require continued fiscal adjustment for a number of years in order to achieve in the long term a fiscal surplus and a significant reduction in public debt. Greece's public debt (104.6% of GDP in 2006) is the second highest in the EU and exceeds by a large margin the Maastricht Treaty reference value (60% of GDP). In addition, the size of the fiscal effort needed to reduce public debt is even greater than indicated by the present level of the debt, if the forecast ageing of the population is taken into consideration. According to available estimates, unless appropriate policy measures are taken (see Section 9.2.2 below), the increase in public spending on pensions and healthcare as a consequence of population ageing will become large after 2015, exceeding 10 percentage points of GDP by 2050.[56] Fiscal pressures generated by population ageing in Greece will be the strongest in the EU.

The Updated Stability and Growth Programme (USGP) for the period 2006-2009 forecasts a further reduction in the general government deficit from 2.6% of GDP in 2006 to 1.2% of GDP in 2009, which entails an increase of 0.9 percentage point in the primary surplus to 2.9% of GDP in 2009. According to the USGP, the medium-term objective of fiscal policy is to achieve a balanced budget or a budget surplus by 2012, with an annual reduction of the structural deficit by at least 0.5% of GDP.[57] At the same time, it is forecast that the growing primary surplus, combined with high growth rates and revenue from privatisation, will allow for a steady reduction in public debt as a percentage of GDP by 2012. However, the forecast fiscal adjustment will not suffice to reduce public debt to 60% of GDP by 2015, when, as previously noted, it is expected that public spending to cover the cost of pensions and healthcare will gradually begin to rise. Therefore, a further improvement will be required in the fiscal position, in order to achieve much higher primary surpluses. The ECOFIN meeting held in March this year discussed the option —given the favourable economic situation in Europe— of accelerating the rate of deficit reduction in those countries (such as Greece) that have not yet achieved the medium-term budgetary objective, but no decisions have been taken at EU level.[58] In any event, accelerating the rate of deficit reduction is a political option at a national level. There must be, therefore, a broader social consensus so that this issue is seen as a top political priority.

Fiscal consolidation may proceed effectively if it is based on prioritising and strictly controlling current expenditure, on broadening the tax base and on curbing income tax and social security contribution evasion.[59] This will make it possible to reduce further the

56 These projections (which are still being updated) are based on data for 2002. As noted in Section 6 of the Updated Stability and Growth Programme 2006-2009 (December 2006), the burden due to the increase in pension outlays will be significant. It is forecast that there will be an additional, though smaller (as a proportion of GDP) burden due to healthcare spending, while no extra burden will arise from long-term care and the education system or from unemployment benefit transfers. See also "The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Report prepared by the Economic Policy Committee and the European Commission (DC ECFIN), *European Economy, Special Report* No. 1/2006, and the corresponding Annex (Annex-Tables on pp. 141-142), 6 February 2006. These projections are based on the assumption that current policies will remain in force.

57 Indeed, according to the USGP, the cyclically adjusted deficit will fall to 1.6% of GDP in 2009 and, therefore —with a further fall by at least 0.5% of GDP annually— it will be completely eliminated by 2012. For the "medium-term budgetary objective" see footnote 34.

58 See the recent statements by the Minister of Economy and Finance (press releases, 27 March 2007 and 12 April 2007). The Minister stated that, if there is agreement in this direction in the EU, he believes that Greece "must support such an agreement".

59 For the available estimates of the size of tax and social security contribution evasion and the vast loss of revenue this entails for central government and social security organisations, see Bank of Greece, *Annual Report 2005*, pp. 75-76 and 78. Note, for example, that revenue from income and property taxes and from social security contributions as a proportion of GDP is noticeably lower in Greece than the euro area average (9.3% compared with 11.7% for taxes and 12.1% compared with 14.4% for contributions), although euro area countries have similar or lower direct tax and contribution rates (when account is taken of the differences in tax brackets and general tax relief). The difference is smaller as regards indirect taxes (12.9% compared with 13.7%). The data refer to 2005 (see Eurostat, Press Release, 41/2007, 20 March 2007).

burden of high tax rates and social security contributions on enterprises and households and to carry out adequate public investment to improve infrastructure and ensure that the more vulnerable social groups are protected. Note that tax rates on corporate profits and capital income have been reduced significantly as a result of international competition, while smaller reductions in tax rates have been applied to other personal income. In general, tax rates cannot be raised without a negative effect on competition and tax evasion, with the exception of certain indirect taxes.

Obviously, the impact of population ageing on public spending for pensions and healthcare cannot be addressed solely by raising taxes or by cutting other spending. This would lay a huge financial burden on the government budget, undermining economic growth and compromising the provision of basic public services. Therefore, fiscal adjustment must be combined with a reform of the pension system and other policy measures to deal with population ageing (as analysed below).

9.2.2 Population ageing and reform of the pension and healthcare systems

According to the latest available demographic projections by the NSSG (based on data from the 2001 Population Census), the low birth rate[60] together with increased life expectancy[61] will raise average age in Greece from 2010 (and reduce the size of the population from 2020).[62] As a result, the "elderly dependency ratio", i.e. the number of people aged 65 years and over, as a percentage of the population aged 15-64 years, which rose from 22% in 1994 to 24% in 2000 and 27% in 2005, is forecast to more than double to 56% by 2050. These projections take account of the net inflow of migrants into Greece noted in recent years (see Box III.3). If demographic aggregates evolve in line with these projections, this will have serious economic and fiscal effects, as the proportion of the population aged 15-64 within the population as a whole is forecast to fall from 67.3% in 2005 to 56.4% in 2050. These forecasts, with stable employment rates, entail a strong downward trend in the number of people in employment. The employment rate is, of course, expected to increase to some degree, as older women (with a limited participation in the workforce) are replaced by younger women, but measures will be needed to increase the employment rate in all age groups. In addition, the increase in the average age of employed people will have a negative impact on the growth rate of productivity. This means that, if the demographic projections are not reversed by the introduction of effective demographic policy measures to boost the birth rate, economic growth in the long term will have to be based exclusively on a continuing rise in labour productivity —via an increase in capital per employed person, more efficient use of productive resources and the upgrading of human capital— and on a further rise in the employment rate, chiefly by attracting young

60 The low birth rate (9.7 births per 1,000 people) reflects the low "total fertility rate" (births per mother), which shows an almost steady decline: from 2.09 births per mother in 1981, a level which almost matches the "generation replacement rate", i.e. the lowest limit at which the population can be replaced (which is 2.1), the rate fell to 1.36 in 1994 and 1.31 in 2004, while in 2005 it stood at 1.34 (see NSSG, Press Release, 2 April 2007).

61 Or "life expectancy at birth" as estimated on the basis of demographic data.

62 See the European Commission projections referred to in footnote 56.

people, women and older people into the labour market (in order to raise, in practice, the average retirement age).

Greece lags behind other EU-15 countries in introducing the policy measures required to limit the size and impact of the expected population ageing and to reform its social security and healthcare systems. As these problems are multifaceted and have many consequences, a global approach is needed to deal with them effectively, including mutually complementary measures and policies, which, in addition to boosting the birth rate, will have as key objectives: (i) the continuation of fiscal adjustment so as to generate considerable primary surpluses and reduce public debt to 60% of GDP by 2015, (ii) the prompt reform of the pension and healthcare systems and (iii) structural measures to increase the employment rate and improve productivity.

It should be recalled that in August 2006, the government established a Committee of Experts on Social Security Issues, whose task is to update existing studies and data concerning the social security system, to compile new studies where necessary, to evaluate all parameters of the system and to submit (sometime around autumn this year) a report which will be evaluated via a dialogue with the political parties and the social partners. From the general viewpoint of the medium-term and long-term prospects of the economy, it is extremely important that the findings of this committee give an effective solution to the problem of the extra burden that will be imposed on the budget by increased pension outlays.

It is worth noting that, to assist the dialogue concerning the social security issue, the Bank of Greece, in previous reports, had concluded that securing the resources needed to meet increased spending on pensions requires, in addition to the State funding provided for by law, a combination of (i) measures involving further changes in the structure and parameters of the social security system and increasing its funded-scheme characteristics and (ii) suitable macroeconomic policies which will favour economic growth and an increase in employment.[63] In addition, certain issues had been highlighted, such as the conditions for early retirement and the tackling of contribution evasion, which can already be looked into from now on. Such measures would have a favourable effect on both revenue and expenditure for pensions. It had also been pointed out in previous reports that it would be advisable to examine other issues, e.g. further reduction of the fragmentation and high operating costs of the social security system; reorganisation of social security funds; better utilisation and more efficient control of the funds' assets and reserves; rationalisation of the requirements that one must satisfy to draw a pension; and further freedom for members of the workforce to move between different funds (successive insurance).[64]

Of these issues, the large number of social security funds in existence, their lax administration, the absence of the infrastructure required to manage them properly and the loopholes in their supervision have all been long-standing problems. In particular, improved utilisation of the funds' assets and reserves and more efficient control have been of seri-

63 Bank of Greece, *Monetary Policy – Interim Report 2002*, November 2002, Box 2, p. 103.
64 See Bank of Greece, *Annual Report 2005*, pp. 77-78.

ous concern to public opinion recently. The government has taken certain decisions with immediate effect and has announced its intention to reform the existing institutional framework.[65] The position of the Bank of Greece is that the impending changes must be as broad as possible in order to bring the new institutional framework into line, as in other countries (e.g. the United Kingdom, Netherlands, Italy), with OECD guidelines on corporate governance of social security funds and the management of their assets[66] and to assign the supervision of these funds to an independent authority.

More particularly, the structure of corporate governance of pension funds must clearly ensure the appropriateness of administration, the suitable division of the functions and tasks of fund employees and the determination of their responsibilities within the operating framework of each such fund. These must be provided for in detail in the statute of each fund so that it is possible to both implement them and facilitate control procedures. Pension funds must have the necessary mechanisms for controls, communication and the provision of incentives which will encourage sound decision making, reliable and timely implementation of decisions, transparency and regular assessment of the effectiveness of the choices the funds have made.

The regulatory framework which will govern the management of pension funds' assets must guarantee that they meet their short-term and long-term obligations to pay the basic pension. To this end, they must aim at security, adequate returns and the maintenance of the necessary liquidity, by applying suitable investment risk management techniques (such as investment diversification), risk hedging and matching of liabilities with assets.

The main aim of pension fund supervision must be to promote stability, security, sound corporate governance and protection of the interests of those insured. Supervision must be assigned to an independent authority and ensure regulatory conformity of pension funds within a smoothly functioning social security system.

9.3 POLICIES TO BOOST THE POTENTIAL GROWTH RATE

The Greek economy continues to suffer from serious structural weaknesses in the labour and product markets as well as in the business environment and public administration. If these weaknesses are tackled decisively, it may be possible to improve labour productivity and the international competitiveness of the economy. As part of the Revised Lisbon Strategy, the European Commission gave a favourable evaluation in October 2006 of the macroeconomic performance of the Greek economy, but pointed out that "additional progress is

65 See the statements by the Minister of National Economy and Finance and the Minister of Employment and Social Protection, 20 March 2007, and the statements by the Prime Minister to Parliament, 22 March 2007. On 13 April 2007 a draft legislative amendment was put before Parliament to reform the system for selecting the Board Chairmen of Social Security Funds, restructure the Funds' Boards of Directors and extend the implementation of International Accounting Standards to cover Main and Supplementary Social Security Funds (including the use of IAS in the publication of the funds' financial statements and in the valuation of their financial assets as from 1 January 2008).

66 See OECD, Working Party on Private Pensions, "Guidelines for Pension Fund Governance", *Financial Market Trends*, No. 83, November 2002, and OECD Guidelines on Pension Fund Asset Management-Recommendation of the Council", 26 January 2006.

needed with respect to microeconomic and employment reforms."[67] It should be stressed that high growth rates do not imply that reforms are superfluous – on the contrary, they facilitate the implementation of difficult structural reforms and thereby create a favourable environment which can be utilised by economic policy makers and the social partners in Greece.

Progress towards the real convergence of the Greek economy with that of the EU-15 has been substantial in the last decade. However, Greece's *per capita* GDP, calculated in purchasing power standards, i.e. the main indicator of living standards, still remains lower than that of the EU-15, by 22.3% in 2005 and 21.5% in 2006, while it had been 35.7% lower in 1997 (as estimated by Eurostat). This differential can be attributed to two main factors. First, the employment rate (i.e. the number of people in employment as a percentage of the population in the 15-64 age group) in Greece was 60.1% in 2005 and 61% in 2006, lagging behind the EU-15 figures (65.2% in 2005 and 65.9% in 2006).[68] Second, according to Eurostat estimates, productivity measured on the basis of GDP in purchasing power standards per hour worked was 71.6% in 2004.[69] Therefore, the rise in the employment rate and the improvement in labour productivity may play a part in bringing about further real convergence and a rise in living standards.

The increase in *per capita* GDP in Greece in the last decade is chiefly due to the fast rise in productivity and, secondly, to the increase in the employment rate.[70] Most (at least 2/3) of the rise in productivity can be attributed to the increase in total factor productivity and the rest to the increase in capital per employee. The increase in total factor productivity reflects both the development of productivity in individual sectors of the economy and the impact of the change in the share of these sectors in GDP – in particular, the impact of the reduction in the share of the primary sector, where labour productivity is relatively low, and of the corresponding increase in the share of the other sectors, whose productivity is relatively high. The favourable effect of the shift in employment away from agriculture into other sectors is diminishing.

However, as analysed below, there is considerable room —if the appropriate reforms are implemented— for a further rise both in the employment rate and in productivity, in order to raise the potential growth rate of the Greek economy.

67 European Commission, *Greece: Assessment of National Reform Programme,* December 2006, and "The Commission assesses progress with reform to boost growth and jobs in Greece", European Commission Press Release, 12 December 2006.

68 If the employment rate is measured in working hours rather than on the basis of the number of people in employment, the differential compared with the EU-15 (as far as this percentage is concerned) is eliminated. See also Bank of Greece, *Annual Report 2004*, p. 72.

69 There are still no Eurostat estimates for 2005 and 2006. Labour productivity measured on the basis of GDP in purchasing power standards per employed person was equal to 95.2% of the EU-15 average in 2005 and to 96.1% in 2006, according to Eurostat. If, in order to calculate productivity in Greece, account is taken of the data contained in the Labour Force Survey, GDP per employed person in Greece in 2005 was equal to 88% of the EU-15 average. It should be recalled that a comparison with the EU-15 on the basis of GDP per employed person is more favourable than a comparison based on GDP per working hour, as the number of working hours per employed person in Greece is higher than the EU-15 average (in the other EU-15 countries part-time employment is more widespread).

70 Although the increase in total employment was relatively small, there was a gradual but large-scale shift of employment away from the primary sector, where there was significant under-employment and low productivity, into other sectors of the economy.

9.3.1 Increase in the employment rate

As already reported, the employment rate in Greece is below the EU-15 average (61% compared with 65.9% in 2006), while the unemployment rate is higher (8.9% compared with 7.8% – see Section 3.2 above). The fact that unemployment remains high (despite accelerated economic growth in recent years) and affects mainly young people and women implies that the problem is structural and that there are serious rigidities in the labour market. The legal framework of employment protection along with other labour market arrangements may sometimes have the opposite effect to that desired and ultimately discourage enterprises from recruiting new staff, thereby feeding the unofficial labour market. This leads to a containment of the growth rate of employment and keeps unemployment relatively high, particularly among young people and women.

It is, however, possible to increase the employment rate by implementing policies aimed at (i) improving the functioning of the labour market by promoting arrangements which combine security and flexibility, (ii) upgrading workforce skills, given the rapid pace of economic and technological change, (iii) expanding child care facilities (crèches, all-day nurseries and primary schools), promoting equal opportunities for men and women as regards employment and career development, striking a balance between work and family life, encouraging part-time employment and reducing early retirement in order to boost the participation of women, young people and older people in the labour market, (iv) further facilitating the integration of immigrants into the Greek labour market, (v) increasing the effectiveness of active labour market policies and of operation of public and private agencies which help match the supply and demand for labour, and (vi) improving the education system at all levels, vocational training and lifelong learning so as to provide (and refresh) the qualifications and knowledge required for employment in rising production sectors with high value added. It should be noted that some of these policies, which facilitate the participation of women in the labour market and help strike a balance between career and family life, may at the same time contribute to an increase in the birth and fertility rates.[71] In addition, it will be beneficial if steps to integrate immigrants into the labour market include measures to improve their education and skills. Immigration policy should, among other things, be aimed at attracting medium- and high-skilled immigrants, as such shortages are evident in the domestic market (other countries which attract immigrants are pursuing a similar policy).

With regard to the above issues, legislation has already been passed introducing significant arrangements in the education system (see Section 9.3.2 below). In addition, the new Civil Service Code[72] (which concerns central government employees) includes measures to make it easier to combine family life with professional activity, while at the beginning of this year a law was passed to complement arrangements existing since 2005, which make it simpler for immigrants from non-EU countries to acquire residence and work permits (see Box III.3). Finally, the government intends to take steps to improve the operation

71 See footnote 60.
72 Law 3528/2007.

of the Greek Manpower Employment Organisation and to achieve a more efficient matching of supply and demand for labour. Legislation has also been passed to improve financial support to the unemployed (see Chapter III.4). These are important arrangements, but, if they are not to act as a disincentive to work, they must be combined with measures that will assist people to gain work experience and attend retraining programmes.

Policies which contribute to a rise in the employment rate by reducing labour market rigidities or upgrading human capital may also lead to an increase in total factor productivity.

9.3.2. Increasing total factor productivity

"Total factor productivity" can be increased through policies aimed at (i) improving the operation of the labour market (already referred to in Section 9.3.1.), (ii) promoting competition and reducing rigidities in the product markets by simplifying the regulatory framework, (iii) modernising public administration and (iv) upgrading human capital.

The strengthening of competition in product markets

The strengthening of competition in product markets contributes directly to increasing total factor productivity, as it exerts pressure on firms to lower production costs and introduce innovation. The progress which has been achieved by the deregulation of the financial sector and telecommunications, as well as other sectors such as energy, coastal sea transport and postal services, has already benefited the economy. However, there is still room for stronger competition in these and in other sectors. Inadequate competition may reflect, depending on the case, defects in the institutional framework, incomplete compliance with EU directives or, more frequently, a restrictive regulatory framework which is aimed at protecting existing businesses or occupational groups and usually involves administrative obstacles hampering new business start-ups or the administrative imposition of operating terms and remuneration levels. As an example, it should be noted that, based on the "Ease of doing business" index compiled by the World Bank,[73] Greece ranks 109th out of 175 countries and has the poorest ranking among the countries of the EU-27,[74] as the cost and time demanded for a business start-up are among the highest (based on the relevant indicator, Greece ranks 140th).

Of course, progress has been made in recent years, as important legislation has been passed (see Box III.1). In addition, the Hellenic Competition Commission, which has expanded the scope of its activities recently, may also contribute to enhancing competition, together with the continuation of the privatisation programme and the further reduction of the share of the State in business activity.

The modernisation of public administration

The modernisation of public administration can contribute decisively to increased productivity. While public administration expenditure is relatively high in Greece, the quality of services offered to citizens and

73 World Bank, *Doing Business 2007: How to Reform,* September 2006.

74 Excluding Cyprus, Luxembourg and Malta, which are not included in the survey.

enterprises lags behind that of other EU countries.[75] At the same time, the "administrative costs" which burden enterprises and individuals in Greece (when they comply with their legal obligations to provide information and data to the authorities and third parties) are the highest in the EU (6.8% of GDP in 2005, compared with 3.5% on average in the EU-25).[76] In addition, according to an earlier survey by the Federation of Greek Industries (SEV), the "measured costs of bureaucracy" stand at 1.6% of value added in large companies, 3.7% in medium-sized companies and 7.2% in small ones.[77]

The benefits to the economy of reforming public administration are, therefore, clear. More effective utilisation of the human resources available, with continuous training (particularly in information technology), transfers of staff and reduction of the ratio of new hirings to retirements, can be combined with greater stability and transparency in legislation and the regulatory framework and the simplification of bureaucratic procedures. At the same time, the adoption of information technology applications offers opportunities for cutting administrative costs and raising efficiency, as demonstrated by experience in other countries. By this approach, fiscal pressures will be reduced, the quality of the services provided will improve and there will be beneficial consequences for productivity in the economy as a whole.

The operation of the Citizen Service Centres (KEP), which now have longer opening hours and can provide ever more administrative services, the fact that a number of public services are now responsible for obtaining a considerable number of certificates themselves rather than requiring citizens to provide them, and the option of communicating on-line with the Tax Offices (DOY) and the Social Insurance Institute (IKA), are all significant steps forward which have already improved the operating efficiency of public administration. However, operating problems still remain, as is clear from the considerable number of documents required for certain transactions, from the lack of co-ordination sometimes observed among different services in the public sector and from the inadequate information provided to citizens on certain issues concerning their transactions with the administrative mechanism.

The creation of web pages/websites for all services which deal with the public and/or assist with economic activity, or the improvement and continuous update of already existing sites, together with greater utilisation in general of information and communication technologies to provide information more smoothly and directly and to serve the needs of interested parties, will lead to a faster completion of bureaucratic procedures with fewer administrative errors and a lesser need for the citizens to visit public services so frequently in person and, therefore, to a reduction in the costs of public services to individuals and enterprises. Electronic transactions may be eventually introduced for all

75 The number of complaints submitted to the Greek Ombudsman (relating to public administration) is among the highest in Europe. See Greek Ombudsman, *Annual Report 2006*, and the relevant Press Release, 28 March 2007.

76 European Commission, (i) "Measuring administrative costs & reducing administrative burdens in the European Union", Memo/06/425, 14 November 2006, and (ii) "Action Programme for Reducing Administrative Burdens in the European Union – Commission Staff Working Document", SEC (2007) 84, 24 January 2007.

77 See Box III.1 and also SEV-IOBE, "Summary results of a pilot survey", 16 June 2005.

types of tender procedures carried out by the government, starting with those related to public works.[78]

To achieve the above requires, *inter alia,* the elimination of any inadequacies in infrastructure (e.g. as far as the use of optical fibres or broadband networks is concerned), prompt procurement of required equipment, staff training to ensure they have the know-how and skills required to use Information and Communication Technologies, and the introduction of the institutional framework required for electronic transactions and communications (e.g. "teleconferencing", "electronic signature", etc.). It is not just in public administration that the scope exists for greater use of new Information and Communication Technologies – such scope exists throughout the *whole economy*. This is evident from Greece's low ranking in the Network Readiness Index (NRI), which is compiled by the World Economic Forum.[79] The index evaluates the performance of an economy in terms of its existing institutional framework and its telecommunications and IT infrastructure, the degree of usage of new technologies and the readiness of the economy (citizens, companies, public administration) to adopt innovations. According to the index, Greece ranks 24th among the EU-27 countries (followed by Romania, Poland and Bulgaria) and 48th among the 122 countries included in the survey.

Several of the measures to reduce bureaucratic procedures and the administrative burden, or the measures previously referred to for addressing the above problems, e.g. for simplifying the regulatory framework, are of relatively low economic and social cost. They can, therefore, be implemented immediately and will be generally acceptable.

Upgrading human capital

In today's economies, human capital is a major factor of production. Since the rapid progress of technology requires continuous adaptation and renewal of the workforce's know-how and skills, all levels of the education system, vocational training and lifelong learning are of particular importance for the growth performance and prospects of the economy and, therefore, for living standards.

Moreover, the educational level has a positive effect on the performance of individuals in the labour market as it increases the chances of finding a job, offers a higher potential salary, and, more generally, improves professional prospects. It should be noted that, in Greece, the employment rate for people with a high educational background was 81.4% in 2005 (close to the average employment rate for the same category in the EU-25, which was 82.5%), while for those with a medium level of education the rate was 61.0% (68.7% in the EU-25) and for people with a low level of education it was 50.5% (46.4% in the EU-25).[80] By con-

78 The Republic of Korea (South Korea) has already introduced this practice. The system is called O.P.E.N., which, among other things, implies that it is aimed at securing transparency and eradicating corruption.

79 World Economic Forum and INSEAD, *The Global Information Technology Report 2006-2007,* March 2007.

80 Data from the report of the European Commission *Employment in Europe 2006,* November 2006, Table 11. A low educational level is defined as completion of preschool or primary or lower secondary school education. A medium-level education is defined as completion of secondary education or post-secondary —non-university— education, while a high-level educational background is defined as completion of a first degree or postgraduate degree at university.

trast, the unemployment rate was significantly lower for people with a high educational background (7.7%) than it was for people with a medium-level education (11.5%) and those with a low-level educational background (9.0%). In addition, it appears that higher educational levels are linked with higher salaries in EU countries,[81] while a recent study[82] confirms that this assumption is also true for Greece.

The need to upgrade education in Greece is clear from the fact that in the 15-64 age group the percentage of the population with a low educational level is very large: 40.8% (in 2005), compared with 32.8% in the EU-25.[83] Only four other countries[84] in the EU-25 report a larger percentage than Greece.

The foregoing analysis shows the crucial importance of efficient public spending on education. For instance, Greece ranks lower than average[85] among OECD countries as regards the efficiency of resource allocation to primary and secondary education. In practical terms this means that, given the level of inputs into the schooling system, the total performance of the system (i.e. the quality of education as reflected in student performance) could be far higher. International comparisons reveal that the relationship between the effectiveness of public spending on school education, various institutional framework indicators and other policy factors is exceptionally complex. Recently, however, the findings of empirical research by the OECD have suggested that factors such as the quality and duration of teacher training, decentralisation of the schooling system (in the sense of allowing greater autonomy for decision-making at the school level), competition between schools, and teachers' salary levels are linked with increased effectiveness. Of course, as countries with high-performing schools frequently differ significantly in terms of the institutional framework of primary and secondary education, planning suitable reforms for Greece requires careful study both of the factors which underpin the positive performance of schools in other countries and of the factors which are specific to the Greek education system and the environment in which it operates.

The National Reform Programme (October 2005) contains references to several goals, including increasing public spending on education to 5% of GDP by 2008, managing resources more effectively, improving the quality of education provided, expanding the provision of lifelong learning and more effectively linking the labour market with education. In particular, the Programme provides for the decentralisation of the management of resources, with enhanced administrative structures at a regional level. The effort to improve the quality of the education provided includes activities such as the introduction of new teaching books for primary and secondary schools and the implementation of legislation (Laws 2986/2002 and 3374/2005) for the appraisal of primary and

81 European Commission, *Employment in Europe 2005,* October 2005.
82 E. Papapetrou, "Education, labour market and wage differentials in Greece", Bank of Greece, *Economic Bulletin,* No. 28, February 2007.
83 People with a high educational level comprise 17.6% of the population of working age (15-64), while 41.6% of the working population has a medium-level education. See *Employment in Europe 2006,* November 2006, Table 10.
84 Italy (50.7%), Spain (51.9%), Portugal (72.8%) and Malta (73.0%).
85 See Gonand, F., I. Joumard and R. Price, "Public Spending efficiency: institutional indicators in primary and secondary education", OECD Economics Department Working papers, No. 543, January 2007.

secondary school units as well as higher education institutions. As for lifelong learning, the percentage of the population between 25 and 64 years participating in educational or training programmes is still very low in Greece (1.9% in 2005, compared with 11.2% in the EU-15). With regard to vocational training and the link-up of the education and training systems with the labour market, the role of the Organisation for Vocational Education and Training has been strengthened, the executive committee of the National Council for Linking Vocational Education and Training with Employment has been set up and the Institutes for Lifelong Learning Scheme can be introduced (on the basis of Law 3369/2005) in universities and TEI (Technological Educational Institutions).

As for tertiary education, in March this year Law 3549/2007 was passed ("Reform of the institutional framework for the structure and operation of Higher Education Institutions"). This law is aimed at improving the quality of higher education and boosting research. More specifically, among other things it contains provisions to improve the governance of Higher Education Institutions, increase their administrative autonomy, enhance their academic and developmental planning and improve transparency of operation. It also includes other reforms to modernise procedures for restructuring and/or creating university schools and departments. The law determines the maximum duration of studies, introduces counselling and support services for students and broadens the options for financial support to students (through financial support for work and interest-free student loans).

There can be no doubt that reform efforts must continue, at the tertiary level as well as at other educational levels, to bring about the overall modernisation of the country's education system.

10 CONCLUSIONS

In 2007 the Greek economy finds itself in its seventh year since the adoption of the euro and the 14th year of continued substantial growth of its gross domestic product and real incomes. Thanks to this growth, major progress has been made towards the convergence of living standards in Greece with the EU-15 average. The annual growth rate stood at 4.3% in 2006, exceeding the average figure for the last decade (4.1%). The rate is expected to remain high this year and is considerably higher than that in the European Union as a whole. In addition, inflation dropped slightly in 2006 to reach 3-3.5% in recent years (i.e. it has fallen significantly in comparison with the rate 10-15 years ago). The budget deficit narrowed to 2.6% of GDP (from 5.5% in 2005), the unemployment rate continued to drop and employment growth accelerated.

Such performance is particularly satisfying but should not lead to complacency. Despite the progress made, the economy still faces macroeconomic imbalances and structural weaknesses. While inflation has fallen, it remains higher than in the euro area as a whole and in many of the country's trading partners, resulting not only in the erosion of incomes but also in an almost uninterrupted decline in the international price competitiveness of the economy. This decline, combined with the relatively low level of structural competitiveness, is among the factors responsible for the growing current account deficit as a percentage of GDP in recent years and the fact that it reached an exceptionally high level in 2006. The unemployment rate, although it fell by 3 percentage points over a seven-year period, remains high, despite rapid economic growth, implying that the cause is structural. The poverty rate has not changed significantly in recent years, and the same is true of income inequality. Finally, public debt as a percentage of GDP has fallen at a relatively low average annual rate since 2000 and was the second highest in the EU in 2006. This has placed a significant burden on the national budget and the economy in general, given the costs involved in servicing the debt. To evaluate fully all these data, account must be taken of the major challenges facing the Greek economy as a result of globalisation and the prospect of population ageing.

These comments should not be taken as implying pessimism. The experience of the last 10-15 years has confirmed that major goals can be achieved, such as entry into the euro area, the successful holding of the Olympic Games in Athens and the continued dynamic growth of economic activity after the end of the Games.

Today, in 2007, the Greek economy is in a better condition than it was 10 or 15 years ago as regards its productive capacity (physical and human capital), the operating terms of its markets and its more general macroeconomic framework, a particularly beneficial element of which has been the country's entry into the euro area.

If full use is made of the experience gained from the successes as well as the failures and delays noted to date, it will be possible to formulate appropriate policies which will be accepted generally and be implemented effectively. Such policies will make it possible to eliminate or minimise macroeconomic imbalances and structural weaknesses so as to maintain high growth rates in the long term, improve Greece's competitive position within the global economy, achieve a faster rise in employment, reduce unemployment drastically, boost social cohesion and bring about a faster convergence of living standards in Greece with those in the more advanced countries of the European Union.

In particular, continued fiscal adjustment is essential if a fiscal surplus and a significant reduction in public debt are to be achieved. If account is taken of the expected long-term increase in public spending on pensions and healthcare as a percentage of GDP because of population ageing, there must be a greater and permanent improvement in the fiscal position in order to create primary surpluses significantly larger than targeted at present. Further fiscal consolidation must be based on the prioritisation and rigorous control of current spending, on expanding the tax base and on reducing tax and contribution evasion. This will make it possible both to reduce further the burden of high tax rates and high social security contributions on enterprises and households and to carry out adequate public investment to improve infrastructure while ensuring social protection for the more vulnerable population groups. Of course, prompt reform of the social security and healthcare systems is of crucial importance if fiscal pressures arising from population ageing are to be tackled in a socially fair manner and without unfavourable effects on the economy's growth outlook.

In addition, given the new economic environment created by the adoption of the euro, the social partners can play a substantial role on a permanent basis in achieving price stability via both collective wage bargaining and pricing policies of enterprises. If wage agreements are consistent with price competitiveness, the level of unemployment and the evolution of productivity, all will stand to benefit, as nominal salary increases will not be eroded by inflation, nor will growth and employment prospects be undermined. Improved productivity can also play a part in containing the increase in unit labour costs. At the same time, there remains significant scope for greater competition in product markets, which will help ensure that price developments are compatible with the evolution of production costs and that profit margins are at levels which will not undermine competitiveness and price stability.

Finally, structural reforms must continue over a wide range of sectors of the economy in order to reduce rigidities in the labour and product markets, upgrade human capital, improve the efficiency of public administration and, eventually, restructure the economy's production base. It will thus be possible to reshape the Greek economy so that its future growth will rely on exports and business investment to a much greater extent than is the case today. These reforms will increase opportunities for all to participate in a more broadly based process of growth. It is also extremely important that the education system be restructured at all levels so as to increase productivity, boost employment, reduce unemployment and limit income inequalities. School and university graduates will thus have the qualifications required for them to keep abreast of technological developments and take part in the rise of technologically advanced branches of economic activity, besides benefiting from this rise and, thereby, improving their income prospects.

Problems and future challenges are not highlighted here in order to discourage economic agents —businesses, workers and households— but with the aim of providing them with the fullest information possible. Information is essential, particularly when it concerns the crucial and sensitive issue of structural reforms. Information is a key prerequisite for constructive social dialogue, which, in turn, is the foundation of the required consensus and will lead to correct and generally acceptable decisions which, on the one hand, will ensure that the costs of the necessary structural changes are fairly divided among social groups and generations and, on the other hand, will allow measures to be taken for the targeted support of those social groups which are likely to be adversely affected by such reforms. Thus, in a radically changing world, it will be possible to implement policies which will permit the Greek economy to achieve the qualitative leap which the times demand.

III ECONOMIC ACTIVITY AND EMPLOYMENT

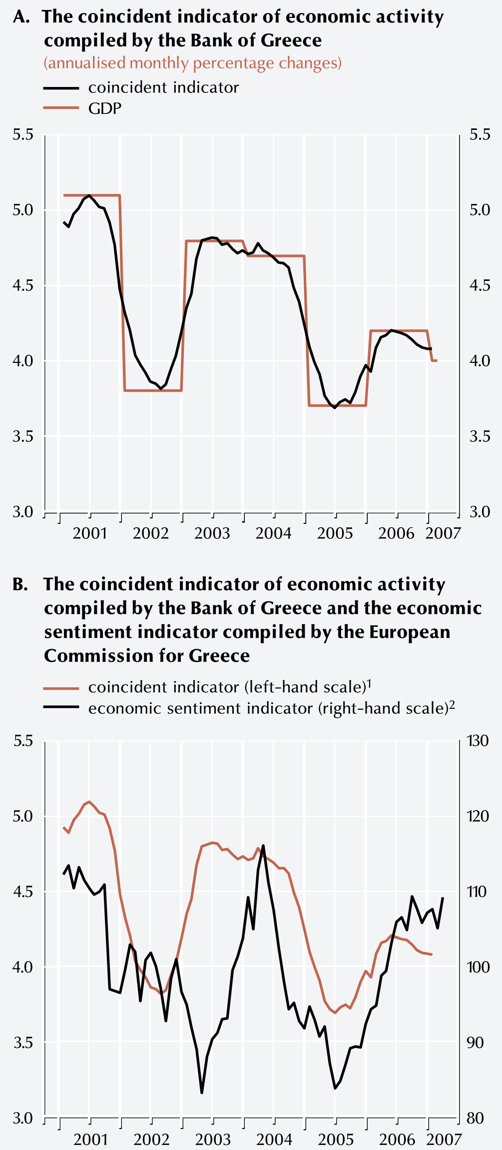
1 EXPENDITURE AND NATIONAL INCOME

1.1 SUMMARY OF DEVELOPMENTS IN 2006 AND THE OUTLOOK FOR 2007

According to the latest national accounts estimates by the Ministry of Economy and Finance,[1] GDP rose by 4.3% in 2006 (3.7% in 2005). The coincident indicator of economic activity, which is compiled by the Bank of Greece and is derived from a set of short-term indicators, records the acceleration of GDP growth, especially in the first half of the year (see Chart III.1). Moreover, the Economic Sentiment Indicator for Greece (compiled by the European Commission based on business survey results), after declining in 2005, showed an upward trend in 2006.

On the demand side, the rise in GDP growth in 2006 was the result of the favourable international environment and the prevailing monetary and financial conditions, which enabled the further financing of household expenditure and business investment. On a more general note, the rapid growth seen in the last few years can also be attributed to structural reforms. It should be noted that the contribution of domestic demand to GDP growth came to 6.1 percentage points, from 2.1 percentage points in 2005, mainly because of the significant increase in business investment and housing investment, as well as the strong growth of private consumption. By contrast, the external sector of the economy, having made a positive contribution (by 1.1 percentage point) to the GDP growth rate in 2005, had, once more, a negative effect (by 2.0 percentage points) in 2006 (see Table III.1).

Chart III.1 Economic activity indicators



1 Annualised monthly percentage changes.
2 Monthly data.
Sources: Bank of Greece (coincident indicator, as well as GDP for 2007), NSSG (GDP 2001-2006) and European Commission (economic sentiment indicator).

The growth rate of private consumption remained at high levels in 2006. Indeed, it

1 April 2007. The estimates were made on the basis of the old national accounts series.

Table III.1 Gross expenditure of the economy and gross domestic product

(constant market prices of 1995)

	Annual percentage changes				
	2002	2003	2004	2005	2006
1. Private consumption	3.6	4.5	4.7	3.4	3.9
2. Public consumption	6.5	–1.3	2.5	1.0	0.6
3. Gross fixed capital formation	5.7	13.7	5.7	–1.4	12.7
3.1a By investor: general government	–1.9	20.3	6.7	–13.3	7.6
3.1b other sectors	7.2	12.5	5.5	0.9	13.6
3.2a By type: construction	3.7	10.9	3.6	–4.4	21.6
3.2b equipment	6.9	18.3	8.0	0.5	3.5
3.2c other investment	21.0	3.4	7.0	14.5	10.9
4. Change in stocks and statistical discrepancy (% of GDP)	0.4	0.2	0.2	0.7	0.9
5. Domestic final demand	5.0	5.5	4.7	2.3	5.7
6. Exports of goods and services	–7.7	1.0	11.5	3.0	5.1
6.1 Exports of goods	–7.1	4.2	–2.5	8.2	11.0
6.2 Exports of services	–8.1	–1.3	21.8	–0.1	1.4
7. Final demand	2.7	4.8	5.8	2.4	5.6
8. Imports of goods and services	–0.8	4.8	9.3	–1.2	9.8
8.1 Imports of goods	3.7	7.7	9.0	–0.1	9.8
8.2 Imports of services	–18.7	–10.0	11.0	–7.6	9.8
GDP at market prices	**3.8**	**4.8**	**4.7**	**3.7**	**4.3**
	Contribution to GDP change (percentage points)				
1. Private consumption	2.5	3.1	3.3	2.3	2.7
2. Public consumption	1.0	–0.2	0.4	0.1	0.1
3. Gross fixed capital formation	1.4	3.4	1.5	–0.4	3.3
3.1a By investor: general government	–0.1	0.8	0.3	–0.6	0.3
3.1b other sectors	1.5	2.6	1.2	0.2	3.0
3.2a By type: construction	0.5	1.4	0.5	–0.6	2.7
3.2b equipment	0.7	1.9	1.0	0.1	0.4
3.2c other investment	0.2	0.0	0.1	0.2	0.1
4. Change in stocks and statistical discrepancy	0.5	–0.2	0.1	0.5	0.2
5. Domestic final demand (excluding the change in inventories)	4.9	6.3	5.2	2.1	6.1
6. Exports of goods and services	–1.9	0.2	2.4	0.7	1.1
6.1 Exports of goods	–0.7	0.4	–0.2	0.7	1.0
6.2 Exports of services	–1.2	–0.2	2.6	0.0	0.2
7. Final demand	3.6	6.3	7.7	3.3	7.4
8. Imports of goods and services	0.3	–1.5	–3.0	0.4	–3.1
8.1 Imports of goods	–1.0	–2.1	–2.5	0.0	–2.7
8.2 Imports of services	1.3	0.5	–0.5	0.4	–0.4
9. Balance of goods and services	–1.6	–1.3	–0.6	1.1	–2.0
GDP at market prices	**3.8**	**4.8**	**4.7**	**3.7**	**4.3**

Source: Ministry of Economy and Finance, April 2007.

accelerated (to 3.9% from 3.4% in 2005) and continued to support domestic demand, reflecting the increase in households' real disposable income and the effects of consumer credit on consumption. However, since the growth of households' real disposable income was outpaced by the growth of private consumption, the average propensity of households to save recorded a small further decline. Specifically, the increase in disposable income is attributed to the rise in the net average take-home pay of employees, increased public transfers to less well-off population groups, as well as the increase in salaried employment. In addition, the increase in the total market value of the stock of dwellings and the rise in the average price level of shares listed on the Athens Exchange contributed to increasing total household wealth and supported private consumption. Lastly, the deregulation of the banking system and the easier access to consumer credit have contributed to maintaining high but relatively constant growth rates of private consumption, which now depend less on short-term fluctuations in the disposable income than in the past.

Public consumption grew by 0.6% in 2006 (1.0% in 2005), partly owing to increased employment in the general government sector, as well as to the rise in other expenditure.

Gross fixed capital formation increased by 12.7% in 2006, following a small decrease (1.4%) in 2005, mainly reflecting the steep rise (32.3%) in residential investment. Public investment increased by 7.6% (having declined in 2005), while the growth rate of business investment accelerated significantly (to 8.6% from 1.5% in 2005). The high growth rate of business investment was decisively influenced by the positive developments in domestic and international demand, the favourable financing conditions, as well as the good financial position of firms. The new investment initiatives taken can also be attributed to the opportunities offered by the existing legislative framework supporting investment (an appreciable number of investment plans, chiefly in manufacturing and tourism, have benefited from the provisions of "development" law 3299/2004), as well as to the improved investment climate, as evidenced by both the significant rise in the Economic Sentiment Indicator and the increase in the IOBE index of business expectations in manufacturing. (For the persisting obstacles to business activity due to regulatory interventions and administrative charges, as well as the measures taken to eliminate them, see Box III.1).

Box III.1

THE EXTENT AND IMPACT OF BUSINESS REGULATIONS

1. Introduction

The regulation of the start-up and operation of enterprises aims to protect consumers, the environment and investors, while it also constitutes a source of public sector revenue. Regulations usually take one of the following forms: (a) payment of fees (b) obligation of firms to inform authorities and the public on a number of issues relating to their operation (e.g. changes in their partnership deed, publication of the founding deed, publication of financial accounts etc.) and (c) restrictions on companies' activities (e.g. environmental regulations etc.).

In certain instances, however, these interventions are not effective (e.g. companies are obliged to submit information more than once to different government agencies)[1] or they no longer satisfy the

1 As an indication note that in April 2005 the Federation of Industries of Northern Greece (SBBE) in a memorandum addressed to the Central Committee for the Simplification of Procedures, which has been set up following the provisions of article 10 of Law 3242/2004 and operates under the auspices of the Ministry of Interior, Public Administration and Decentralisation to simplify procedures governing the transactions of the public sector with firms and citizens, lists a number of instances in which firms are obliged to submit the *same* information to different agencies (e.g. social security funds, the Manpower Employment Organisation – OAED, the tax offices etc.), which make limited use of the information they already have and of information technology to exchange information across the public sector.

goal for which they were initially established or they create distortions in market operations. In other words, the total cost of these regulations might exceed the expected benefit. It is indicative that not only businesses, but also the agencies responsible for the implementation of regulations propose their rationalisation.

Business surveys (both in Greece and internationally) suggest that regulations can hinder economic activity. Greek firms that took part in the survey for the 2006-2007 *Global Competitiveness Report* singled out both red tape and the frequent changes in legislation as deterrents to business activity.[2] Calls for the curtailment of these regulations have been voiced by, *inter alia,* the Federation of Greek Industries (SEB), the Federation of Industries of Northern Greece (SBBE)[3] and the National Confederation of Hellenic Commerce (ESEE).[4]

An increasing number of agencies planning and introducing business regulations are becoming all too aware of these "side effects". The expected positive impact from reducing and rationalising regulations, whether these arise from EU legislation or from national legislation, on the economy as a whole and on small and medium-sized enterprises (SMEs) in particular, was also stressed in the Presidency Conclusions of the March 2007 European Council.[5]

2. Cross-country comparisons of administrative burdens

From studies by the OECD, the World Bank and other organisations (e.g. SEB, research institutes etc.) it appears that administrative burdens in Greece are more extensive and impose a higher cost on enterprises. More specifically, the OECD indicator on the *extent* of business regulations in 2003,[6] shows that Greece, together with France and Italy, were among the countries where administrative burdens weighed highest, due to the pervasiveness of state control, bureaucracy and economic regulations (e.g. price controls, command and control regulation etc.).

A more recent cross-country comparison on the burdens caused by the regulations relating to the start-up of companies has been published by the World Bank.[7] The comparison relates to the number of procedures and the cost of launching a business with the most representative in each country legal form in 2004. In Greece the most representative legal form is that of a Limited Liability Company (EPE).[8] Launching a business with this legal form requires 15 procedures, which take around 38 days to complete at an approximate cost of €3,700. The procedures to set up a business in Athens with company capital of around €155 thousand together with an estimate of the number of days it takes to com-

2 See *Federation of Greek Industries (SEB) Bulletin,* No. 628, September-October 2006 (in Greek).
3 See *SBEE Bulletin,* No. 6, November-December 2006 (in Greek).
4 See ESEE Press Release following a meeting between the Chairman of ESEE and the Deputy Minister of Development on 22 Feb. 2007 (in Greek).
5 See Presidency Conclusions of the Brussels European Council on 8 and 9 March 2007 (http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/93135.pdf).
6 Also see Bank of Greece, *Monetary Policy 2004-2005,* February 2005, Appendix to Chapter III, pp. 84-90.
7 World Bank, *Doing Business in 2007: How to Reform,* September 2006.
8 According to Law 3190/1955 ("Regarding Limited Liability Companies") an EPE is considered as a commercial firm even if this is not its line of business. Certain activities, however, cannot be exercised by a company with this legal form. These are: banking, insurance, brokerage, asset portfolio management, mutual funds management, leasing, factoring, venture capital and activities related to sports.

Table A Procedures and costs for launching a limited liability company (EPE) in 2004

Procedure	Days for completion	Estimate in euro[1]
Get approval by the Chamber of Commerce and Industry to use the company's name	1	30
File company documents with the Athens Bar Association	1	706
Sign the articles of incorporation before a notary public	5	1,000
Deposit capital with a bank	1	0
Pay the capital tax on the concentration of capital[2]	1	1,552
Obtain a stamp from the Lawyers' Pension Fund	1	0
Obtain certification by the Lawyers' Welfare Fund	1	6
Submit the Articles of Incorporation and register with the secretariat of the Court of First Instance, which issues a register number	1	5
Submit summary of the Articles of Incorporation to the Printing Office for publication in the Official Gazette (FEK)[3]	26	250
Register at the Chamber of Commerce and Industry[4]	1	125
Register with the relevant social security authorities[4]	1	0
Obtain a Tax Registration Number (AFM)[4]	1	0
Make a seal[4]	1	40
Have the Tax Authority hole-stamp the company's invoice and account books[4]	1	0
Notify the Manpower Employment Organisation[4] (OAED) within 8 days of hiring a worker[4]	1	0
Total	**38**	**3,714**

1 Refers to the cost for launching an EPE (limited liability company) in 2004, belonging to the Athens Chamber of Commerce and Industry, with capital ten times the per capita income (€15,520) of the country in the same year. The data refer to 2004 in order to be able to compare them with those for other EU-15 countries (Table B).
2 The tax is equal to 1% of the company capital.
3 The number of days refers to the length of time required for *publication* in the Official Gazette. Notification about the issue in which the summary of the articles of incorporation will be published takes only 4-5 days.
4 Completion of these steps does not depend on the completion of other procedures.
Source: World Bank (2006), *Doing Business in 2007: How to Reform,* Washington.

Table B Time and cost needed to start up a business in EU-15 countries in 2004

Country	Number of procedures	Days for completion of the procedures	Cost for starting up a business as a percentage of per capita income	Minimum capital required as a percentage of per capita income
Greece	**15**	**38**	**24.0[1]**	**116.0[2]**
Spain	10	47	16.2	14.6
Italy	9	13	15.2	10.4
Netherlands	6	10	7.2	62.3
Belgium	4	27	5.8	21.8
Austria	9	29	5.6	59.6
Germany	9	24	5.1	46.2
Portugal	8	8	4.3	38.7
France	7	8	1.1	0.0
Finland	3	14	1.1	27.1
Sweden	3	16	0.7	33.7
UK	6	18	0.7	0.0
Ireland	4	19	0.3	0.0
Denmark	3	5	0.0	44.6
Average	**6.9**	**19.7**	**6.2**	**33.9**

1 Refers to the cost for launching an EPE (limited liability company) in 2004, belonging to the Athens Chamber of Commerce and Industry, with capital ten times the per capita income (€15,520) of the country in the same year. The data refer to 2004 in order to be able to compare them with those for other EU-15 countries.
2 Minimum capital required for an EPE is €18,000.
Source: see Table A.

plete each of them are listed in Table A.[9] A comparison of these figures with those in other EU-15 countries suggests that companies in Greece fare worse, since both the time and the cost of launching a business are among the highest (see Table B).

9 To facilitate comparisons across countries the World Bank looks at companies of the most representative legal form in each country and with capital equal to ten times the per capita income in each country. The amount of €155 thousand is the equivalent of ten times the per capita income in Greece in 2004.

In addition to any cost involved in setting up a business (illustrated in Tables A and B), regulations also imply a cost for companies *already* in operation. This cost is both direct (e.g. fees) and indirect (e.g. opportunity cost to comply with regulations, foregone profits, restriction of economic activity and thus job creation). Both the direct and the indirect cost can weigh high on SMEs which cannot exploit economies of scale. A first attempt at quantifying the indirect cost for Greek companies was done in a joint study by the Federation of Greek Industries (SEB) and the Foundation for Economic and Industrial Research (IOBE).[10] The findings of this study suggest that for a small company (with between 2 and 50 employees) the cost of bureaucracy (defined as to include the cost of compliance to administrative regulations, the cost of delayed payments by the public sector and the cost of delayed start of investments or other actions) amounts to 7.2% of the company's value added.

Table C Administrative burdens as a percentage of GDP in EU-15 countries[1]

Country	Administrative burdens
UK	1.5
Sweden	1.5
Finland	1.5
Denmark	1.9
Ireland	2.4
Belgium[2]	2.8
France	3.7
Germany	3.7
Netherlands	3.7
Austria	4.6
Spain	4.6
Italy	4.6
Portugal	4.6
Greece	**6.8**

1 Refers to administrative burdens caused by regulation.
2 Includes Luxembourg.
Source: Kox, H. (2005), "Intra-EU differences in regulation-caused administrative burden for companies", *CPB Memorandum 136*, The Hague.

Researchers and research institutes in EU-15 countries have proceeded to further estimates of the total direct and indirect cost for each economy arising from the need to comply with administrative regulations. More specifically, according to a study by the Netherlands Bureau of Economic Analysis,[11] the results of which are used by the European Commission,[12] the sum of the direct and indirect cost of administrative burdens for companies amounts to 6.8% of Greece's GDP as against just 1.5% in the UK and Sweden (see Table C).[13] These estimates are inevitably tentative since there is without doubt some degree of arbitrariness in the assumptions made and as a result there are large discrepancies between alternative estimates of the cost of the same procedure.[14] To obtain a clearer and more complete picture, the European Commission is proceeding to record all the necessary procedures to meet administrative requirements and the cost that these involve in all EU countries.

3. Measures to simplify regulations for starting businesses

Steps have been taken in Greece to reduce the administrative burdens for companies arising from regulations. These include an improved information flow regarding the regulations themselves,[15] the use,

10 SEB (2005) "Cost for Greek firms of adhering to regulatory burdens: concise summary from a pilot survey by SEB-IOBE" (http://www.fgi.org.gr/uploads/largefiles/SEV_IOBE.pdf, in Greek).
11 Kox, H. (2005), "Intra-EU differences in regulation-caused administrative burden for companies", *CPB Memorandum 136*, Hague.
12 See, *inter alia,* European Commission (2007), "Impact assessment of the Action Programme for Reducing Administrative Burdens in the European Union", SEC(2007) 84.
13 The indirect cost is calculated as the product of time needed to comply with the regulations times the average wage.
14 The discrepancies are partly attributed to differences in the definitions followed (e.g. whether the entrepreneurs' time in adhering to the administrative burdens is taken into consideration or not), the breadth of the procedures included etc. See Kox (2005) for more details.
15 For example, the portal of the Hellenic Center for Investment (www.elke.gr) contains information about the procedures necessary for establishing a company in Greece.

albeit limited, of electronic means for the completion of certain procedures and the obligation of a number of government agencies to collect for themselves certain of the required supporting documents. Further, certain legislative initiatives have been taken to facilitate the procedures for launching and operating manufacturing sector establishments and firms in business lines under the supervision of the Health Directorate (e.g. cafés, restaurants etc.). More specifically, Law 3325/2005 ("Establishment and operation of manufacturing and handicraft firms in the context of sustainable growth and other provisions") provides for the speeding up of the process required to issue licenses for the establishment and operation of manufacturing firms, extends the time for which these licenses are valid and lifts the obligation, for small and low disturbance plants, of issuing a license. Furthermore, a Ministerial Decision was signed in February 2007 providing for the simplification of the establishment of restaurants, cafés etc.[16]

A measure expected to lead to more rational regulation in the future is the obligation of Ministries, following a circular by the Prime Minister in July 2006, to accompany their legislative proposals with an impact assessment of the economic and social cost of these measures and with a quantification of the administrative burden of the legislation.

For the simplification of the setting up procedure for companies of all forms and in all sectors of economic activity, the Ministry of Development in July 2006 published for consultation a proposal, according to which setting up a company will take at most 5 working days. This simplification will be realised through the Citizens' Service Centres (KEP) and the special services of the General Registry of Commercial Enterprises. Following certain changes to the proposal, resulting from the public consultation procedure, this has been submitted to the Council of State before being presented to Parliament.

At the same time the government is proceeding with the revision of codified Law 2190/1920 "On Sociétés Anonymes", which is expected to have a positive impact on entrepreneurial activity.[17] The revision aims to reduce the administrative supervision during the establishment and operation of Sociétés Anonymes (SAs) and to strengthen the position of shareholders and especially that of minority shareholders.

The rationalisation and simplification of regulatory procedures is expected to enhance economic activity, strengthening *inter alia* foreign direct investment flows. Measures to this effect could be adopted without delay, given that the cost of implementation is small, while the benefits are substantial. The importance of the reduction of administrative burdens for the European economy as a whole is clear from the fact that the European Council has set a target to reduce by 25% until 2012 the administrative burdens that derive from EU legislation and has called on Member States to set during 2008 their own national targets for the reduction of administrative burdens due to national legislation. The European Council has asked from the Council of Ministers to review, on an annual basis, progress regarding the improvement of legislation in general, and the reduction in administrative burdens more specifically.[18]

16 See Press Release of the Ministry of Development, 26 February 2007 (in Greek).
17 More specifically, in mid-July the Ministry of Development published for public consultation a draft bill produced by the committee which had been set up to revise the law. The comments made on this draft bill have been codified and have to some extent been adopted in the second draft bill on which the public will again be consulted. Following the second round of consultation, the draft bill will be submitted to Parliament.
18 See Presidency Conclusions of the Brussels European Council on 8 and 9 March 2007 (http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/93135.pdf).

According to national accounts estimates by the Ministry of Economy and Finance, exports of goods rose by 11% in 2006 (8.2% in 2005), outpacing the growth rate of global demand. This increase would have been much bigger had the cumulative losses of international price competitiveness in recent years been reduced (see Table IX.2). Exports of services picked up slightly in 2006 (1.4%, against –0.1% in 2005), because of the rise in shipping and tourism receipts. As a result, the growth rate of total exports of goods and services accelerated to 5.1% in 2006, from 3.0% in 2005.

Imports of goods and services grew by 9.8% according to national accounts estimates by the Ministry of Economy and Finance, having declined by 1.2% in 2005. The accelerated growth of imports was mainly due to the high growth rates of private consumption and to strong business investment activity.

As regards the outlook for 2007, GDP is projected to grow by 4% or slightly more, compared with 4.3% in 2006. Private consumption will keep up a high growth rate and will be supported by the expected increase in salaried employment, the maintenance of the growth rate of real incomes at least at 2006 levels, as well as the cumulative effects of the rise in the market value of household assets. The growth of private consumption will also be significantly influenced by the continuing increase in consumer loans, although their growth rate will probably be lower than in 2006. The growth rate of total gross fixed capital formation is expected to decelerate, mainly because the growth rate of residential investment will drop substantially from the extremely high levels recorded in 2006. By contrast, the growth rate of business investment should accelerate, as demand prospects for the products of many sectors are positive and corporate liquidity is sufficient. Furthermore, an appreciable number of investment plans have benefited from the provisions of development Law 3299/2004, while advantage is being taken of the provisions of Law 3389/2005 on public-private partnerships (also see Box VIII.2). For investment in the various regions of Greece on the basis of the National Strategic Reference Framework, see Box III.2.

Box III.2

THE REGIONAL DIMENSION OF THE NATIONAL DEVELOPMENT STRATEGY IN THE PERIOD 2007-2013

The national development planning for the period 2007-2013 is set out in the National Strategic Reference Framework (NSRF), formulated in collaboration with the competent ministries and regional and local authorities, as well as in consultation with the EU and various economic and social bodies. The main landmarks in the context of the consultation were Circulars I and II of the Ministry of Economy and Finance (June 2004 and October 2005, respectively), the organisation of Regional Development Conferences – RDCs (June-July 2005) and the organisation of the 1st and 2nd National Development Conferences – NDCs (July 2005 and December 2005, respectively).[1] After the finalisation of the new regulatory framework at the EU level, the Ministry of Economy and Finance for-

1 See Bank of Greece, *Annual Report 2005*, Box III.3.

warded Circular III,[2] while the 3rd NDC[3] and the 4th NDC[4] were held in June 2006 and October 2006, respectively.

Specifically, according to the NSRF 2007-2013,[5] the goal of national development strategy in the new programming period is to expand the country's growth potential, accelerate its economic growth rate and raise productivity to levels higher than the EU average. A key feature of development strategy is the enhancement of regional competitiveness, which requires significant structural reforms in each region's economy.

Indicative annual financing allocation of Community Contribution to ROPs (Objectives 1 and 2)[1]

(million euro, current prices)

	Regions						
	Macedonia-Thrace	Western Greece-Peloponnese-Ionian Islands	Crete-Aegean Islands	Thessaly-Sterea Ellada-Epirus	Attica	ERDF	Total ERDF 2007-2013
2007	430,161.7	122,943.9	146,446.1	225,137.4	416,821.7	1,939,449.3	3,085,468.1
2008	415,463.6	125,402.8	138,022.6	199,944.4	398,591.9	1,887,420.6	3,027,319.2
2009	400,005.5	127,910.9	129,203.7	173,653.6	365,471.1	1,805,450.3	2,965,710.1
2010	383,763.0	130,469.1	119,976.7	146,231.3	345,938.1	1,744,232.4	2,900,527.7
2011	366,710.7	133,078.5	110,329.1	117,642.6	325,476.0	1,682,556.4	2,831,551.6
2012	348,822.8	135,740.0	112,535.6	119,995.4	304,055.3	1,662,089.4	2,814,192.9
2013	330,072.7	138,454.8	114,786.4	122,395.3	281,645.9	1,637,617.3	2,795,007.2
Total	**2,675,000.0**	**914,000.0**	**871,300.2**	**1,105,000.0**	**2,438,000.0**	**12,358,815.8**	**20,419,777.0**

1 Objective 1 includes all 5 ROPs, while Objective 2 includes only the ROPs for Crete-Aegean Islands and Thessaly-Sterea Ellada-Epirus.
Source: Calculations based on data from the Ministry of Economy and Finance, *National Strategic Reference Framework 2007-2013,* January 2007.

Development interventions in the country's regions in the period 2007-2013 will focus on the following five spatial entities: (a) Macedonia-Thrace, (b) Peloponnese-Western Greece-Ionian Islands, (c) Thessaly-Sterea Ellada-Epirus, (d) Crete-Aegean Islands, (e) Attica.

To implement the country's development planning, the following actions are being prepared: (i) at national level, eight Sectoral Operational Programmes[6] (SOPs), (ii) at the level of the five spatial entities, five Regional Operational Programmes (ROPs), and (iii) at the level of the "European Territorial Cooperation" objective, 12 Operational Programmes. (It should be recalled that, in the period 2007-2013, the actions supported by the EU in the context of cohesion policy focus on three new Objectives: "Convergence", relating to the acceleration of the economic convergence of less developed

2 Circular III identifies the principles governing the structure and content of Operational Programmes (OPs) in order to provide the ministries' and regions' Programme Planning Groups and, by extension, the competent programming authorities with proper support and guidance in the OP preparation process. To support the Circular, a special Technical Guideline was forwarded, relating to the structure, content and methodology required for the preparation of the 2007-2013 OPs.
3 The first draft of the NSRF strategy part, the progress achieved so far in the planning of the OPs and the timetable for finalising the planning were presented in the 3rd NDC, along with the conclusions drawn from consultations with social and economic partners.
4 The management competence criteria of potential beneficiaries for the period 2007-2013, the Management, Monitoring and Control Framework of Operational Programmes and the timetable for the finalisation of the new programming period's National Development Planning were presented in the 4th NDC.
5 Ministry of Economy and Finance, *National Strategic Reference Framework 2007-2013*, January 2007.
6 Environment—sustainable growth, Improvement of accessibility, Competitiveness and entrepreneurship, Digital convergence, Reinforcement of public administration efficiency, Development of human resources, Education and lifelong learning, Technical assistance.

regions, "Regional Competitiveness and Employment" and "European Territorial Cooperation", relating to the reinforcement of crossborder cooperation through joint projects.[7])

In more detail, ROPs are being prepared for Macedonia-Thrace, Western Greece-Peloponnese-Ionian Islands, Crete-Aegean Islands, Thessaly-Sterea Ellada-Epirus and Attica, which will contribute to achieving the national strategic goals by supplementing sectoral programmes, the emphasis being on the special features and needs of each spatial entity/region. The specific programmes come under the "Convergence" and "Regional Competitiveness and Employment" Objectives and will be financed —regarding Community contribution (see the table)— by the European Regional Development Fund (ERDF).

Spatial dimension of the development strategy

The country's development strategy is concluded with its spatial dimension, which identifies three territorial priorities: (i) sustainable urban development, (ii) rural development and (iii) crossborder, transnational and interregional development.

(i) A decisive element of the urban development policy for the 4th programming period (2007-2013) is the country's development poles. The aim of this effort is to attract investment, improve the operating conditions of urban areas and upgrade the quality of life of the inhabitants. The development poles consist of three groups: metropolitan centres (Athens-Attica, Thessaloniki), urban centres and the large urban centres of Crete, the Aegean and the Ionian Islands. The choice of development poles was made on the basis of criteria such as the population size of the cities, the population dynamics, the location of cities in relation to development axes, their administrative importance, the availability of research and healthcare infrastructures and the presence of networks with neighbouring urban centres. The following development poles were defined using the specific evaluation methodology for the country's urban centres: Athens-Attica, Thessaloniki, Patra, Heraklio-Chania, Larissa-Volos, Ioannina, Kavala-Drama-Xanthi, Kalamata, Alexandroupoli-Komotini, Rhodes, Kozani-Ptolemaida.

(ii) The development strategy of mountainous areas aims at restructuring production activities that show significant seasonality, thereby putting at risk the economic viability of several mountainous areas. This may be achieved by supporting the production of agricultural products with a distinctive title (Protected Designation of Origin-PDO, organic), in conjunction with mild tourism development. The development strategy for insular areas faces difficulties, since they are largely non-uniform. This is why it is necessary to establish case-specific strategies, taking into consideration the special features of each island or category of islands. The main elements of this strategy are: establishing a sustainable and differentiated production pattern that will rely on private business initiative; tackling accessibility and infrastructure issues of the islands; and protecting their natural and cultural environment. Moreover, given that one of the priorities of the Common Fishing Policy is to reduce fishing, islands that depend on fishing need to partially modify their production pattern. The development strategy for rural areas focuses on supporting the three dimensions of sustainable development, namely the economic, the social and the environmental dimensions.

7 See Bank of Greece, *Annual Report 2005,* Box IX.3.

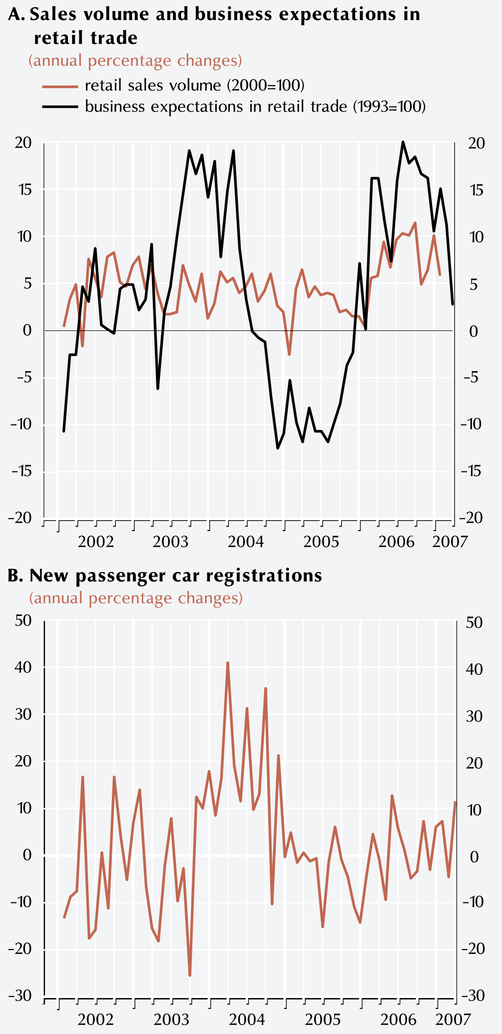
(iii) Lastly, the main options for achieving the European Territorial Cooperation objective (cross-border, transnational and interregional) are polycentricity, access to knowledge, preserving and bringing forward the natural environment, improving competitiveness and promoting the business environment.

It is estimated that the change in the real external balance of goods and services will once again make a negative contribution to GDP growth in 2007. Specifically, the growth rate of exports of goods and services will remain at 2006 levels, while the growth rate of imports of goods is expected to fall slightly (a little more than the growth of final demand). The current account deficit will remain at very high levels, despite the assumption that the average annual level of oil prices will decrease or remain almost unchanged in 2007, since, along with the above assessment concerning the outlook of exports and imports, it is estimated that expenditure for merchant fleet renewal and interest payments will continue to rise at a high rate, while current and capital transfers surpluses will remain virtually unchanged.

1.2 CONSUMER DEMAND

The strong growth of private consumption contributed 2.7 percentage points to the increase in GDP in 2006. According to national accounts estimates by the Ministry of Economy and Finance, private consumption increased by 3.9% in 2006 (against 3.4% in 2005 and 4.7% in 2004). As shown by available short-term indicators, the volume of retail sales of goods (excluding passenger cars and fuel) grew by 8.0% in 2006, against 3.0% in 2005 (see Chart III.2 and Table III.2).[2] A considerable contribution to this growth was made by furniture, household equipment and food. Expenditure for passenger car

Chart III.2 Consumer demand



Sources: NSSG (retail sales and cars), IOBE (expectations). The revised retail sales index (turnover of retail trade at constant prices) is based on the NSSG's new sample for the year 2000. 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.

2 In January 2007, the volume of retail sales grew at an annual rate of 5.9%.

Table III.2 Retail trade turnover index (at current prices)

(percentage changes over previous year)

Components	2006
1. Big food stores	14.6
2. Department stores	19.9
3. Food – beverages – tobacco	5.2
4. Pharmaceuticals – cosmetics	3.8
5. Clothing – footwear	3.0
6. Furniture – electrical appliances – household equipment	17.6
7. Books – stationery – other	5.0
8. Retail sales not in stores	2.7
Retail trade turnover index	**10.8**

Source: NSSG. Revised retail trade turnover index (based on the NSSG's new sample for the year 2000).

imports increased by 16.2% in 2006, although new passenger car registrations rose by only 0.5%.[3] A substantial increase was also recorded in 2006 in consumer demand for services (mobile telephony, cargo traffic through ports, information technology services etc.),[4] while business expectations in the services sector (except retail trade and banks)[5] rose by 10.8%,[6] after falling in 2005 (–0.7%).[7]

In 2006 the growth of private consumption continued to rely on the rise in households' real disposable income, supported by the increase in the average take-home pay of employees (see Table IV.5), increased transfer payments by the government to less well-off population groups and the rise in salaried employment. However, as final household consumption expenditure grew more than gross disposable income, it is estimated that the savings ratio decreased.

A similar positive contribution to the growth of private consumption was made in the last few years by the increase in consumer loans, the annual growth rate of which remained high, despite its appreciable slowdown in 2006 (December 2006: 23.9%, December 2005: 28.7%).[8] Factors associated with positive household expectations about their future income, financial market deregulation and increased competition, as well as the stable macroeconomic environment owing to Greece's entry in the euro area seem to con-

3 Passenger car sales picked up in the first quarter of 2007, as the annual growth rate of new passenger car registrations came to 5.3%. The increased expenditure for imports compared with the unchanged number of new car registrations may be attributed to the increase in both the prices and the average engine capacity of new cars, as well as to the fact that a significant number of imported cars is re-exported to nearby countries (see Chapter IX).

4 Tax revenue from flat fees per mobile telephony subscription increased by 11.8% in 2006, while the annual rate of increase in cargo traffic through the port of Piraeus was 16.9% in the first nine months of 2006. A big increase (23.3%) was also recorded in 2006 by the new NSSG index on IT business turnover.

5 The IOBE survey covered hotels and restaurants, travel agencies, land and other transport, advertising and provision of business services, insurance etc.

6 The increase in the index (annual rate: 17.9%) was even higher in the first two months of 2007.

7 According to NSSG household budget surveys, in 1999-2004 there were small changes in the consumer pattern of households, with a slight decrease in the share of food, clothing-footwear and household durables and a rise in the share of services. The relative stability of the consumption pattern can be attributed, to some extent, to the presence of economic immigrants, to whom basic necessities are more important than services. A corresponding contribution to maintaining the existing consumer pattern may have also been made by increased household demand for housing, which has reduced purchases of other goods and services.

8 Including securitised and written-off loans.

tinue to have a positive effect on the growth rate of private consumption in the last few years. Low real interest rates and easier access to consumer credit enable households to control their consumer expenditure and maintain a relatively high level of consumption, which now depends less on short-term fluctuations of disposable income than in the past.

The continuing rise in the prices of dwellings (see Table III.3)[9] is estimated to have had, to a certain degree, a positive effect on private consumption, since it led to an increase in the market value of household assets, as well as to an increase in rents (which usually follows the rise in house prices[10]). The increased value of household assets may also be attributed to the rise in the average annual level of the prices of shares listed on the Athens Exchange (26.3% in 2006, against 29.4% in 2005).

1.3 INVESTMENT DEMAND

The large increase in investment (12.7%), following a slight decline in 2005 (–1.4%), contributed 3.3 percentage points to GDP growth, against an average of 1.8 percentage points in the period 2001-2006. This development is mainly attributed to the strong growth of investment in the construction sector, especially housing (32.3%).[11] Investment in equipment also increased substantially.

General government investment grew, at constant prices, by 7.6%, after decreasing by 13.3% in 2005, but its contribution to GDP growth was very small (0.3 percentage point), since it makes up a relatively small part of total investment.[12]

Business investment grew much faster (by 8.6% in 2006, against 1.5% in 2005 and 7.3% in 2004), despite the drop in public enterprises' investment (–4% at current prices, according to the Introductory Report on the 2007 Budget). This is mainly associated with the opportunities offered by the current investment framework[13] and the overall improvement in investment sentiment.[14] Specifically, 4,399 applications were submitted by 9 March 2007 for inclusion under the provisions of Law 3299/2004, of which 2,907 were finally included, and aggregate investment of €5,5 billion was approved. Over 100 investment proposals were submitted in 2006 to the Hellenic Centre for Investment (ELKE), totalling €3 billion.

Particularly in manufacturing, the latest (October-November 2006) IOBE investment survey shows that enterprises increased their investment expenditure by 8.3% (at current prices) in 2006 (11.0% for private

9 The average annual increase in the prices of dwellings in urban areas outside Athens was 13.0% in 2006 (against 13.4% in 2005).

10 According to a Eurobank study that summarises the proceedings of a recent conference on the property market (see M. Davradakis and G. Hardouvelis, "Is the property market overpriced?", Eurobank Research – *Economy and Markets*, 6 February 2006), the ratio of residential prices to rents in Greece was rising until the early 2000s (mainly due to the fall in interest rates), but has been stable since 2002.

11 This development is recorded by the IOBE business expectations index in construction, the rise of which was strong throughout 2006 (44.8%, against a decrease of 22.9% in 2005 and 28.9% in 2004). Similarly positive developments were also recorded in cement output in 2006, which increased by 3.1% (2005: 2.4%, 2004: -2.3%).

12 A positive outlook for public investment is also derived from the 8.9% increase in disbursements from the public investment programme, against a 21% drop in 2005.

13 The recent amendment (by article 37 of Law 3522/2006) to certain provisions of Law 3299/2004 (towards, *inter alia,* giving more incentives to small enterprises) further expands these business opportunities.

14 A significant rise is recorded in both the EU Economic Sentiment indicator for Greece (103.1 in 2006, against 89.3 in 2005 and 102.9 in 2004) and the IOBE index of business expectations in manufacturing (+9.7% in 2006).

Table III.3 Dwelling price index

	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	Over previous period	Over corresponding period of previous year	Over previous period	Over corresponding period of previous year	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	137.7	10.6	10.6	149.1	15.1	15.1	171.3	6.1	6.1
2001	157.5	14.4	14.4	175.4	17.6	17.6	190.2	11.0	11.0
2002	179.3	13.9	13.9	203.8	16.2	16.2	211.7	11.3	11.3
2003	189.0	5.4	5.4	211.9	4.0	4.0	226.8	7.1	7.1
2004	193.4	2.3	2.3	212.4	0.3	0.3	237.4	4.7	4.7
2005	214.5	10.9	10.9	230.8	8.6	8.6	269.3	13.4	13.4
2006	...	...	...	...	...	...	304.2	13.0	13.0
2000 Q1	132.1	2.5	9.7	141.6	4.1	14.3	166.1	0.8	5.2
Q2	135.7	2.8	9.8	146.5	3.5	14.4	169.6	2.1	5.3
Q3	138.8	2.2	10.8	150.4	2.7	15.3	172.6	1.8	6.4
Q4	144.2	3.9	11.9	158.0	5.0	16.2	177.1	2.6	7.5
2001 Q1	150.5	4.4	14.0	165.7	4.9	17.0	184.0	3.9	10.8
Q2	156.1	3.7	15.0	174.2	5.1	18.9	188.0	2.2	10.8
Q3	159.5	2.2	15.0	178.7	2.6	18.8	191.3	1.8	10.9
Q4	164.0	2.8	13.7	183.0	2.4	15.8	197.5	3.2	11.5
2002 Q1	171.5	4.6	14.0	193.6	5.8	16.8	204.0	3.3	10.8
Q2	180.3	5.1	15.5	208.0	7.4	19.4	208.9	2.4	11.2
Q3	180.7	0.2	13.3	205.4	-1.3	14.9	213.3	2.1	11.5
Q4	184.9	2.3	12.7	208.2	1.4	13.8	220.5	3.4	11.6
2003 Q1	188.6	2.0	10.0	214.6	3.1	10.8	222.5	0.9	9.1
Q2	187.5	-0.6	4.0	210.6	-1.8	1.3	224.4	0.8	7.4
Q3	189.0	0.8	4.6	210.6	0.0	2.6	228.1	1.7	7.0
Q4	190.9	1.0	3.3	211.5	0.4	1.6	232.1	1.7	5.3
2004 Q1	190.6	-0.2	1.0	209.7	-0.9	-2.3	233.6	0.6	5.0
Q2	191.6	0.5	2.2	209.4	-0.2	-0.6	236.5	1.2	5.4
Q3	193.3	0.9	2.3	211.1	0.8	0.2	238.8	1.0	4.7
Q4	198.0	2.4	3.7	219.4	3.9	3.7	240.9	0.9	3.8
2005 Q1	205.2	3.6	7.7	223.7	2.0	6.6	254.1	5.5	8.8
Q2	211.6	3.1	10.5	228.9	2.3	9.3	264.1	3.9	11.7
Q3	216.9	2.5	12.2	231.5	1.1	9.7	274.5	4.0	15.0
Q4	224.1	3.3	13.2	239.0	3.2	8.9	283.8	3.4	17.8
2006 Q1	...	...	...	...	...	...	294.1	3.6	15.7
Q2	...	...	...	...	...	...	301.7	2.6	14.2
Q3	...	...	...	...	...	...	307.4	1.9	12.0
Q4	...	...	...	...	...	...	313.7	2.0	10.5
2005 Jan.	...	...	...	223.6	1.1	5.1	...	...	...
Feb.	...	...	...	223.5	-0.1	7.9	...	...	...
March	...	...	...	224.0	0.2	6.9	...	...	...
April	...	...	...	226.4	1.1	8.8	...	...	...
May	...	...	...	229.1	1.2	8.3	...	...	...
June	...	...	...	231.3	1.0	10.9	...	...	...
July	...	...	...	230.7	-0.2	10.5	...	...	...
Aug.	...	...	...	230.7	0.0	8.6	...	...	...
Sept.	...	...	...	233.0	1.0	9.8	...	...	...
Oct.	...	...	...	235.4	1.0	8.0	...	...	...
Nov.	...	...	...	238.8	1.5	9.0	...	...	...
Dec.	...	...	...	242.7	1.6	9.8	...	...	...

Note: The "other urban areas" index for recent years has been revised because regional weights have been adjusted to take into account the results of the 2001 population census.
* Provisional data for the second half of 2005.
Sources: For the other urban areas: Bank of Greece. For Athens: calculations based on data from "Danos and Associates" (1993-1997) and "Property Ltd" (1997-2006). For the total of urban areas: weighted index based on the housing stock in Athens and the other urban areas.

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.

manufacturing firms), while a slight decrease (2.1%) is forecast for 2007 (–1.3% for private firms).[15] According to the results of this survey and the relevant IOBE estimates,[16] companies are rather reluctant to introduce new technologies and production methods, since investment expenditure for the replacement of existing equipment and the increase in productive capacity for already produced items makes up more than 50% of total investment expenditure. However, in 2007 enterprises intend to increase investment entirely connected with new products, possibly by utilising the highest subsidies provided for by the current institutional framework.

The maintenance of business investment at high levels is also encouraged and supported by satisfactory profitability in several sectors of the economy, favourable financing conditions and faster credit expansion

15 It should be recalled that these estimates are often substantially revised. The next survey was carried out in March-April 2007, but its results have not been announced yet.
16 IOBE, *Quarterly Report on the Greek Economy,* February 2007.

to enterprises,[17] as well as the outlook for domestic and international demand, as recorded in the new orders index in industry.[18] In addition, the further promotion of projects through the Special Secretariat for Public-Private Partnerships (PPP) should help mobilise private capital in education and healthcare and in upgrading facilities and infrastructure (e.g. sports and seaport facilities). Specifically, in addition to the 8 approved PPP projects, amounting to €800 million, 11 new projects were approved in early March 2007 by the Inter-ministerial PPP Committee, with a total budget of over €1.4 billion (see also Box VIII.2).

A very large increase was recorded in residential investment (32.3%), following a slight decrease of 1.4% in 2005 and 0.6% in 2004, reflecting the effect of administrative and tax measures. The rate of change in the volume of private building activity on the basis of permits, which is a leading indicator, remained positive and high in the first half of 2006, but then turned negative (because of the comparison with the very high levels of building volume on the basis of permits twelve months before – see Chart III.3), to record an average annual fall of 19.5%. However, it is estimated that, for most permits issued at the end of 2005,[19] the construction of housing began in the course of 2006. Significant support to residential investment is afforded by the fact that bank financing is maintained at very high levels.[20] It is, however, estimated that factors such as the upward trend of interest rates, the increase in the degree of coverage of housing needs in the last few years and the evolution of the rate of return on dwellings (rents) will contribute to further stabilising the housing market in the coming years.

2 PRIMARY AND SECONDARY PRODUCTION

2.1 AGRICULTURAL PRODUCTION

According to NSSG national accounts estimates, the value added of the primary sector (at constant prices) decreased by 8.4% in 2006, compared with a 2.5% drop in 2005 and a 4.5% rise in 2004. A reduction was recorded in almost all major crops, especially durum wheat, cotton, sugar beet and oranges. In the livestock sector, milk production remained unchanged, while the production of meat dropped slightly (see Table III.4).

There was a 6.5% rise in agricultural products' prices paid to producers in 2006 (compared with a 3.1% rise in 2005), reflecting a significant increase in the prices of plant products (7.1% in 2006, compared with 3.1% in 2005). By contrast, the prices paid by producers rose less than in 2005 (2006: 3.9%, 2005: 5.1%), due to the slowdown of the growth rate of input prices (to 4.2%, from 5.6% in 2005 – see Table III.5).[21] This development contributed to a 1.2% increase in real income per full-time employee, while the

17 See Chapter VI.2.2.

18 The NSSG index for new orders in industry (at current prices) recorded an overall increase of 11.5% in 2006, against a 1.3% drop in 2005, while the index of new orders from the external market also increased by 20.8% in 2006, against 8.3% in 2005.

19 The acceleration of the issuance of building permits in the last few months of 2005 was mainly due to the pre-announced and imminent tax and administrative arrangements (adjustment of objective values, VAT on newly-built houses as from 1 January 2006).

20 The annual growth rate of the balance of housing loans to households was 25.8% in December 2006, against 33.5% in December 2005 and 27.3% in December 2004.

21 The prices of inputs of energy and lubricants recorded a large increase (8.6%).

Table III.4 Production of main agricultural products

(thousand tonnes)

Product	2000	2001	2002	2003	2004	2005[1]	2006[1]
Soft wheat	408	442	427	322,7	274	270	251
Durum wheat	1,450	1,457	1,902	1,309	1,500	1,491	1,129
Maize	1,850	2,010	2,194	2,206	2,210	2,169	1,710
Tobacco	125	118	116	116	112	108	25
Cotton (natural)	1,235	1,247	1,137	972	1,035	1,100	850
Industrial tomatoes	1,149	1,126	1,000	985	1,180	900	800
Sugar beets	3,146	2,825	2,531	2,200	2,095	2,800	1,600
Olive oil	430	360	414	310	435	424	370
Lemons	139	78	109	102	36	42	37
Oranges	903	898	1,176	849	765	1,017	880
Apples	309	231	262	202	275	247	263
Peaches	1,020	952	706	123	948	769	700
Meat, total	492	484	488	480	486	483	464
Milk, total	1,896	1,902	1,928	1,927	1,948	1,866	1,866

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

Table III.5 Producer prices[1] and input prices

(2000=100)

Product	Weights	2001	2002	2003	2004	2005	2006
Percentage changes in producer prices (output prices)							
Plant production	70.704	5.4	11.0	11.6	–3.2	2.4	7.1
Livestock production	29.296	7.7	–2.2	1.3	2.0	5.2	4.9
General producer price index	**100.000**	**6.1**	**7.1**	**8.8**	**–1.9**	**3.1**	**6.5**
Percentage changes in input prices							
Consumables	74.854	1.4	2.3	4.2	9.0	5.6	4.2
Fixed capital	25.146	4.0	4.4	3.2	3.1	3.8	3.3
General input price index	**100.000**	**2.1**	**2.8**	**4.0**	**7.5**	**5.1**	**3.9**

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

corresponding increase in the European Union (EU-27) was 3.8%.[22]

The gradual decrease in the share of gross value added (GVA) of the primary sector in total GVA (from 5.7% in 2000 to 3.3% in 2006)[23] underlines the need —also given the competitive international environment— to increase modern business initiatives in the agricultural sector, which should be export-oriented and less dependent on Community Budget subsidies. The new institutions for the development of the agricultural sector, namely the Local Agricultural Development Centres and Accredited Agricultural Consultants, will be introduced in the course of 2007, as stipulated by Law 3399/2005, while the public invest-

22 See Eurostat, *Statistics in Focus,* No. 38/2007. It is the net value added of agricultural activity (minus taxes, plus subsidies) per employee (employment is calculated at annual full-time work units).
23 At current prices, according to NSSG national accounts estimates (March 2007).

ment budget provides for expenditure of €657 million[24] for the implementation of projects in the sectors of agriculture, forests and fishing, as well as land reclamation. Moreover, developments in the field of organic cultivation are encouraging since, according to estimates, the target of increasing —in the course of 2006— organically cultivated expanses to 2.8% of all cultivated areas was more than achieved, while the relevant ministry also announced new promotional actions.[25] At the same time, the production of biofuel[26] is expected to gradually favour the cultivation of energy plants, thus possibly becoming an alternative to diminishing and low yield crops. To support sound business initiatives in the agricultural sector, it is very important to educate and train farmers (mainly in the framework of the Organisation of Agricultural Vocational Training and Employment – OGEEKA "DIMITRA" projects), with a view to enhancing human capital and promoting innovative actions and practices in rural districts.

2.2 MANUFACTURING

Industrial output, which had remained subdued over the past five years, recorded a slight recovery in 2006. According to final NSSG data, total industrial output increased by 0.5% in 2006, having decreased by 0.9% in 2005. The increase mainly reflects a continuing rise in the production of energy and consumer durables, as well as a recovery in the production of intermediate and capital goods. By contrast, the production of consumer non-durables continued to decrease (see Table III.6).

Manufacturing output grew by 0.8%, having fallen by 0.8% in 2005. However, the annual growth rate of manufacturing output was

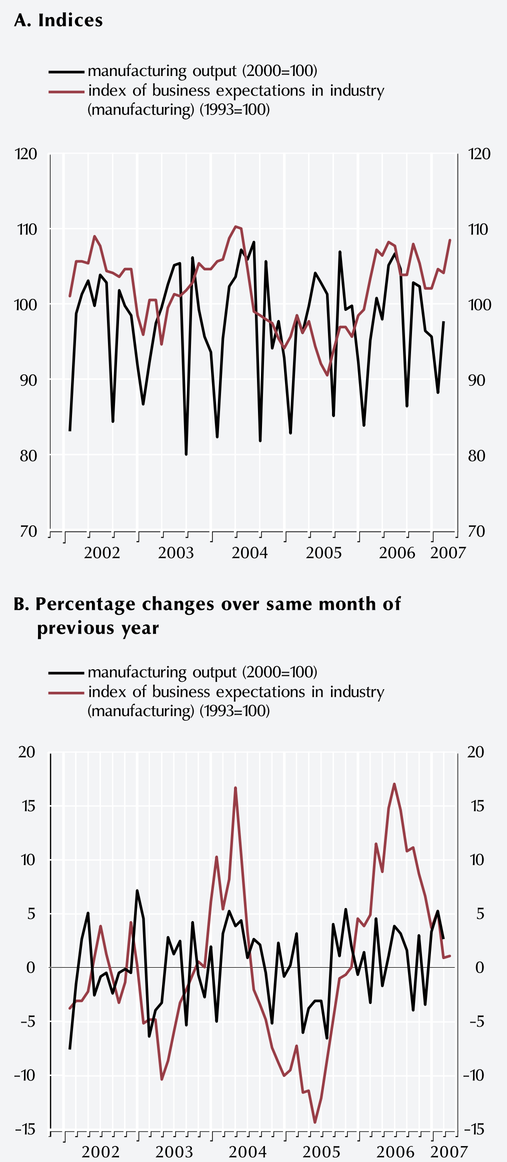
24 According to estimates by the Ministry of Rural Development and Food, €479 million were absorbed in 2006.
25 Including the creation of new infrastructure for marketing and promoting organic products and implementing vocational training schemes for producers, manufacturers and public administration executives.
26 According to certain estimates, the relevant investment already amounts to €100 million.

Table III.6 Industrial production (2000=100)

	Weights 2000		Average annual percentage changes 2003	2004	2005	2006	Level 2006 (2000=100)
Industry	**100.0**		**0.3**	**1.2**	**–0.9**	**0.5**	**100.1**
1. Mining and quarrying	**5.9**	**100.0**	**–5.2**	**0.3**	**–6.2**	**–2.2**	**98.0**
Coal and lignite extraction		48.3	–3.4	1.6	–3.7	–6.0	98.8
Oil wells and extraction of natural gas		5.2	–24.5	3.0	–29.7	–7.1	34.9
Ore extraction		11.5	–22.7	–2.5	4.6	–16.6	89.8
Other extraction and quarrying activities		35.1	1.0	–0.7	–11.0	8.6	108.9
2. Manufacturing	**77.5**	**100.0**	**–0.4**	**1.2**	**–0.8**	**0.8**	**98.1**
3. Electricity - natural gas - water supply	**16.6**	**100.0**	**5.8**	**1.4**	**0.6**	**0.1**	**109.9**
Electricity		80.9	6.8	0.8	0.6	–1.7	106.9
Natural gas		5.3	13.2	9.9	6.1	16.9	162.3
Water		13.8	–2.8	1.6	–1.7	2.6	106.8
Industry	**100.0**		**0.3**	**1.2**	**–0.9**	**0.5**	**100.1**
Main industrial groupings							
Energy	28.5		2.9	0.3	0.6	1.3	107.3
Intermediate goods	31.1		–0.4	1.0	–1.7	0.7	100.7
Capital goods	10.6		0.8	–0.5	–5.1	1.3	77.8
Consumer durables	2.5		–3.6	1.8	11.4	2.0	80.7
Consumer non-durables	27.3		–1.4	2.7	–0.9	–1.0	102.3

Source: NSSG.

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.

higher in the first eight months of 2006 (1.4% on average), while it fluctuated from September on. Moreover, in January and February 2007 manufacturing output and total industrial output grew at an average annual rate of 3.9% and 3.2% respectively.

Additional information about developments in industry in 2006 can also be drawn from the turnover index in industry (at value terms), which records total sales of goods and services to third parties. It is worth noting that this index increased in 2006 at a rate (12.3%) much higher than in 2005 (7.7%) or the 2000-2005 average (4.4%).[27] A favourable picture of industrial activity is also recorded by the index of business expectations in industry, which in 2006 reached the peak of the last four years (9.7%),[28] while it increased at an average year-on-year rate of 2.5% in the first quarter of 2007 (see Chart III.4). In addition, positive developments were recorded by the index of months of secured production, which stood at higher levels (4.8) compared with 2005 (4.5),[29] while the capacity utilisation rate for industry as a whole also rose in 2006 (by 3.9 percentage points – see Chart III.5),[30] especially as far as capital and intermediate goods are concerned. Similarly positive developments in manufacturing production were also recorded by the Purchasing Managers' Index (PMI), the average level of which came to 52.4 in 2006 (see Chart III.6). It should be noted that this value was the highest since 2002 (52.8),[31] while the evolution of the PMI was

27 The rise in the turnover in industry was significant for the domestic market (9.9%) and even bigger for the external market (19.9%).

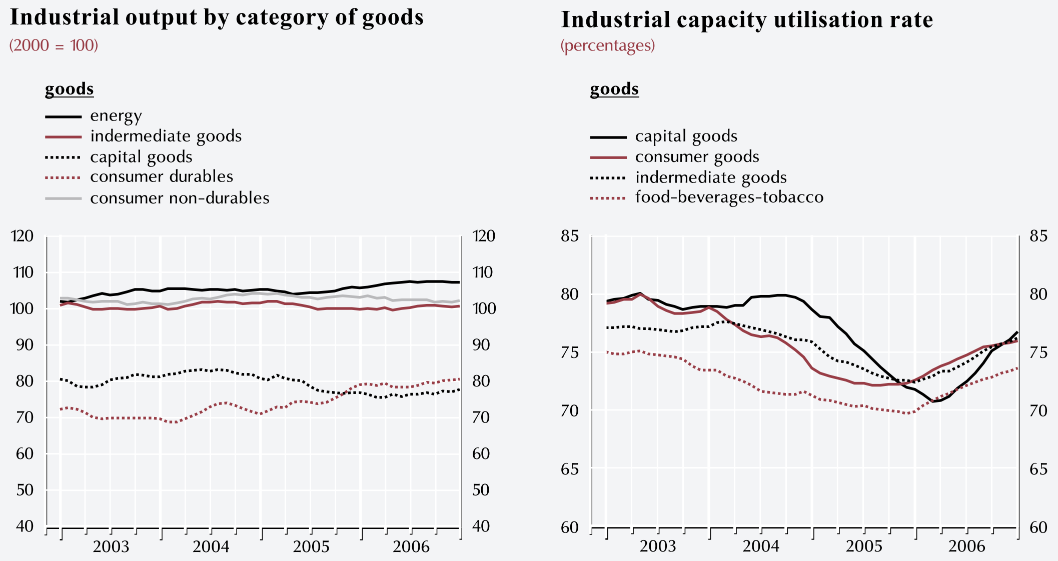
28 According to the business survey carried out by IOBE, in 2006 industrial firms' estimates of output and new orders were more positive compared with 2005, while negative estimates of total demand and foreign demand fell markedly. Firms' expectations regarding their activity during the next quarter were also more optimistic in 2006.

29 Months of secured production of manufacturing firms averaged 5.0 in the first quarter of 2007.

30 It should be noted that in the first quarter of 2007 the capacity utilisation rate remained on average at 2006 levels (76.2).

31 Of the main sub-indices of the PMI, the largest increase in 2006 was recorded by output and new orders, while employment also improved. However, there was an increase in the time of delivery of supplies, while the level of stock dropped.

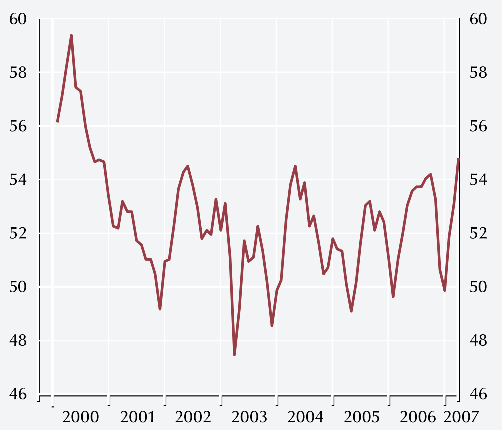
Chart III.5 Indicators of industrial production[1]



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

Chart III.6 Purchasing Managers' Index (PMI) for manufacturing

(seasonally adjusted index, positive deviations from the value of 50 indicate an expansion of economic activity)



Sources: Hellenic Purchasing Institute and NTC Research.

also positive in the first quarter of 2007, as it stood above 50 (the peak being 54.8 in March), indicating constant improvement in conditions in the manufacturing sector.

As regards developments in individual manufacturing industries (see Table III.7), of a total of 23 industries, 14 increased and 9 reduced their output. It should be noted that the output of the seven most dynamic industries showed an average increase of 3.6% in 2006, while their level of output in the period 2000-2005 had recorded a cumulative increase of 14.5%.[32] Also significant was the growth of the other seven smaller industries (accounting for 15% of manufacturing in 2000), which recorded a remarkable increase in the last few years (2000-2006: cumulative increase of 19.0%).[33] However, a sharp fall (–12.2%)

32 These industries, whose production in 2000 accounted for 59% of total manufacturing, are: food-beverages, coke and refined petroleum products, non-metallic minerals, basic metals, metal products, publishing-printing and equipment.

33 Electrical machinery and apparatus, medical and precision instruments, other transport equipment, rubber and plastic products, paper and paper products, furniture and other industries, as well as office machinery and computers.

Table III.7 Manufacturing production (2000=100)

	Weights (2000)	Average annual percentage changes				Level 2006
		2003	2004	2005	2006	
Manufacturing, total	**100.0**	**–0.4**	**1.2**	**–0.8**	**0.8**	**98.1**
Food – beverages	20.0	–2.9	3.7	–1.4	2.4	106.0
Tobacco	1.2	2.4	9.9	–6.1	–8.7	99.9
Textiles	5.6	–3.3	–10.4	–18.3	–12.9	55.6
Wearing apparel	4.3	–0.6	–5.2	–14.8	–13.0	61.3
Leather – footwear	0.9	–10.1	–9.0	–12.2	–5.2	61.2
Wood and cork	1.1	–5.2	0.6	–5.8	–2.7	77.1
Paper and paper products	2.4	–1.4	3.2	4.4	1.1	94.1
Publishing – printing	4.2	2.9	3.6	13.8	5.0	127.9
Coke and refined petroleum products	11.2	0.4	–2.4	2.6	6.5	107.8
Chemicals	7.7	2.0	6.6	1.9	–6.9	112.1
Rubber and plastics	3.6	–0.6	–4.1	–4.2	6.1	97.6
Non-metallic minerals	8.5	1.8	–0.7	0.9	2.5	109.6
Basic metals	8.0	–0.9	5.2	1.3	2.4	118.8
Metal products	4.3	5.8	10.1	4.0	4.3	116.8
Machinery and equipment	3.2	–1.9	–1.7	14.4	10.5	109.6
Office machinery and computers	0.0	–89.3	99.5	–66.9	1.642.5	211.4
Electrical machinery and apparatus	2.3	16.1	6.4	5.1	5.8	112.6
Radio, TV and communication equipment	3.7	–12.7	7.9	–38.3	–70.1	9.2
Medical tools and precision instruments	0.2	30.6	–25.3	6.6	30.1	151.1
Motor vehicles	1.0	14.6	3.5	–36.5	–5.7	43.7
Other transport equipment	4.3	–2.5	–7.5	–2.4	7.3	93.0
Furniture – other manufacturing	2.3	–9.5	–1.7	18.4	2.4	73.2
Recycling	0.0	8.6	–4.0	–0.9	–9.5	115.6
		Contributions by industry to changes in total manufacturing production (percentage points)				
Manufacturing, total		**–0.40**	**1.18**	**–0.76**	**0.79**	
Food – beverages		–0.61	0.78	–0.31	0.51	
Tobacco		0.03	0.13	–0.09	–0.12	
Textiles		–0.17	–0.53	–0.82	–0.47	
Wearing apparel		–0.02	–0.20	–0.54	–0.40	
Leather – footwear		–0.09	–0.07	–0.08	–0.03	
Wood and cork		–0.05	0.01	–0.05	–0.02	
Paper and paper products		–0.03	0.07	0.09	0.02	
Publishing – printing		0.12	0.16	0.63	0.26	
Coke and refined petroleum products		0.04	–0.29	0.29	0.75	
Chemicals		0.18	0.59	0.17	–0.66	
Rubber and plastics		–0.02	–0.15	–0.15	0.21	
Non-metallic minerals		0.17	–0.07	0.08	0.23	
Basic metals		–0.09	0.47	0.12	0.23	
Metal products		0.24	0.44	0.19	0.22	
Machinery and equipment		–0.06	–0.05	0.40	0.34	
Office machinery and computers		–0.05	0.01	–0.01	0.06	
Electrical machinery and apparatus		0.32	0.15	0.12	0.15	
Radio, TV and communication equipment		–0.26	0.14	–0.72	–0.82	
Medical tools and precision instruments		0.08	–0.09	0.02	0.09	
Motor vehicles		0.10	0.03	–0.28	–0.03	
Other transport equipment		–0.11	–0.32	–0.09	0.28	
Furniture – other manufacturing		–0.15	–0.02	0.25	0.04	
Recycling		0.00	0.00	0.00	0.00	

Source: Calculations based on NSSG data.

was recorded in the other nine industries.[34] As a result, the rise in the output of all manufacturing industries was more limited in 2006 (+0.8%) and its level was 1.9% lower than in 2000.

The largest positive contribution to the increase in manufacturing production in 2006 came from petroleum products and coal (0.75 percentage point) and food and beverages (0.51 percentage point), also owing to their substantial share in total manufacturing output. High growth rates were also recorded in firms' turnover (at value terms) in these two industries. According to the NSSG index, the turnover (at current prices) of coal and petroleum production recorded a substantial increase in 2006 (+22.5%), compared with an even higher growth in 2005 (+42.9%).[35] The increase in turnover (at current prices) in food and beverages production was also marked in 2006 (6.1%, against a 0.4% drop in 2005).

By contrast, the large drop in the production of textiles and clothing in the last few years (the production of both industries has decreased cumulatively by 41.6% since 2000) is associated with growing competition from similar products, mainly of Chinese origin.[36] However, according to an IOBE study,[37] prospects are positive for domestic commercial and industrial clothing firms that manufacture branded items and have a specialised sales network. By contrast, for industrial firms active in clothing subcontracting, the assessment is negative due to fierce competition from Asian countries, especially China.[38] A decrease was also recorded in 2006 in the output of chemicals, which, however, was 12.1% higher than in 2000.

According to balance of payments statistics compiled by the Bank of Greece, in 2006 exports of manufactured products (except fuel) grew at a higher rate (11.7%) than total non-fuel exports of goods (10.6%). Also, the export performance of manufacturing excluding fuels, i.e. the share of production

34 Mainly radio-television and communication apparatus, textiles, wearing apparel, chemical products, as well as five smaller industries. These nine industries together accounted for 25.6% of total manufacturing in 2000.

35 According to the ELPE financial results for 2006 (21 February 2007), the turnover of the group (which is the most important in the industry) increased by 22% compared with 2005, while net profits dropped (-22%), having increased substantially in 2005 (+161%). Moreover, the volume of sales of the group's Greek refineries increased by 2% compared with 2005, while the total volume of sales of OKTA was also substantially higher than in 2005 (+13%). In addition, the group decided to invest €1 billion by 2010 to upgrade its refineries. It should also be noted that the tripartite interstate agreement between Greece, Russia and Bulgaria was signed on 15 March 2007; this agreement concerns the construction of the oil pipeline "Burghas-Alexandroupoli", estimated to be completed in early 2010. The pipeline, which will have an initial capacity of 35 million tonnes of oil annually (with the possibility to expand it up to 50 million tonnes annually), is expected *inter alia* to reduce the cost of crude oil imports.

36 It should be noted that, according to NSSG provisional data, the manufacture of textiles, clothing and leather-footwear made a significant recovery in January-February 2007 (at annual rates of 5.2%, 10.9% and 10.7% respectively).

37 *Industry and trade in ready to wear apparel*, January 2006.

38 In addition, this IOBE study notes that market conditions for domestic firms active in clothing subcontracting are expected to worsen even more after the expiry (on 31 December 2007) of the bilateral agreement between the European Union and China concerning the application of a quota system for 10 products. For these reasons, the study recommends that the industry's production be focused on differentiated products of high value added and new technologies be applied, so that the industry's firms can be converted from work-intensive into technology-intensive. Moreover, in December 2006 the Ministry of Development approved the financing of 366 investment projects (out of 384 that were submitted) by textile, clothing, footwear and leather firms, with a total budget of €42.9 million and with a total public expenditure of €23.6 million. This investment comes under action 2.7.5 of the Operational Programme "Competitiveness" (EPAN), which was activated for the first time and aims at adopting new technologies and producing innovative products so as to enhance the export-orientation of these industries and resolve the problems created by the deregulation of trade with third countries, mainly in the Far East.

Table III.8 Import penetration and export performance of basic manufacturing industries

Industries[1]	Annual percentage changes					
	Current prices			2000 prices		
	Import bill[2]	Export receipts[2]	Gross value of production	Gross value of production	Import penetration[3]	Export performance[4]
Food-beverages (15)						
2002	–0.7	9.8	6.2	2.0	33.8	15.0
2003	–2.8	13.3	–0.6	–2.9	33.9	17.2
2004	10.8	–11.4	12.3	3.7	32.6	13.5
2005	0.1	17.1	0.0	–1.4	33.2	15.8
2006	11.1	12.2	9.0	2.4	33.8	16.3
Tobacco(16)						
2002	7.0	–15.5	6.9	1.9	73.3	74.0
2003	–14.1	57.8	4.3	2.4	125.4	111.9
2004	9.3	–23.5	11.6	9.9	71.2	76.7
2005	5.0	8.1	–5.4	–6.1	83.9	87.7
2006	6.6	–18.2	–6.2	–8.7	75.6	76.5
Textiles, wearing apparel, leather, footwear (17, 18, 19)						
2002	3.8	3.0	–3.6	–4.1	60.2	45.9
2003	–1.9	11.9	–1.4	–2.8	63.0	52.2
2004	5.7	–3.5	–5.7	–8.2	66.2	53.3
2005	5.1	–6.5	–17.1	–16.4	74.4	60.1
2006	11.2	–13.3	–11.4	–12.3	77.9	58.9
Wood, cork (20)						
2002	–46.1	59.2	–0.6	–1.3	10.7	3.2
2003	–11.8	–75.8	–4.4	–5.2	9.7	0.8
2004	–11.6	–71.2	5.1	0.6	8.3	0.2
2005	10.9	82.4	–2.6	–5.8	9.3	0.4
2006	–59.5	40.6	0.8	–2.7	4.0	0.6
Paper and paper products, publishing-printing (21, 22)						
2002	–2.4	19.6	3.0	–0.4	32.4	4.0
2003	8.6	24.9	3.7	1.3	33.6	4.8
2004	3.6	15.9	3.7	3.5	33.7	5.4
2005	–5.4	–4.2	11.4	10.3	30.0	4.7
2006	11.8	–19.1	5.2	3.7	31.0	3.6
Petroleum and coal products (23)						
2002	19.7	–3.5	0.9	2.1	55.4	20.1
2003	8.4	28.9	0.4	0.4	59.1	25.8
2004	13.9	21.7	7.8	–2.4	61.5	29.1
2005	46.6	45.1	28.5	2.6	65.8	32.9
2006	31.6	30.0	19.2	6.5	69.0	35.8
Chemicals, rubber and plastic products (24, 25)						
2002	4.8	33.5	4.9	3.9	72.4	34.9
2003	–5.2	17.5	2.9	1.3	72.3	39.8
2004	3.9	6.4	2.5	3.7	73.1	41.3
2005	8.1	6.3	3.6	0.3	74.3	42.4
2006	7.8	12.1	–1.1	–3.7	77.7	48.1
Non-metallic minerals (26)						
2002	–22.3	232.0	6.1	2.6	19.6	7.3
2003	1.3	–12.5	1.9	1.8	19.3	6.2
2004	13.9	33.4	2.3	–0.7	21.4	8.1
2005	–6.1	17.3	3.4	0.9	20.0	9.2
2006	2.4	6.7	6.9	2.5	19.3	9.2

(continued)→

Table III.8 Import penetration and export performance of basic manufacturing industries *(continued)*

	Annual percentage changes					
	Current prices			2000 prices		
Industries[1]	Import bill[2]	Export receipts[2]	Gross value of production	Gross value of production	Import penetration[3]	Export performance[4]
Basic metals and metal products (27, 28)						
2002	4.4	-14.8	3.9	5.3	39.6	19.1
2003	9.4	-3.4	0.4	0.6	41.4	18.4
2004	18.5	38.9	12.0	6.4	44.2	22.8
2005	6.7	45.3	7.0	2.0	46.9	31.0
2006	27.0	35.7	9.7	2.9	53.3	38.3
Machinery and apparatus (29, 30, 31, 32, 33)						
2002	-3.2	-5.0	-9.1	-10.2	85.7	31.9
2003	-2.1	43.2	4.9	2.8	87.1	43.6
2004	6.2	-16.2	6.1	1.7	85.3	34.4
2005	0.3	7.0	6.6	0.5	84.6	34.5
2006	5.6	12.4	20.3	0.3	82.3	32.3
Means of transport and other transport equipment (34, 35)						
2002	5.2	-25.1	-4.9	-9.6	80.5	3.3
2003	9.3	134.5	4.8	1.7	81.8	7.4
2004	18.2	87.3	-3.5	-4.4	85.6	14.3
2005	-2.6	39.5	-10.6	-12.6	87.8	22.3
2006	17.5	41.8	6.7	4.4	89.7	29.6
Furniture and other industries (36)						
2002	1.0	-16.0	-15.5	-16.7	86.2	46.1
2003	-2.9	28.7	-8.7	-9.5	91.1	65.0
2004	16.5	16.8	-0.1	-1.7	94.6	76.0
2005	-8.2	-10.3	22.1	18.4	87.7	55.8
2006	10.6	4.9	5.4	2.4	88.1	55.5
Total manufacturing						
2002	3.3	4.0	1.4	-0.1	57.5	21.7
2003	1.3	19.0	0.8	-0.4	58.9	25.6
2004	10.3	5.4	6.6	1.2	59.6	25.3
2005	9.7	19.1	4.7	–0.8	61.8	28.7
2006	16.2	16.1	7.3	0.8	64.5	31.1
Total manufacturing (except fuel)						
2002	0.6	5.5	1.5	–0.7	57.9	22.0
2003	0.0	17.1	0.9	–0.6	58.8	25.5
2004	9.5	2.0	6.4	2.1	59.2	24.5
2005	1.7	12.7	–0.2	–1.6	60.7	27.6
2006	11.4	11.7	4.1	–0.6	63.0	29.6

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. Apparent consumption is defined as the gross value of production plus imports minus exports.
4 Ratio of exports to gross value of production (current prices).
Sources: Bank of Greece and NSSG. Revised data.

sold in foreign markets, increased by two percentage points (see Table III.8). Specifically, a significant rise in exports and a parallel improvement in export performance were achieved mostly by basic metals and metal products, means of transport and transport equipment, chemicals, rubber-plastics and coal and petroleum products. An improved export performance, albeit on a smaller scale, was also recorded by food and beverages,[39] while the export performance of non-metallic minerals remained at 2005 levels. It should be noted, however, that as far as chemicals and rubber-plastics are concerned, the improvement in export performance was not combined with a comparable strengthening of the industry's position in the domestic market.[40]

At the same time, a rise was recorded in 2006 in payments for imports of most categories of manufacturing products, together with an increase in import penetration,[41] but with the exception of non-metallic minerals and machinery-apparatus,[42] in which import penetration decreased. In any event, total payments for imports of manufactured products (except fuel) increased by 11.4% in 2006 (2005: 1.7%), while import penetration of manufactured products (except fuel) rose by 2.3 percentage points.

2.3 MINING AND QUARRYING

In 2006 mining and quarrying production decreased (–2.2%), albeit less than in 2005 (–6.2%). According to NSSG data (see Table III.6), the fall in mining output was mainly associated with the drop in the production of energy goods (coal, lignite and crude oil), as well as ores. By contrast, quarry output recovered significantly, after a continuous decrease in the past two years.

In greater detail, according to NSSG data, coal and lignite mining dropped more in 2006 (–6%) than in 2005 (–3.7%), owing to reduced demand for lignite by Public Power Corporation's (DEH) lignite-fired power plants.[43] At the same time, a decrease (–7.1%), albeit smaller than in 2005 (–29.7%), was recorded in crude oil and natural gas output, which — with the exception of 2004 (+3%) — has been falling since 2001. Non-ferrous ores mines,[44] after the recovery of their activity in 2005 due to the re-opening of the Chalkidiki mines, recorded a significant fall again (–16.6%) in 2006.[45] A similar negative development was also recorded by foreign demand for certain ores. According to provisional NSSG trade statistics, the volume of aluminium and alumina ore exports during January-November 2006 fell by 10.4%, because of reduced demand (–22.6%) from non-EU countries. Over the same period, the volume of aluminium exports to third countries fell by 34.4%, while demand for this ore from the EU increased by 16.6%.

The production of quarry materials recovered again in 2006 (+8.6%), having dropped in

39 However, as noted in a recent (December 2006) IOBE study *(The Greek Food-Beverages Industry: Findings-Policy Recommendations)*, the low export performance of food and beverages is due both to the structural features of the industry and to the overall institutional and economic environment, which creates barriers to all exports.

40 By contrast, a decrease in export receipts and export performance, accompanied by reduced production, was mainly recorded by tobacco, textiles and footwear-clothing apparel.

41 Namely the ratio of imports to "apparent consumption", which is the gross value of production plus imports minus exports.

42 This group comprises machinery and equipment, office machinery and computers, electrical machinery and apparatus, radio, TV and communication equipment.

43 According to DEH data, the quantity of lignite extracted from its own mines in 2006 decreased by 7.1%, compared with 2005, and amounted to 62.5 million tonnes (against 67.3 million tonnes in 2005). However, the tender announced by the Ministry of Development in September 2006 is under way, relating to the acquisition of the right to exploit the lignite mine of Vevi in Florina, which has been inert since 2000. According to the terms of the tender, the annual output of the lignite mine cannot be less than 1.5 million tonnes, while the exploitation right will be leased for 15 years, the lessee being able to unilaterally extend it every 5 years for 50 years.

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

45 The mixed sulphur deposits mines of Cassandra, which had closed in March 2003, have been operating again since 2005, when their exploitation was assigned to "Hellenic Gold S.A.".

the past two years (2004: –0.7%, 2005: –11%). In more detail, gravel and sand quarrying recorded a significant recovery (+16.3%) compared with 2005, while foreign demand for these materials also increased significantly in 2006. According to NSSG data, the total volume of stone, sand and gravel exports over January-November 2006 recorded a significant increase of 26.5%, which was higher to third countries (30.1%), while demand from EU countries also picked up (6%). Marble and stone output recovered (1.6%) in 2006, after a steady drop in the past two years. Foreign demand for marble was also very increased in 2006. According to provisional NSSG customs data, during January-November 2006 the volume of marble exports grew by 22% (against a 7.1% fall in the same period of 2005). Specifically, marble exports to China, which has absorbed almost half of Greek marble exports in recent years (47.2% in 2006), recorded a substantial increase (41.7%). Thus, according to NSSG data, during January-November 2006 marble exports to China reached 120.2 tonnes, from 84.8 tonnes in the same period of 2005. However, increased domestic demand for marble caused a 9.3% increase in the volume of imports over the same period. (Marble imports from Turkey, which meet over 50% of domestic demand, rose by 12.3%).

A 17.4% increase was also recorded in the production of limestone, gypsum and chalk, while the mining of clay and kaolin and the production of salt remained increased (+1.8% and +1.5% respectively).[46]

Another important development in the sector of mining and quarrying was the release by the Ministry of Development of a draft law in June 2006 ("Research and exploitation of quarries and other provisions"), aimed at simplifying and shortening the required licensing procedures and modernising the institutional framework for the operation of mines and quarries.

2.4 ELECTRICITY-NATURAL GAS-WATER SUPPLY

As shown by the relevant NSSG index, the generation of electricity, the production of natural gas and the supply of water (see Table III.6) remained virtually unchanged in 2006 (+0.1%) compared with 2005, due to the drop in electricity generation, following four years of continuous rise. By contrast, large increases continue to be recorded by the distribution of natural gas, while the index of water treatment and distribution recovered.

In more detail, according to Public Gas Corporation (DEPA) data, the total quantities of natural gas distributed in 2006 increased by 16.8% (from 2,669 million Nm^3 to 3,118 million Nm^3). This increase stemmed mainly from the very large rise in demand for this fuel by "natural gas enterprises" (EPAs), which supply small industrial and commercial firms and households (+31.6%), as the

46 Additional data on the course of mining and quarrying production in 2006 are provided by the NSSG index of turnover (in value terms) of mines-quarries, relating to total sales of goods and services to third parties. This index rose by 10.8% in 2006, having dropped by 4.6% in 2005. The increase in turnover in 2006 was higher in the domestic market (17.5%), while the external market decreased by 1.8%, owing to a large drop in sales of ores (-23.6%). However, between 2001 and 2006 the turnover of mines-quarries in the external market increased at an average annual rate of 4.6%, while the rise in turnover in non-euro area countries was even higher (7.2%). Specifically, the turnover of quarry and other materials in non-euro area countries increased at an average annual rate of 14.8% over the same period.

development and operation of city networks continues. A large increase was also recorded in the demand for natural gas for electricity generation (20.0%), mainly owing to the fact that the ELPE power plant and the new DEH unit in Lavrio commenced operations in early 2006; as a result, the share of electricity generation in total natural gas consumption reached 69.8%. By contrast, industrial demand decreased (–1.9%), while demand from commercial consumers remained at the same levels (16 million Nm^3). In 2007 total natural gas sales are expected to increase further (+18.5%) to 3.7 billion Nm^3, while total demand for natural gas is expected to reach 7.2 billion Nm^3 by 2015. On the basis of these projections and to ensure greater natural gas sufficiency and promote its use more effectively, the Ministry of Development, following consultations with the Energy Regulatory Authority (RAE), recently approved (February 2007) 12 projects for the expansion of the national natural gas system, with a total budget of €976.5 million.[47]

Another important development was the signing of a ministerial decision (in January 2007), which determines the procedures for concluding contracts between private individuals and the National Natural Gas System Manager (DESFA) for the exercise of the right of access and use of the National Natural Gas System (ESFA), in implementation of Law 3428/2005 on the deregulation of the natural gas market.[48] Thus, initially holders of electricity and heat co-generation licences and gradually other consumers will be able to procure natural gas from suppliers of their choice.[49]

As shown by provisional DEH data, net electricity output increased by 4.6% in 2006 (2005: 1.3%) and amounted to 57,489 GWH. This figure, however, includes DEH purchases from domestic energy producers and surplus imports by private firms that were fed into the system, which were markedly increased in 2006 and amounted to 5,408 GWh (from 2,014 GWh in 2005).[50] Thus, net DEH power generation came to 52,081 GWh in 2006, dropping by 1.6% (2005: +0.6%), owing to a further decrease in output from its lignite-fired plants (2006: –8.8%, 2005: –1.5%). By contrast, a marked recovery was recorded in the production of electric power by natural gas-fired plants (11.6%), (2005: –5%), while increases continued to be recorded in the production of energy by hydroelectric stations (2006: 16.8%, 2005:

47 These projects will be partly financed by EU funds, since they have been included in "bridge-projects" between CSF III and CSF IV, while the larger ones have been included for co-financing in the programming period 2007-2013. These projects comprise the terrestrial parts of international connections with Turkey and Italy, the upgrading of the liquefied natural gas (LNG) terminal station in Revythousa, Attica, as well as projects to improve the performance of the transportation network and expand into new areas. Specifically, the Greek-Turkish pipeline is expected to start operating in June 2007, initially conveying 250 million m^3 annually. At the same time, a significant development for the promotion of construction of the undersea Greek-Italian natural gas pipeline, which will enable the transport of large quantities of natural gas from Caspian and Central Asia to European markets, is the signing, on 31 January 2007, of the cooperation protocol between the Ministers of Development of Greece and Italy (the interstate agreement was signed on 4 November 2005). The total cost of the investment is estimated at €1.2 billion and, according to current planning, the construction of the pipeline will begin in the second half of 2008, with construction expected to be completed in 2011.

48 The ministerial decision on natural gas transport pricelists was also signed in March 2006.

49 Since the entry into force of Law 3428/2005, the natural gas market formally opened up for the holders of electricity and heat co-generation licences. As of November 2008, the market will be open to non-household customers in areas outside the jurisdiction of the EPAs and as of 2009 it will open to all consumers.

50 Under Law 3175/2003, DEH is compelled to absorb electricity generated by RES in non-connected islands, as well as the surplus electricity of producers, if it is generated from Renewable Energy Sources or co-generated.

9%) and oil-fired power plants (2006: 2.3%, 2005: 10.6%), also associated with the 359 MW increase in the installed capacity of the latter during the period 2001-2006.

DEH purchases from mild energy sources (wind and other renewable energy sources) amounted to 1,950 GWh in 2006 (against 1,437 GWh in 2005), thereby increasing by 35.7%. An increase was also recorded in 2006 in the capacity of private stations operating with renewable energy sources (RES),[51] while conditions are becoming more favourable for investment in this field, owing to the amendment to the current institutional framework by the passing of Law 3468/2006 ("Generation of Electricity using Renewable Energy Sources and High-Efficiency Co-generation of Electricity and Heat") in June 2006. Under the provisions of the new law, licensing procedures for electricity generation plants using RES and co-generation are simplified and accelerated, while increased financial incentives are provided, especially for electricity generation by photovoltaic and solar systems.[52] It is thus sought to ensure increased penetration in the energy balance, in order to develop the available potential of the country and fulfil the obligations stemming from the provisions of EU Directive 2001/1977 relating to the increase in the share of RES in total generated electricity from the present 11%[53] to 20.1% in 2010 and 29% in 2020. Greece's target for increasing the share of RES in electricity generation is also associated with the commitments stemming from the Kyoto Protocol, ratified in 2002 (by Law 3017/2002).[54]

Significant steps towards the lifting of obstacles to the implementation of investment in the field of renewable energy sources in Greece include the publication, on 1 February 2007, of the special land use framework for RES, which determines criteria and conditions for the location of the relevant plants, as well as tax incentives for natural persons to make use of RES, in force since 1 January 2007.

Total electricity consumption increased, according to DEH data, by 6.0% in 2006 (2005: 1.0%). This rise was caused mainly by the significant recovery of industrial demand (10.5%), following continuous decreases in the past three years (2005: –2.2%, 2004: –1.2%, 2003: –0.9%). A large increase compared with 2005 was also recorded in the demand for commercial (7.2%) and household uses (4.7%), while demand by the public sector increased less (3%). By contrast, demand by the agricultural sector fell significantly (–10.3%).

51 According to Ministry of Development data, 22 new operating licences were issued, for a total capacity of 161.7 MW. Thus, the capacity of operating RES stations rose to 708 MW. At the same time, according to recent RAE data, a total of 735 licences for a capacity of 6,939 MW have been issued since 2001.
52 According to the RAE opinion files, from February 2001 to February 2007 11 power generating licences were issued for photovoltaic systems, with a capacity of 1,8 MW. It should be noted that, on the basis of current legislation, the selling prices of energy generated by photovoltaic systems to the power generating system will be up to 600% higher than the current prices of energy from other sources.
53 Including the production of major hydroelectric stations.
54 On the basis of the Kyoto Protocol, the European Union as a whole should reduce the emissions causing the greenhouse effect by 8% compared with the 1990 levels between 2008 and 2012. However, the allocation of obligations stemming from the Kyoto Protocol varies among EU Member States. Thus, Greece is obliged over the same period to restrict the *increase* in emissions to 25% compared with the 1990 levels for certain pollutants and compared with 1995 levels for other pollutants. At the same time, in the European Council in Brussels on 8-9 March 2007, which dealt *inter alia* with the planet's climatic changes, the leaders of the 27 EU Member States unilaterally committed to reduce further gas emissions by 2020 (at least by 20% compared with 1990). It is also noted that, to implement these commitments, provision is made *inter alia* for increasing to 20% the share of renewable energy sources in total EU energy consumption (by 2020).

Concerning the country's energy potential, installed capacity increased in 2006 with the introduction into the system of the 390 MW ELPE plant[55] (since January 2006), as well as the 385 MW DEH's station in Lavrio (since April 2006).[56] However, it seems that it was not enough to cover the ever-increasing power requirements of the country; as a result, net imports rose by 11.2% in 2006. This is also associated with the delay in the tender procedures by the System Manager (DESMHE) with independent producers for the conclusion of contracts for 90 MW power availability, as provided for by the new institutional framework on the operation of the deregulated electricity market.[57] However, on 22 February 2007 DESMHE announced the first tender for the construction of a natural gas plant with a capacity equal to or higher than 360 MW, installed in the southern part of the country, while tenders will be announced in the course of 2007 for two additional private electricity generation plants, each with a capacity of about 400 MW.[58] Thus, by the end of 2010, these plants will be gradually introduced into the system, which will significantly contribute to meeting the increased needs of the country in electric power. At the same time and independently of the tender procedures, interest has rekindled since early 2007 among energy groups for participation in energy generation.[59] Moreover, in the context of the possibilities offered by Law 3175/2003, DEH is proceeding with the implementation of its programme for modernising and/or replacing its old power plants, with a total capacity of 1600 MW.[60]

3 SERVICES

The increase in the gross value added of the services sector in 2006 was the result of both growing supply, reflecting the gradual implementation of past years' structural interventions, and increasing demand in most industries. The increase in the gross value added (GVA) of the services sector in the past few years has led to a rise in the share of the services sector in total GVA (to 75.9% in 2006, from 73.1% in 2000[61]). Specifically, telecommunications, financial services, real estate management and trade recorded a satisfactory performance and supported GDP growth.[62]

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55 "Energiaki Thessalonikis", which is the first independent (non-DEH) power plant.

56 DEH's installed capacity amounted to 12,698 MW in 2006 (against 12,227 MW in 2005). Including the ELPE plant, the country's total capacity in 2006 was 13,088 MW.

57 The institutional framework for the operation of the deregulated electricity market was completed in 2005 with the signing by the Ministry of Development of the New Code of Electricity Transactions System Management (May 2005) and the passing of Law 3426/2005 (30 November 2005), by which Greek legislation was fully harmonised with the rules of Directive 2003/54/EC.

58 According to the tender notice, the new plant will start operating 29 months after the tender award (namely after the second half of 2009).

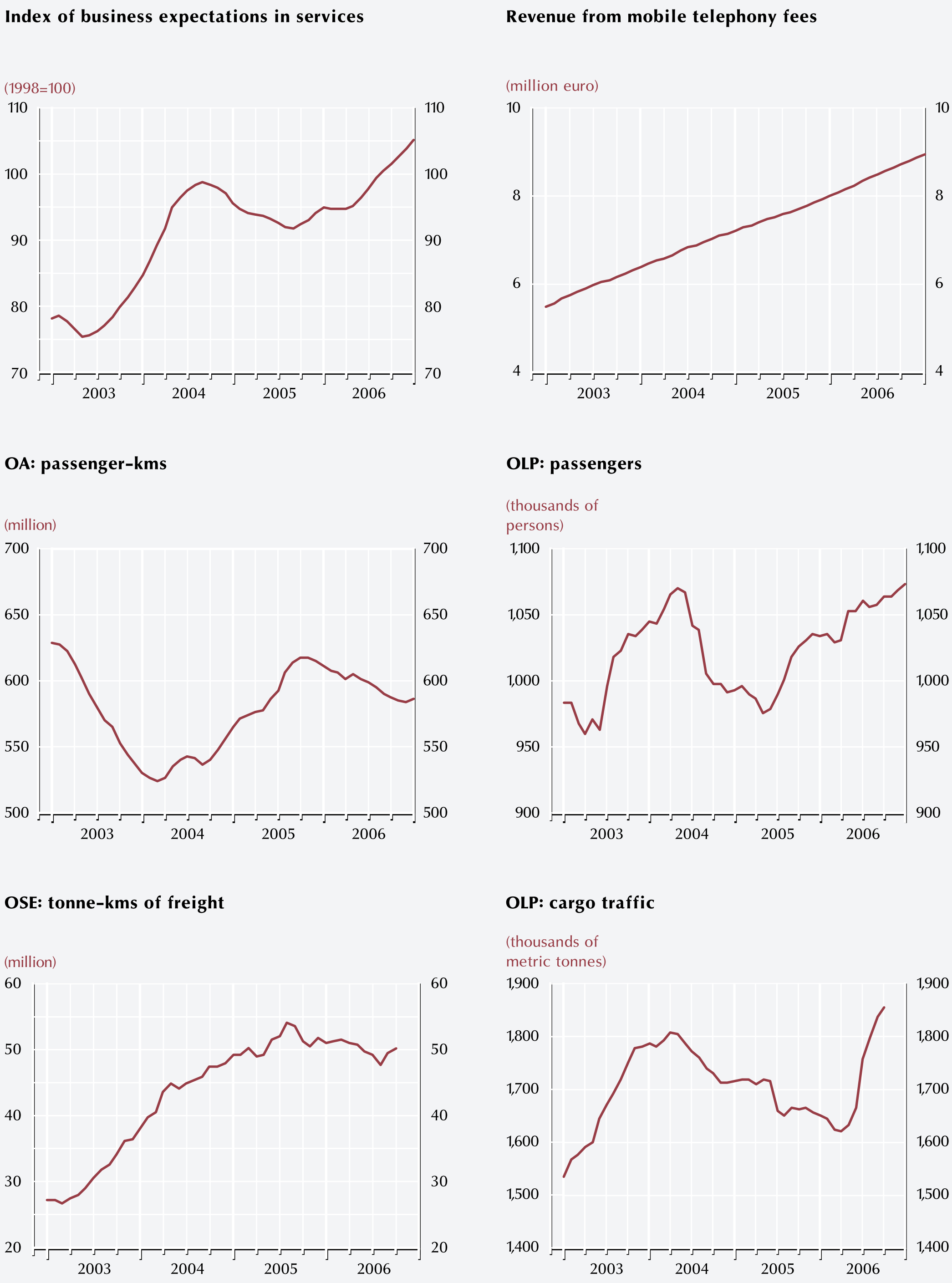
59 Indeed, the Mytilineos Group announced (on 21 February 2007) the immediate commencement of construction of a private plant, with a capacity of 412 MW, which is expected to be completed in 2009. Moreover, according to the RAE opinion archives, from February 2001 (commencement of formal market deregulation) to February 2007, 13 generation licences were issued for major private thermal plants, with a capacity of 5,366 MW, while electricity-generation licences issued over the same period totalled 907, with a cumulative capacity of 14,791.4 MW. In addition, 24 licences for the supply of 4,936 MW were issued.

60 A tender is under way (on the basis of the DEH Board of Directors' decision of 18 May 2005) for the construction of a natural gas plant with a capacity of 400 MW at Aliveri, which is expected to start operating in the summer of 2009, while the DEH Board of Directors also decided (on 3 October 2006) to replace two lignite-fired plants in Megalopoli with a total capacity of 250 MW and set up a new natural gas-fired plant with a capacity of 400 MW, scheduled for completion in 2011.

61 At current prices, according to NSSG national accounts estimates (March 2007).

62 According to the IOBE business survey, the index of business expectations in services (except retail trade and banks) increased by 10.8% in 2006, reaching the peak of the last few years. According to the main results of the survey, a larger percentage of firms estimates that the course of business activity has improved and demand has significantly increased.

Chart III.7 Activity indicators for services[1]



1 Twelve-month moving average centred on the last month of the period.
Sources: IOBE (expectations), Ministry of Economy and Finance (mobile telephony), Olympic Airways (OA), Piraeus Port Authority (OLP), Hellenic Railways Organisation (OSE).

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 foreign trade) and air transport (see Chart III.7),[63] as well as and growing demand for telecommunications services,[64] especially mobile telephony[65] and IT services. Coastal shipping recorded an increase in both passenger and cargo transport.[66] By contrast, railway cargo transport decreased.[67]

The use of computers and the Internet increased.[68] The rate of penetration of broadband connections in the population reached 4.5% at the end of 2006 (from 1.5% in 2005 and 0.5% in 2004).[69] The goal is for penetration to reach 7% by the end of 2007, while broadband convergence with EU-25[70] is sought to be achieved in 2009.[71] In implementation of Law 3431/2006 and for strengthening competition, protecting consumers and promoting broadband connections, the EETT made a decision (420/33/2 February 2007) concerning the procedures to be followed for shifting from wholesale broadband access (ADSL services via the OTE network) to broadband services via other providers' networks. Access speeds doubled and prices fell,[72] while a series of critical

63 Total passenger traffic (domestic and foreign) through the Athens International Airport increased by 5.6% and passenger traffic through the ten major airports of the country increased by 6.3%. Specifically, Aegean Airlines passenger traffic (the market share of which amounts to 22.5%) increased by 11%. By contrast, Olympic airways passenger traffic dropped by 4.1% in 2006.

64 According to NSSG data, turnover in telecommunications-postal services increased by 3.2%, in IT services by 23.3% and in other business activities (the largest share of which concerns architects-engineers, legal activities and advertising) by 9.7%.

65 The turnover of mobile telephony companies increased, despite the decrease in termination fees (by approximately 16% as from 1 June 2006) imposed by the National Telecommunications and Posts Commission (EETT). According to EETT estimates, the weighted average decrease in retail call charges from fixed-line to mobile telephones from 1 January 2006 to 1 January 2007 varies around 27%. Company data show increases both in the use (average use of mobile telephone per month) and the number of subscriptions. More than 14 million connections were reported at the end of 2006; taking into account that 20% thereof are inoperative connections, mobile telephony penetration exceeds 100% of the population. Moreover, public revenue from mobile telephony fees increased by 11.8% compared with 2005.

66 Passenger traffic from and to the port of Piraeus increased by 3.7% in 2006, while cargo transport increased by 16.8%, according to Piraeus Port Authority data. It is noted that the Greek coastal transport market is one of the most competitive in Europe, since it is estimated that 70% of the main (as to volume) lines operates in competitive conditions, as determined by Law 2392/2001 (a study conducted by XRTC Business Consultants, "Competition in the European coastal shipping market").

67 According to OSE data, cargo transport decreased at an annual rate of 2.4% between January and September 2006.

68 In 2006, the first year of implementation of the "Digital Strategy", which aims at promoting the use of information technologies and supporting broadband connections, Greek citizens increased the use of computers and the Internet. According to the latest survey of new technologies and the Information Society, conducted by the National Research and Technology Network (EDET S.A.), 31% (38.9% in ages 15-65) of the Greek population makes use of computers, while 24.6% (31.1% in ages 15-65) of the population uses the Internet. The utilisation of Internet technologies, with the purpose of upgrading the quality of service to citizens and firms and improving public administration productivity, is also supported by the Citizen Service Centres (KEPs), since they make up an extended network for the distribution of information, services and products generated by public administration and achieve full electronic and secure completion of transactions through the Internet.

69 ADSL lines were over 500,000 in December 2006 (from 151,000 at the end of 2005 and 44,000 at the end of 2004) and alternative providers' connections amount to 28,000 (February 2007). In addition, according to Ministry of Development data, approximately 18,000 students activated ADSL connections through the "Diodos" project for the provision of cheap broadband access to students. According to the OTE press release of 15 January 2007, 1/7 of households has a broadband connection (rate of penetration: 13%), while only one out of 100 households had an ADSL connection in early 2005 (rate of penetration: 1%).

70 According to European Commission data, in July 2006 2.68% of the Greek population had access to broadband services, while the EU-15 average was 16.59% and the EU-25 average was 14.68%.

71 Recommendation of the Minister of Economy and Finance to the Government Committee on the Digital Strategy (13 February 2007).

72 According to an OTE announcement (press release of 2 January 2007), ADSL charges decreased up to 7% as from 1 February 2007, while in the past 3.5 years (since the introduction of the service in June 2003), ADSL charges have dropped by 46%-67% in total, depending on the speed of access.

actions are under way to expand broadband services further, especially in the regions.

In 2006 Information Society S.A. signed contracts worth €401.5 million and realised outlays totalling €107.3 million.[73] Thus, the absorption of funds of the "Information Society" programme reached 55% of the public expenditure budget, while €1.3 billion remain to be spent in the next two years, given that the programme of Information Society S.A. will terminate at the end of 2008.

Retail trade activity grew in 2006, as shown by the 8% increase in retail sales volume and the 1.7% increase in employment in retail trade (NSSG data). Moreover, according to the monthly IOBE retail trade survey, the business expectations index rose by 14.5% and remained at levels much higher than the long-term average, while retail firms' sales forecasts are positive. In addition, NSSG data show that turnover in car sales and wholesale trade increased by 4.9% and 11.4% respectively. The development of franchising was also significant since, according to the latest surveys, 16,500 franchise stores operate in Greece; restaurants and wearing apparel remain the most attractive sectors for investors.

Tourist traffic is estimated to have increased in 2006, according to data on foreign tourists' arrivals[74] and total overnight hotel stays (except camping sites) (annual rate of growth: 2.9% between January and September 2006), despite the fact that hotel booking indicators remained virtually unchanged.[75] The continuing promotion and advertising of the country as a tourist destination, investment in tourism (especially for modernisation, as well as for the establishment or extension of hotels)[76] and the upgrading of the quality of infrastructure, the improvement in the quality of services and the work force in order to increase the competitiveness[77] of the tourist product, as well as the boosting of alternative forms of tourism so as to prolong the tourist season, are expected to have a positive effect on tourism in this and the coming years.

The Operational Programme "Competitiveness" (EPAN) continues to support small and medium-sized enterprises.[78] Under this programme, tourism, research and trade have achieved an absorption rate of 69%, 58.5% and 51% respectively (compared with 45.3%, 38.1% and 2.6% in 2005), while 73% of firms included in the EPAN come from regions outside Attica.

It is estimated that insurance production also increased. According to data from the Asso-

73 Press release from Information Society S.A., 2 January 2007.

74 According to Bank of Greece data (see Chapter IX), arrivals of foreign travellers increased by 5.8% in 2006, while gross travel receipts at constant prices increased by 4.8%.

75 Total bookings in Greek hotels (except camping sites) in January-September 2006 stood at 62.9%, compared with 62.8% over the same period of 2006 (NSSG press release, 26 January 2007). By contrast, according to data from the Athens-Attica Hotel Association, hotel bookings in the Athens region increased by 10% in January-November 2006, while overnight stays increased by 9.8% in 2006, prices by 2.6% (the average room price remains the lowest among major European cities) and revenue per available room by 12.6%.

76 In the course of implementation of development Law 3299/2004 from March 2005 to 9 March 2007, 798 tourism investment plans were approved, with a total budget of €2.3 billion, corresponding to 27% of all approvals (2,907). Moreover, a draft law was submitted to Parliament in February 2007 concerning the ratification of decisions for the inclusion of investment plans under article 9 of the development law.

77 Greece ranks 24th among 124 countries concerning the competitiveness of the tourism sector, according to the new index of Travel and Tourism Competitiveness, published for the first time by the World Economic Forum (WEF) in *The Travel and Tourism Competitiveness Report-2007*.

78 Also see Box VI.1.

ciation of Insurance Companies of Greece, insurance production has been constantly increasing since 1998.[79]

The provision of healthcare services by private firms has been on an upward course in the last few years, with an average annual growth rate of 12.7%.[80]

Finally, the significant contribution of the financial services sector to the increase in gross value added of the tertiary sector continued in 2006.[81]

4 EMPLOYMENT AND UNEMPLOYMENT

4.1 SUMMARY OF DEVELOPMENTS

Economic growth in 2006 was accompanied by an increase in the number of employed persons and a decrease in the number of unemployed. According to Labour Force Survey (LFS) data, the number of employed persons increased by 1.9% (see Chart III.8) and the unemployment rate fell by one percentage point, from 9.9% to 2005 to 8.9% in 2006 (see Chart III.9). The increase in the number of employed persons in 2006 was accompanied by a decrease in the average weekly working hours (by 0.7%) in the whole economy, mainly because of a significant decrease in weekly working hours in the primary sector, while in the non-agricultural economy working hours decreased only marginally (–0.2%).[82]

The rise in employment in 2006 was substantial and much higher than that recorded in the period 2000-2005, when the 4.4% average annual rate of growth was accompanied by a 1.3% average annual rise in employment.

Chart III.8 Employment

(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 1998-2003, published in January 2005. No changes are shown for 2004, since data are not fully comparable, due to a change in the survey sample.
Source: NSSG, Labour Force Surveys.

79 According to data processed by Hellastat S.A. (for 64 companies out of 83), total premia production reached €3.9 billion in 2005 (6.8% increase), while the average annual increase in 2002-2004 was close to 12% annually. However, the concentration of profits is very high, since five companies receive 55.5% of the profits. In 2006, the Association of Greek Insurance Brokers (SEMA), with 53 registered members, estimated that the growth rate will be high.

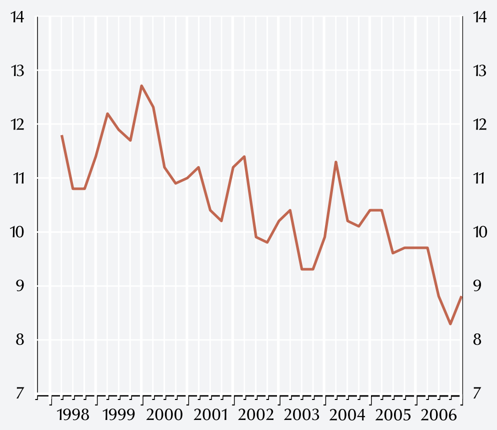
80 According to the ICAP sectoral study, the market of private healthcare services grew from 1997 to 2005 at an average annual rate of 12.7%. Owing to mergers and acquisitions, mainly in the last few years, among the sector's companies, strong business groups were created in primary and secondary healthcare, which provide a broad range of services. It is estimated that the positive growth rates of the private healthcare services market will continue in 2007. It should be noted that, according to NSSG data, the share of private firms in total healthcare expenditure amounts approximately to 47% (EU-15 average: 22.8%).

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

82 These changes refer to weekly working hours in the primary job and calculations include people who, although regularly employed, did not work in their primary job during the reference week of the survey and, therefore, recorded zero working hours. It is also noted that, if working hours in any secondary job are included, non-agricultural economy does not record any decrease, but rather a marginal increase in average weekly working hours.

Chart III.9 Total unemployment rate

(percentages of the labour force)



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

The difference in the average annual rate of increase in employment between 2000-2005 and 2006 may be due to developments in the primary sector and in "public administration".[83] Specifically, in 2000-2005 the average annual rate of decrease in employment in the primary sector was 5% (thus contributing –0.7 percentage point to the annual change in total employment), while in 2006 it stood approximately at –1.6% (thus contributing –0.2 percentage point to the change in total employment). At the same time, in 2000-2005 the average annual growth rate in employment in "public administration" was 3.2% (thus contributing 0.2 percentage point annually to the increase in total employment), while in 2006 it was 9.5% (thus contributing 0.7 percentage point to the increase in total employment).

The increase in employment in 2006 was supported by the 1.8% rise in the number of employees (1.2 percentage points),[84] the 1.3% increase in the number of self-employed (0.4 percentage point) and the 5.5% rise in the number of "assistants in family businesses" (0.3 percentage point). The number of "assistants in family businesses" increased despite the overall downward trend recorded in the last few years.[85]

The rise in the number of employed persons led to an increase in the employment rate of persons aged 15-64 years, from an average of 58.1% in 2000-2005 to 61% in 2006. This change stemmed from the rise in the employment of persons over 25, which was faster than the increase in the population of the same age and higher for women than for men.[86]

4.2 SECTORAL DEVELOPMENTS

The rise in employment in 2006 stemmed from services, while the primary and the secondary sector recorded a decrease and a marginal increase respectively (see Table III.9).[87]

In the *primary sector*, the average number of employed persons decreased in the course of 2006 by 1.6% (from 542 thousand in 2005 to about 533 thousand). This continues the downward trend observed in the past few years and has led to a drop to 12%

83 Under the terms of the statistical classification of sectors of economic activity (STAKOD-91), "public administration" corresponds to subsector 75 ("Public Administration, Defence and Compulsory Social Security") and includes local authorities.

84 The contribution of "public administration", where all persons are in salaried employment, to the increase in total salaried employment came to 1.2 percentage point.

85 At least since 1998.

86 Specifically, the employment rate of women aged 15-64 increased from 43.6% on average in 2000-2005 to 47.4% in 2006, while the employment rate of men rose from 72.7% to 74.6%.

87 As the LFS is conducted among households, the developments at a sectoral level as indicated by the data from this research are crosschecked, where possible, with data obtained from firms.

Table III.9 Population, labour force and employment

	2006 (thous. persons)	Annual percentage changes				
		2002	2003	2004[7]	2005	2006
Population aged 15 and over[1]	9,150	0.7	0.6	. . .	0.5	0.5
Population aged 15-64[1]	7,152	0.2	0.1	. . .	0.1	0.3
Labour force[1]	4,880	1.5	1.6	. . .	0.5	0.6
Employment[1]	4,453	2.1	2.3	. . .	1.2	1.6
– Primary sector[1]	536	–2.0	1.1	. . .	–0.1	–1.7
– Secondary sector[1]	981	1.0	1.2	. . .	1.0	–0.2
– Tertiary sector[1]	2,936	3.6	3.0	. . .	1.5	2.9
Labour force participation rate[1,2]	. . .	64.2	65.1	66.5	66.8	67.0
Employment rate[1,3]	. . .	57.7	58.9	59.6	60.3	61.0
Unemployment as a percentage of the labour force[1]	. . .	9.9	9.3	10.2	9.6	8.8
Employment in:						
– Manufacturing[1]	563	–0.2	–2.5	. . .	–1.6	0.5
– Construction[1]	358	3.4	8.6	. . .	4.9	–2.5
– Banks[4]	65	1.4	0.1	–2.9	3.0	1.0
– Central government[5]	486[6]	2.2	0.8	2.5	2.7	. . .

1 NSSG, Labour Force Surveys. Changes from second quarter to second quarter. New revised data 1998-2003, published in January 2005. New sample as from 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. Including public hospital personnel. The increase in average annual employment was 4.0% in 2002, 1.8% in 2003, 1.4% in 2004, 2.9% in 2005 and 2.2% in 2006 (provisional estimate).
6 June 2006.
7 Labour Force Survey data for 2004 are not fully comparable with those for the previous years.

in the sector's share in total employment in 2006 (from about 17% in 2000). The fall in employment in 2006 reflects the fact that the number of pensioners was higher than that of new entrants. Along with the drop in the number of employed persons, the LFS records a significant decrease (–5.2%) in average weekly working hours (to 36.6 from 38.5 working hours).[88] Regarding the medium-term outlook of the sector, a further decrease is expected in the number of employed persons, given that (i) the average age of persons employed in the sector is higher than in the whole economy, (ii) the sector is still characterised by a significant percentage of self-employed without any personnel[89] and (iii) the number of average working hours is lower than in the whole economy, as a high percentage of the sector's employed persons (about 25%) work 20 hours or less per week.

In the *secondary sector,* there has been a marginal increase in the number of employed persons (0.3%), mainly reflecting a rise in electricity, gas and water supply, while manufacturing and construction remained virtually unchanged. Specifically,

88 This calculation includes people who, although normally working, did not work during the reference week of the survey and, therefore, recorded zero working hours. If these people are not included, weekly working hours fall from 41.8 in 2005 to 40.3 in 2006.
89 This percentage is still high, despite the rise in the percentage of employees in the past few years, driven by the substitution of assistants in family businesses with immigrants working as employees (see Cavounidis, J., 2006, "Labour market impact of migration: employment structures and the case of Greece", *International Migration Review,* 40:3, pp. 635-60); also see Box III.3.

the slack in the total number of people employed in manufacturing (+0.04%) is estimated to stem from the increased number of staff of large enterprises, which was counterbalanced by a decrease in the staff of small and medium-sized enterprises.[90] Average weekly working hours in manufacturing increased by 1% approximately. Developments in manufacturing differ significantly by geographical area, reflecting variations in the geographical allocation of manufacturing activity. Thus, the biggest fall in employment is observed in the regions of Eastern Macedonia and Thrace and in Central Macedonia, where activity is concentrated in traditional industries (e.g. textiles).

As already mentioned, in *electricity, gas and water supply enterprises,* the number of employed persons and average weekly working hours increased significantly in 2006 (by 7.4% and 3.7% respectively), mainly due to the expansion of natural gas supply. However, due to the small size of the sector, its share in the growth of total employment was less than 0.1 percentage point.[91] Despite the substantial rise in employment, the sector's output increased at a much lower rate and this is why productivity is estimated to have decreased.

In the *construction sector,* the average number of employed persons in 2006 was only marginally (0.2%) higher than in 2005, while average weekly working hours fell (–1.3%). The evolution of employment in the sector stems from the decrease in the number of self-employed, which was counterbalanced by an increase in the number of employees and "assistants in family businesses". The marginal change in the number of employed persons contrasts with the high growth rates of residential investment, the higher growth rate of cement production in 2006 compared with 2005 and the increased vacancies in the sector (in the course of 2006 the average number of vacancies as a percentage of total workers in the sector came to 1.3%, from 0.3% in 2005). The drop in the number of immigrants employed in the sector, in conjunction with the increase in the number of vacancies, leads to the estimate that changes in employment may reflect a decrease in the supply and not in the demand for work.[92]

In business sector services, it is estimated that employment increased in almost all branches. Specifically, in *retail trade*, the accelerated growth rate of retail sales volume (+8%) was accompanied by a rise in the number of employed persons (+1.7%), as shown by the special NSSG survey conducted among relevant firms. Owing to the increase in the percentage of part-time workers (from 5.2% in 2005 to 6.8% in 2006), average weekly working hours decreased. These developments imply increased productivity in the sector. Despite the rise in the number of employed persons in 2006, there are still vacancies in trade, although, as a percentage of the total number of workers, they record a small decrease compared with 2005. The LFS also recorded an increase

90 This estimate is based on LFS data, in conjunction with the evolution of the industrial production index and the results of the IOBE business survey (which show an increase in capacity utilisation in 2006), as well as on the positive image recorded by the employment sub-index of the PMI index.

91 The sector's share in the change in employment in the secondary sector was 0.3 percentage point.

92 However, the decrease in weekly working hours in the sector is not necessarily consistent with this estimate.

(0.4%) in the number of persons employed in *hotels and restaurants*, also confirmed by IOBE data, while a rise was observed in 2006 in the number of vacancies (as a percentage of employed persons) in the branch. A rise in employment was also observed in *financial intermediaries,* according to both LFS data (+2.3%) and banks' published data (also see Chapter X). A significant increase was recorded in 2006 in the number of persons employed in *transport and communications*, which has been on an upward course in the past few years.

The rise in employment in "public administration" (which includes local authorities and accounts for about 40% of those employed in "non-market services")[93] was significant (+9.5%) in 2006 and made a 0.7 percentage point contribution to total employment growth. According to LFS data, this increase stemmed from the rise in the number of employees both in public services and local authorities.[94] Regarding other "non-market" services, the average number of employed persons increased by 5.7% in *education* and 3.6% in *healthcare*.

4.3 FORMS OF EMPLOYMENT

The share of part-timers in total employment increased to 5.7% in 2006, from 5% in 2005. This rise is attributed to the significant percentage (about 18%) of "new entrants"[95] in the labour market who are employed part-time and is related to the increase in employment in education and retail trade (where part-time work is common). At the same time, there was a rise in 2006 in the number of persons who combine work with education (either within or outside the official education system).

4.4 UNEMPLOYMENT

Data from the LFS and OAED —the Greek Manpower Employment Organisation— indicate that the number of jobless fell significantly in 2006. According to the definition and data of the LFS, the average number of those out of work in 2006 was 434,000 (unemployment rate: 8.9%), i.e. about 43,000 fewer than in 2005 (unemployment rate: 9.9%). A decrease in the number of unemployed was observed in all age groups and both sexes, with the sole exception of men aged 15-19, where the number of unemployed increased slightly. However, the decrease in the number of unemployed mainly reflects the fall in the number of unemployed women (see Table III.10), especially those aged 30-44. The drop in the average number of unemployed in 2006 may be attributed, regarding men, to the decreased number of those who were made redundant in the year and, regarding women, mainly to increased possibilities to find work.

93 Under the terms of the statistical classification of sectors of economic activity (STAKOD-91), "non-market services" comprise the following: (a) Public Administration, Defence and Compulsory Social Security (subsector 75), Education (subsector 80), (c) Health and Social Care (subsector 85) and (d) Extraterritorial Organisations and Bodies (subsector 90). Despite the increasing supply of education and healthcare services by the private sector, "non-market services" include all such services, irrespective of the ownership of the firms providing them.

94 According to LFS data, in 2006 the annual increase in the number of central government and local authorities' employees was 6% and 18.3% respectively. Data from the Introductory Report on the Budget also show a rise, albeit a much smaller one, in the number of central government employees in the first half of 2006. According to these data, which do not include those employed in local authorities, the total number of employees in central government, the Regions, Prefecture Authorities and the Security Forces was 2.4% higher at end-June 2006 compared with end-June 2005.

95 "New entrants" are those who got a job in 2006, but were either jobless or economically inactive in the previous year.

Table III.10 Population, labour force, employment and unemployment: second quarter

(thousand persons)

	Population					Labour force					Employed					Unemployed					Unemployment rate				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
Men and women																									
– total (aged 15 and over)	8,958	9,009	9,057	9,103	9,150	4,652	4,728	4,823	4,849	4,880	4,190	4,287	4,330	4,382	4,453	462	442	493	467	427	9,9	9,3	10,2	9,6	8,8
– aged 15-64	7,109	7,118	7,127	7,133	7,152	4,563	4,634	4,742	4,767	4,792	4,102	4,193	4,250	4,301	4,366	461	441	492	466	426	10,1	9,5	10,4	9,8	8,9
– aged 15-24	1,374	1,324	1,279	1,232	1,216	499	463	477	417	395	369	345	351	312	298	130	119	126	106	97	26,1	25,6	26,5	25,3	24,5
– aged 25 and over	7,583	7,685	7,778	7,871	7,935	4,153	4,265	4,346	4,432	4,485	3,821	3,942	3,979	4,070	4,155	332	323	367	361	331	8,0	7,6	8,4	8,2	7,4
Men																									
– total (aged 15 and over)	4,356	4,382	4,406	4,428	4,454	2,803	2,837	2,862	2,873	2,887	2,622	2,666	2,680	2,706	2,726	181	171	182	167	161	6,4	6,0	6,4	5,8	5,6
– aged 15-64	3,528	3,536	3,544	3,550	3,567	2,738	2,768	2,803	2,812	2,821	2,558	2,598	2,621	2,645	2,661	180	170	182	166	160	6,6	6,1	6,5	5,9	5,7
– aged 15-24	693	665	641	616	611	275	258	259	228	223	222	211	211	189	184	52	46	49	40	38	19,0	18,0	18,7	17,5	17,3
– aged 25 and over	3,664	3,717	3,765	3,812	3,842	2,528	2,579	2,603	2,644	2,664	2,400	2,455	2,469	2,517	2,542	128	125	134	127	122	5,1	4,8	5,1	4,8	4,6
Women																									
– total (aged 15 and over)	4,601	4,627	4,651	4,675	4,696	1,849	1,892	1,961	1,976	1,994	1,568	1,621	1,650	1,676	1,727	282	271	311	300	267	15,2	14,3	15,9	15,2	13,4
– aged 15-64	3,582	3,583	3,583	3,582	3,586	1,826	1,866	1,940	1,955	1,971	1,544	1,595	1,629	1,656	1,705	282	271	310	299	266	15,4	14,5	16,0	15,3	13,5
– aged 15-24	682	659	638	616	604	225	206	218	189	172	147	133	140	123	114	78	72	78	66	58	34,7	35,2	35,7	34,8	33,9
– aged 25 and over	3,920	3,968	4,013	4,058	4,092	1,624	1,686	1,744	1,787	1,821	1,421	1,487	1,510	1,553	1,613	203	199	233	235	208	12,5	11,8	13,4	13,1	11,4

Source: NSSG, Labour Force Survey, 2001-2006. New revised data for 2001-2003, published in January 2005. New sample as from 2004.

These developments are consistent with the significant decrease in 2006 in the number of persons unemployed for less than two months. By contrast, the average share of long-term unemployed (namely those out of work for 12 months or more) in the total number of unemployed increased to 56.0% in 2006, from 54.2% in 2005, because the number of long-term unemployed declined less than the number of short-term ones. The decrease in the number of long-term unemployed does not necessarily imply that they found a job; it may also be due to the fact that these people withdrew from the labour market. Although available data do not allow us to validate this assumption, a small increase was recorded in 2006 in the percentage of people who withdrew from the labour market having been unemployed in the previous year.

Apart from the increase in employment (see Chart III.8), the decrease in unemployment in the past few years was also supported by the small drop in the growth rate of the labour force, as well as by changes in the age structure of the labour force. Specifically, in the period 1998-2004 the average annual growth rate of the labour force was 1.1%, compared with 0.8% in 2005-2005 (see Table III.10), possibly also owing to a smaller inflow of immigrants. Regarding the age structure of the labour force, data show that the percentage of young people, who usually have higher unemployment rates, has fallen and has contributed to some extent to the decrease in the total unemployment rate.[96]

Despite the small decrease, the total unemployment rate remains much higher than in the EU-15 (2006: less than 8%). Moreover, the unemployment rates for women and young people remain at very high levels in Greece. The unemployment rate of women fell to 13.6% in 2006 (from 15.3% in 2005), while it is below 9% in the EU-15. In addition, a very significant percentage of unemployed women (over 60%) have been looking for work for more than 12 months. The unemployment rate of young people aged 15-24 fell to 25.2% in 2006 (from 26% in 2005), while it is about 16% in the EU-15.

4.5 MEASURES TO INCREASE EMPLOYMENT AND COMBAT UNEMPLOYMENT

Active employment policies already implemented or planned[97] are expected to make a positive contribution towards increasing employment and combatting unemployment. OAED plans include measures for the most effective organisation of the Employment Promotion Centres, such as the systematic activation of the so-called "Employment Promotion Centres 2" (EPC 2),[98] which will be created by merging the local employment services with the existing Employment Promotion Centres (EPCs) in order to operate as "one-stop shops", the electronic link-up between the EPCs 2

96 Specifically, despite the decrease in the unemployment rate of almost all age groups, if the age structure of the labour force in 2006 were the same as in 2000, the unemployment rate would have been higher.

97 According to statements by the Deputy Minister of Employment on 9 January 2007, provisional jobs created through OAED programmes lead to permanent jobs for approximately 45% of the participants.

98 See article 67 of Law 3518/2006 ("Restructuring of the sectors of the Engineers and Public Works Contractors Pension Fund (TSMEDE) and settlement of other matters falling into the competence of the Ministry of Employment and Social Protection").

and the Citizen Service Centres (KEPs) etc. Moreover, actions are being planned for matching demand for, and supply of, labour more effectively, e.g. by creating an internet portal for this purpose and providing incentives to employers to inform OAED of any vacancies. At the same time, the mediating role of OAED is also upgraded so as to offer employment or vocational training or other opportunities for work experience to young people who do not continue their studies after compulsory education and do not enter the labour market within six months from the completion of their studies.[99] Similar measures were taken in other EU-15 countries (e.g. United Kingdom)[100] and contributed to the decrease in the unemployment rate of young people.

At the same time, the law passed in March 2007 provided for the financial support of the unemployed, with the establishment of the Special Social Solidarity Fund (ETKA) and the increase in the unemployment benefit.

Specifically, ETKA will support the income (for a period to be determined by ministerial decisions) of unemployed persons aged 50 and over, who were insured in the main pension branch of IKA-ETAM, have completed 7,500 insurance days (25 years) and were dismissed from "enterprises included in a declining sector of the economy, whose production plant is located in parts of the country where the unemployment rate is at least double the national average".[101]

Regarding the basic daily unemployment benefit, on 1 January 2004 it stood at €12.45 and at the end of 2006 corresponded to 44.5% of the minimum daily wage. Under the new arrangement, the unemployment benefit increased as from January 2007 to 50% of the minimum daily wage (thus amounting to €13.98 as from 1 January 2007 and €14.69 as from 1 May 2007), while as from January 2008 it will steadily correspond to 55% of the applicable minimum daily wage.

These "passive" measures are significant but —to prevent the creation of counterincentives to work— they should be accompanied by measures providing workers with work experience and re-training.

Lastly, Law 3536, passed in early 2007, includes measures for further facilitating the integration of immigrants in the labour market (also see Box III.3).

99 Subsidies for these projects are included in the Operational Programme of the Ministry of Employment and Social Protection with the ESRF 2007-13.

100 See e.g. Quintini, G., J. P. Martin and S. Martin (2007), "The changing nature of the school-to-work transition process in OECD countries", IZA Discussion Paper 2582.

101 As stated in the law, a joint decision of the Ministers of Economy & Finance and Employment & Social Protection will determine these regions on the basis of data stemming from measurements by the NSSG and the Employment Observatory-Research Informatics S.A. on unemployment, while a similar decision will also determine the declining sectors of the economy. The Economic and Social Committee (OKE), in its opinion on the draft law, had made certain reservations concerning the application of this arrangement, specifically regarding the identification of declining sectors and regions with more than double unemployment rate, given that the smallest geographical unit for which the LFS data may be utilised is the geographical region and today none of the 13 regions posts an unemployment rate that is more than double the national average.

Box III.3

THE IMPACT OF IMMIGRATION ON THE GREEK ECONOMY: A SUMMARY

1. The extent of immigration and migration policies

With effect from the end of the 1980s Greece has gradually changed from a country of emigration to a country of immigation.[1] Although it is difficult to estimate the extent of the presence of immigrants, immigration is by now the main source of population increase.[2] According to the population census, which is thought to be the most reliable source of data on the matter at hand, immigrants, defined as individuals who are not Greek nationals, were around 760,000 (7% of the population) in 2001, compared with 167,000 (1.6% of the population) in 1991.[3] Despite the fact that the census is considered as a more reliable source, there is still a degree of uncertainty surrounding the data on immigration from this source.

The inflow of groups of this size in any country demands regularisation measures and actions to facilitate their social inclusion. In Greece, the first attempt to regularise immigrants was performed in 1991 with Law 1975/1991 ("Entry-exit, stay, work, expulsion of foreigners, procedure to legitimise refugees, and other provisions"). The law, however, was not designed to deal with flows of the size that finally took place. The first effective attempt to regularise immigrants instead was that provided by Presidential Decrees 358 and 359 of 1997 (produced by authorisation of Law 2434/1996). On the basis of these decrees, immigrants applied initially for a "white card", a six-month residence permit, and then for a "green card", a renewable work and residence permit.[4] Administering the task, however, proved more difficult than expected due to the sheer number of applications received. For this reason, further legislative measures were adopted. In 2001, Law 2910/2001 ("Entry and residence of foreigners in Greece, acquisition of Greek citizenship through naturalisation") was introduced with the aim to eliminate certain weaknesses of previous laws, to rationalise the procedures needed and to provide immigrants with a second opportunity for regularisation.

Despite the fact that during the period 2001-2004 a number of changes to Law 2910/2001 were introduced, the number of illegal immigrants was still sizeable in 2004. Certain estimates put the number of illegal immigrants at 300,000 in 2004.[5] There was thus a clear need for further efforts to regularise them.[6] To this effect Law 3386/2005 ("Entry, residence and social integration of third country nationals in Greece") was enacted and Presidential Decrees 131/2006 and 150/2006 were issued for its implementation. The law provided for a third opportunity for the regularisation of immigrants[7] and for the transposition into national law of three relevant EU directives.[8]

1 The net (excess of inward migration over outward migration) migration rate as a proportion of the population was positive and high in the 1991-95 period (around 9 per thousand inhabitants), while in the same time period the corresponding rate for the EU-15 was less than 3‰.
2 From 1987 onwards, natural population changes contribute to a limited extent to the change in overall population size, while their contribution in the period 1980-1986 was around 70%.
3 These figures include individuals from EU countries (around 36,000 in 1991 and 47,000 in 2001).
4 A total of 228,211 applications were submitted to the Ministry of Labour for a "white card", while the Manpower Employment Organisation (OAED) received 371,641 applications for a "green card".
5 This is through provisions of Laws 3013/2002, 3146/2002 and 3274/2004.
6 See Kanellopoulos, K. (2006), *Illegal immigrants in Greece*, KEPE.
7 A total of 170,000 immigrants benefited from this third regularisation programme (speech, in Greek, by the Minister of Interior, Public Administration and Decentralisation at a conference of the Hellenic Migration Policy Institute on 29 January 2007).
8 The three EU directives are: 2003/86/EC on the right to family reunification; 2003/109/EC concerning the status of third-country nationals who are long-term residents, and 2004/83/EC on minimum standards for the qualification and status of third -country nationals or stateless persons as refugees.

A significant innovation of Law 3386/2005 is that it provides for a single permit (work and residence), while a single agency, the Prefectures, are made responsible for issuing this permit. In order to deal with certain practical issues that arose from the implementation of the 2005 law, a further law was enacted at the beginning of 2007 (Law 3536/2007). The new law introduced measures to facilitate the issuance of a permit,[9] while it also established a "National Committee on the Social Inclusion of Immigrants" and an "Inter-ministerial Committee to Monitor Migration Policy".

While it is difficult to estimate the total number of immigrants and to distinguish them according to their legal status, small scale surveys[10] have concluded that in general terms the demographic features (age, gender, country of origin) of immigrants do not differ significantly according to their legal status.

2. Countries of origin and features of immigrants

The most numerous group of immigrants by country of origin is that from Albania (57.5%), while the second largest group, with a wide margin from the first one, is that from Bulgaria (4.6%). Other countries represented among immigrants are Georgia (3.0%) and Romania (2.9%).[11] In certain regions (e.g. Epirus, Ionian islands) the percentage of immigrants originating from Albania is much higher than the average percentage for the country as a whole and exceeds 70%. Having a dominant country of origin differentiates Greece as a host country from other EU-15 countries and might have led to the speedier integration of immigrants.[12]

Despite the lack of data regarding the average length of stay of immigrants in Greece, in 2001, 41% of those who entered the country with the purpose of finding a job remained in the country for over 5 years, 47% stayed for between one and five years, while 12% stayed for a year.

As expected, immigrants in Greece are younger than the native population, given that older individuals are less likely to migrate. According to the 2001 population census, the average age of Greeks is 40 years, while the average age of migrants from countries outside the EU-15 is just 30. Indicative is the fact that immigrants over 65 years old are just 3.2% of the total number of immigrants, while the corresponding figure for Greeks is around 18%.

Notwithstanding the difficulty created by the differences in the education systems that natives and immigrants have followed, it appears than among individuals younger than 50 years old the percentage of immigrants who have attended tertiary education is lower than the corresponding percentage of Greeks.[13]

9 The time limit for submission of documents to support an application is extended, more "Immigrant Committees" are being established to speed up the processing of applications, immigrants are given the option to buy out around 20% of the required social security contributions, all minors are exempted from paying a fee in the case of family reunification etc.

10 See, e.g. Lianos, T.P., A.H. Sarris and L.T. Katseli (1996), "Illegal immigration and labour markets: the case of Northern Greece", *International Migration,* 34:3, pp. 449-83, and Kasimis, C. and A. Papadopoulos (2005), "The multifunctional role of migrants in the Greek countryside: implications for the rural economy and society", *Journal of Ethnic and Migration Studies,* 31:1, pp. 99-127, and Kanellopoulos, K. (2006), *op. cit.*

11 Figures are from the 2001 Population Census.

12 See Cavounidis, J. (2002), "Migration in Southern Europe and the case of Greece", *International Migration,* 40:1, pp. 45-70.

13 More specifically, among immigrants (from countries outside the EU) aged 35-39 the percentage of those with tertiary education stood at 14%, while the corresponding figure for Greeks was around 23%.

3. Economic aspects of immigration

Immigrants contributed to the increase in the labour force and total employment and thus to the increase in output. More specifically, in the period 1998-2006 four tenths of the annual 1% increase in the labour force was due to the increased presence of immigrants.

The short-run impact of immigration on the labour market depends on the substitutability of immigrants for natives.[14] Most applied studies for Greece find that immigration has not in general led to an increase in unemployment among natives.[15] This result is attributed to, *inter alia,* the limited substitutability between the two groups and the fact that immigrants settled in regions with increased demand for the skills they offer.

Immigrants are concentrated in a limited number of sectors (primary sector, construction, hotels and restaurants, services to private households), in which there is a shortage of labour supply by natives.[16] Employees in these sectors are in general unskilled and younger than the average. In 2001, most immigrants (around 73% of men and 58% of women) were working as craftsmen, mobile plant operators, unskilled workers and workers in elementary occupations, while the corresponding percentage for all employees (Greeks and immigrants) was 39% for men and 16% for women.[17]

It is often mentioned that the high employment rates of immigrants in Greece are due to the existence of the informal economy, which to a certain extent they help to maintain.[18] At the same time, however, immigrants have contributed to organisational changes in enterprises by substituting unpaid family members with dependent employees (note that according to the 2001 Population Census over 90% of immigrants are employed as dependent employees).[19] This is one of the reasons for which the share of dependent employment in total employment has increased from 52% in 1990 to 64% in 2006.

It is difficult to estimate the contribution of immigrants to GDP without a *general equilibrium model* which takes into account the impact of immigration on total supply and demand. According to the only available estimates of this type for Greece,[20] the short-run impact of immigrants on GDP is positive,[21] but redistributional effects cannot be ruled out.[22]

14 See, for example, Borjas (1995), "The economic benefits from immigration", *Journal of Economic Perspectives,* 9:2, pp. 3-22.
15 See, *inter alia,* Lianos *et. al.* (1996), Kasimis and Papadopoulos (2005).
16 This statement is based on the fact that the percentage of unemployed Greek who used to work in these sectors prior to becoming unemployed is low. Furthermore, a survey by the Ministry of Agriculture some years ago recorded labour supply shortages in the agricultural sector (see announcements by the Ministry of Agriculture in the Press on 30 March 2001). See also, Bank of Greece, *Annual Report 2000,* April 2001, p. 101, footnote 7.
17 Figures from the 2001 Population Census.
18 See, *inter alia,* OECD *Economic Surveys: Greece-2005,* September 2005, Chapter 5.
19 See Cavounidis, J. (2006), "Labour market impact of migration: employment structures and the case of Greece", *International Migration Review*, 40:3, pp. 635-60.
20 See, Sarris, A.H. and S. Zografakis (1999), "A computable general equilibrium assessment of the impact of illegal immigration on the Greek economy", *Journal of Population Economics,* 12:1, pp. 155-82. The model is based on a social accounting matrix for the Greek economy in 1988.
21 If the inflow of immigrants resulted in a labour force increase of the order of 3.2%, this would lead to a GDP increase of 1.5%.
22 If low skilled Greek workers were replaced by immigrants.

Immigrants have a positive impact both on supply and on demand but because their propensity to consume is smaller than that of natives their impact on consumption is less than what would result from an increase of the population by a similarly sized group of natives. Immigrants in general try to save in order both to financially support their relatives in the country of origin as well as to accumulate wealth. A field-study in 3 countries (Greece, Italy and the UK) which experienced significant inflows from Albania shows that 75% of Albanian immigrants have bank accounts.[23]

Moreover, the OECD estimates that even the short-run fiscal impact of immigration is going to be positive for Greece since immigrants contribute to both direct and indirect taxation, while at present they do not contribute to public expenses to the same extent (since they are not yet claiming pensions).[24]

Finally, immigrants have an impact on the current account, given that immigrants' remittances to their countries of origin do burden the current transfers balance. It is estimated that in 2006 these remittances amounted to €500 million.[25]

In general, the economic activity of migrants contributes to GDP growth, increases labour market flexibility, contributes to contain labour costs and delays population ageing. Recent legislative initiatives for the regularisation of immigrants are in general viewed positively by the social partners given that they simplify the necessary procedures, while the establishment of the National Committee for the Social Inclusion of Immigrants (on the basis of Law 3536/2007) is expected to help shape immigration policy.[26]

The long-term impact from immigration on the Greek economy will depend on, *inter alia,* the size of future immigrant flows in conjunction with labour market conditions. To the extent that immigrants will be integrated into the Greek society and that their skills and education level will ameliorate, they will be able to contribute to productivity growth and to the expansion of other sectors apart from the ones that they are now concentrated in.

23 See Nikas, C. (2006), "The saving attitude and the remittances of Albanian immigrants in Greece'', presentation at the Hellenic Migration Policy Institute Conference on 23-24 November 2006, available from the Institute's home page: (http://www.imepo.gr/documents/Nikas24_11_2006.pdf). The paper presents estimates of the average annual saving of an Albanian household (around €5.4 thousand) but does not distinguish according to which country the household is residing in.
24 See footnote 18 of this box.
25 This is the Bank of Greece estimate, based on figures for the outflow of remittances, reported by financial intermediaries operating in Greece and on estimates of remittances transferred through unofficial channels on the basis of travel expenses. Travel expenses are recorded as part of the "Frontier survey on travel expenditure" conducted to estimate figures for the balance of payments statistics. The estimated figure for remittances could, however, be an underestimation of the true outflow to the extent that this is not recorded by either of the two sources mentioned above.
26 See the Opinion 165/2007 of the Economic and Social Committee.

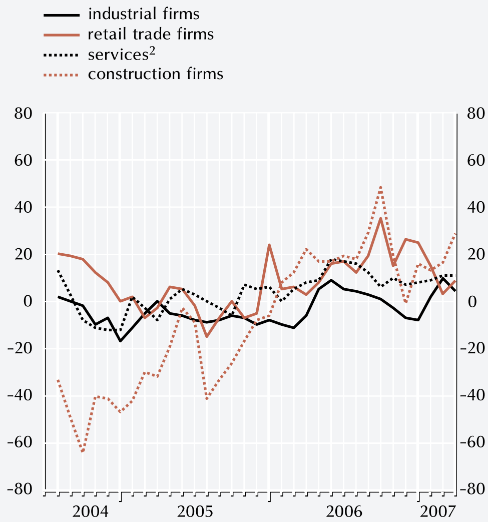
4.6 THE OUTLOOK FOR EMPLOYMENT AND UNEMPLOYMENT

Regarding short-term prospects in the labour market, enterprises in all sectors forecast a rise in employment (see Chart III.10).[102] This estimate is supported by NSSG data showing that there is a significant number of vacancies, at least in some sectors (construction, retail trade, hotels and restaurants).

102 A picture similar to that of the IOBE business survey, except for the steady number of construction workers, is recorded by the new "Labour Market Trends Index", which is compiled by the ALBA Liberal Studies Centre, but is based on a much smaller sample of enterprises (see ALBA press release, 28 March 2007).

Chart III.10 Business expectations[1] for employment (July 2004 – March 2007)

(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.

However, given the significant increase in employment recorded in 2006, there may be a small slowdown in the rate of increase in total employment this year.

Medium-term prospects for a further rise in employment mainly depend on expanding the productive capacity of the economy, which is strongly related to improvement in education, vocational and in-company training, and on introducing incentives for stay or entry in the labour market (e.g. measures facilitating the harmonisation of family life and professional career etc.), given that demographic parameters are not favourable. Specifically, given the present structure of the population and provided that it will not change due to migration, then, assuming that the employment rates of each age group will remain unchanged, the number of workers aged 15-64 in 15 years will be lower than today.[103] On a long-term basis, according to the latest available population projections by the NSSG, which are based on certain assumptions ("average version"), the population aged 15-64 ("economically active population") will decrease from 68.1% of total population in 2000 to 56.4% in 2050.[104]

103 Certainly, the employment rates of each age group (except the youngest one) are not expected to remain steady but rather to increase. The main reason for the expected increase is the so-called "cohort effect", given that it is easier to induce people now aged 40-50 years with a higher employment rate to remain in the labour market in the following decade than it is to attract in the labour market people now aged 50-60 who have never worked before.
104 NSSG, press release, 2 April 2007.

IV INFLATION, WAGES AND BUSINESS PROFITS

1 INFLATION

1.1 DEVELOPMENTS IN, AND DETERMINANTS OF, INFLATION IN 2006

Average annual inflation fell slightly in 2006. More specifically, average annual inflation on the basis of the Harmonised Index of Consumer Prices (HICP) came down to 3.3%, from 3.5% in 2005. The average annual level of core inflation, as measured on the basis of the HICP excluding the prices of energy and unprocessed food, fell to 2.9%, from 3.2% in 2005. During the year, however, an upward trend was observed in core inflation (3.4% in the fourth quarter of 2006, from 3.0% in the final quarter of 2005).[1]

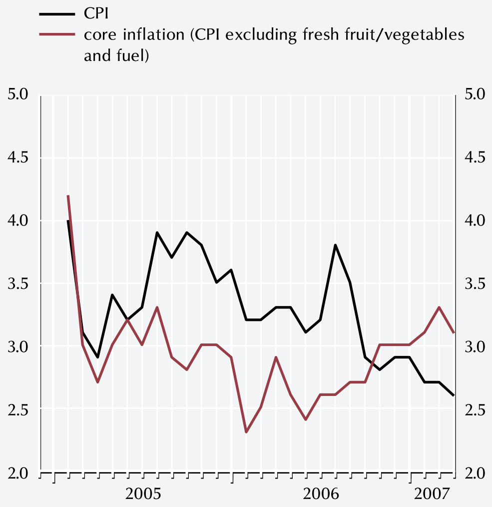
The limited drop in inflation in 2006 was the net result of the favourable and unfavourable effects of various factors, which are analysed below.

A number of extraordinary or exogenous factors played a significant part in determining inflation. In particular, factors which contributed to the fall in inflation were the gradual elimination (from April 2006 onwards) of the impact of increases in indirect taxation (in 2005) on the annual rate of increase in consumer prices. (It has been calculated[2] that the rise in indirect taxation, after having been fully implemented, contributed 0.75 percentage point to the annual rate of increase in the CPI in December 2005, while its impact on average annual inflation in 2005 was of the order of 0.6 percentage point.)

As for imported inflation, which is an exogenous factor, the world price of crude oil rose markedly until July 2006, but began to fall from August. Thus, the euro price of

Chart IV.1 Consumer price index and core inflation

(percentage changes over same month of previous year)



Source: Calculations based on NSSG data.

Brent crude oil increased at an average annual rate of 18.6% in 2006, compared with 46.2% in 2005 (see Chart IV.2).[3] By contrast, a sharp acceleration was observed in the average annual growth rate of the international prices (in euro terms) of other (non-energy) raw materials to 24.8% (from 9.4% in 2005).

As a result of these developments, the average annual growth rates of the prices of goods imported into Greece (excluding fuel) accelerated significantly, but still remained generally lower than domestic inflation and thereby helped to restrain it. Indeed, the Import Price Index in Industry (compiled by the NSSG)

1 Average annual inflation, based on the national Consumer Price Index (CPI), fell to 3.2% (from 3.5%). Core inflation (CPI excluding fuel and fresh fruit and vegetables) fell to 2.7% (from 3.1%) on an average annual basis, while in the fourth quarter of 2006 it stood at 3.0%, i.e. the same as in the corresponding quarter of 2005 (See Table IV.1 and Chart IV.1).
2 See *Annual Report 2005,* April 2006, pp. 150-51.
3 See ECB, *Monthly Bulletin,* Euro area statistics, Table 5.1.2.

Table IV.1 Inflation indicators

(annual percentage changes)

Year or quarter	Consumer Price Index								Industrial producer price index					Import price index in industry	
		Sub-indices							Domestic market				External market		
										Sub-indices					
	General index	Goods	Services	CPI excluding fuel & fresh fruit and vegetables	CPI excluding food & fuel	Food and non-alcoholic beverages	Fresh fruit and vegetables	Fuel	General index	General index excl. energy	Intermediate goods	Consumer goods	General index	General index	General index excl. energy
2000	3.2	3.4	2.8	2.0	2.0	1.9	1.4	26.8	5.2	3.3	4.5	2.2	13.6	6.4	4.8
2001	3.4	3.2	3.7	3.8	3.7	5.1	9.2	–4.8	3.6	5.1	5.5	5.0	0.7	3.1	3.4
2002	3.6	3.2	4.3	3.6	3.6	5.3	13.8	–1.7	2.3	2.3	1.3	3.2	1.1	0.3	0.4
2003	3.5	3.1	4.2	3.2	3.1	5.0	10.7	3.9	2.3	2.5	2.3	2.7	–0.3	0.7	0.6
2004	2.9	2.3	3.8	3.3	3.2	0.5	–11.9	7.5	3.5	4.7	3.2	6.0	5.0	3.1	0.8
2005	3.5	3.4	3.7	3.1	3.2	0.6	–8.1	18.0	5.9	3.0	3.8	2.5	3.7	8.8	1.2
2006	3.2	3.4	3.0	2.7	2.5	3.7	3.3	10.9	6.9	6.3	7.5	5.9	4.2	4.4	2.8
2003 Q1	3.8	3.4	4.5	3.6	3.4	2.3	–5.4	15.9	3.6	2.5	2.7	2.5	0.8	1.0	0.7
Q2	3.7	3.4	4.1	3.1	3.0	8.3	27.6	–2.4	1.7	2.2	2.2	2.1	–2.5	0.5	0.5
Q3	3.4	2.9	4.1	3.0	2.9	6.1	19.2	0.9	2.0	2.4	2.0	2.8	–0.3	0.6	0.6
Q4	3.2	2.5	4.3	3.2	3.3	3.3	4.6	1.9	2.1	2.8	2.1	3.5	0.9	0.6	0.5
2004 Q1	2.7	1.8	4.0	3.3	3.2	3.3	2.6	–5.7	1.3	4.3	1.6	6.5	2.3	–0.1	0.1
Q2	2.9	2.3	3.9	3.3	3.2	–0.7	–16.3	11.6	4.4	5.3	3.3	6.9	7.4	2.3	1.0
Q3	2.8	2.1	3.9	3.4	3.4	–1.3	–22.8	9.6	4.4	5.0	3.6	6.1	6.0	4.3	1.0
Q4	3.2	2.9	3.5	3.0	2.9	0.8	–11.3	15.5	4.1	4.3	4.1	4.5	4.4	5.8	1.2
2005 Q1	3.3	3.1	3.6	3.3	3.5	–0.6	–11.5	15.1	4.6	2.6	4.9	0.8	2.7	8.2	1.4
Q2	3.3	3.0	3.8	3.0	3.1	–0.3	–12.4	18.1	4.9	2.3	3.6	1.4	2.3	8.4	1.1
Q3	3.9	4.0	3.6	3.0	3.1	1.4	–4.1	21.6	6.3	2.6	3.3	2.2	4.5	9.8	1.1
Q4	3.7	3.6	3.7	3.0	3.0	2.1	–2.2	17.1	7.7	4.7	3.5	5.7	5.4	8.9	1.4
2006 Q1	3.3	3.3	3.2	2.5	2.3	1.9	–5.8	19.6	9.2	6.8	4.7	8.8	7.0	7.7	1.8
Q2	3.2	3.6	2.7	2.5	2.3	3.4	1.3	14.8	8.6	7.2	7.6	7.4	5.9	6.8	2.7
Q3	3.4	3.9	2.8	2.7	2.4	5.1	10.8	11.8	6.8	7.2	9.2	6.2	3.2	2.7	3.1
Q4	2.9	2.7	3.1	3.0	2.8	4.6	9.4	–1.2	3.0	4.3	8.6	1.6	0.8	0.7	3.4
2007 Q1	2.7	2.1	3.4	3.2	3.3	3.1	4.9	–4.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .

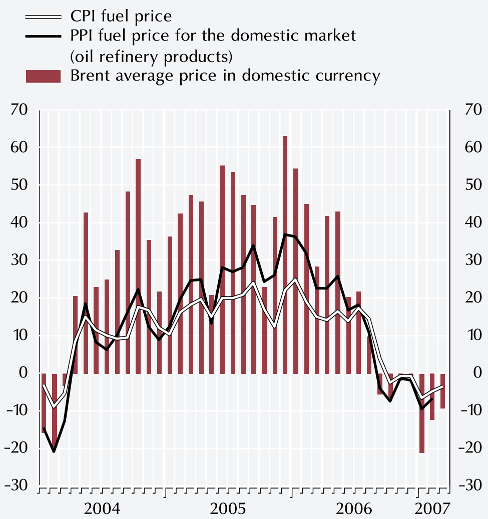
Source: NSSG.

showed an annual average increase of 4.4% in 2006, compared with 8.8% in 2005 (see Table IV.1 and Chart IV.3). Excluding energy prices, the increase was restricted to 2.8%, but was more than double the 2005 figure (1.2%). The evolution of the prices of imported consumer goods was similar (2.0% compared with

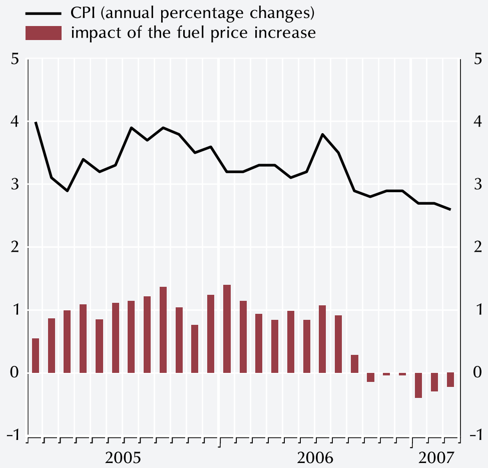
Chart IV.2 Fuel prices

(percentage changes over same month of previous year)

A. Evolution of CPI/PPI prices and of the euro price of Brent crude oil



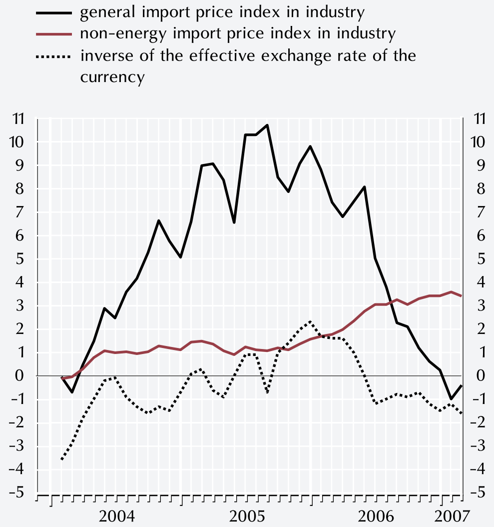
B. Inflationary contribution of changes in fuel prices



Source: Calculations based on NSSG data and forward contracts on the London market for the price (in US dollars) of Brent oil.

Chart IV.3 Import price index in industry and inverse of the effective exchange rate of the currency

(percentage changes over same month of previous year)



Note.: Since 2004 the import price index also includes crude oil (and not only final petroleum products); thus, the rise in the general index becomes steeper.
Sources: NSSG and Bank of Greece.

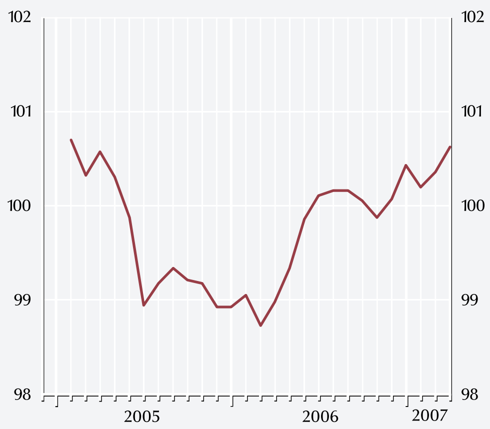
1.4%). The growth rate of the prices of imported intermediate goods not only picked up but also reached a high level (5.7%, compared with 2.7%).

Of course, the appreciation of the euro against the dollar and other currencies during 2006 (which was, however, limited – see Chart IV.4)[4] helped contain imported inflation somewhat. In addition, it should be taken into account that the rate of increase in the prices of non-fuel imported goods would have been even greater if the rate of increase in the prices of final products imported from euro area countries had not

4 The euro appreciated at an average annual rate of 0.9% against the US dollar in 2006, while it had remained stable (on average) in 2005. In addition, the average nominal exchange rate of the euro against other currencies, weighted on the basis of Greece's external trade, rose by 0.1% in 2006, while it had fallen by 0.7% in 2005.

Chart IV.4 Revised nominal effective exchange rate index, weighted on the basis of Greece's external trade

(1999 Q1=100, monthly averages)



Note: The revised nominal effective exchange rate index comprises Greece's 28 main trading partners (among them, the other 12 euro area countries, including Slovenia). The weights are calculated on the basis of manufacturing imports and exports (categories 5-8 of the Standardised International Trade Classification – SITC 5-8) during 1999-2001, taking into account competition in third markets.
Source: Bank of Greece.

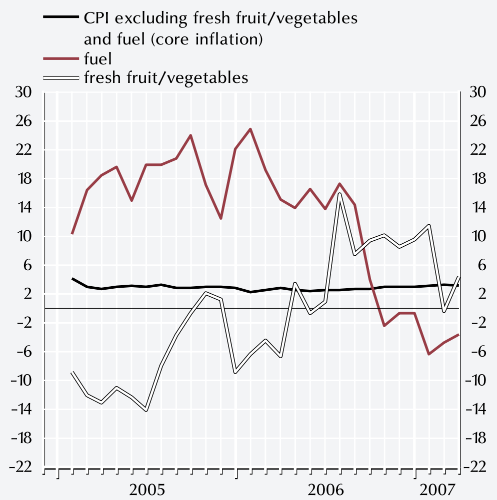
remained relatively low (although it did accelerate). Finally, competition —due to globalisation and the increase in the share of imports of final products (e.g. clothing and footwear, consumer durables and household goods) from countries where production costs are relatively low, particularly from the emerging economies of Asia— helped to restrain the rise in the prices of similar goods imported from other countries or manufactured domestically and thus to contain inflation.

The rate of increase in the prices of imported crude oil and natural gas decelerated sharply (to 10.8%, from 57.1%), while the rise in the prices of imported final fuel products (i.e. gasoline, as well as heating oil, diesel and heavy oil) also decelerated considerably (to 9.2%, from 22.7%). It is worth noting that, at wholesale level in the domestic market, fuel prices (final products) included in the Industrial Producer Price Index for the domestic market rose at an average annual rate of 12.9% in 2006 (compared with an increase of 25.1% in 2005), while retail prices of fuel included in the CPI rose in 2006 at an average annual rate of 10.9% (compared with 18.0% in 2005).

However, the increase in the price of oil in the first seven months of 2006 continued to affect, with a time lag, production costs after July. This indirect effect partly explains the significant acceleration recorded in 2006 in the growth of consumer and intermediate goods prices at the level of producer prices in the domestic market (wholesale prices). The average annual rate of increase in the producer prices of consumer goods reached 5.9% in 2006, from 2.5% in 2005. This acceleration was limited exclusively to consumer non-durables (from 2.4% to 6.0%), which account for 95% of total consumer goods

Chart IV.5 Core inflation, prices of fresh fruit/vegetables and fuel prices

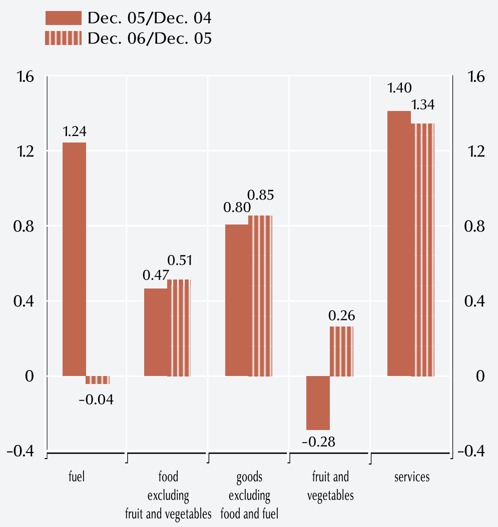
(annual percentage changes)



Source: Calculations based on NSSG data.

Chart IV.6 Contribution of key components to Greek inflation

(percentage points)



Source: Calculations based on NSSG data.

and 25% of the goods included in the Producer Price Index for the domestic market. Approximately 1/3 of non-durables are processed food, beverages and tobacco, which are characterised by a high degree of concentration, at least at the supplier level. By contrast, the increase in the prices of consumer durables registered a small slowdown (from 4.2% to 3.5%), although the rate remained relatively high. Finally, the average annual rate of increase in the prices of intermediate goods reached 7.5% in 2006, from 3.8% in 2005.

Another exogenous factor was the prices of fresh fruit and vegetables, which had an inflationary effect in 2006 as they rose at an average annual rate of 3.3%, compared with a fall of 8.1% in 2005 (see Charts IV.5 and IV. 6).[5] The prices of these goods were affected to a significant degree by supply and demand conditions at a European level, owing to weather conditions (high temperatures and drought) in several countries.

The more permanent determinants of inflation are associated with costs and demand as well as the interaction between them.

More particularly, the growth rate of unit labour costs is estimated to have accelerated significantly in 2006 both in the economy as a whole (to 3.3%, from 2.0% in 2005) and in the business sector[6] (to 4.1% from 2.4% – see Section 2 of this chapter).

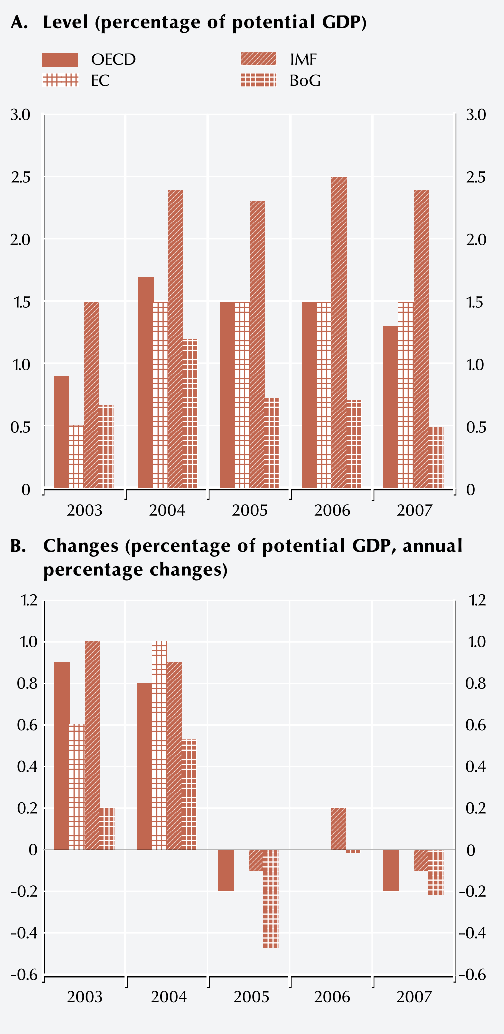
Excess demand in the economy continued to exert inflationary pressure, as the GDP growth rate continued to exceed the potential growth rate of the economy, but the strength of inflationary pressures remained effectively unchanged in comparison with 2005. Specifically, the growth rate of total domestic demand accelerated significantly in 2006 (due to the recovery of investment), while a small pick-up was obsverved in the growth rate of private consumption on a national accounts basis (see Chapter III). The "output gap"[7] of the Greek economy, i.e. the most comprehensive measure of excess demand, has been positive in recent years (i.e. the level of current pro-

5 It should be recalled that a large drop in the prices of fresh fruit and vegetables had been observed in 2004 and 2005, following a steep rise in 2002 and 2003.

6 The business sector comprises public and private enterprises and banks.

7 The "output gap" is defined as the difference between the level of current output (GDP) and the country's production potential (level of potential GDP) as a percentage of the *level* of potential GDP. It is an aggregate not directly measurable but estimated by 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 consideration when conclusions of analyses are assessed. The *change* in the "output gap", which is measured in percentage points of GDP, is perhaps a more reliable indicator.

Chart IV.7 The output gap of the Greek economy



Sources: OECD, *Economic Outlook*, December 2006.
European Commission, *Autumn 2006 Economic Forecasts*.
IMF, *Greece - Staff Report for the 2006 Article IV Consultation*, January 2007.
Bank of Greece (BoG), estimates of the Economic Research Department.

duction exceeds the "potential" level) and remained virtually unchanged in 2006 (see Chart IV.7).[8]

However, the fiscal policy pursued led to a reduction in the general government deficit and helped contain inflationary pressures, to the extent, of course, that deficit reduction was the result of expenditure restraint or revenue increase related to items which affect demand.

There was also stronger competition in the retail trade sector, with the entry of new department store chains and increasing numbers of so-called discount stores in the supermarket, clothing and footwear and household goods sectors. This led both to a fall in the prices of certain goods and to a containment of the rise in the general level of consumer prices.

Finally, it should be noted that inflation would have been higher if public utility rate increases had fully reflected the increases in cost factors. It is characteristic that, as shown by the analysis of the data from the period 2001-2005, the average annual increase in the rates of six major public utility companies (the Public Power Corporation – DEH, the Hellenic Telecommunications Organisation – OTE, the Athens-Piraeus Water Supply and Sewerage Company – EYDAP, the Hellenic Railways Organisation – OSE, the Athens Urban Transport Organisation – OASA and the Hellenic Post Office – ELTA) was less than the average annual increase in the "costs of sales", i.e. the pro-

8 According to the European Commission (*Autumn 2006 Economic Forecasts*, November 2006) and the OECD (*Economic Outlook,* December 2006), the "output gap" was maintained at 1.5 in 2006 (the same as in 2005). In addition, according to IMF estimates (*Greece – Staff Report for the 2006 Article IV Consultation,* January 2007), it rose slightly to 2.5, from 2.3 in 2005. It should be noted, however, that estimates of stability in the positive "output gap" of the Greek economy in 2006 do not provide the same picture as two other indicators: (i) in industry (from which, however, only 11% of GDP is derived), the capacity utilisation rate increased markedly in 2006 (to 76.2 from 72.3 in 2005) and (ii) the unemployment rate dropped, while the employment rate increased, implying an increase in the labour force utilisation rate (see Chapter III).

Table IV.2 Evolution of sales costs and of the rate of change in the prices of services offered by six major public utility companies

Utility company	Average annual percentage changes: 2001-2005 Total turnover	Sales costs	Services price index
DEH	5.1*	7.1*	2.7*
OTE	–5.9	4.0	–3.0
EYDAP	4.9	7.8	6.0
OSE	3.4	10.5	2.2
OASA	5.1	15.2	4.0
ELTA	6.8	7.5	6.5

Note: The average annual rate of change in the Consumer Price Index during 2001-2005 was 3.4%.
* For the period 2003-2005.
Sources: Companies' balance sheets (for the turnover and sales costs) and NSSG (for the prices of services offered to consumers).

duction costs of the services provided by these companies (see Table IV.2).

1.2 THE INFLATION DIFFERENTIAL BETWEEN GREECE AND THE EURO AREA AND INDICATORS OF INTERNATIONAL PRICE COMPETITIVENESS

In the euro area, HICP inflation and core inflation remained unchanged in 2006 at 2.2% and 1.5% respectively (see Table IV.3 and Chart IV.8). Thus, the differential of Greek inflation over the corresponding figure in the euro area as a whole narrowed to 1.1 percentage points (from 1.3 percentage points in 2005) and the differential of core inflation was reduced to 1.4 percentage points (from 1.7 percentage points in 2005).[9] As in previous years, the differential between Greece and the euro area in terms of the average annual increase in unit labour costs in 2006 (2.4 percentage points) was higher than the inflation differential.

In part, the positive differential of inflation in Greece over inflation in the euro area as a whole is due to the fact that, irrespective of the rate of price changes, the level of prices in Greece continues to be lower than the euro area average and is gradually converging with the latter. Insofar as this price convergence also concerns internationally non-tradable goods or services, the inflation differential does not necessarily imply an equivalent deterioration in the international competitiveness[10] of the economy. Nevertheless, there can be no doubt that there has been a significant drop in international price competitiveness, which is reflected in the widening current account deficit and the fact that, despite its fall, the unemployment rate remains relatively high. The decrease in price competitiveness is derived from calculations that take into account developments both in consumer prices and in unit labour costs in the manufacturing sector and in the whole economy in Greece and in the 28 countries which are Greece's major trading partners, in conjunction with the evolution of the nominal exchange rate of the euro (weighted on the basis of Greece's external trade with these countries). It is estimated (see Table IX.2) that the real effective exchange rate (REER) based on consumer prices (i.e. the relative consumer prices expressed in a common currency) rose cumulatively in the last six years

9 Regarding the rates of change in the prices of the individual groups of goods and services which comprise the HICP "basket", see Table IV.3 and Chart IV.9.

10 Of course, certain services traditionally considered internationally non-tradable are now provided by sectors which have been deregulated and are affected by international competition or — in any event — their prices influence the production costs of other, internationally tradable, products. See Bank of Greece, *Monetary Policy – Interim Report 2006*, October 2006, p. 88, footnote 2.

Table IV.3 The evolution of prices in Greece and the euro area

(annual percentage changes, unless otherwise indicated)

	2005	2006	2006 July	2006 Aug.	2006 Sept.	2006 Oct.	2006 Nov.	2006 Dec.	2007 Jan.	2007 Feb.	2007 March
A. Euro area											
Harmonised Index of Consumer Prices (HICP) and its components											
General index	**2.2**	**2.2**	**2.4**	**2.3**	**1.7**	**1.6**	**1.9**	**1.9**	**1.8**	**1.8**	**1.9**
Goods	2.1	2.3	2.7	2.5	1.6	1.3	1.7	1.8	1.5	1.5	...
Food	1.6	2.4	2.7	2.9	2.9	3.0	3.0	2.7	2.8	2.4	...
Processed food[1]	2.0	2.1	2.3	2.2	1.8	2.3	2.2	2.1	2.2	2.1	...
Unprocessed food	0.8	2.8	3.2	3.9	4.6	4.2	4.4	3.7	3.7	2.8	...
Industrial goods	2.4	2.3	2.7	2.4	1.0	0.5	1.1	1.4	0.9	1.1	...
Industrial goods excluding energy	0.3	0.6	0.6	0.6	0.8	0.8	0.8	0.9	0.9	1.1	...
Energy	10.1	7.7	9.5	8.1	1.5	-0.5	2.1	2.9	0.9	0.8	...
Services	2.3	2.0	2.1	1.9	2.0	2.1	2.1	2.0	2.3	2.4	...
Producer prices in industry	**4.1**	**5.1**	**6.0**	**5.7**	**4.6**	**4.0**	**4.3**	**4.1**	**3.1**	**2.9**	**...**
International non-oil commodity prices[2]	**9.4**	**24.8**	**26.7**	**26.8**	**26.4**	**28.7**	**22.9**	**17.7**	**15.6**	**13.9**	**...**
Oil prices (euro per barrel)[3]	**44.6**	**52.9**	**58.8**	**57.8**	**50.3**	**47.6**	**46.7**	**47.4**	**42.2**	**44.9**	**...**
B. Greece											
Harmonised Index of Consumer Prices (HICP) and its components											
General index	**3.5**	**3.3**	**3.9**	**3.4**	**3.1**	**3.1**	**3.2**	**3.2**	**3.0**	**3.0**	**2.8**
Goods	3.4	3.5	4.6	3.8	3.2	3.0	3.1	3.0	2.6	2.3	2.2
Food	1.1	4.0	5.1	4.2	4.8	5.8	5.2	5.0	4.8	2.6	2.8
Processed food[1]	2.8	5.2	5.0	5.0	5.5	6.7	6.4	5.8	5.6	5.0	4.5
Unprocessed food	-1.5	1.9	5.2	3.0	3.4	4.3	3.3	3.6	3.5	-1.2	0.0
Industrial goods	4.8	3.1	4.3	3.5	2.4	1.4	1.8	1.8	1.2	2.2	1.9
Industrial goods excluding energy	2.8	1.6	1.6	1.1	1.9	2.0	2.0	2.0	2.5	3.5	2.7
Energy	13.6	9.4	14.8	12.3	4.1	-0.6	1.2	1.1	-3.8	-2.3	-1.2
Services	3.6	3.1	3.0	3.0	2.9	3.3	3.4	3.5	3.7	3.8	3.7
Producer prices in industry for the domestic market	**5.9**	**6.9**	**8.3**	**7.7**	**4.5**	**3.0**	**3.4**	**2.7**	**0.4**	**0.6**	**...**

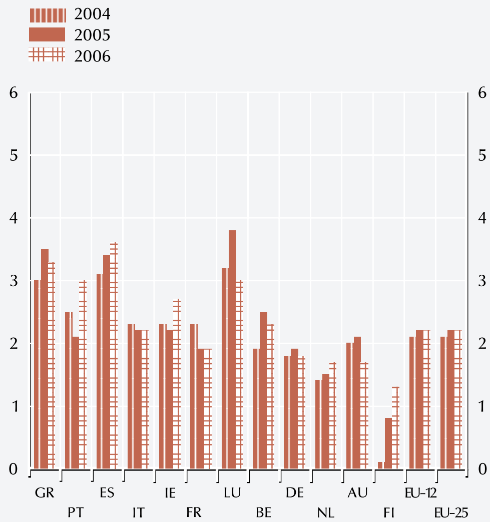
1 Including alcoholic beverages and tobacco.
2 In euro.
3 Brent blend (delivery after one month).
Source: Calculations based on ECB and NSSG data.

(between 2000 and 2006) by 13.0%, while the REER based on labour costs in manufacturing (i.e. the relative unit labour costs in manufacturing expressed in a common currency) increased cumulatively by 34.7%. The REER on the basis of unit labour costs in the whole economy rose cumulatively by 15.2% in the same period, while the nominal euro exchange rate (weighted on the basis of Greece's external trade) rose cumulatively by 8.4%.

The persistence of inflation and core inflation at relatively high levels and their positive differential over inflation in the euro area are due in the main to more permanent macroeconomic factors associated with the fact that the GDP growth rate continues to exceed the potential growth rate of the economy and with the high growth rates of production costs (which are also partly affected by excess demand). They are also due to unsatisfactory competitive conditions in certain markets.

Chart IV.8 Inflation in EU countries on the basis of HICPs

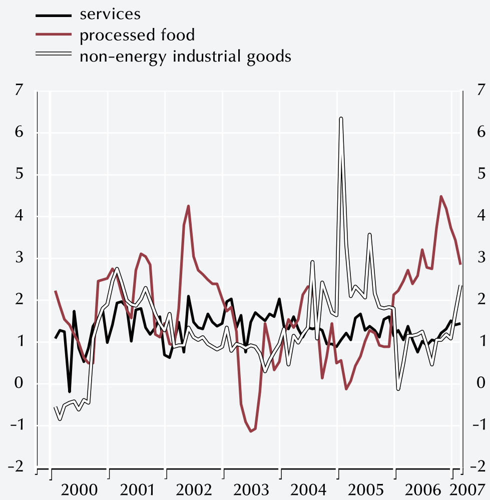
(average annual percentage changes)



Source: Eurostat.

Chart IV.9 Annual inflation differentials between Greece and the euro area

(selected indices, differentials in percentage points)

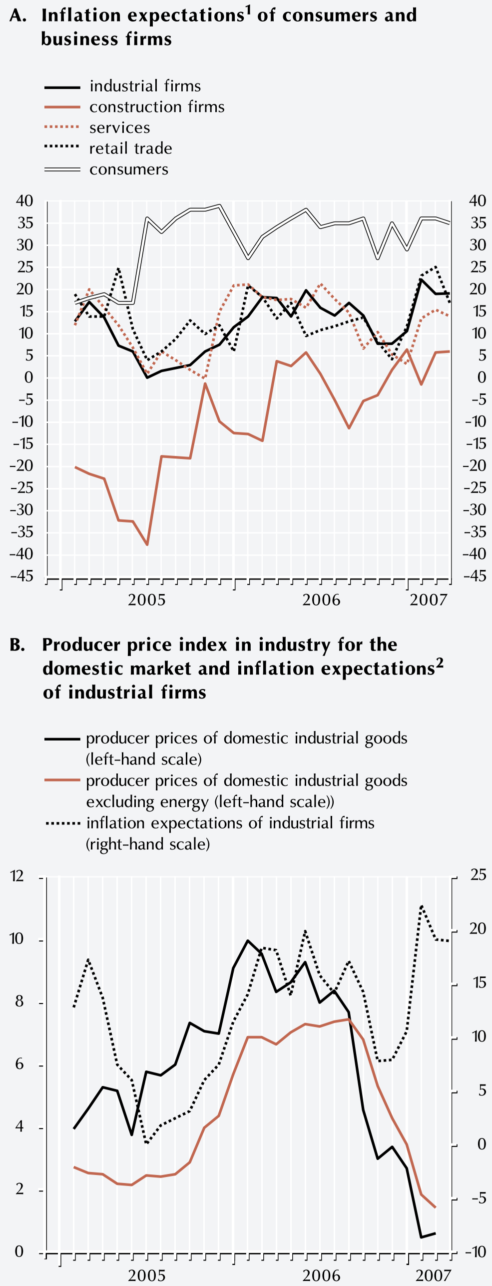


Source: Calculations based on NSSG and Eurostat data.

Depending on the case, prices are adversely affected by production cost developments, excess demand, price inelasticity of demand

Chart IV.10 Inflation expectations

(percentage balances)



1 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 in the next 12 months. The data for consumers are seasonally adjusted.
2 Prices: Annual percentage changes. Expectations: Percentage balances of responses. Business firms' responses concern the prospect, in the next 3-4 months, of price increases for the goods they produce.
Sources: IOBE and European Commission, *Business and Consumer Surveys*.

(for some articles), as well as the fact that a number of businesses take advantage of their dominant market position and that there exist harmonised practices or collusion between enterprises. Investigating for harmonised practices/collusion falls in the field of competence of the Competition Commission, which has taken specific initiatives to tackle these problems.[11] In addition, inadequate competitive conditions and elements of rigidity in the goods and labour markets increase the inflationary impact of possible exogenous shocks.

1.3 INFLATION PROSPECTS FOR 2007

For 2007, it is forecast that the average annual rate of HICP and CPI inflation will decelerate to approximately 3.0%. Average annual core inflation,[12] however, will accelerate to around 3.5%.

As always, this forecast is based on certain technical assumptions concerning exogenous factors (the international price of oil and other raw materials, the exchange rate of the euro and the prices of fresh fruit and vegetables) and on estimates concerning unit labour costs, profit margins and the growth rate in conjunction with the production potential of the economy. At the same time, account has been taken of the impact of the economic policy pursued.[13] As usual, there is an element of uncertainty in the forecast, insofar as the latter depends on the accuracy of assumptions concerning the impact of exogenous factors.

The forecast of a fall in inflation (measured on the basis of the HICP and the CPI) is based chiefly on assumptions of a drop in or stability of the price of crude oil both in dollar and in euro terms —*on an average annual basis*— and of a significant slowdown in the growth rate of prices of non-energy raw materials and other commodities in dollar terms. It is also based on the estimate that in 2007 there will be a slight slowdown in the rate of increase in unit labour costs and on indications that the increase in public utility rates will continue to be contained and will not fully reflect increases in cost components. In more detail:

The impact of "imported" inflation is expected to be limited in 2007:

- In the last IMF report the assumption is made that the average annual level of the

11 For example, an investigation into possible collusion on pricing policies among companies in the dairy industry revealed indications of price distortion affecting consumer prices (Press Releases 29 November 2006 and 18 December 2006). The Competition Commission has also ascertained that there are significant margins for greater competition in the petroleum product purchasing and marketing sector. It has announced that the proposed measures (Press Release 3 January 2007) would be subject to public consultation (3 January-5 February 2007), while on 5 February 2007 it imposed a fine on petroleum companies for harmonised pricing policies regarding aircraft fuel. On 20 March 2007 the Commission issued a major decision including both measures and proposals to strengthen competition in the petroleum product purchasing and marketing sector (Press Release 21 March 2007).

12 As measured on the basis of the HICP excluding energy and unprocessed food prices.

13 In addition, as regards short-term expectations of business firms themselves concerning the prices of their goods or services, the surveys carried out by the IOBE in the first quarter of 2007 indicate that there was a marked increase, compared with the last quarter of 2006, in the percentage of firms in manufacturing, retail trade and services (excluding retail trade and banks) which expect that, during the coming 3-4 months, the prices of the goods or services they offer will rise (to be precise: there was an increase in the positive balance between the percentage of firms that expect an increase in their prices and the percentage of those that expect a reduction), while in the housing construction sector no appreciable change was noted (see Chart IV.10). As regards consumers' inflation expectations, the percentage of consumers who expect inflation to rise in the coming twelve months (as recorded in a survey carried out on behalf of the European Commission) indicates an increase in such expectations in the first quarter of 2007.

average world price of the main types of crude oil will fall by 5.5% in US dollars, compared with a rise of 20.5% in 2006: this entails a fall of approximately 10% in the average annual euro price.[14] There is, however, considerable uncertainty as to both the price of oil in dollars and the euro/dollar exchange rate. The most recent forward market developments indicate that the average annual price level in US dollars will not change appreciably in comparison with 2006.

- The prices of non-oil commodities (raw materials and other products) in US dollars are expected to increase by 4.2% in 2007 (compared with 28.4% in 2006),[15] while in euro terms these prices will decrease by almost 1%, compared with an increase of 27.2% in 2006.[16]

- The average annual nominal exchange rate of the euro, weighted on the basis of Greece's external trade, is expected to increase by 0.8% (compared with an increase of 0.1% in 2006) if the technical assumption is made that the exchange rates of the euro against other currencies will remain at the levels reached on average in March 2007. Hence, the anti-inflationary impact of the appreciation will be more noticeable than in 2006.

The growth rate of unit labour costs is expected to decelerate slightly this year, both in the economy as a whole (to 3.1%, from 3.3% in 2006) and in the business sector (to 3.5% from 4.1% – see Section 2 of this chapter).

It is estimated that inflationary pressures associated with excess demand will remain more or less stable in 2007, if account is taken of the fact that the GDP growth rate (see Chapter III) and the positive "output gap" will not change substantially.[17] Nevertheless, the significant increase in key ECB rates since December 2005 and the fiscal policy pursued in order to achieve a further reduction of the general government deficit as a percentage of GDP are helping to contain inflationary expectations at lower levels.

The above factors will play a part in reducing inflation, which had already fallen to 2.9% in the first quarter of 2007 (based on the HICP). However, as reported above, the average annual level of core inflation is forecast to rise to 3.5% in 2007, from 2.9% in 2005 (the average annual increase in core inflation in the six years 2001-2006 was 3.4%). This is because the large increase in the price of oil in 2005 and in the first seven months of 2006 continues, with a time lag, to push up production costs. This is corroborated by the increase in core inflation to 3.4% in the last quarter of 2006 and to 3.7% in the first quarter of 2007, as well as by the significant acceleration recorded in 2006 in the rate of increase in the prices of consumer and intermediate goods at the level of producer prices in the domestic market. However, these indirect inflationary effects are expected to weaken by the end of this year.

14 For oil, see IMF *World Economic Outlook,* April 2007. For the euro-dollar exchange rate, the technical assumption is made here that the rate will remain —from March onwards— stable at the average level it reached in March 2007 (1 euro = $1.324) and that the euro will, accordingly, show an average annual appreciation of the order of 5% against the dollar in 2007.

15 See IMF, as above.

16 Based on the above-mentioned technical assumption concerning the euro-dollar exchange rate.

17 The European Commission forecasts that the output gap will remain at 1.5, while the OECD and the IMF forecast a very small reduction to 1.3, from 1.5, and to 2.4, from 2.5, respectively. See also footnote 8.

2 WAGES AND INCOME DISTRIBUTION

2.1 WAGE DEVELOPMENTS IN 2006

The rate of increase in unit labour costs[18] is estimated to have accelerated significantly in 2006, both in the economy as a whole (to 3.3%, from 2.0% in 2005) and in the business sector[19] (to 4.1%,[20] from 2.4%), chiefly reflecting a similar acceleration in the growth rate of average nominal pre-tax earnings (to 5.6% from 4.4% in 2005) and of compensation per employee (which includes employers' social security contributions) to 5.8%, from 3.9% in 2005. The rate of increase in productivity (GDP per employee[21]) accelerated to 2.4%, from 1.9% in 2005.

18 For the method used to calculate the rate of change in unit labour costs, see Box IV.1
19 See footnote 6.
20 Of course, it should be taken into account that the rate of increase in unit labour costs in the business sector was, on an annual basis, rather lower than reported here, insofar as it was affected by the provisions of Articles 1 and 2 of Law 3385/2005, which are aimed at reducing overtime costs and facilitating the "arrangement" of working hours (these provisions came into force on 1 October 2005).
21 For the reasons why this particular productivity indicator is chosen for the calculation of the rate of change in unit labour costs, see Box IV.1. A more general examination of developments and prospects for productivity can be found in Chapter II.9.

Box IV.1

APPROACHES TO CALCULATING UNIT LABOUR COSTS[1]

The concept of "unit labour costs" refers to the costs of dependent (salaried) labour and is defined as the ratio of average labour compensation (i.e. total compensation for dependent labour per employee or per hour worked) to productivity (i.e. output per employed person or per hour worked). The calculation of unit labour costs on the basis of this general definition is relatively simple at the level of an enterprise, but more complex at the level of an economy, where not all workers are employees. The rates of change in unit labour costs in the whole of the Greek economy which are included in Bank of Greece reports refer to the change in the ratio of total compensation of employees including employers' social security contributions (at current prices) to GDP (at constant prices), or —expressed in a mathematically equivalent form— to the change in the ratio of "total compensation per employee (including employers' contributions)" to "GDP *per employee*". However, a different definition is used by the NSSG, the Ministry of Economy and Finance, Eurostat and the European Commission: the change in the ratio of "total compensation per employee including employers' social security contributions" to "GDP per *employed person in general*", (i.e. the change in GDP is compared with the change in the total number of employed persons, salaried or otherwise). Thus, different rates result from the two definitions.

The two definitions are equivalent in the case of a business firm or branch of activity where all employed persons are salaried, but produce different results for an economy such as the Greek one. In fact, according to data for 2005 and 2006, in Greece salaried workers represent only 63.6% of total employment, compared with 84.6% in the euro area as a whole (in 2005). Moreover, in the last few years the rates of change in total employment have been, as a rule, lower than those in

1 See also Bank of Greece, *Monetary Policy 2002-2003,* March 2003, Box 2, pp 47-48.

dependent employment,[2] mainly because the former incorporate the downward trend in the number of (mainly self-employed) workers in the agricultural sector, which fell by 24.5% between 2000 and 2006, while the share of these workers in total employment decreased from 17.3% in 2000 to 12.0% in 2006, although it is still much higher than in the euro area as a whole (4.3% in 2005). Precisely because of this phenomenon, measuring changes in productivity on the basis of the change in the ratio of GDP to total employment (as is done by the NSSG, the Ministry of Economy and Finance, Eurostat and the European Commission) usually leads to an overestimation of productivity growth, and, therefore, to an underestimation of the increase in unit labour costs.

That is why, in its reports, the Bank of Greece opts for calculating changes in productivity on the basis of the change in GDP per employee (i.e. comparing the change in GDP with the change in dependent employment, since this is considered to be a better approximation. However, even this method is no more than an approximation, since it is not possible to isolate statistically that part of GDP which is produced by employees.

It should also be emphasised that all calculations by the method used by the Bank of Greece for its reports relate *only to the rates of change in —not to the levels of—* productivity and unit labour costs. This is noted here because the ratio of "GDP per employee" has been criticised as meaningless, as GDP is produced by all those in work, not solely by salaried employees. This is, of course, self-evident and the *level* of the ratio "GDP per salaried employee" (e.g. in euros at constant values) does, indeed, have no meaning – the *change*, however, in this ratio *does* have economic significance, as will be explained immediately below. Specifically, the calculation of the rate of change in productivity based on a comparison of the rate of change in GDP with the rate of change in dependent employment offers a satisfactory approximation of the rate of change in productivity in the non-agricultural sector of the economy, i.e. in the sector where most employees work and where it is of interest to examine the impact of wage policies and developments. Available data confirm that this approximation is satisfactory.

Indeed, in the six years 2001-2006, the number of employees in the whole economy increased cumulatively —according to the estimates used by the Bank of Greece— by 14.6%. (The relevant data are derived from the NSSG Labour Force Survey, though a correction has been made to the rate of change in salaried employees in 2004, as the NSSG data for that year are not comparable with data from previous years, due to changes in the sample and methodology.) The number of employed persons (both employees and self-employed) in the non-agricultural sector of the economy (which does not include "agriculture, hunting and forestry" and "fishing") increased cumulatively by 15.9% in the same five years, according to data from the NSSG Labour Force Survey, or by 15.7% according to data from the revised national accounts published by the NSSG since October 2006 (these have not yet been validated by Eurostat). Thus, on a six-year basis, the approximation is extremely satisfactory, despite the existence of upward or downward deviations in individual years. A similar conclusion can be drawn regarding the change in productivity. According to estimates from the Bank of Greece, productivity,

2 According to the NSSG Labour Force Survey, total employment rose by 8.9% between 2000 and 2006, while the number of employees increased by 18.9% (it should be noted, however, that the data of the LFS for 2006 are not fully comparable with 2000 data). Also, according to old national accounts data, total employment increased by 8.0% in the same period and the number of salaried employees by 12.3%, while, according to revised national accounts (which have not yet been validated by Eurostat), the corresponding percentages are 9.0% and 15.7%.

measured on the basis of the change in the ratio "GDP per employee in the whole economy", rose cumulatively by 12.6% in the six years 2001-2006.[3] Productivity in the non-agricultural sector of the economy, measured on the basis of the change in the ratio of non-agricultural GDP (or, more accurately: the gross value added at constant basic prices in all sectors except agriculture, hunting, forestry and fishing) to non-agricultural employment (employees and self-employed), increased cumulatively by 11.6% (if, for employment, Labour Force Survey data are used) or by 11.8% (if, for employment, revised national accounts estimates are used). Therefore, as far as the change in productivity is concerned, the approximation is also very close.

What do the above mean for the estimates of the change in unit labour costs in the whole economy? According to the definition used by the Bank of Greece (and the estimates it has published), unit labour costs in the whole economy rose cumulatively by 23.4% in the six years 2001-2006. According to the definition used by the NSSG, the Ministry of Economy and Finance, Eurostat and the European Commission, the same aggregate rose cumulatively in the same six years by 21.7% (according to the old national accounts data) or 18.6% (according to the revised national accounts). With all three methods, the cumulative increase in unit labour costs in Greece (18.6% or 21.7% or 23.4%) is significantly larger than in the euro area as a whole (11.4% in the same six years).

It should be recalled that the Bank of Greece uses its own estimates concerning the increase in average labour compensation (outlays for compensation per employee, including employers' social security contributions). According to these estimates, the cumulative increase in compensation per employee was 38.5% in the six years 2001-2006, i.e. more restrained than the figure derived from the corresponding national accounts estimates (45.9% according to the old national accounts data, 40.3% according to the revised national accounts). This means that the Bank of Greece cannot be criticised for inflating the growth rate of earnings in order to show a bigger rise in unit labour costs.

The final conclusion is that, if the Bank of Greece's estimates concerning compensation per employee are combined with the estimates concerning productivity in the non-agricultural sector of the economy based on the revised national accounts, it can be seen that, in the six years 2001-2006, the cumulative increase in labour costs in the non-agricultural sector (based on the usual definition and not that used by the Bank of Greece) was 23.9% or 24.1%, i.e. the figure almost coincides with the estimate made by the Bank of Greece on the basis of its own definition (23.4%).

As noted above, the increase in unit labour costs in the whole economy or in the non-agricultural sector of the economy, however this is measured, is larger than the corresponding increase in the euro area as a whole, a fact which implies a loss in price competitiveness. Of course, this does not mean that the loss in price competitiveness is due solely to labour costs. It may also be associated with a greater increase in Greece (than in its competitor countries) in *other* cost elements or with the pricing policy of enterprises and the evolution of corporate profit margins. Moreover, apart from the loss in price competitiveness, the low level of *structural* competitiveness is also significant, as it reflects the structural weaknesses of the economy and the inadequate compet-

3 If the change in productivity is measured on the basis of the change in the ratio "GDP per employed person in general in the whole economy", the cumulative increase in the six years 2001-2006 reaches 19.8% based on the old national accounts or 18.4% based on the revised national accounts.

itive conditions in certain markets, something which has been repeatedly emphasised in Bank of Greece reports.

Particularly as far as the loss in price competitiveness is concerned, it is worth comparing the available estimates. As calculated by the Bank of Greece, the real effective exchange rate (against the currencies of Greece's 28 main trading partners) based on consumer prices (i.e. the relative consumer prices expressed in a common currency) rose cumulatively in the six years 2001-2006 by 13.0%, while the relative unit labour costs in manufacturing, expressed in a common currency, increased in total by 34.7% (see Table IX.2). These increases are equivalent to corresponding losses in competitiveness. If the real effective exchange rate (against the currencies of Greece's 28 main trading partners) is calculated on the basis of unit labour costs not only in manufacturing but in the *whole economy*, the resulting loss in competitiveness is smaller, but still significant. In particular, this loss reached 15.2% cumulatively in the six-year period 2001-2006 (if unit labour costs in the Greek economy as a whole are calculated on the basis of Bank of Greece estimates concerning labour costs) or 10.7% (based on the revised national accounts) or 13.6% (based on the old national accounts).

In the euro area as a whole, it is estimated that compensation per employee increased in 2006 by 2.1%, while unit labour costs rose by 0.9% (see Table IV.4).[22] As unit labour costs are a key component of nominal production costs, their faster growth for a series of years in Greece compared with the euro area (in the six years 2001-2006, the average annual rate was 3.6% and 1.8% respectively) is, as noted in Section 1 of this chapter, one of the reasons for the positive differential of inflation and the loss of price competitiveness.

Regarding increases in average earnings in 2006 by sector of economic activity (see Table IV.5), according to the most recent *ex post* data from the General Accounting Office, the total increase in central government out-

22 See European Commission, *Autumn 2006 Economic Forecasts*, November 2006.

Table IV.4 Average earnings and unit labour costs in the whole economy: Greece and the euro area (2001-2007)

(annual percentage changes)

	Average earnings		Unit labour costs	
	Greece	Euro area	Greece	Euro area
2001	4.7	2.8	3.5	2.4
2002	6.6	2.8	5.1	2.5
2003	5.6	2.8	3.4	2.5
2004	7.2	2.5	4.1	1.3
2005	4.4	2.0	2.0	1.3
2006	5.6	2.1	3.3	0.9
2007 (forecast)	5.6	2.2	3.1	1.2

Sources: For Greece, Bank of Greece estimates and forecasts. For the euro area: European Commission, *Economic Forecasts-Autumn 2006, Economic Forecasts-Spring 2006*.

Table IV.5 Earnings, labour costs and productivity

(annual percentage changes)

	1999	2000	2001	2002	2003	2004	2005	2006
Whole economy								
– Average gross earnings[1] (nominal)	4.5	6.0	4.7	6.6	5.6	7.2	4.4	5.6
– Average gross earnings[1] (real)	1.9	2.7	1.3	2.9	2.0	4.2	0.9	2.3
– Net income of an employee with average earnings[1] (nominal)	3.6	8.0	3.4	6.3	6.3	5.3	3.6	5.2
– Net income of an employee with average earnings[1] (real)	1.0	4.7	0.0	2.6	2.7	2.3	0.1	1.9
– Total compensation of employees[1, 2]	6.8	8.9	8.3	9.1	8.3	8.9	5.8	7.8
– Compensation (earnings and employer contributions) per employee	4.5	5.8	4.8	5.9	5.5	7.6	3.9	5.8
– Unit labour costs[1, 3]	3.3	4.2	3.5	5.1	3.4	4.1	2.0	3.3
– Consumer price index[4]	2.6	3.2	3.4	3.6	3.5	2.9	3.5	3.2
– Gross domestic product[5]	3.4	4.5	4.6	3.8	4.8	4.7	3.7	4.3
Business sector[6]								
– Total compensation of employees[1]	7.1	9.1	9.2	8.5	8.7	7.5	6.2	8.6
– Unit labour costs[1]	3.6	4.4	4.4	4.5	3.8	2.7	2.4	4.1
Central gonernment[7]								
– Average gross earnings of employees	3.5	7.1	5.5	7.3	5.9	9.7	2.3	2.8
– Total outlays for salaries and pensions	6.1	8.5	6.3	10.5	7.4	12.1	4.9	5.9
– Total outlays for salaries (excluding pensions)	5.7	9.0	6.1	11.6	7.8	11.2	5.2	5.1
Public utilities								
– Average gross earnings of employees[8]	5.1	12.9	7.0	10.6	10.9	9.9	7.6	7.0
– Total compensation of employees[8]	3.1	8.2	2.1	4.9	8.3	7.6	6.1	4.9
Banks								
– Average gross earnings of employees[1]	13.1	6.8	6.4	2.9	3.1	8.0	1.5	10.8
– Total outlays for salaries[9]	14.3	9.3	5.3	4.3	3.2	6.5	–0.3	12.1
– Total compensation of employees[9]	12.7	9.4	6.4	3.6	3.1	7.3	–6.5	11.6
Non-bank private sector								
– Minimum earnings[10] (nominal)	3.5	4.2	3.5	5.4	5.1	4.8	4.9	6.2
– Minimum earnings[10] (real)	0.9	1.0	0.1	1.7	1.5	1.8	1.4	2.9
– Average contractual earnings[11]	3.9	4.2	4.2	5.7	5.1	5.0	5.0	6.3
– Average gross earnings[1]	4.4	5.0	5.3	6.5	5.8	5.8	5.6	6.8
– Total compensation of employees[1]	7.2	9.2	10.7	9.6	9.4	7.5	7.5	8.9
– Hourly earnings of blue-collar workers in manufacturing[4]	4.4*	5.5*	5.5*	6.4*	5.9*	5.8*	5.6*	6.8*
– Output per hour worked (manufacturing)[4]	0.6*	2.0*	–0.6*	0.6*	1.2*	1.2*	–0.4*	2.9*
– Unit labour costs (manufacturing)[4]	3.8*	3.4*	6.1*	5.3*	4.7*	4.5*	6.0*	3.8*

1 Bank of Greece estimates.
2 Ministry of Economy and Finance estimates on the growth in total compensation of employees (April 2007): 1999: 8.9%, 2000: 6.8%, 2001: 7.2%, 2002: 8.7%, 2003: 6.9%, 2004: 12.5%, 2005: 7.7%, 2006: 8.6%.
3 Ministry of Economy and Finance estimates on the rate of increase in unit labour costs (as defined by the Ministry of Economy and Finance): 1999: 3.0%, 2000: 1.3%, 2001: 0.2%, 2002: 6.0%, 2003: 1.2%, 2004: 4.0%, 2005: 4.1%, 2006: 4.6%.
4 Calculations based on NSSG survey data.
5 Old national accounts data, estimates of the Ministry of Economy and Finance, April 2007.
6 The business sector comprises public utilities, banks and the non-bank private sector.
7 Estimates based on data from the Ministry of Economy and Finance and from Introductory Reports on the Budget. Healthcare outlays were not taken into account in the calculation of expenditure growth.
8 Calculations based on Ministry of Economy and Finance data and estimates, as well as OTE reports.
9 Data from annual profit and loss accounts (1999-2006).
10 National General Collective Labour Agreement.
11 Calculations based on data from collective labour agreements at branch and occupational level.
* Estimates.

lays for wages excluding pensions reached 5.1% in 2006 (5.2% in 2005), while outlays for wages and pensions increased by 5.9% (4.9% in 2005). The increase in the number of civil servants is estimated at 2.2% in 2006 (based on data for the first six months) and 2.9% in 2005 (according to data from the Ministry of Economy and Finance and the Introductory Report on the State Budget). Thus, gross outlays for wages per employee rose by 2.8%, compared with 2.3% in 2005.

In the non-bank private sector, according to the two-year National General Collective Labour Agreement (3 April 2006), minimum wages for unskilled workers rose by 2.9% from 1 January 2006 and by 2.9% from 1 September 2006, while they will increase by 5.1% from 1 May 2007, with an average annual increase of 6.2% in 2006 (compared with 4.9% in 2005) and 5.4% in 2007. The increase in contractual earnings at branch level was similar (6.3% in 2006, compared with 5.0% in 2005), while actual average earnings (including the effect of "wage drift") are estimated to have risen by 6.8% in 2006, compared with 5.6% in 2005.

In public utilities,[23] it is estimated —based on the two-year collective agreements already signed— that the average annual increase in contractual earnings in 2006 was of the order of 5.5% and that in actual earnings of the order of 7%.[24]

Finally, the two-year collective labour agreement 2006-2007 for bank workers, signed on 22 December 2006, provided for contractuel increases of the order of 5-5.5% payable from 1 January 2006 and 1 January 2007. If the "carry-over" effect from 2005 is also taken into account, the average annual increase in contractual earnings is calculated to be 6.9% for 2006 and 5.3% for 2007. However, as shown by the annual income statements of major banks, total labour costs in 2006 (including employers' social security contributions and other outlays) rose by 11.6% and the wage bill by 12.1%. Given that average annual employment in these banks increased by 1.2%, actual average earnings are estimated to have risen by 10.8%.

2.2 WAGES AND SALARIES: PROSPECTS FOR 2007

In 2007, the growth rate of unit labour costs is forecast to slow down somewhat, both in the whole economy (to 3.1%, from 3.3% in 2006) and in the business sector (to 3.5% from 4.1%), reflecting the slightly lower growth rate of outlays for salaries and employers' social security contributions per employee (5.7%, compared with 5.8% in 2006)[25]

23 Both in public enterprises coming under Chapter A of Law 3429/2005, relating to public enterprises and entities (DEKO), and in public utility companies which are not covered by this law (such as the Hellenic Telecommunications Organisation –OTE, the Public Power Corporation –DEH and the Hellenic Post Office –ELTA).

24 The circular (15 February 2006) on "Implementation Instructions for Law 3429/2005" stated that, in the enterprises covered by this law, increases in basic salaries will be paid in one instalment at the beginning of the year and that, for 2006, they will not exceed 3%. On 5 April 2006, the Inter-Ministerial Committee for DEKOs decided that these enterprises should aim to sign collective agreements which provide for an increase in basic salaries of 3% in 2006 and 4% in 2007, so that the total increase in wages and personnel outlays does not exceed 5% and 6% respectively. On 31 May 2006, the above-mentioned committee found that the collective agreements that had been signed were in line with this aim. It should be noted that the rates of increase referred to in the text have been calculated also taking into account the collective agreements signed in companies which are not covered by Chapter A of Law 3429/2005.

25 It should be noted that in the euro area as a whole, average earnings (compensation per employee including employers' social security contributions) are forecast to increase by 2.2%, compared with 2.1% in 2006 (European Commission, *Autumn 2006 Economic Forecasts,* November 2006).

and the unchanged productivity growth rate (approximately 2.5%). Given that a slight acceleration in the rate of increase in unit labour costs[26] is forecast for the euro area, the differential between the two rates will be reduced, but will remain significant.

More particularly, it is estimated that in 2007 the growth rate of average earnings in the whole economy will remain at 5.6%, if account is taken of the following:

- In central government —based on budget forecasts— it is estimated that outlays for wages per employee will increase by 5.5%.[27] According to article 1 of the law on incomes policy for the year 2007, basic salaries for civil servants will increase by 3.5% from 1 January 2007, while there are also other special provisions.[28]

- In the non-bank private sector, in banks and in public utilities, wage increases in 2007 are governed by the two-year collective labour agreements signed last year. More specifically, in the non-bank private sector, according to the National General Collective Labour Agreement, minimum wages for unskilled employees will rise by 5.1% from 1 May 2007. As noted above, these arrangements mean that the average annual increase in minimum earnings will come to 5.4% compared with 6.2% in 2006. The increase in contractual earnings at branch level will be broadly similar, while average actual earnings (including "seniority") are expected to rise by 6.1%, compared with 6.8% in 2006.[29] Finally, in banks, as mentioned previously, the average annual increase in contractual earnings is expected to reach 5.3% in 2007.

2.3 THE SHARE OF WAGES IN THE TOTAL PRODUCT, INCOME DISTRIBUTION AND THE "RISK OF POVERTY"

According to all available data and estimates, in the last six years (i.e. during the period in which Greece has been a member of the euro area) total compensation of employees (which includes employers' social security contributions) increased more than gross domestic product at current prices, resulting in the increased share of wages in the total product. Specifically, between 2000 and 2006 GDP at current market prices increased cumulatively by 56.9% (according to the old national accounts data). In the same period, total compensation of employees including employers' social security contributions rose more: by 63.8% according to the old national accounts data and by 58.9% according to Bank of Greece estimates published in this report (see Table IV.5). The share of wages in GDP at current market

26 According to the European Commission (see previous footnote) the growth rate of unit labour costs in the euro area is forecast to accelerate slightly to 1.2% in 2007, from 0.9% in 2006.

27 According to the state budget for 2007, the total increase in personnel outlays excluding pensions is expected to reach 6.1%, while, including pensions, it should come to 6.4%. At the same time, it is assumed that the increase in the number of civil servants will be limited (approximately 0.6%).

28 Increase in the special conditions allowance payable to the uniformed members of the Armed Forces and the Security Forces etc. from 1 September 2007, payment of an allowance to teachers in primary and secondary education for lesson planning, which will increase gradually (1 January 2007, 1 July 2007, 1 January 2008, 1 January 2009), higher allowances payable to hospital staff (in stages between 1 January 2007 and 1 January 2009), etc.

29 Of course, the fall in the unemployment rate and the increase in employment observed during 2006 may result in a larger (than currently forecast) increase in actual earnings, as these earnings will be determined at a firm or individual level (given that at a branch or occupational level the collective agreements were signed last year and are of two-year duration).

prices increased from 32.9% in 2000[30] to 34.3% in 2006, according to data from the old national accounts.[31] In addition, according to the revised national accounts data from the NSSG (which have been submitted to Eurostat but have not yet been validated), the increase in the share of wages reflects two developments:

(i) the cumulative rise in compensation per employee at a slightly higher rate than the rise in GDP or Gross Value Added (GVA) at current basic prices per employed person in general (45.6%, compared with 44.1% or 45.0%), which indirectly indicates that the increase in nominal wages was greater than inflation and the rise in productivity during the 2000-2006 period.

(ii) the cumulative increase in the number of salaried employees at a rate faster than that in total employment in the same six-year period (15.7%, compared with 9.0%), resulting in an increase in the share of employees in total employment.

The contribution of the development described in (ii) above to the increase in the share of wages was more significant than the contribution made by the development in (i) above.

The share of wages in the total product can also be measured in other ways. In particular, it is calculated that the share of total compensation of employees, including employers' social security contributions, to GVA at current basic prices[32] rose from 37.9% in 2000[33] to 38.5% in 2006, according to the old national accounts data. If total compensation of employees and employers' social security contributions are deducted from GVA, what remains is the "net operating surplus", which includes not only private and public enterprises' (small and large) gross profits but also agricultural income and income earned by the self-employed. In addition, given that dependent employment is very limited in the agricultural sector, it is worth calculating the share of wages in the GVA of the non-agricultural sector:[34] the relevant percentage is also increasing – from 36.5% in 2000 to 38.0% in 2006 (according to the revised national accounts data of the NSSG, which have not yet been finalised).

Apart from developments concerning the share of wages in the total product, there are other indicators which provide useful information concerning income distribution. More specifically, based on special surveys by the NSSG, the following can be calculated: (i) special indicators of inequality in the distribution of monetary income of households and (ii) the percentage of households at risk of poverty (see Box IV.2). The main conclusion arising from these surveys is that inequality in the distribution of personal income remains greater in Greece than (on average) in the European Union and has not changed substantially in Greece over the last decade. In addition, the at-risk-of-poverty rate in Greece fluctuated between 20% and 22% throughout the period 1994-2004.

30 The share of wages in GDP at current market prices was 32.3% in 1995, according to the old national accounts data.
31 Ministry of Economy and Finance estimates, April 2007.
32 Adding net indirect taxes to GVA, we derive GDP at market prices.
33 The share of total compensation of employees including employers' social security contributions in GVA at current basic prices was 36.1% in 1995, according to the old national accounts data.
34 I.e. excluding agriculture-livestock breeding-forestry-logging-fishing.

According to the Eurostat definition, a person is considered to be in poverty when his/her disposable monetary income is less than 60% of the median of disposable income for the entire population. Hence, given that, during the period examined above, average income increased significantly, the same happened for the income which is equal to 60% of the median of the income distribution (i.e. the "poverty line").

Box IV.2

RISK OF POVERTY, INEQUALITY AND EFFECTIVENESS OF SOCIAL SPENDING

The NSSG[1] has recently published estimates concerning the "risk of poverty" in Greece, based on statistical data from the 2005 EU-SILC, European Union – Statistics on Income and Living Conditions for households survey.[2] This sampling survey has been carried out since 2003 in all EU countries. Data are gathered concerning the monetary income of all members of the household, their employment and working conditions, housing conditions, level of education and vocational training history and their state of health. Data are also collected concerning other social indicators which relate to households' living conditions, their access to social services, social cohesion, etc. The results of the surveys for the years 2003, 2004, 2005 (which relate to income earned in the years 2002, 2003 and 2004) can be obtained from Eurostat.

Estimates concerning the risk of poverty in Greece and the other EU countries based on the above mentioned statistical data are presented in Table A and Chart A in this box. These data show that Greece and the other countries of Southern Europe (plus Ireland and the United Kingdom) have the highest percentage of relative poverty[3] based on the monetary income distribution. Moreover, the risk has remained broadly unchanged in the last decade both in Greece and in the EU-15, fluctuating between 20%-22% and 15%-17% respectively. In Greece in particular, around 1/5 of the population, in other words more than two million people, have found themselves below the poverty line in recent years, i.e. their disposable income is less than 60% of the median of disposable income for the entire population (Euro-

1 See NSSG Press Release, 18 January 2007. The results were presented on that day by the Minister of Economy and Finance, who noted that the situation in Greece has shown a small improvement in the last decade but the country still lags considerably behind other countries in the EU as regards the effectiveness of social spending. He emphasised that progress towards resolving the problem of effective social spending must be based on "more and better targeted social spending."

2 The EU-SILC, European Union – Statistics on Income and Living Conditions for households survey uses the methodology and harmonised definitions of Regulation 1177/2003 of the European Council. Using a sampling approach, the survey covers all private households in a cross-sectional and longitudinal manner, providing for the substitution of 1/4 of the number of households each year. It appears that the joint planning and compilation of the questionnaires in accordance with Eurostat's instructions and supervision has to a large degree ensured the comparability of the data from each of the countries in the EU. The EU-SILC, European Union – Statistics on Income and Living Conditions for households survey replaced the ECHP, European Community Household Panel, which covered the period 1994-2001, and represented the main source of primary data for the analysis of inequality and poverty in EU countries. In Greece, the survey for the ECHP was carried out by the NSSG. The survey covered, in addition to the years 1994-2001, the year 2002 (thereby covering income until end-2001). The results of the 2002 survey in Greece were published solely by the NSSG (see NSSG Press Release, 16 July 2003).

3 The term "relative poverty" means that a person is considered poor (in relation to others) when his income is insufficient to guarantee living conditions which are consistent with the habits and standards of the community in which he lives. By contrast, the term "absolute poverty" refers to those who lack basic living requirements or whose income is inadequate for them to survive and to keep body and soul together.

Table A Recent data on the risk of poverty in Greece and in the other EU countries

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	13	14	13	13	12	12	12	:	13^{b}	13	12
Belgium	16	15	14	14	13	13	13	:	15^{b}	15	15
France	15	15	15	15	15	16	13^{b}	12	12	13^{b}	13
Germany	15	14	12	11	11	10	11	15^{b}	15	16	13^{b}
Denmark	10	:	10	:	10	:	10	:	12^{b}	11	12
Greece	**22**	**21**	**21**	**21**	**21**	**20**	**20**	**20**	**21^{b}**	**20**	**20**
United Kingdom	20	18	18	19	19	19^{b}	18	18	18	:	19^{bp}
Ireland	19	19	19	19	19	20	21	:	20^{b}	21	20
Spain	19	18	20	18	19	18	19	19^{b}	19	20^{b}	20
Italy	20	20	19	18	18	18	19	:	:	19^{b}	19^{b}
Luxembourg	12	11	11	12	13	12	12	:	10^{b}	11	13
Netherlands	11	12	10	10	11	11^{p}	11^{p}	11^{p}	12^{p}	:	11^{b}
Portugal	23	21	22	21	21	21	20	20^{p}	19^{p}	21^{b}	20
Sweden	:	:	8	:	8	:	9	11^{b}	:	11^{b}	9
Finland	:	8	8	9	11	11	11^{b}	11	11	11^{b}	12
New member countries*	**:**	**:**	**:**	**:**	**:**	**:**	**14**	**15**	**15**	**16**	**17**
EU-15*	**17**	**16**	**16**	**15**	**16**	**15**	**15**	**:**	**15**	**17**	**16**
EU-25*	**:**	**:**	**:**	**15**	**16**	**16**	**16**	**:**	**15**	**16**	**16**

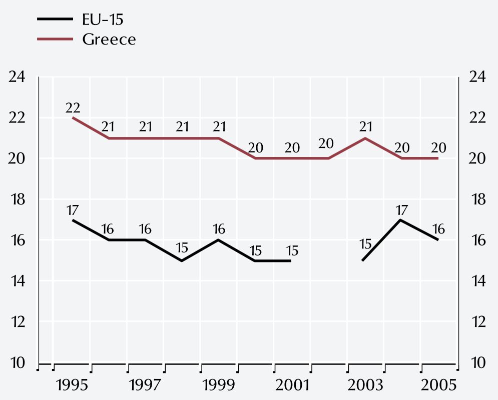
Note: The year refers to that in which the survey was conducted, whereas the income data used for the evaluation of the risk of poverty refer to the year before.
* Eurostat estimates, : data are not available, b break in the series, p provisional data.
Sources: Eurostat; for 1995-2001, calculations based on monetary income data from the ECHP survey (European Community Household Panel), for 2002-2005, calculations based on monetary income data from the EU-SILC survey (European Union – Statistics of Income and Living Conditions), NSSG for Greece for 2002.

stat definition).[4] The poverty rate was 19.6% (rounded up to 20%) in 2004, while, according to studies, *the relative risk is reduced by approximately 3 percentage points when the assessment of income takes into account owner-occupied housing, producer-consumed goods and goods and services provided to households by third parties free of charge.*[5] It should also be noted that, despite the stability of the relative risk of poverty over time, the living standards of the population as a whole, and above all the living standards of the poor, have improved over time in absolute terms.

As for the distribution of poverty within individual population groups, it is of particular significance that 27.8% of senior citizens (65 years old or older) or 25.0% of pensioners or 32.8% of the

Chart A Percentage of population at risk of poverty in Greece and the EU

(distribution of monetary income, poverty line: 60% of the median)



Source: see Table A.

4 According to the Statistics on Income and Living Conditions survey in 2005, which covered income in 2004, one-member households with an income of €5,650 per annum or less were considered to be below the poverty line, whereas for households comprising two adults and two dependants, the figure was €11,865 per annum.
5 The “relative gap” or poverty “depth” indicator, which refers to the income of those beneath the poverty line and which, more specifically, measures the gap between the median income of the poor and the poverty line (as a percentage of the poverty limit) was 24.1% in 2004. This means that 50% of poor people have an income higher than 75.9% of the poverty line, i.e. above €4,288 annually per person.

Table B Recent data on unequal distribution (Gini coefficient) in Greece and in the other EU countries

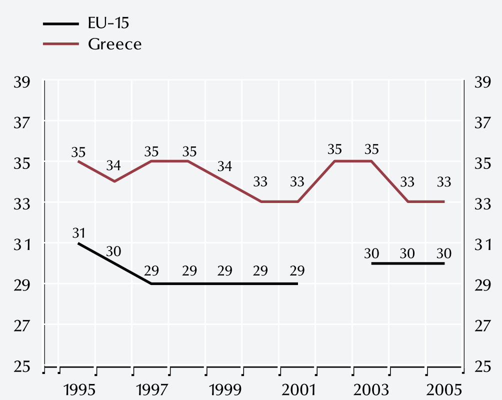
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	27	26	25	24	26	24	24	:	27[b]	26	26
Belgium	29	28	27	27	29	30	28	:	28[b]	26	28
France	29	29	29	28	29	28	27[b]	27	27	28[b]	28
Germany	29	27	25	25	25	25	25	29[b]	28	28	28[b]
Denmark	20	:	20	:	21	:	22	:	25[b]	24	24
Greece	**35**	**34**	**35**	**35**	**34**	**33**	**33**	**35**	**35[b]**	**33**	**33**
United Kingdom	32	32	30	32	32	32[b]	35	35	34	:	:
Ireland	33	33	33	34	32	30	29	:	31[b]	32	32
Spain	34	34	35	34	33	32	33	31[b]	31	31[b]	32
Italy	33	32	31	31	30	29	29	:	:	33[b]	33[b]
Luxembourg	29	28	25	26	27	26	27	:	28[b]	26	26
Netherlands	29	29	26	25	26	29[p]	27[p]	27[p]	27[p]	:	27[b]
Portugal	37	36	36	37	36	36	37	:	:	38[b]	41
Sweden	:	:	21	:	22	:	24	23[b]	:	23[b]	23
Finland	:	22	22	22	24	24	27[b]	26	26	25[b]	26
New member countries*	**:**	**:**	**:**	**:**	**:**	**:**	**29**	**29**	**29**	**30**	**32**
EU-15*	**31**	**30**	**29**	**29**	**29**	**29**	**29**	**:**	**30**	**30**	**30**
EU-25*	**:**	**:**	**:**	**29**	**29**	**29**	**29**	**:**	**29**	**30**	**31**

Note: The year refers to that in which the survey was conducted, whereas the income data used for the evaluation of the risk of poverty refer to the year before.
* Eurostat estimates, : data are not available, b break in the series, p provisional data.
Sources: see Table A.

unemployed or 27.9% of single-member households (usually elderly people living alone) are below the poverty line. Moreover, as regards the *composition* of the population living in poverty, 31.8% of those below the poverty line are employed, 7.9% are unemployed and looking for work, 27.3% are pensioners and the remaining 33.0% are other economically inactive citizens (3/4 of whom are women). In addition, 58.0% of poor people have completed at most primary school education, while 64.4% live in sparsely populated or rural areas. In other words, the elderly, members of households headed by a pensioner or an unemployed person, and members of households headed by a person with a low-level education or who is employed in the primary sector form a disproportionately large group within the section of the population considered poor.

Various indicators which show the extent of economic inequality in Greece have shown similar stability over the last ten years, such as the Gini coefficient, the S80/S20 index, the Atkinson index, etc. These indicators provide a summary overview of the differences observed among members of a population in terms of their individual income or spending. The most widely used

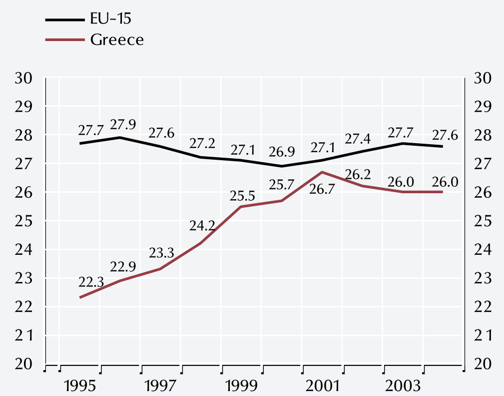
Chart B Gini coefficient of monetary income unequal distribution in Greece and the EU



Source: see Table A.

indicator of unequal distribution, the Gini coefficient, is presented in Chart B and Table B of this box for the countries of the EU (1995-2005). Based on these data, Greece belongs to the group of EU countries which display a relatively high degree of inequality, together with the other Mediterranean countries, the United Kingdom and Ireland.[6] The inequality of the distribution of households' disposable monetary income has remained fairly stable in the period under review, both in Greece and in EU countries as a whole. For Greece in particular, the value of the Gini coefficient fluctuated between 33 and 35 (compared with a range of 29-31 for EU countries as a whole), showing no clear trend. The ratio of the share of income earned by the wealthiest 20% of the population compared with that earned by the poorest 20% (S80/S20) was similarly stable, fluctuating between 5.7 and 6.6 (compared with 4.5 to 6.1 for EU countries as a whole).[7]

Chart C Total social expenditure as a percentage of GDP in Greece and the EU



Source: Eurostat, ESSPROS (European System of Integrated Social Protection Statistics) data.

It should also be noted that, based on the results of studies relating to Greece, approximately 2/3 of total inequality can be attributed to the differences which exist within various groups of the population, when these are distinguished on the basis of characteristics which are geographical (e.g. the area where someone lives, the degree of urbanisation of the area), demographic (e.g. gender, age, family status), or other (e.g. position in labour market, occupation). In addition, *educational inequalities* are very closely associated with economic inequalities, accounting for approximately 1/4 of all economic inequalities. Therefore, it is expected that policies which improve the education level of the population and enhance human capital (reduction of school "drop-out" rate, "support teachers" in schools, lifelong training, etc.) will moderate economic inequalities in our country.

Indicators of inequality and poverty have remained essentially stable in the last ten years in Greece, despite the significant increase in social spending as a percentage of GDP. In fact, as presented in Chart C in this box, total social spending increased from 22.3% of GDP in 1995 to 26.7% in 2001, approaching the European average (27.1%), and has remained thereafter at approximately the same levels.[8] This demonstrates that there is a problem regarding the relatively limited effectiveness of social spending in Greece in comparison with other EU countries. As can be seen in Table C of this box, total social

6 There is a strong correlation in EU countries between inequality indicators and the risk of poverty. For example, the correlation coefficient between the Gini coefficient and the risk of poverty for the period 1995-2005 was 0.81.
7 According to the most recent data available from the Statistics on Income and Living Conditions for households in 2005 (income in 2004), the Gini coefficient stood at 33.3 and the S80/S20 at 5.8 (compared with 32.9 and 5.9, respectively, in the previous year). See NSSG Press Release, 18 January 2007.
8 Total social spending can be divided into two main categories: (i) old age pensions and widows' pensions and (ii) social benefits, such as family benefit, unemployment and sickness benefit, disability pension or benefits for those incapable of working, educational benefits and social assistance (Social Solidarity Benefits for Pensioners – EKAS, income support for permanent residents of mountainous and underprivileged areas, etc.).

Table C The risk of poverty in Greece and in EU countries without payment of pensions and social benefits

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	41	40	39	39	39	37	38	:	43[b]	42	43
Belgium	42	42	41	41	40	40	38	:	44[b]	42	42
France	42	42	42	41	41	41	44[b]	44	42	44	45
Germany	38	38	39	40	40	39	39	34[b]	35	36	44
Denmark	:	:	:	:	:	:	36	:	38[b]	39	39
Greece	**38**	**38**	**38**	**37**	**38**	**39**	**39**	**:**	**41[b]**	**40**	**39**
United Kingdom	41	38	42	41	42	41	42	42	43	:	:
Ireland	42	42	39	38	37	37	36	:	37[b]	39	40
Spain	41	41	42	41	39	37	37	40[b]	40	41	39
Italy	40	40	41	40	41	42	42	:	:	45[b]	43[b]
Luxembourg	40	40	39	40	41	39	40	:	39[b]	38	40
Netherlands	38	38	38	36	35	35[p]	35[p]	35[p]	37[p]	:	37[b]
Portugal	37	37	37	38	39	38	37	:	:	42[b]	42
Sweden	:	:	:	:	:	:	34	45[b]	:	43[b]	42
Finland	:	36	36	34	33	32	40[b]	40	40	42[b]	40
New member countries*	**:**	**:**	**:**	**:**	**:**	**44**	**42**	**44**	**44**	**44**	**47**
EU-15*	**40**	**39**	**41**	**40**	**40**	**40**	**40**	**:**	**39**	**41**	**43**
EU-25*	**:**	**:**	**:**	**:**	**:**	**:**	**40**	**:**	**40**	**41**	**43**

Note: The year refers to that in which the survey was conducted, whereas the income data used for the evaluation of the risk of poverty refer to the year before.
* Eurostat estimates, : data are not available, b break in the series, p provisional data.
Sources: Eurostat; for 1995-2001, calculations based on ECHP (European Community Household Panel) survey data on monetary income, for 2002-2005, calculations based on EU-SILC (European Union – Statistics on Income and Living Conditions) survey data on monetary income.

spending (pensions and benefit payments) in 2004 (2005 survey) reduces the poverty risk in Greece by 19 percentage points (from 39% to 20%), compared with a corresponding reduction of 27 percentage points (from 43% to 16%) for EU countries as a whole. However, the final result stems chiefly from the effect of pensions (reduction from 39% to 23%), and much less from the payment of social benefits, which reduce the poverty risk by just 3 percentage points (from 23% to 20%, see Table D of this box).[9] By contrast, the redistributive effect of social benefits reduces the poverty risk from 26% to 16% or by 10 percentage points for the EU countries as a whole. In any event, the effectiveness of social spending in Greece, despite the small improvement noted in the last ten years,[10] still lags behind compared with the other EU countries.

The redistributive role played by social spending is generally greater in countries which allocate a higher proportion of GDP for such spending.[11] However, there are other important factors beyond

9 To be precise, based on the latest data available from the Statistics on Income and Living Conditions for households survey for 2005, announced by the NSSG, the risk of poverty before all social transfers (i.e. if social benefits and pensions are not included in household revenue) came to 39.2%, while, if pensions alone are included without social benefits, the figure came to 22.5%.
10 The improvement over time, albeit limited, in the effectiveness of social spending may be attributed to the considerable support given in recent years to low pensions (OGA – Farmers' Insurance Fund, pensions for those who do not have social security, etc.) and EKAS.
11 For example, the countries with the highest levels of social spending per GDP, such as Sweden (32.9%), France (31.2%), Denmark (30.7%) and Germany (29.5%) show the lowest risk of poverty (9%, 13%, 12% and 13%, respectively).

Table D The risk of poverty in Greece and in EU countries without payment of social benefits (but with payment of pensions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	24	25	24	24	23	22	22	:	24[b]	25	24
Belgium	27	27	26	25	24	23	23	:	29[b]	28	28
France	26	26	26	25	24	24	26[b]	26	24	26[b]	26
Germany	22	22	22	22	21	20	21	23[b]	23	24	24[b]
Denmark	:	:	:	:	:	:	29	:	32[b]	31	31
Greece	**23**	**22**	**23**	**22**	**22**	**22**	**23**	**:**	**24[b]**	**23**	**23**
United Kingdom	32	29	30	30	30	29[b]	28	28	29	:	:
Ireland	34	34	32	32	30	31	30	:	31	33	32
Spain	27	26	27	25	23	22	23	22[b]	22	25[b]	24
Italy	23	23	22	21	21	21	22	:	:	23[b]	24[b]
Luxembourg	25	24	22	23	24	23	23	:	23[b]	22	23
Netherlands	24	24	23	21	21	22[p]	22[p]	22[p]	23[p]	:	22[b]
Portugal	27	27	27	27	27	27	24	26[p]	26[p]	27[b]	26
Sweden	:	:	:	:	:	:	17	29[b]	:	30[b]	29
Finland	:	23	23	22	21	19	29[b]	28	28	29[b]	28
New member countries*	**:**	**:**	**:**	**:**	**:**	**:**	**25**	**27**	**27**	**27**	**27**
EU-15*	**26**	**25**	**25**	**24**	**24**	**23**	**24**	**:**	**25**	**26**	**26**
EU-25*	**:**	**:**	**:**	**24**	**24**	**23**	**24**	**:**	**25**	**26**	**26**

Note: The year refers to that in which the survey was conducted, whereas the income data used for the evaluation of the risk of poverty refer to the year before.
* Eurostat estimates, : data are not available, b break in the series, p provisional data.
Sources: see Table C.

the amount of available resources which affect the final result. Such factors include the distribution of social payments within transfers of different types (pensions, benefits, etc.) and the degree to which individual payments are "targeted."[12] The composition of social spending in favour of pensions and at the expense of social benefits limits the effectiveness of the welfare state in Greece, and there also exists a problem regarding the targeting of social benefits.[13] It is estimated that more and better targeted social spending will improve the effectiveness of the social solidarity system in Greece. However, social policy to restrict the poverty risk must take into account the multidimensional nature of the phenomenon. In any event, the fact that certain population groups are lagging behind the rest of the community is not solely the result of income: therefore, it is essential that concerted action be taken to improve not just monetary social spending but also to improve human capital, to provide better social services (education, healthcare, culture, etc.) and to facilitate access to such services.

12 The term "targeting" refers to the extent to which individual social benefits reach those who are truly entitled to receive them.
13 In fact, Greece shows a lower reduction in percentage terms in the risk of poverty due to social benefits (excluding pensions) in relation to countries with a similar or smaller proportion of such spending per GDP (Italy, Spain, Portugal and Ireland). This fact must be attributed to the problem of targeting social benefits. It is indicative that the poorest 10% of the population (1st decile) receive 6.6% of social benefits, compared with 12.5% of the 5th decile and 7.4% of the richest 10% of the population (10th decile). In particular, the poorest 10% of the population receive just 5.4% of disability payments, 4.6% of housing benefits and 6.1% of the benefits paid to those with no means of support. On the other hand, the richest 10% of the population receive almost 10% of the unemployment benefits paid and 12.9% of family benefit payments.

3 BUSINESS PROFITS

3.1 PROFITS, SALES AND PROFITABILITY

The profits, sales and other economic aggregates of enterprises in 2006 are examined using a sample of 472 non-financial corporations, of which 248 (121 industrial firms, 44 commercial firms and 83 service pro-viders or other companies) are companies whose shares are listed on the stock exchange.[35] Although the sample is relatively small and the published data (most of which are now compiled according to the international accounting standards) are limited, it is possible to draw certain basic conclusions concerning both the development of the sales and profits of these businesses in 2006 and their financial structure.

Net pre-tax profits for the entire sample of enterprises increased by 15.9% in 2006 and the rise in corporate profitability was much greater in comparison with the relatively small increase in 2005 and the limited drop in 2004.[36] (The average annual growth rate of profits in the three years 2004-2006 was 6.4%.) A comparatively large rise in profits was observed in trade (31%) and "other" sectors (31.2%), while, by contrast, the rate fell for industry (–6.5%). A significant variation was observed in the development of profits among the individual branches which make up each sector.

Sales by firms included in the sample increased by 14.8% in 2006, compared with a smaller increase (of the order of 10%) in the previous two years. With minor exceptions, a general increase in sales was observed in 2006, albeit at different rates in individual sectors.

Gross profits earned by all the companies in the sample increased by 5.7% in 2006, i.e. approximately the same as in 2005 (5.5%).

As a result of the faster increase in sales in 2006 compared with the increase in gross profits, a small reduction in gross profit margins (i.e. in the ratio of gross profits to sales) was recorded, i.e. to 18.5% in 2006, compared with 20.1% in 2005. By contrast, the net profit margin (i.e. the ratio of net profits to sales) improved only slightly in 2006 (to 8.5%, from 8.4% in 2005), as net pre-tax profits increased in 2006 at a somewhat higher rate than sales. These figures imply that the significant growth in net pre-tax profits in 2006 was not due to an overall improvement in the production process on the part of businesses, but is, rather, a reflection of the evolution of other net outlays (administrative and marketing costs, financial and extraordinary net expenses), which as a whole were reduced to 9.8% of sales (from 11.6% of sales in 2005). In particular, the improvement in net profit margins in 2006 was chiefly due to the marked containment of administrative and marketing costs, which were 1.3% less than in 2005. In addition, a substantial proportion of business profitability in 2006 is due to income from

35 Data are derived from balance sheets or summary financial statements recently published in the daily press by the firms concerned. These include companies whose shares are listed on the Athens Exchange and other firms, whose sales exceed €5 million. The sample excluded businesses whose published data for 2006 are, for various reasons (splits, mergers, etc.), not comparable with those of 2005. It also excluded public enterprises and financial enterprises, as well as holding companies (but their subsidiaries' published data were included). Finally, the sample excluded OTE and DEH, as the size of these companies is so large that it would have had a decisive impact on the aggregate data.

36 According to data from similar sample groups of companies, profits increased by 5.3% in 2005, whereas they fell by 1.2% in 2004.

capital or sales of assets or to other extraordinary non-operating income. By contrast, financial expenses showed a 32.9% increase compared with 2005, owing to the relatively large increase in corporate borrowing (14.1%) and the rise in bank interest rates[37] in 2006. As a result of these developments, the ratio of financial costs to gross profits, which is often used as an indicator of companies' financial fragility, increased to 7.39% in 2006, from 5.85% in 2005. It should be noted that, despite its deterioration, this ratio remains at a low level: this is to a large degree associated with the fact that the level of interest rates remains relatively low (despite having increased). A major exception to this general trend is the construction industry, where the ratio of financial costs to gross profits stands at a particularly high level (52% in 2006, compared with 38% in 2005), since activity and profitability in this industry, despite a recovery in 2006, still remain at a lower level than in 2004 (when projects associated with the Olympic Games were completed).

The appreciable rise in the profits of all the firms in the sample in 2006 led to a significant improvement in both return on equity (ROE) and return on total assets (ROA) (i.e. net profits as a percentage of equity or of total assets). Specifically, ROE reached 16.8% in 2006, from 15.2% in 2005, while ROA rose to 7.7% in 2006, from 7.3% in 2005. Profitability improved in all branches of trade and most branches of "other" activities, where — with the exception of the "hotels-restaurants-recreation" branch and "technical-construction companies"— it reached a very satisfactory level.[38] By contrast, in industry, ROE dropped to 10.9% in 2006, from 12.0% in 2005, and ROA to 5.7%, from 6.4% in 2005. The "textiles-clothing" branch saw continued losses, while losses were also reported by the "wood-paper-publishing-printing" branch, despite increased sales in 2006.[39] In other branches of industry, profitability increased generally in 2006 and in any event reached a relatively satisfactory level.

3.2 PROFITS AND SALES BY BRANCH OF ECONOMIC ACTIVITY

As noted above, there are significant differences among individual branches as far as the development of sales and —to a far greater extent— profitability are concerned.

In the individual branches of *industry*, the following can be observed:

The food-beverages-tobacco industry recorded a drop in profits of 10.8% in 2006, despite increased sales. This decline is due chiefly to Hellenic Sugar SA, which again made a loss and which, due to its size, has an impact on the profitability of the industry as a whole.

In the "textiles-clothing" branch, the relatively small growth in sales (7.8%) is an indication of the problems the branch has been facing in recent years due to strong competition from exports by countries with low production costs. The branch recorded losses for yet another year.

37 The average bank rate on loans to businesses increased by 91 basis points in 2006.
38 Profitability in the information technology branch was particularly high, as net pre-tax profits for 2006 were significantly affected by extraordinary income derived from the distribution of assets. Profitability in this branch remains high even without taking this extraordinary income into account: in this case, ROE stands at 21.3% and ROA at 10%.
39 Both these branches reported a fall in sales in 2005.

In the wood-paper-publishing-printing branch, the increase in sales was, generally, very small (5.9%). Quite a few companies saw a reduction in profits or substantial losses (chiefly affecting one wood processing company and companies in the newspaper printing sub-branch). As a result, the branch as a whole recorded a loss.

In the refineries-chemicals-plastics industry, the two oil refineries had a decisive impact on figures for the whole branch. Thus, although, due to high oil prices, sales for the branch increased by 19.8% in 2006, a 24.3% drop in gross profits was recorded, with an even greater fall —30.5%— in net pre-tax profits.

In the non-metallic minerals industry, the two main cement producing companies have a major impact on industry aggregates. Both these companies showed a major increase in sales and gross profits. However, in 2006, net profits for the industry remained at almost the same levels as in 2005, as profits had previously been pushed up by a significant amount of extraordinary income.

In the metallurgy branch, which includes some of the most profitable companies in Greek industry, sales grew by 28.1% and profits by 48.1% in 2006.

In other industries, the reduction in losses reported by Hellenic Shipyards due to extraordinary income had a major impact. This boosted the whole branch, which reported a very significant increase in profits, although sales increased by a mere 10%.

In *trade*, an increase of 11.7% was recorded in sales and an even more significant rise of 31.0% in profits, stemming from the three branches of trade.

Results for the *services provision and other activities* sector differ depending on the subsector.

In the information technology branch, profits more than tripled in 2006 as a result of a large amount of extraordinary income realised by one company from the sale of a subsidiary with high surplus value and profits. The branch's sales, however, remained stable. The branch faces difficulties which have led certain companies to a standstill.

Despite the 13.5% increase in sales recorded by the hotels-restaurants-recreation branch in 2006, there was a large drop in profits as a result of the losses recorded by three major firms (which fully offset the increase in profits reported by other companies in the branch included in the sample).

Passenger shipping companies reported very large profits, which increased by 95.3% due to extraordinary income. Receipts decreased by 4.9%.

For technical-construction companies profits dropped by 20.9%, the result of various developments within the branch. The number of loss-making companies remained the same (6) in 2005 and in 2006. However, the significant increase in sales (27.4% in 2006 compared with 8.5% in 2005) appears to signal renewed dynamism within the branch, after the decrease that followed the intense activity recorded in connection with the Olympic Games of 2004. This dynamism is also reflected in the significant improvement in expectations recorded in IOBE conjunctural surveys.

In the telecommunications industry, excluding OTE due to its large size, the other two major companies (COSMOTE SA and Germanos SA) determine the course of the entire branch. Despite the limited rise in sales (7.5%) and gross profits (5.7%), net profits showed a considerable increase of 9.7%, chiefly as a result of the sharp drop in administrative and marketing costs.

In healthcare, there was a considerable increase in sales and an even more significant increase in profits for all the companies in the branch. This is directly associated with the strong expansion of investment activity in the healthcare industry.

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

1 THE ECB'S SINGLE MONETARY POLICY

The stance of the European Central Bank's (ECB) monetary policy changed in December 2005 and key rates were raised six times up to the end of 2006[1] by a total of 150 basis points. The Governing Council decided on a further increase (of 25 basis points) in key ECB rates on 8 March this year in view of the risks to price stability which, in its opinion, still exist. Thus, the minimum bid rate of the main refinancing operations came to 3.75%, the marginal lending facility rate to 4.75% and the deposit facility rate to 2.75% (see Table V.1 and Chart II.12). These increases in key ECB rates were deemed essential to ensure that inflation expectations would remain anchored at levels consistent with price stability. Such anchoring of inflation expectations to a level below but close to 2% in the medium term is a prerequisite for monetary policy to make an ongoing contribution towards fostering sustainable economic growth and job creation. In spite of the rise in key rates, monetary policy remained accommodative during 2006, as identified by the Governing Council on the basis of its economic and monetary analysis, given that both nominal and real rates on all maturities remained low in comparison with previous upward phases of the economic cycle, monetary and credit expansion was vigorous and liquidity was ample.

Economic analysis showed that during the first six months of 2006 economic activity recovered significantly, chiefly due to increased investment. The GDP quarterly growth rate accelerated to 0.8% and 1% in the first and second quarters respectively, compared with 0.3% in the last quarter of 2005. Inflation reached 2.5% in the second quarter, and the relevant long-term projections[2] published in March and June were gradually revised upwards, particularly for 2006, owing to rising oil prices. The Governing Council repeatedly stressed that there were risks to price stability in the event of a new increase in oil prices or a stronger pass-through of previous oil price rises to consumer prices or additional increases in administered prices and indirect taxes. Although wage increases were restrained (as was ascertained later) in 2006 (chiefly due to the pressure of international competition), it was not possible at the beginning of the year to rule out the risk of a significantly faster rise in wages as a result of second-round effects of increased raw material prices and —chiefly— of the impact of the

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	Oct.	2000	3.75	4.75	5.75
11	May	2001	3.50	4.50	5.50
31	Aug.	2001	3.25	4.25	5.25
18	Sept.	2001	2.75	3.75	4.75
9	Nov.	2001	2.25	3.25	4.25
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
6	Dec.	2005	1.25	2.25	3.25
8	March	2006	1.50	2.50	3.50
15	June	2006	1.75	2.75	3.75
9	Aug.	2006	2.00	3.00	4.00
11	Oct.	2006	2.25	3.25	4.25
13	Dec.	2006	2.50	3.50	4.50
14	March	2007	2.75	3.75	4.75

1 As from 10 March 2004, the effective date of changes in all three key ECB interest rates is the date of the first main refinancing operation following the relevant decision of the Governing Council.
Source: ECB.

1 On 1 December 2005, and 2 March, 8 June, 3 August, 5 October and 7 December 2006.
2 Long-term projections are made in March and September each year by ECB staff and in June and December by Eurosystem staff.

increase in total demand. Monetary analysis also indicated further risks to price stability, as the growth rate of the broad monetary aggregate M3 and of loans to the private sector, particularly housing loans, was increasing continuously in an environment of already excess liquidity (see Chart V.1). This was attributed to the recovery of economic activity and to the fact that the level of interest rates remained low. Combining the findings of economic analysis with those of monetary analysis, the ECB increased its key interest rates in March and again in June 2006, by 25 basis points each time.

It was expected that economic conditions would remain favourable in the second half of 2006, but the growth of economic activity was forecast to accelerate less than in the first six months of 2006. Indeed, the quarterly GDP growth rate stood at a lower level (0.6%) in the third quarter in comparison with the previous quarters, but there was a significant upturn (to 0.9%) in the fourth quarter, chiefly because of stronger domestic demand. The inflation rate remained above 2% until end-August, but in the following months it dropped to levels below 2% due to a significant decrease in oil prices from the beginning of August onwards. The consequent downward revision of expectations regarding future oil prices led to a corresponding revision of inflation projections, particularly for 2007, in the context of the macroeconomic projections by Eurosystem staff published in December (in comparison with previous projections). However, as in the first six months of 2006, the Governing Council of the ECB continued to foresee inflationary risks, chiefly owing to the likelihood of higher than expected wage increases, given the favourable development of economic activity and increased employment. For this reason, it was crucial, as stressed by the Governing Council, that social partners continue to meet their responsibilities, so that wage agreements take into account productivity developments and the implications for competitiveness. The conclusion of economic analysis that there are inflationary risks was corroborated by monetary analysis. The growth rate of M3, which the Governing Council considered very high as early in the first half of 2006, fell slightly in the third quarter, but increased significantly in the last quarter. Credit expansion to the private sector also remained at historically high levels. The growth rate of lending to enterprises accelerated, while, after June, the growth rate of lending to households decelerated, but was still at a high level. Taking the above into account, the Governing Council raised the ECB's key rates in August, October and December 2006 (by 25 basis points each time).

According to the most recent indicators, economic recovery is continuing in the first months of 2007, though at a more moderate pace than in the last quarter of 2006, as a result of the impact of higher VAT rates in Germany. Macroeconomic projections published in March indicate that in 2007 and 2008 economic growth will continue to be faster than the potential rate and higher than predicted in December 2006. The annual inflation rate remained at 1.8% in January and February, chiefly due to the relatively high level of prices a year earlier and the decrease in oil prices this year. It is expected that the inflation rate will remain at this level until the third quarter of the current year, but it is likely that it will accelerate again and reach a level of around 2% in the last quarter. In

March, inflation sped up slightly to 1.9%. As far as recent macroeconomic projections are concerned, the upper bound of the range for inflation projected for 2007 was revised downwards as a result of the drop in oil prices. By contrast, inflation projections for 2008 have been revised upwards, as it is expected that the rate of capacity utilisation will increase, thereby raising production costs, as a result of stronger economic activity. It is estimated that, in the medium term, when the effects of the current monetary policy decisions will materialise, the inflationary risks which were ascertained in 2006 will continue to exist, mainly the possibility of an acceleration in wage increases. Inflationary risks in the medium and long term were strengthened by, *inter alia*, the further acceleration of M3 growth in January and February 2007 to historical highs since the beginning of Monetary Union in January 1999 as well as by the continuing high rate of credit expansion. Thus, on 8 March this year, the Governing Council decided once again to raise the key ECB rates by 25 basis points,[3] stressing that these rates have now reached a "moderate" level and that monetary policy remains "rather" accommodative. Finally, it reiterated that it would monitor economic and monetary developments very closely (particularly forthcoming wage negotiations and house prices) and that it would act in a firm and timely manner to ensure price stability in the medium term.

On 1 January 2007, Slovenia became the 13th member of the euro area (see Box V.1).

3 The minimum bid rate of the main refinancing operations reached 3.75%.

Box V.1

SLOVENIA'S ENTRY INTO THE EURO AREA – A BRIEF PRESENTATION OF THE SLOVENIAN ECONOMY AND OF TRADE BETWEEN GREECE AND SLOVENIA

Less than three years after it joined the European Union in May 2004, Slovenia became the 13th member[1] of the euro area on 1 January 2007. Slovenia was the first country to join the euro area since Greece joined on 1 January 2001.

Slovenia has a population of approximately 2 million (0.6% of the euro area-13) and its gross domestic product stood at €27.6 billion at current prices in 2005 (0.3% of the euro area GDP). The services sector provides 69.3% of the total value added of the economy (euro area: 77.6%), manufacturing provides 28.2% and the agricultural sector 2.5%. The economy of Slovenia continues to find itself in a process of real convergence, as the country's per capita income is calculated to be 52% of the EU-15 average, based on current exchange rates, and 75% of the EU-15 average based on purchasing power parities. Slovenia's annual GDP growth rate stood at 4.4% on average over the last three years, with unemployment at 6.3%, while HICP inflation reached 2.8% in January and 2.3% in February 2007. The general government deficit was calculated at 1.6% of GDP in 2006 and public debt at just 28.4% of GDP, i.e. less than half the reference value set in the Maastricht Treaty (60% of GDP).

1 The adoption of the single currency by Slovenia saw the replacement of the tolar at an exchange rate of 239.64 tolars to the euro, the central exchange rate of the Slovenian currency in the Exchange Rate Mechanism II (ERM II).

Geographical distribution of Slovenia's trade

(percentage of total)

Exports to/imports from	Exports			Imports		
	2003	2004	2005	2003	2004	2005
Greece	0.4	0.3	0.4	0.3	0.4	0.3
Euro area	54.5	53.8	54.5	63.5	72.0	67.3
EU-27	68.4	69.2	70.1	76.5	84.3	80.0

Source: IMF, *Direction of Trade Statistics.*

The Slovenian economy is very outward looking. The bulk of its trade is carried out with the other EU countries. In 2006, more than 70% of the country's exports and more than 80% of its imports involved EU-25 countries, while transactions with euro area countries represented approximately 60% of its total trade. Trade transactions between Greece and Slovenia remain relatively limited, although they grew from €41.5 million in 1999 to €89.7 million in 2005. In 2005, trade between the two countries represented 0.15% of Greece's total trade and 0.32% of Slovenia's.[2]

The financial market in Slovenia is less developed than in other euro area countries. Credit to the private sector is at a low level at present but is rising rapidly, while the convergence of short-term and long-term interest rates took place smoothly and was completed in the second half of 2006. Stock market capitalisation is small.

2 Greek exports to Slovenia consist mainly of petroleum products, aluminium oxide, insulation materials, citrus fruit, fresh peaches, fresh fish, plastic materials, unprocessed tobacco, cotton, textile fibres and men's clothing. Imports from Slovenia include, *inter alia*, paper and cardboard, machinery, electrical materials, rubber, glass and fish.

2 THE EVOLUTION OF M3 AND ITS COUNTERPARTS

In 2006, the growth rate of the monetary aggregate M3 rose further (with the exception of the third quarter) to reach 8.4% on average, compared with 7.4% in 2005 (see Table V.2 and Chart V.1). The potential of M3 during the year is indicated by the fact that in December 2006 its annual growth rate reached the historically high level of 9.7%. The acceleration of M3 growth is mainly due to the faster increase in other short-term deposits and in marketable instruments, which more than offset the slowdown in M1 growth.

In more detail, M1 growth slowed down during the year, because, on the one hand, the annual growth rate of currency in circulation fell and, on the other hand, funds from overnight deposits (the interest rates on which, in effect, did not follow the changes in key rates) shifted to time deposits, the interest rates on which increased comparatively much more, since they followed money market rates. Between December 2005 and December 2006, interest rates on overnight deposits rose by 21 basis points for households and by 50 basis points for firms, while rates on new time deposits with an agreed maturity of up to two years rose by 106 basis points for households and by 250 basis points for firms. For the same reason, a shift of funds to time deposits was also observed from deposits redeemable at notice of up to three

Table V.2 Main components of M3 in the euro area

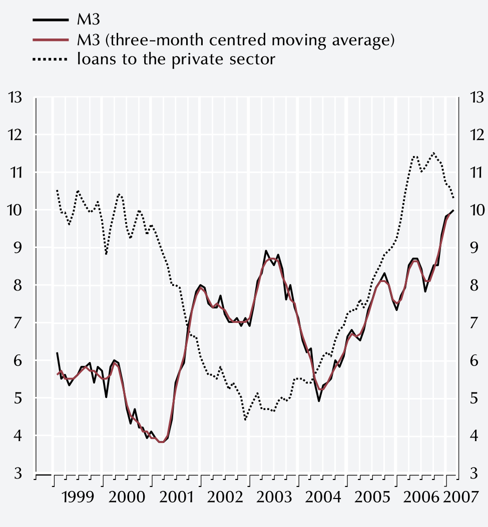
(annual percentage changes,[1] derived from data adjusted for seasonal and calendar effects; for 2006: quarterly averages[2])

	2006				2007	
	Q1	Q2	Q3	Q4	January	February
M1	**10.3**	**9.8**	**7.6**	**6.7**	**6.5**	**6.6**
Currency in circulation	13.3	11.9	11.4	11.1	10.5	10.2
Overnight deposits	9.8	9.5	7.0	5.9	5.8	5.9
Other short-term deposits (=M2–M1)	**6.8**	**8.5**	**9.5**	**11.1**	**12.0**	**11.6**
Deposits with an agreed maturity of up to two years	9.8	15.3	19.7	25.3	29.3	29.3
Deposits redeemable at notice of up to three months	4.6	3.8	2.4	1.1	–0.5	–1.4
M2	**8.6**	**9.2**	**8.4**	**8.6**	**8.9**	**8.8**
Marketable instruments (=M3–M2)	**3.3**	**5.7**	**6.4**	**11.1**	**16.2**	**17.6**
M3	**7.8**	**8.6**	**8.1**	**9.0**	**9.9**	**10.0**

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 "Euro area statistics" of the ECB *Monthly Bulletin*).
Source: ECB.

Chart V.1 Euro area M3[1] and loans to the euro area private sector

(percentage changes over same month of previous year, monthly data)



1 Data adjusted for seasonal and calendar effects.
Source: ECB.

months,[4] the growth of which had shown a continuous deceleration in 2006. Due to the comparatively higher rise in interest rates on these deposits, the increase in time deposits maturing in up to two years showed a corresponding significant acceleration (from 6.5% in the fourth quarter of 2005 to 25.3% in the last quarter of 2006).

A strong increase was also recorded in the annual growth rate of debt securities with a maturity of up to two years. These are mainly floating-rate securities, which allow investors to benefit from a rise in interest rates in the period up to the maturity date. Therefore (as long-term yields in 2006 were not substantially higher than short-term interest rates), these securities were favoured over more long-term fixed-rate bonds, as interest rates were expected to increase. Moreover, this M3 component also includes new composite products, which show dynamic growth as they embody financial derivatives. These composite instruments allow investors to benefit from any rise in equity prices, as well as protect themselves against capital losses in the event of a stock market downturn.

4 The interest rates on new deposits redeemable at notice of up to three months rose by 41 basis points in the period December 2005-December 2006.

Table V.3 Main counterparts of M3 in the euro area

(annual percentage changes,[1] derived from data adjusted for seasonal and calendar effects; for 2006: quarterly averages[2])

	2006				2007	
	Q1	Q2	Q3	Q4	January	February
Longer-term financial liabilities[3]	**8.8**	**8.7**	**8.4**	**8.4**	**8.4**	**8.2**
Credit to general government	**2.4**	**1.0**	**–0.9**	**–3.1**	**–4.8**	**–4.1**
Loans to general government	0.8	0.3	–0.6	–0.3	–1.5	–0.8
Credit to the private sector	**10.5**	**11.8**	**11.9**	**11.9**	**11.3**	**10.7**
Loans to the private sector	10.0	11.2	11.2	11.1	10.6	10.3
– to non-financial corporations[4]	9.2	11.0	11.9	13.0	13.2	12.6
– to households[4]	9.5	9.7	9.3	8.6	8.0	8.0

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 "Euro area statistics" of the ECB *Monthly Bulletin*).
3 Including capital and reserves.
4 Data not adjusted for seasonal and calendar effects.
Source: ECB.

Regarding the counterparts of money in a broad sense, the pick-up in M3 growth chiefly reflects the development of credit expansion to the private sector (see Table V.3). More specifically, the annual growth rate of loans to the private sector showed a significant increase in the first six months of 2006 and hovered at a high level thereafter (a little above 11%), with only a slight downturn towards the end of the year. The strong demand for loans on the part of the private sector in the euro area is due to the recovery of economic activity, to the still low level of interest rates in 2006 (despite a gradual shift in monetary policy towards a more restrictive stance) and to other (excluding the interest rate) favourable loan terms.[5] The slight decline in the growth rate of loans to the private sector towards the end of the year may reflect the impact, with a time lag, of the rise in ECB rates.

The high growth rate of private sector loans chiefly reflects the development of corporate loans. The increase in corporate loans accelerated in 2006, due to increased fixed capital investment and working capital requirements, as well as mergers and acquisitions. As regards loans to households, the slowdown of their growth in the second half of the year reflects the deceleration in the growth of housing loans due to higher interest rates and the slower rise in house prices in a number of euro area countries.[6] The increase in consumer loans to households decelerated only in the last quarter of 2006.

In contrast to the development of loans to the private sector, the growth rate of credit to the general government sector showed a slowdown in the first six months, while credit to this sector decreased in absolute terms in the second half of 2006, as the fiscal situation in

5 Loan terms (apart, of course, from interest rates) include the collateral required for the loan, the duration and amount of the loan, various clauses relating to the loans, payable charges other than interest and, in the case of housing loans, the ratio of the amount of the loan to the value of the mortgage.
6 It should be noted that the relationship between house prices and the demand for housing loans is interactive, as a slowdown of the rise in house prices leads to a reduction in the demand for housing loans, but, at the same time, any reduction of housing loans leads to a slowdown of the rise in house prices.

the euro area improved, chiefly owing to the faster growth of economic activity. The maintenance of the growth rate of the longer-term financial liabilities of Monetary Financial Institutions (MFIs) at high levels (close to 8.5%) also contributed, to a significant degree, to restraining the acceleration of M3 growth.

The faster growth of M3 in the last two months of 2006 can largely be attributed to the stronger net external position of MFIs owing to capital inflows into the euro area, which may have been caused by expectations of a further appreciation of the euro.

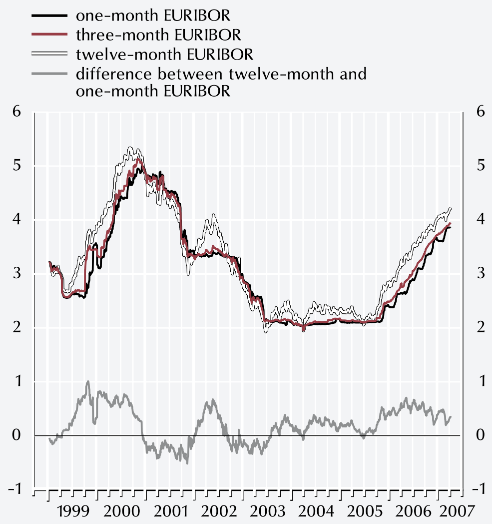
The increase in M3 continued to accelerate in the first two months of 2007. As a result, the growth rate reached 10% in February, the highest level in the last 17 years. At the beginning of 2007, the M1 growth rate moved at slightly lower levels in comparison with the end of 2006. However, this effect was more than offset by the growth of marketable instruments at still higher rates than in 2006. As regards M3 counterparts, a small deceleration was noted in the increase in credit to the private sector and in long-term financial liabilities, while credit to general government continued to decrease.

3 MONEY MARKET AND MFI INTEREST RATES, LONG-TERM BOND YIELDS

Money market interest rates increased progressively throughout the whole of 2006 (see Chart V.2) on account of the rise in key ECB rates. The three-month EURIBOR interest rate rose by approximately 120 basis points (December 2006: 3.68%, December 2005: 2.47%).[7] The uncertainty in the euro area money market concerning the development of

Chart V.2 Short-term interest rates in the euro area

(percentages per annum, daily data)



Source: ECB.

short-term interest rates, as measured by the implied volatility of the three-month EURIBOR rate,[8] fell to historically low levels in 2006. This fact confirms the effectiveness of the ECB's communication policy, which has resulted in the markets forecasting increases in key rates with relative accuracy, thereby preventing sharp changes in short-term interest rates.

The difference between the 12-month and one-month EURIBOR rates fluctuated during the year, but stood at around 50 basis points on average, i.e. it moved at a higher level than in the previous year, since interest rates for longer maturities generally increased more than those for shorter maturities. This

7 It should be recalled that the Governing Council of the ECB increased key rates by 125 basis points in 2006.
8 This volatility is calculated on the basis of the prices of options on three-month EURIBOR futures. These contracts embody market expectations concerning the future level of the three-month EURIBOR rate.

development is due to the fact that the more short-term rates (from one day to one month) closely followed the changes in key ECB rates, while rates for longer maturities (e.g. 12 months) during 2006 embodied expectations of a further increase in key rates and thus rose more sharply.

The increase in EURIBOR rates continued in early 2007 (three-month EURIBOR: March 2007: 3.89%). The markets do not appear to have ruled out the possibility of a further small increase in short-term interest rates (some time in 2007),[9] following the decision of the ECB's Governing Council to raise key rates by 25 basis points in March 2007.

In 2006, Monetary Financial Institutions' (MFI) deposit and lending rates increased on account of the rise in interest rates in money and capital markets. MFIs' short-term rates rose more sharply than long-term rates, owing on the one hand to the correspondingly larger increase in money market interest rates in comparison with the yields on medium- to longer-term bonds (e.g. five-year bonds), and, on the other hand, to the fact that the adjustment of MFI long-term rates to capital market yield variations is more limited and gradual than the adjustment of MFI short-term rates to changes in money market rates.

As far as deposit rates are concerned, the increases were between 21 basis points (for overnight deposits by households) and 250 basis points (for deposits with an agreed maturity of between one and two years by non-financial corporations). The rise in lending rates was between 36 basis points (for household overdrafts) and 125 basis points (for corporate loans above €1 million with a floating rate or a rate fixed for up to one year).

In January and February 2007 lending and deposit rates showed a further rise in most categories.

In contrast to the increase in interest rates, the other loan terms (i.e. excluding interest rates) improved. As far as firms are concerned, these terms became less tight in the first quarter of 2006 and did not change significantly thereafter, as confirmed by the Eurosystem Bank Lending Surveys for 2006.[10] These surveys also show that, for households, the other lending terms became less tight during the whole of the year as far as consumer loans are concerned, while for housing loans the terms became less tight during the first six months and thereafter changed very little.

Long-term bond yields fluctuated during 2006, but rose overall in comparison with the historically low levels they had reached in 2005 (see Chart V.3). On an average monthly basis, the yield on 10-year bonds stood at 3.90% in December 2006, compared with 3.41% in December 2005. The rise in yields possibly reflects the increase in the real interest rate, while inflation expectations do not appear to have changed significantly.

More specifically, the sharp rise in yields on 10-year bonds in the first six months of 2006 was chiefly due to favourable expectations concerning economic activity, which were revealed by surveys of business confidence and were then confirmed by the publication of short-term indicators and national accounts

9 On 13 April 2007, the markets expected the three-month EURIBOR rate to stand at 4.14% in June, 4.28% in September and 4.35% in December 2007.
10 See ECB, *Monthly Bulletin,* May, August and November 2006 and February 2007.

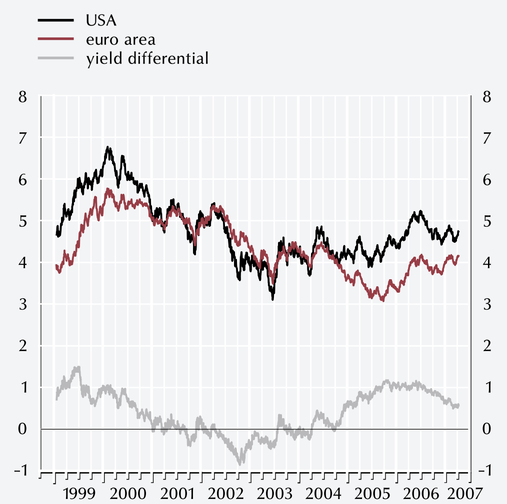
data. However, the drop in prices which spread from emerging to developed equity markets in May and June 2006 led investors to shift to more secure assets, chiefly government bonds, resulting in a reduction in long-term interest rates. The decrease in long-term rates continued in the following months, possibly because the risk premium incorporated into bond yields was reduced, but also because the markets became convinced that the growth of US economic activity was slowing down and that the Federal Reserve (FED) would not raise its key rate any further. From December 2006, however, the yields on long-term bonds recovered, probably as a result of a new increase in real yields, minus the risk premium, caused by a further improvement in economic activity prospects in the euro area.

Since the increase in 10-year bond yields in 2006 was smaller than the increase in money market interest rates, the bond yield curve gradually became significantly flatter (see Chart V.4). This development, however, does not appear to herald lower growth rates for economic activity, but is rather associated with the fall throughout most of the year, as in the previous years, in the risk premium which is embodied in long-term bonds.[11]

The implied volatility in the bond market,[12] which is an indicator of investor uncertainty, fell further in 2006 (despite the temporary increase in the period between May and

Chart V.3 10-year bond yields in the euro area and the United States

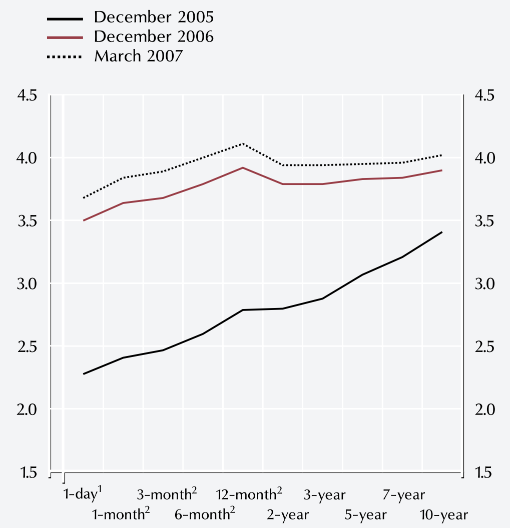
(daily data, percentages per annum)



Source: ECB.

Chart V.4 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.

11 It should, of course, not be overlooked that the calculation of the risk premium is surrounded by increased uncertainty. An estimate published in the ECB *Monthly Bulletin,* December 2006 (Box 3), shows that the risk premium incorporated into debt securities with a maturity of more than one year decreased significantly in October 2006 in comparison with January 2004.

12 The implied volatility in bond markets, a statistical series derived from data on futures, is an indicator of the uncertainty of bond market participants. For the euro area, this figure is calculated on the basis of the prices of options on 10-year German government bond futures.

June) and reached historically low levels towards the end of the year.

In the US, bond yields grew less in 2006 (from 4.46% in December 2005 to 4.57% in December 2006). As a result, the yield differential between the US and the euro area decreased significantly during 2006. The comparatively smaller total increase in long-term interest rates in the US was chiefly due to the less favourable outlook for economic activity.

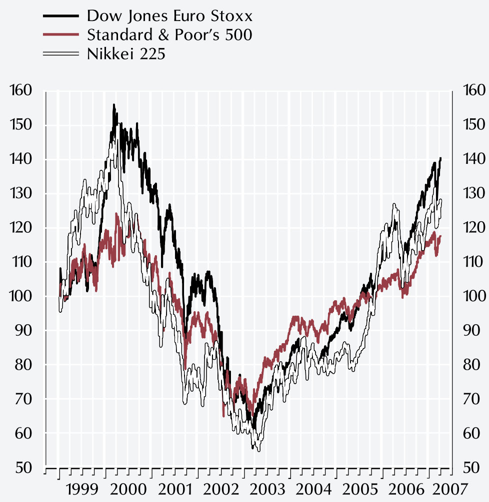
The rise in 10-year government bond yields (from December 2006) continued until mid-February 2007, when a fall in yields was again noted. The sharp drop in stock market prices and the fluctuations in prices on other financial markets brought investors back to the government bond market. From mid-March 2007, yields on 10-year bonds in the euro area began to recover. As a result, average monthly yields reached a level approximately 10 basis points higher than in December 2006 (4.02%).

4 STOCK MARKET DEVELOPMENTS

Equity prices in euro area stock markets rose considerably in the course of 2006, resulting in a 20% increase in the Dow Jones Euro Stoxx index. By way of comparison, equity prices in the US and Japan showed smaller rises, 14% (Standard & Poor's 500) and 7% (Nikkei 225), respectively (see Chart V.5). The increase in equity prices in the euro area can be attributed primarily to high corporate profitability and also to the continuing high profit expectations, along with improved prospects for economic activity (in the euro area). These factors more than offset the (negative) impact of the appreciation of the euro on exporting sectors and the (negative) impact of the rise in long-term interest rates. Public utilities' share prices showed a greater increase, while the rise in technology sector shares was smaller.

Chart V.5 Stock price indices

(1 January 1999=100, daily data)



Source: ECB.

The rise in share prices was continuous, apart from the brief period, noted above, between May and June, when a decrease was observed both in emerging and developed stock markets, together with a significant increase in uncertainty. This was the result of a re-evaluation of risk on the part of investors, which led to an increase in the risk premium. In addition, it appears that the attention of investors during this period was focused on the risk of rekindled inflation and a consequent rise in interest rates, particularly in the US. This uncertainty, however, diminished thereafter and reached historically low levels in the euro area in the second half of 2006.

The upward trend in equity prices in the developed stock markets continued until the last week of February 2007, when a sharp drop in stock prices occurred internationally, together with fluctuations in other financial markets. This development was accompanied, as in May-June 2006, by a significant increase in investor uncertainty. Equity prices in international stock markets recovered from mid-March 2007 onwards.

APPENDIX TO CHAPTER V

CHRONOLOGY OF MAIN MONETARY POLICY MEASURES OF THE EUROSYSTEM

12 January, 2 February 2006

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 2.25%, 3.25% and 1.25% respectively.

2 March 2006

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 2.50%, starting from the operation to be settled on 8 March 2006. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 3.50% and 1.50% respectively, both with effect from 8 March 2006.

6 April, 4 May 2006

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 2.50%, 3.50% and 1.50% respectively.

8 June 2006

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 2.75%, starting from the operation to be settled on 15 June 2006. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 3.75% and 1.75% respectively, both with effect from 15 June 2006.

6 July 2006

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 2.75%, 3.75% and 1.75% respectively.

3 August 2006

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 3.0%, starting from the operation to be settled on 9 August 2006. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 4.0% and 2.0%, respectively, both with effect from 9 August 2006.

31 August 2006

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 3.0%, 4.0% and 2.0% respectively.

5 October 2006

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 3.25%, starting from the operation to be settled on 11 October 2006. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 4.25% and 2.25%, respectively, both with effect from 11 October 2006.

2 November 2006

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 3.25%, 4.25% and 2.25% respectively.

7 December 2006

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 3.50%, starting from the operation to be settled on 13 December 2006. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 4.50% and 2.50%, respectively, both with effect from 13 December 2006.

21 December 2006

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 2007 from €40 billion to €50 billion. This increased amount takes the following aspects into consideration: the liquidity needs of the euro area banking system have grown strongly in recent years and are expected to increase further in the year 2007. Therefore the Eurosystem has decided to increase slightly the share of the liquidity needs satisfied by the longer-term refinancing operations. 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 2008.

11 January, 8 February 2007

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 3.50%, 4.50% and 2.50% respectively.

8 March 2007

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 25 basis points to 3.75%, starting from the operation to be settled on 14 March 2007. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 25 basis points, to 4.75% and 2.75%, respectively, both with effect from 14 March 2007.

12 April 2007

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 3.75%, 4.75% and 2.75% respectively.

VI MONETARY AND CREDIT DEVELOPMENTS IN GREECE

1 MONETARY DEVELOPMENTS

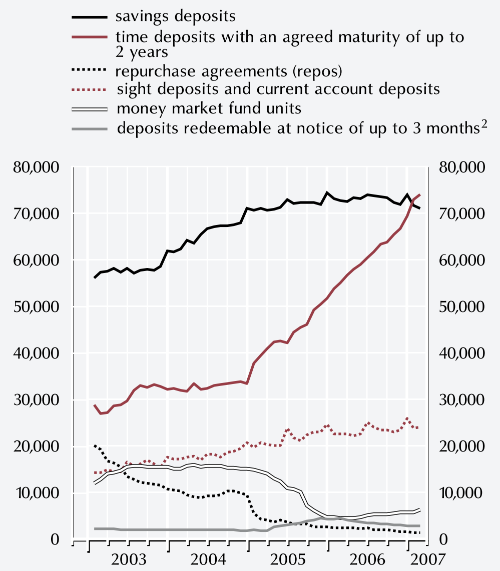
The annual growth rate of the Greek contribution to the euro area M3[1] (excluding currency in circulation) accelerated significantly in 2006 and stood at 10.6% in the fourth quarter (fourth quarter 2005: 6.9%), a trend that continued into the first two months of this year (February 2007: 11.8%). The increase in key ECB interest rates last year had a stronger impact on short-term than on long-term interest rates, thus causing shifts from assets not included in M3 (such as bond-type mutual funds) to assets included in M3 (such as deposits with an agreed maturity of up to two years), which have higher yields. Thus, the annual growth rate of the Greek M3 (excluding currency in circulation) since the second quarter of 2006 stood again at levels higher than the corresponding rate in the euro area, a development that continued into the January-February 2007 period.

The larger increase in interest rates on time deposits in 2006, compared with interest rates on other deposits, also led to shifts of funds within M3, as savers turned to deposits with higher yields. Time deposits increased significantly during the year and their growth rate, though decelerating, remained quite high, while savings deposits fluctuated slightly and even recorded a negative rate of change at the end of the year. As regards other M3 components, repo holdings decreased further, while holdings of money market fund units gradually recovered.

Owing to the above developments, the growth rate of total deposits included in M3 gradually fell to 12.1% in the last quarter of 2006 (fourth quarter 2005: 20.7%, see Table VI.1) and remained unchanged in the first two months of this year (February 2007: 12.1%). Deposits with an agreed maturity of up to two years kept rising during 2006 (a movement that had started at the beginning of 2005, see Chart VI.1), reflecting the aforementioned shifts out of M3 (savings deposits and repos), due to their relatively higher yields[2] (see below the section on bank 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.

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 any 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 Real yields on time deposits with an agreed maturity of up to one year turned positive as from September 2006.

Table VI.1 Greek contribution to the key monetary aggregates of the euro area

(not seasonally adjusted data)

	Outstanding balances on 31.12.06 (million euro)	Annual percentage changes[1]								
		2003	2004	2005	2006					2007
		Q4[2]	Q4[2]	Q4[2]	Q1[2]	Q2[2]	Q3[2]	Q4[2]	December[3]	February[3]
1. Overnight deposits	100,106.8	6.8	16.8	9.3	5.4	4.5	3.6	0.7	1.0	–0.4
1.1 Sight deposits and current account deposits	26,029.5	17.7	19.1	20.2	13.0	10.0	8.8	1.8	5.1	6.0
1.2 Savings deposits	74,077.3	4.1	16.1	6.3	3.3	2.8	1.9	0.2	–0.5	–2.3
2. Time deposits with an agreed maturity of										
up to 2 years	69,302.2	29.3	5.3	45.2	41.1	40.6	43.1	37.5	37.8	37.7
3. Deposits redeemable at notice of up to 3 months[4]	2,965.0	1.5	2.8	105.2	108.6	47.6	2.6	–24.4	–29.9	–31.4
4. Total deposits (1+2+3)	**172,374.0**	**12.6**	**13.1**	**20.7**	**17.5**	**16.4**	**15.9**	**12.1**	**12.3**	**12.1**
5. Repurchase agreements (repos)	1,569.0	–47.7	–12.6	–72.8	–51.2	–37.9	–36.5	–35.7	–42.4	–43.9
6. Money market fund units	5,808.2	68.0	–1.9	–51.8	–60.4	–52.6	–35.0	–2.5	19.3	33.8
7. Bank bonds with a maturity of up to 2 years	491.1	268.6	–0.3	–42.2	–35.8	–16.6	14.3	24.2	16.3	–23.0
8. M3 excluding currency in circulation (4+5+6+7)	**180,242.3**	**6.4**	**9.2**	**6.9**	**7.6**	**9.7**	**11.8**	**10.6**	**11.6**	**11.8**

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 "Euro area statistics" section of 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.
Sources: Bank of Greece and ECB.

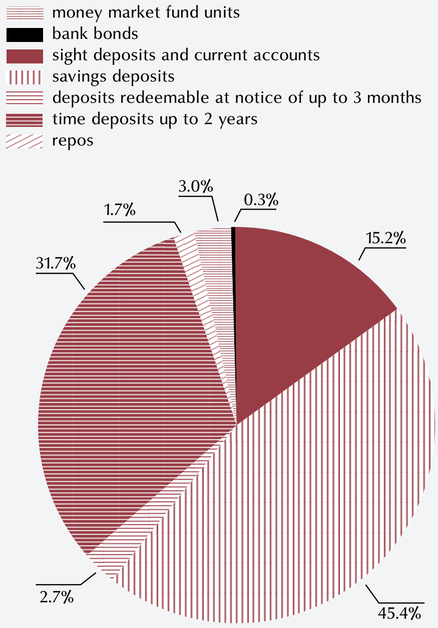
The growth of the above time deposits, though slightly decelerating, stood at relatively high levels in the last quarter of the year (fourth quarter 2006: 37.5%, fourth quarter 2005: 45.2%), as well as in the first two months of 2007 (February 2007: 37.7%). Thus, the gradual shift of investors to time deposits with an agreed maturity of up to two years in the last two years contributed to the significant increase to 38.4% at the end of last year in the share of this category in M3 (excluding currency in circulation) (see Chart VI.2B), i.e. to a level 6.7 percentage points higher than at end-2005 (and 16.5 percentage points higher than at end-2004). This trend continued into the first two months of this year, as for the first time in January the outstanding amount of time deposits was larger than that of savings deposits. In contrast, the annual growth rate of savings deposits fell significantly (fourth quarter 2006: 0.2%, fourth quarter 2005: 6.3%), while their rate of change turned negative as from December (February 2007: –2.3%). This implies that investors clearly prefer to hold assets with higher yields, as real yields on savings deposits remained negative throughout 2006. At end-2006, the share of savings deposits in M3 (excluding currency in circulation) fell by 4.2 percentage points to 41.2%.

As regards other M3 components, repo holdings dropped further in 2006 (see Chart VI.1), although their rate of decrease decelerated (fourth quarter 2006: –35.7%, fourth quarter 2005: –72.8%). However, in the first two months of 2007 it stood at a higher level (February: –43.9%). This development was partly attributed to the relatively lower yield on repos, compared with deposits with an agreed maturity, as well as to the fact that credit institution holdings of Greek govern-

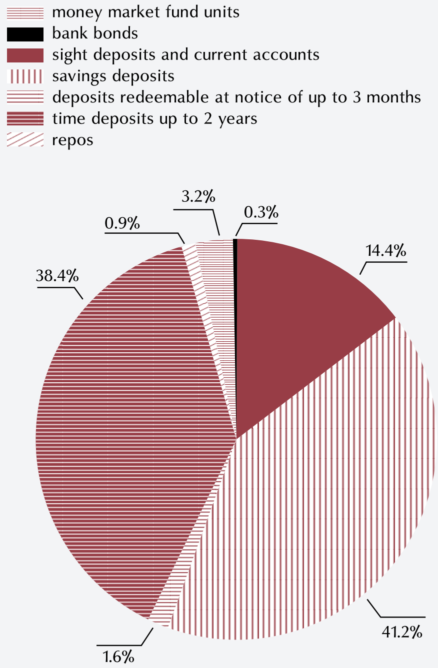
Chart VI.2 Percentage contribution of M3 components (excluding M0) in Greece

(end-of-year data)

A. 2005



B. 2006



Source: Bank of Greece.

ment securities, which constitute the basis of repos, fell further as a percentage of banks' total assets last year.[3] Thus, the share of repos in M3 (excluding currency in circulation) fell to 0.9% at end-2006, from 1.7% at end-2005. Finally, holdings of money market fund shares/units started to rise and their negative rate of change decreased substantially (fourth quarter 2006: –2.5%, fourth quarter 2005: –51.8%), while this rate turned positive in November and even rose to a fairly high level in the first two months of 2007 (February: 33.8%). This is associated with higher yields on this mutual funds category (due to the increase in short-term interest rates). At the end of the year, the share of money market fund units in M3 (excluding currency in circulation) rose slightly compared with 2005 (2006: 3.2%, 2005: 3.0%).

2 CREDIT DEVELOPMENTS

2.1 TOTAL CREDIT EXPANSION AND BANK CREDIT TO GENERAL GOVERNMENT

The total financing[4] of the economy by domestic Monetary Financial Institutions (MFIs) accelerated in 2006. Thus, the annual growth rate rose to 15.3% in the fourth quarter of the year, from 14.0% in the corresponding quarter of 2005 (see Table VI.2). The acceleration was mostly attributed to developments in MFI credit to enterprises and households. In particular, the annual growth rate of credit to enterprises accelerated substantially, while the annual growth rate of credit to households decelerated. In the first two months of 2007, the annual growth rate of the total financing of the economy fell to 13.0% in February.

In greater detail, the annual rate of change in the financing of general government was positive during the January-September 2006 period (while it was negative in the last quarter of 2005). However, this rate turned negative again in October (fourth quarter 2006: –1.8%, fourth quarter 2005: –0.7%) and maintained this course in the first two months of 2007 (February 2007: –8.0%). The volatility of general government financing is attributed to the restructuring of MFI portfolios towards government securities, mostly associated with conjunctural factors regarding the yields of these securities and with a view to the realisation of profits through changes in their prices. As regards government securities, the net borrowing requirement of central government on a cash basis was lower in 2006 (€10,467 million) than in the corresponding period of 2005 (€14,424 million). Thus, securities issuance in 2006 was substantially lower than in the corresponding period of 2005.

2.2 BANK CREDIT TO ENTERPRISES AND HOUSEHOLDS

The annual growth rate of credit to enterprises and households stood at 21.3% in the fourth quarter of 2006, i.e. it accelerated compared with the fourth quarter of 2005

3 During the last few years, credit institutions substituted Greek government securities with higher yield assets (such as loans), thus reducing the share of this category in the total assets of credit institutions almost by half between December 2002 and December 2006.

4 The growth rate of the total financing of the economy by domestic MFIs concerns the outstanding balance of MFI loans to enterprises, households and the general government, as well as the outstanding amount of government debt securities and corporate bonds held by MFIs. It should be noted, however, that to estimate the rate of change in total financing, securitisation and write-offs by banks during the reference period are also taken into account.

Table VI.2 Total Financing of the economy by domestic MFIs in Greece

(annual percentage changes)

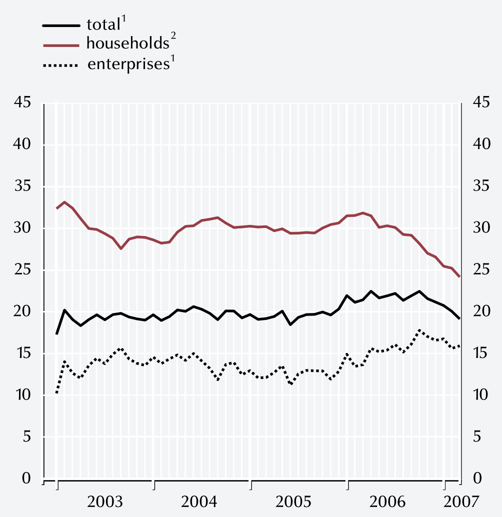
	2002	2003	2004	2005	2006					2007
	Q4[1]	Q4[1]	Q4[1]	Q4[1]	Q1[1]	Q2[1]	Q3[1]	Q4[1]	December[2]	February[2]
1. Total financing by MFIs[3,4]	7.1	4.4	11.0	14.0	16.6	18.1	17.9	15.3	14.5	13.0
2. Financing of general government	–5.2	–15.9	–5.6	–0.7	4.2	8.0	7.0	–1.8	–3.0	–8.0
3. Financing of enterprises and households[3,4]	18.2	19.1	19.6	20.1	21.5	21.8	21.7	21.3	20.6	19.8
3.1 Enterprises[3]	11.3	13.7	13.0	12.7	13.9	15.3	15.9	16.8	16.6	15.9
3.2 Households[4]	33.1	28.8	30.2	30.6	31.6	30.3	29.1	26.7	25.3	24.2
of which:										
3.2.1 Housing loans[4]	35.4	27.8	26.9	31.5	33.7	32.7	31.4	28.0	25.8	25.2
3.2.2 Consumer loans[4]	27.4	25.0	38.4	30.4	28.7	26.7	24.7	23.7	23.9	21.9

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 "Euro area statistics" section of the ECB *Monthly Bulletin*).
2 Annual rate of change at the end of the month.
3 Including corporate bonds held in MFI portfolios, as well as securitised loans. Loan write-offs are also taken into account since the fourth quarter of 2003, when the relevant statistical data were made available.
4 Including securitised loans. Loan write-offs are also taken into account since the fourth quarter of 2003, when the relevant statistical data were made available.
Source: Bank of Greece.

(20.1%, see Chart VI.3). This reflected offsetting trends in credit to enterprises and households. The growth rate of credit to enterprises accelerated considerably during 2006 and stood at a fairly high level (fourth quarter 2006: 16.8%, fourth quarter 2005: 12.7%). In contrast, the growth rate of credit to households fell substantially, although it remains at a high level (fourth quarter 2006: 26.7%, fourth quarter 2005: 30.6%). In the first two months of 2007, credit expansion to enterprises and households decelerated and the corresponding growth rates stood at 15.9% and 24.2%, respectively. The persistent relatively high growth rates of credit to enterprises and households led to a significant increase in their total liabilities vis-à-vis domestic MFIs, which stood at 91.9% of GDP at end-2006, compared with end-2005 (82.8%).

Chart VI.3 Financing of enterprises and households by domestic MFIs in Greece

(percentage changes over same month of previous year)



1 Including corporate bonds in MFIs' portfolios, as well as securitised loans. Also taking into account write-offs of claims as from 2003 Q4, when relevant statistics were made available.
2 Including securitised loans. Also taking into account write-offs of claims as from 2003 Q4, when relevant statistics were made available.
Source: Bank of Greece.

During 2006 there was a continued increase in the issuance of corporate bonds, which were almost exclusively held by credit institutions. At the same time, credit institutions conducted further securitisations of liabilities stemming from housing loans and, for the first time, from loans to enterprises. As a result, the annual rate of change in total credit to enterprises and households is quite different from the rate of change in bank loans to enterprises and households. In particular, loans to enterprises and households, including securitised loans, increased by 18.4% in the fourth quarter of 2006, i.e. they accelerated compared with the corresponding quarter of 2005 (16.8%, see Table VI.3).

In greater detail, notwithstanding the significant deceleration in the annual growth rate of loans in foreign currency in 2006 (21.8%, against 27.7% in 2005), this rate was higher than the corresponding rate of euro-denominated loans (14.2%), slightly increasing the share of these loans in total loans to 5.2%, from 4.9% at end-2005. However, developments in the balance of loans in foreign currency, when expressed in euro, also include the effect of foreign exchange valuation differences. In particular, the euro appreciated against major foreign currencies[5] in 2006, particularly against the US dollar, in which the bulk of foreign currency loans are denominated (December 2006: 75%). Loans in Swiss francs also had a significant contribution, as their outstanding balance increased substantially in the fourth quarter of 2006. Thus, the annual growth rate of loans in foreign cur-

5 Excluding the pound sterling, which appreciated against the euro between end-December 2005 and end-December 2006.

Table VI.3 Loans to domestic firms and households from domestic MFIs in Greece

	Outstanding balances on 31.12.06 (million euro)	Annual percentage changes									
		2002	2003	2004	2005	2006					2007
		Q4[1]	Q4[1]	Q4[1]	Q4[1]	Q1[1]	Q2[1]	Q3[1]	Q4[1]	December[2]	February[2]
A. Enterprises[3,4]	**79,523**	**11.4**	**11.0**	**8.6**	**6.4**	**8.8**	**10.6**	**10.4**	**11.1**	**11.6**	**11.7**
1. Agriculture	3,067	–14.0	3.3	7.8	–12.7	–6.6	1.7	4.0	9.0	3.8	3.3
2. Industry[5]	16,665	11.5	10.4	1.1	–0.6	0.9	4.1	5.1	5.7	5.8	4.4
3. Trade	21,616	7.8	4.0	12.7	6.6	3.3	2.4	2.0	5.4	8.3	11.0
4. Tourism	4,346	33.7	24.4	17.6	4.6	3.3	3.5	4.9	5.3	3.7	5.4
5. Shipping	6,718	5.5	2.3	3.0	34.4	34.2	22.1	18.4	12.0	8.6	7.6
6. Non-monetary financial institutions	2,909	72.5	–3.2	9.5	–29.7	–0.6	17.9	23.4	23.4	30.1	27.3
7. Other loans	24,203	14.3	26.5	11.7	15.7	20.8	24.6	22.7	21.5	21.0	20.2
B. Households[3]	**85,877**	**33.1**	**28.6**	**30.0**	**30.3**	**31.2**	**30.0**	**28.7**	**26.2**	**24.7**	**23.6**
1. Housing loans	57,145	35.4	27.7	26.9	31.3	33.6	32.6	31.3	28.0	25.8	25.2
2. Consumer loans	26,597	27.4	24.8	37.9	29.9	27.9	25.9	23.8	22.4	21.9	19.9
– Credit cards	8,716	37.1	27.8	23.4	12.4	8.0	4.2	3.6	4.6	3.2	3.6
– Other consumer[6] loans	17,881	19.2	21.8	53.1	44.5	43.9	42.2	37.9	33.9	33.6	29.5
3. Other loans	2,135	62.6	135.7	18.8	11.5	14.2	16.7	27.0	29.9	29.5	27.0
Total	**165,400**	**18.3**	**17.3**	**17.0**	**16.8**	**18.9**	**19.5**	**19.0**	**18.4**	**18.0**	**17.6**

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 "Euro area statistics" section of the ECB *Monthly Bulletin*).
2 Annual rate of change at the end of the month.
3 Excluding loan write-offs (taken into account since the fourth quarter of 2003 in Table VI.2) but including securitised loan balances.
4 Excluding corporate bonds held in MFI portfolios. For the growth rates counting in these items, see Table VI.2.
5 Comprising manufacturing and mining/quarrying.
6 Comprising personal loans and loans against supporting documents.
Source: Bank of Greece.

rency, as calculated on the basis of changes in the balance of these loans expressed in euro (December 2006: 21.8%), is significantly lower than the growth rate which does not include foreign exchange valuation differences (December 2006: 31.8%).

The growth rate of short-term loans (i.e. loans with an initial maturity of up to one year) accelerated in 2006 (fourth quarter 2006: 8.5%, fourth quarter 2005: 5.3%). In contrast, the annual growth rate of medium and long-term loans (i.e. loans with an initial maturity of more than one year) remained at high levels in 2006 (fourth quarter 2006: 20.7%, fourth quarter 2005: 21.8%), thus further increasing their share in total loans (December 2006: 64.9%, December 2005: 62.4%).

This was mostly due to the high growth rate of housing loans, most of which (December 2006: 98.3%) have an initial maturity of more than five years. A large share of consumer loans (December 2006: 48.5%) is loans with a maturity of up to one year, including loans through credit cards and open loans, which are classified as short-term loans. As regards corporations, despite the tendency to lengthen the average maturity of loans in the last few years, short-term loans still account for the bulk of total loans (December 2006: 53.4%), as almost one third of bank loans to enterprises are credit lines.

Bank credit to enterprises

As mentioned above, the growth rate of credit to enterprises sped up considerably in 2006. To a large extent, this development is associated with an increase in business investment during the year, as well as improved business expectations, also recorded in IOBE conjunctural surveys. This development was largely attributable to bank holdings of new corporate bond issues, which represented 34.4% of total net funds granted by banks to enterprises in 2006. As already noted in previous annual reports, this is a widely used practice mostly due to the tax advantages bonds offer as a fund raising mechanism vis-à-vis common bank loans.[6] In particular, the value of corporate bonds held by MFIs grew by 56.5%[7] in the fourth quarter of 2006 (fourth quarter 2005: 81.8%), and they accounted for 15.0% of total MFI credit to enterprises at the end of the year (December 2005: 12.0%). A remarkable development concerning bank lending to enterprises was the first ever securitisation of receivables stemming from loans to small enterprises (to the amount of €2,873 million) by a Greek credit institution, which took place in November 2006.

The breakdown of lending to enterprises by sector of economic activity shows that the rate of change in loans[8] to most sectors accelerated, except trade and shipping, where a deceleration was observed (see Table VI.3 and Chart VI.4).

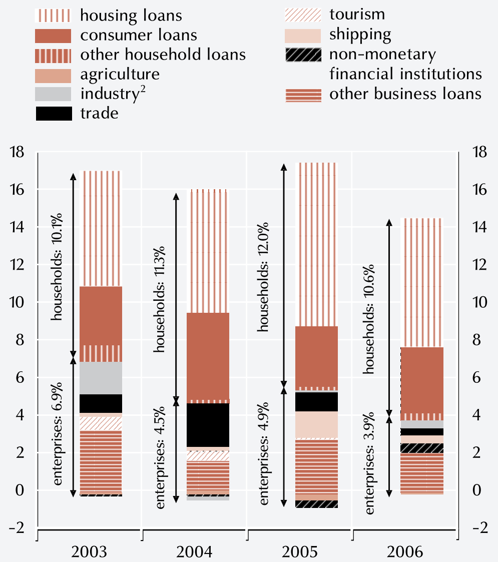
6 Corporate bond issuance is exempt from the contribution under Law 128/1975, which is levied on bank loans.
7 When assessing the exceptionally high rates of change in the value of corporate bonds held by MFIs, account should be taken of the fact that up to the fourth quarter of 2003 the relevant amounts had been very low. Increased corporate bond issuance activity is essentially due to the enactment in June 2003 of Law 3156/2003, establishing the new institutional framework of corporate bond issuance, according to which, among other things, corporate bonds are exempt from contributions under Law 128/1975. For details on corporate bond issuance, see Bank of Greece, *Monetary Policy 2004-2005,* Appendix to Chapter IV, February 2005.
8 Corporate financing concerns the total (irrespective of the size of the borrowing firm). As regards financing to small and medium-sized enterprises, see Box VI.1.

In particular, the annual rate of change in loans to agriculture accelerated substantially and even turned positive in the second quarter of 2006 (fourth quarter 2006: 9.0%, fourth quarter 2005: –12.7%), while it decelerated markedly in the first two months of 2007 (February 2007: 3.3%). One-off write-offs in agriculture continued in 2006.[9] Thus, when the amount of the specific write-offs is taken into account, the annual rate of change in credit to agriculture stood at higher levels in 2006 (fourth quarter 2006: 11.0%).

The annual rate of change in loans to industrial firms appears to be particularly low, even negative, since mid-2005. However, in the first quarter of 2006 it turned positive and accelerated further during the year (fourth quarter 2006: 5.7%, fourth quarter 2005: –0.6%), also remaining positive in the first two months of 2007 (February 2007: 4.4%). It should be noted, however, that this rate is heavily influenced by the substitution of bank loans with corporate bond issues, which is a widely used practise by enterprises in this sector. In particular, industrial firms issued 20.3% of corporate bonds held by MFIs in December 2006 (see Chart VI.5). Taking these bonds into account, the year-on-year growth rate of total MFI credit (loans, securitised loans and bonds) to industrial firms stood at 8.7% in the fourth quarter of 2006,[10]

Chart VI.4 Breakdown of credit expansion to enterprises and households

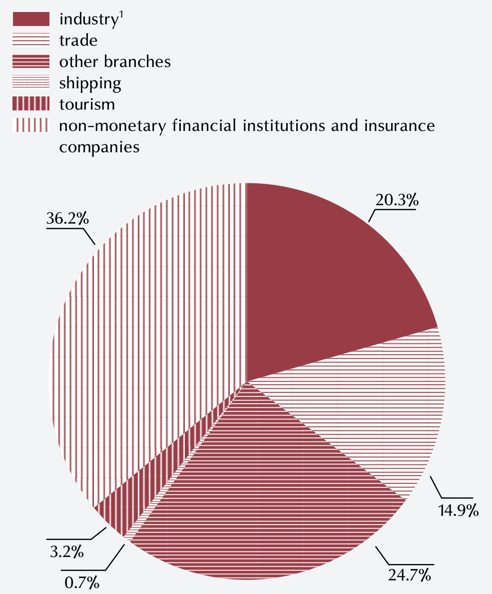
(percentage changes in outstanding balances[1])



1 Over the end of the previous year. Excluding corporate bonds held by MFIs and securitised loans.
2 Comprising manufacturing and mining-quarrying.
Source: Bank of Greece.

Chart VI.5 Breakdown of corporate bonds held by MFIs by branch of economic activity

(percentage shares, end-2006 data)



1 Comprising manufacturing and mining-quarrying.
Source: Bank of Greece.

9 In particular, pursuant to article 39 of Law 3259/2004, while, as regards other debtors, the total outstanding amount due should not exceed by more than three times the initial principal, in the case of agricultural loans the total outstanding amount due should not exceed by more than twice the initial principal.
10 Statistical information regarding MFI holdings of corporate bonds by sector is available since March 2005.

while enterprises in this sector accounted for 20.9% of total MFI credit to enterprises.

The growth rate of loans to trade firms, after recording a significant decline in the first three quarters of 2006, recovered in the fourth quarter of the year and stood at 5.4% (fourth quarter 2005: 6.6%), a trend that continued into the first two months of 2007 (February 2007: 11.0%). However, it should be noted that enterprises in this sector also substituted part of their bank loans with bonds, as they issued 14.9% of corporate bonds held by MFIs in December 2006. Taking these bonds into account, the annual growth rate of total MFI credit to trade firms stood at 9.1% in the fourth quarter of 2006. Moreover, trade firms still account for a very significant share of total credit to enterprises (25.3% in December 2006).

The annual growth rate of bank loans to shipping decelerated substantially during 2006, compared with the exceptionally high growth rates recorded in 2005 (fourth quarter 2006: 12.0%, fourth quarter 2005: 34.4%). This trend continued into the first two months of 2007 (February 2007: 7.6%). To a large extent, this development reflected the appreciation of the euro against the US dollar in 2006,[11] as almost 80% of loans to shipping are granted in dollars. Not taking into account the effects of this foreign exchange valuation difference on balances of loans granted in euro, the rate of credit expansion to shipping decelerated less than in the fourth quarter of 2005 (fourth quarter 2006: 18.9%, fourth quarter 2005: 26.0%), i.e. it remained relatively high, a fact which is associated with the increased investment activity of shipping companies in 2006.

The rate of change in loans to non-bank financial corporations recorded significant developments, as it turned positive and stood at 23.4% in the fourth quarter of 2006 (fourth quarter 2005: –29.7%), accelerating further to 27.3% in February 2007. It should be noted that bank subsidiaries, mostly leasing companies, which constitute the bulk of this sector, issued bonds which were almost fully absorbed by their parent banks. In particular, enterprises in this sector issued 36.2% of total bonds held by MFIs in December 2006. The annual growth rate of total MFI lending, i.e. loans and bonds, to non-bank financial corporations rose noticeably to 34.7% in the fourth quarter of 2006, against 11.7% in the corresponding quarter of 2005.

After the exceptionally high investment activity associated with the Olympic Games of 2004, loans to tourist enterprises diminished during 2005 and the first half of 2006. The corresponding annual rate of change recovered slightly in the last two quarters, accelerating to 5.3% in the fourth, quarter of 2006 (fourth quarter 2005: 4.6%), and remained almost unchanged in February 2007 (5.4%). The growth rate of loans to "other" sectors accelerated considerably in 2006 (fourth quarter 2006: 21.5%, fourth quarter 2005: 15.7%) and stood at 20.2% in February 2007. Most of these loans concern construction companies, which, after the decline recorded following the intense investment activity until the Olympic Games of 2004, show a reviewed dynamism, reflected in improved estimates regarding the development of their business activity. Moreover, communications and transport compa-

11 From end-December 2005 to end-December 2006, the euro appreciated by 11.6% against the US dollar.

Box VI.1

FINANCING OPTIONS FOR SMEs AND START-UPS

1. Introduction

It is widely recognised that small and medium-sized enterprises (SMEs)[1] make a substantial contribution to economic growth, employment and decentralisation. In Greece, SMEs play a pivotal role in the economy, accounting for around 83% of total value added, 85% of total workforce and 99.9% of the total number of enterprises.[2] However, as has repeatedly been pointed out,[3] the development of SMEs in Greece is hampered by the same constraints that have been identified for most other countries as well, including in particular the access of SMEs to external financing.[4] With a view to addressing this problem, concrete policy measures have been taken in the last few years, such as the recent amendments to the Development Law[5] or the utilisation of resources available under the CSF through the operational programme "Competitiveness".

2. Entrepreneurship in Greece and its constraints

Sufficient financing is a prerequisite for any type of entrepreneurship. Start-ups or young enterprises, in particular, have limited ability to finance their investment plans internally through retained earnings. It is therefore necessary for them to have access to external sources of financing.

In Greece, despite an improvement in entrepreneurship seen over recent years,[6] SMEs continue to face increased funding requirements[7] and difficulties in their efforts to tap external sources of financing: one out of four owners of small enterprises state that their investment plans are underfunded. This represents the third largest proportion among the EU-15 countries.[8]

1 In 2003 the European Commission adopted a new definition for micro, small and medium-sized enterprises. Thus, a micro-enterprise is an enterprise with 0-10 occupied persons and annual turnover or annual balance sheet of up to €2 million; a small enterprise is an enterprise which employs 10-49 persons and whose annual turnover or annual balance sheet does not exceed €10 million; and a medium-sized enterprise is an enterprise that employs 50-249 persons and has an annual turnover of up to €50 million and an annual balance sheet of up to €43 million.
2 The corresponding rates for the EU-15 are around 50%, 70% and 99%, respectively. For further information, see "SMEs in Europe 2003", *Observatory of European SMEs 2003/No. 7*, European Commission, 2003.
3 See IOBE (Foundation for Economic and Industrial Research), *Entrepreneurship in Greece, 2003, 2004-2005, 2005-2006*. These surveys are conducted in the context of the Global Entrepreneurship Monitor (GEM) international survey.
4 This phenomenon is observed in all SMEs throughout the world. See "The SME Financing Gap: Theory and Evidence", OECD, 2006.
5 Law 3299/2004 ("Private investment incentives for economic development and regional convergence") was amended by article 37 of Law 3522/2006.
6 In this respect, the most recent (end-2005) data suggest that the necessity entrepreneurship rate, i.e. the percentage of people who start a business because they have no better employment options, fell for the second consecutive year (2005: 14.2%, 2004: 28%, 2003: 40%). See footnote 3.
7 The investment required on average for starting a business in Greece is almost double the corresponding average for the countries (predominantly developed economies) covered by the GEM survey. For further details, see Bygrave, W.D. and S.A. Hunt (2005), "Global Entrepreneurship Monitor: 2004 Financing Report".
8 See "SME Access to Finance", *Flash Eurobarometer 174*, European Commission, October 2005.

On the other hand, the vast majority (85%) of owners of small enterprises in Greece, the highest in the EU-15, believe that their access to bank financing has improved in the last few years. However, one third of these enterprises had not received a loan of any type from a bank, and almost 40% had never resorted to bank lending, even though they could have done so.[9] Thus, business plans in Greece are primarily financed by the entrepreneur's own resources and/or funds coming from "informal investors", i.e. persons who do not acquire a share of the enterprise (friends, family etc.), while bank lending and state support schemes account for only a small part of total external financing. Turning to a breakdown of SME financing needs, more than 80% of their bank financing is channelled into short-term working capital and, to a lesser degree, small-scale investment projects.[10] This implies that these enterprises mostly seek to maintain their production levels rather than expand their activity.

3. Measures to foster the financing of SMEs

In order to deal with the aforementioned difficulties in SME financing, the government, in addition to its effort to motivate commercial and cooperative banks and venture capital companies,[11] has from time to time established mechanisms to promote SME financing, including incentives under the various development laws and the operational programme "Competitiveness".

3.1 Amendments to the Development Law

Article 37 of Law 3522/2006, passed by the Greek Parliament in late 2006 with effect from 1 January 2007, amended Development Law 3299/2004 with a view to fostering entrepreneurship in general and SMEs in particular. To this end, the new provisions increase the amounts of cash grants and simplify procedures for the implementation of investment plans.[12] With specific regard to SMEs, the regional aid ceiling (40% of investment expenditure) is raised by up to 10 and 20 percentage points (for medium and small enterprises, respectively), thus increasing the maximum aid awarded to 60% of the projected investment expenditure (from 55%). Naturally, maximum aid applies to small enterprises in areas of Greece with low per capita GDP and high unemployment rates. Apart from the main aid, small enterprises can receive grants up to a total of €1-2 million for the first five years of their operation, depending on the location and type of the enterprise. Additionally, the acquisition of land also qualifies for aid (up to 10% of the investment cost), as long as it refers to building plots that are necessary for the materialisation of the investment plan. Finally, in order to help enterprises (irrespective of size) deal with potential cash flow difficulties faced at commencement of the investment project implementation, up to 50% of the total grant will be awarded in advance (against a 30% formerly applying), subject to the enterprise providing a letter of guarantee in the same amount, increased by 10%, issued by a bank established and legally operating in Greece.

9 See "SMEs and Access to Finance", *Observatory of European SMEs 2003/No. 2*, European Commission, 2003.
10 See IOBE, ibid.
11 Venture capital companies invest in the equity of an enterprise, usually also providing consultancy services, with the aim to sell their stake at a higher price to potential investors.
12 The implementation of an investment project can start as soon as the expenditure is approved by the review committee, which is required to have reached an assessment within five (5) working days.

3.2 Operational Programme "Competitiveness"

The Greek Ministry of Development has designed the Operational Programme "Competitiveness" (OPC) with a view to improving the competitiveness of the Greek economy and to promoting the country's social and economic convergence with the other Member States of the European Union.[13] The strategic objectives ("Axes") of the OPC include (i) support to entrepreneurship in such areas as new technologies, the deregulated energy market, environment and tourism; (ii) promoting entrepreneurship among specific population groups, such as young people, women and disabled individuals; and (iii) funding actions for business modernisation, particularly regarding SMEs in processing-manufacturing, tourism and the services sector.

OPC Axis 2 ("Support and encouragement for entrepreneurship") is very important for the development and funding of SMEs; it includes Measure 2.6 ("Support to SME credit providers") and Measure 2.10 ("Establishment and operation of the Credit Guarantee Fund for Small and Very Small Enterprises – TEMPME SA). Both these measures contribute substantially to improving SMEs access to financing sources.

3.2.1 Venture capital

Under the OPC, the New Economy Development Fund S.A. (TANEO) was established,[14] with the purpose of providing venture capital to new businesses that are involved in the New Economy (information technology, biotechnology, microelectronics, e-commerce etc.) or whose development is based on innovation. By end-2005, TANEO's assets under management stood at €150 million, of which €45 million came from the Greek government and the remainder from other investors. Another initiative in the same direction was the establishment[15] of the High Technology Venture Capital Fund (KESYT). Its aim is to invest €100 million in order to foster innovative initiatives in the area of telecommunications and information technology.

In the last few years, the role of venture capital in the financing of Greek enterprises has increased, with Greece ranking tenth among EU-15 countries at end-2005 in terms of the ratio of venture capital investment to GDP, up from the last position it held at end-2004 (see Chart A). Despite this significant improvement, the Greek venture capital market is still underdeveloped, since the aforementioned ratio, at 0.2%, remains well below the EU-15 average of 0.4%.

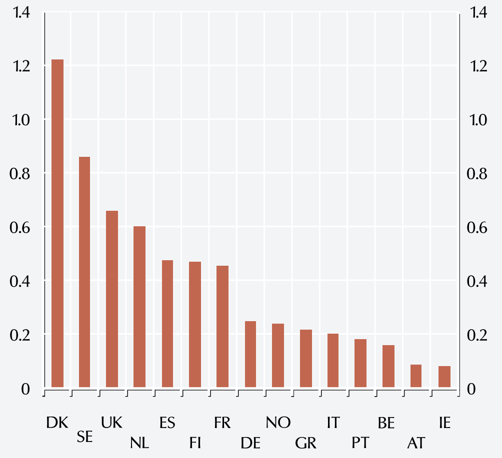
3.2.2 Credit Guarantee Fund for Small and Very Small Enterprises (TEMPME)

An important step towards facilitating the financing of viable investment plans of SMEs was the establishment of the Credit Guarantee Fund for Small and Very Small Enterprises (TEMPME), which is sub-

13 The OPC includes 9 priority axes with 42 measures, which are, in turn, divided into specific actions that implement the corresponding policies in the intervention areas of the programme. These actions are co-financed by the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Greek government and Greek private enterprises.
14 Law 2843/2000.
15 Law 2919/2001.

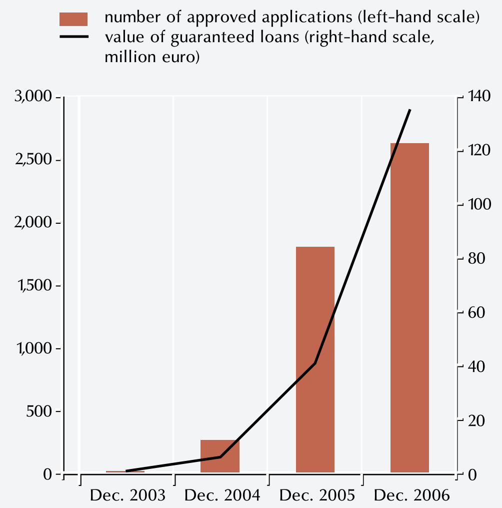
Chart A Ratio of venture capital investment to GDP

(percentages)



Source: *European Private Equity and Venture Capital Association*, Thomson Financial, PriceWaterhouse Coopers.

Chart B Volume and value of TEMPME guarantees



Source: TEMPME.

ject to prudential supervision of credit risk by the Bank of Greece.[16] The mission of TEMPME is to support sound and viable Small and Very Small Enterprises, of all sectors and branches of the economy and in any stage of their development (startups, enterprises already operating or being set up), by providing guarantees for them, thus facilitating their access to the credit system. The amount of the guarantee ranges from 45% to 70% (in exceptional circumstances, 80%) of the approved loan amount.[17] Since the late 2004, when its operation effectively began, TEMPME's approved guarantees have increased significantly in terms of volume and value (see Chart B).[18]

At end-2005, three fifths of TEMPME's outstanding guarantees involved relatively small amounts (of up to €25,000 euro), while over 90% of the volume of guarantees had been provided to enterprises employing up to nine persons (a sectoral breakdown is not available). The largest part of the volume of guarantees concerned small loans to very small enterprises (TEMPME Programme 4), while in terms of value, the highest share concerned support to enterprises under establishment, startups or enterprises less than three years old (TEMPME Programme 1). Finally, guarantees predominantly concerned loans to cover short-term financing needs. The greater importance of short-term financing relative to long-term financing applies to all Greek enterprises.[19]

16 The operation of TEMPME is governed by the provisions of its founding Law 3066/2002, as well as by Law 2190/1920, given that the Fund has the legal form of a société anonyme.
17 The amount of these loans can range between €10,000 and €400,000.
18 TEMPME guarantees are structured around six programmes: (i) Guarantee funds for the establishment or the development of new small enterprises, (ii) Guarantee funds for very small enterprises, (iii) Guarantee funds for small enterprises, (iv) Micro-loans guarantee funds for very small enterprises, (v) Guarantee funds for mergers, acquisitions or transfers of small enterprises, (vi) Guarantee funds for leasing operations of small and very small enterprises.
19 See P. Athanasoglou, I. Asimakopoulos and C. Siriopoulos, "External financing, growth and capital structure of the firms listed on the Athens Exchange", Bank of Greece, *Economic Bulletin*, No. 26, January 2006.

When evaluating guarantee applications, TEMPME uses similar criteria to those applied by credit institutions for assessing the creditworthiness of potential borrowers. These criteria are designed to ensure the fulfilment of adequate credit standards in order to contain risks to levels that are considered as acceptable for a credit guarantee scheme.

3.2.3 Credit guarantee fund and interest rate subsidies

The provision of guarantees is very helpful for SMEs, as it enables them to tap sources of financing that would have otherwise been out of their reach. In line with the objective of alleviating SMEs' borrowing costs, a joint decision of the Ministry of Finance and the Ministry of Development entrusted TEMPME with the management and implementation of OPC Action 2.10.2 "Subsidy of Financing Cost of Small and Very Small Enterprises". In this context, SMEs may apply for a subsidy equal to four percentage points of the nominal interest rate applying on their loan agreement or, in the case of leasing contracts, 10% of the value of the asset leased concerned.[20]

Importantly, the subsidy scheme is aimed to promote the development of SMEs, as eligible loans are only those intended for investment purposes, while working capital loans are excluded. Among leasing contracts, eligible are only those that include an option to purchase and concern equipment and machinery, commercial buildings (land is excluded) and commercial vehicles.

Eligible for being included in this Action are existing enterprises, startups, as well as enterprises being set up, in all sectors of the economy (except those excluded under Commission Regulation (EC) 69/2001), if they fulfil all of the following criteria: (i) they are located within the territory of Greece; (ii) they employ up to 20 persons;[21] (iii) their annual turnover is up to €1 million euro; (iv) they enter into a loan agreement (or a leasing contract) covered by a guarantee from TEMPME, according to the applicable TEMPME regulations; and (v) at the time when the application is submitted and reviewed, the applicant enterprise has not been subject to sanctions for any violation of Community regulations or Greek legislation.

20 Of the total cost of this action, budgeted at €20 million, 67% will be financed by the European Union through the European Regional Development Fund (ERDF), and 33% by the Greek government. The deadline for concluding the action and subsidy payment is 31 December 2008.
21 The number of employees is expressed in annual labour units (ALU), namely the number of persons employed full time (or full-time equivalents) during a given year, at or for the enterprise under review.

nies (excluding shipping) make now a considerable contribution to the faster credit expansion to tourist enterprises.

Bank credit to households

The annual growth rate of MFI credit to households remained high during 2006, despite the general downward course it had followed[12] during the year. In particular, the growth rates of housing and consumer loans decelerated, while the growth rate of other loans to households accelerated. Given that

12 Characteristically, despite the deceleration of credit expansion to households, the net increase in bank loans to households was higher (2006: €16,983 million, 2005: €16,333 million).

the growth rate of loans to households remained at levels greatly exceeding the nominal GDP growth rate, total household indebtedness (MFI loans, including securitised loans) rose to 44.0% of GDP at end-2006, against 38.0% in 2005. Excluding securitised loans, this percentage fell to 41.1% in December 2006 (December 2005: 36.3%), which is lower than the corresponding percentage in the euro area (December 2006: 54.3%, December 2005: 52.4%), though the difference is gradually diminishing. However, no safe conclusions can be drawn about the total indebtedness of households based only on this comparison, as securitised loans, which account for part of household indebtedness, represent a different percentage of GDP in Greece,[13] compared with the euro area.[14]

In greater detail, the effect on the growth rate of housing loans of the announcement that VAT would be imposed on new residential buildings and that the objective values of real property would be readjusted as of January 2006 wore off and since the third quarter of 2006 this growth rate decelerated. Thus, the annual growth rate of housing loans (including securitised loans, see Table V1.2) fell, particularly towards the end of 2006, to stand at 28.0% in the fourth quarter of the year, from 31.5% in the corresponding quarter of 2005. This trend continued into the first two months of 2007 (February 2007: 25.2%). Due to the high growth rate of housing loans, their outstanding balance (including securitised loans) as a percentage of GDP rose to 29.3% in December 2006, from 25.1% in December 2005. Moreover, credit institutions conducted securitisations of housing loans amounting to €2,422 million in 2006. Excluding securitised loans, the outstanding balance of housing loans as a percentage of GDP stood at 26.9% in December 2006 (December 2005: 23.9%), i.e. still lower than the corresponding percentage in the euro area (December 2006: 38.4%, December 2005: 36.4%). The upward trend of monetary policy rates has also had a remarkable effect on households' choices concerning the duration of the initial rate fixation for housing loans. Thus, in December 2006, 51% of the housing loans granted had an initial rate fixation of more than a year,[15] while the corresponding rate in 2005 was merely 11% on average.[16]

The deceleration of the growth rate of consumer loans that started in 2005 continued into 2006. Thus, this growth rate stood at 23.7% in the fourth quarter of the year (fourth quarter 2005: 30.4%), a development also recorded in the first two months of 2007 (February 2007: 21.9%, see Table VI.2). This falling trend in 2006 is associated with the fact that the consumer credit market has matured as household indebtedness in Greece is gradually approaching the corresponding measure in the euro area, where the growth rate of consumer loans is significantly lower (December 2006: 7.8%). However, despite the deceler-

13 Securitised loans are no longer included in the receivables of the credit institution, as they are transferred to a Special Purpose Vehicle (SPV), through which the securitisation takes place (see *Monetary Policy 2004-2005*, Appendix to Chapter IV, February 2005). However, they are still part of households' indebtedness.

14 Securitisation of receivables is a relatively recent development in Greece (the first securitisation of receivables by Greek credit institutions took place in November 2003), though it was previously used in the euro area. However, no statistical information about the outstanding balance of securitised loans in the euro area is available (see ECB, *Monthly Bulletin,* Box 1, September 2005).

15 The corresponding percentage for the euro area as a whole in December 2006 was 53%.

16 Among loans with an initial rate fixation of more than a year, households mostly prefer loans with an initial rate fixation of one and up to five years (December 2006: 41.7% of total new housing loans).

ation, the growth rate of consumer loans is still very high, due to the dynamic evolution of "other" consumer loans (personal loans and loans against supporting documents) (fourth quarter 2006: 33.9%, fourth quarter 2005: 44.5%, see Table VI.3). In contrast, loans through credit cards (including securitised loans), which formed the major category of consumer loans in the past, increased only slightly, thus causing their rate of change to fall further in 2006 (fourth quarter 2006: 4.6%, fourth quarter 2005: 12.4%). The difference observed between developments in those two categories of consumer loans is due to the substitution of borrowing through credit cards with personal loans, which bear lower interest rates. This development shows that households manage their liabilities in a more rational way. Thus, the share of loans through credit cards in total consumer loans fell to 33% (including securitised liabilities) in December 2006, from 39% in December 2005.

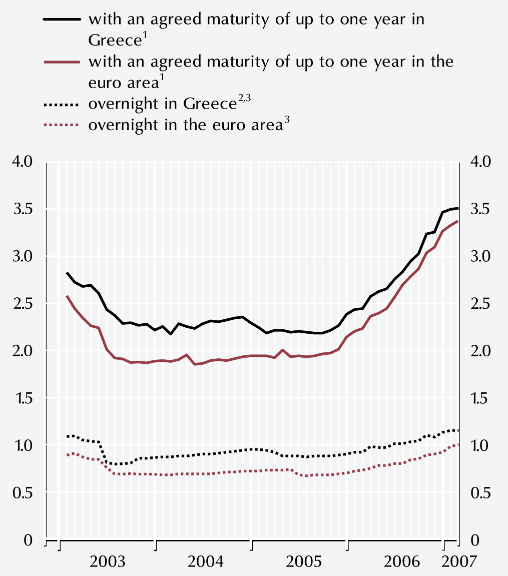
Finally, the growth rate of other loans[17] to households recorded a significant pick-up in 2006 and stood at 29.9% in the fourth quarter of the year (fourth quarter 2005: 11.5%). However, the share of these loans in total loans to households is still very small (December 2006: 2.7%, December 2005: 2.5%), although in the first two months of 2007 the growth rate of other loans to households fell even lower (February 2007: 27.0%).

3 BANK RATES

Bank interest rates moved upwards during 2006 in all deposit categories and in most loan categories, as they were influenced by the gradual increase in key ECB interest rates, which began in December 2005.

Chart VI.6 Bank interest rates on new deposits by households in Greece and 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 identical to the overnight rate.
3 End-of-month rate.
Sources: Bank of Greece and ECB.

In particular, as regards new deposits by households, the interest rate on deposits with an agreed maturity of up to one year[18] recorded the strongest increase (108 basis points, December 2006: 3.47%), while the rise in the interest rate on deposits with a high degree of liquidity, such as overnight deposits, was much smaller (23 basis points) (see Chart VI.6). The interest rate on savings deposits[19] increased almost equally (by 21 basis points) and stood at 1.09% in December 2006. In the January-February period this

17 Including loans to private non-profit institutions, private loans for the purchase of stocks, loans to pay taxes and insurance liabilities, overdrafts from current accounts, etc.
18 They represent the largest category of deposits with an agreed maturity, as well as a significant share in total deposits by households, as mentioned in Section VI.1.
19 Savings deposits made up 90% of overnight deposits by households in 2006.

Table VI.4A Bank interest rates on new deposits by households in the euro area and Greece

(percentages per annum)

	December 2005	February 2007	Change Feb. 2007/ Dec. 2005 (in percentage points)
Overnight[1]			
Weighted average interest rate in the euro area	0.71	1.01	0.30
Maximum interest rate	1.20	2.24	1.04
Minimum interest rate	0.15	0.17	0.02
Interest rate in Greece	0.91	1.16	0.25
Interest rate differential between Greece and the euro area	0.20	0.15	-0.05
With an agreed maturity of up to one year[2]			
Weighted average interest rate in the euro area	2.15	3.37	1.22
Maximum interest rate	2.48	3.67	1.19
Minimum interest rate	1.57	2.39	0.82
Interest rate in Greece	2.39	3.51	1.12
Interest rate differential between Greece and the euro area	0.24	0.14	-0.10

1 End-of-month rate.
2 Monthly average rate.
Sources: ECB and euro area NCBs.

Table VI.4B Bank interest rates on new deposits by households in euro area countries[1]

	Overnight[2]		With an agreed maturity of up to one year[3]	
	December 2005	February 2007	December 2005	February 2007
Austria	1.00	1.59	2.19	3.37
Belgium	1.01	1.23	2.02	3.49
France	0.16	0.23	2.27	3.45
Germany	1.20	1.61	2.06	3.33
Greece	**0.91**	**1.16**	**2.39**	**3.51**
Ireland	0.57	1.05	1.96[4]	3.36[4]
Spain	0.41	0.58	2.30	3.38
Italy	0.64	1.00	1.57	2.39
Luxembourg	1.19	2.24	2.09	3.21
Netherlands	0.48	0.67	2.48	3.54
Portugal	0.15	0.17	1.98	3.21
Slovenia	. . .[5]	0.33	. . .[5]	2.91
Finland	0.44	0.79	2.34	3.67

1 Despite the efforts to harmonise the methodology for compiling euro area statistics, interest rate grouping has not eliminated product heterogeneity in each interest rate category, which reflects in part differences in national conventions and practices (e.g. the bulk —76%— of deposits in Greece between January 2003 and May 2006 concerns overnight deposits, which are renumerated at a relatively low interest rate; see ECB, "Differences in MFI interest rates across euro area countries", September 2006, Table 2), as well as national differences in regulatory and fiscal arrangements.
2 End-of-month rate.
3 Monthly average rate.
4 The interest rate concerns all time deposits irrespective of maturity.
5 No data available before December 2006.
Sources: ECB and euro area NCBs.

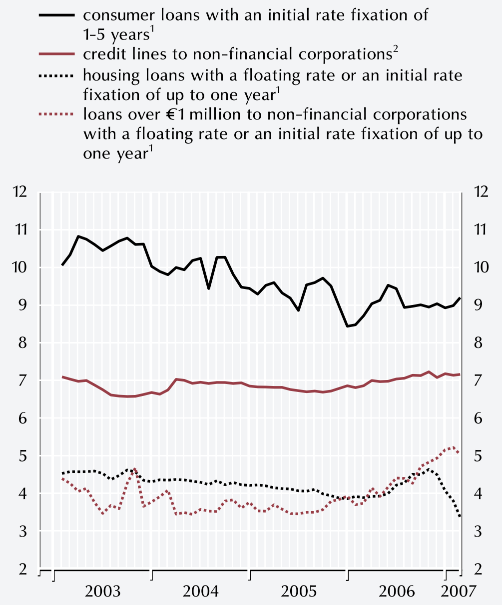
year, the interest rate on deposits with an agreed maturity of up to one year recorded a slight further rise, while the interest rate on savings deposits remained unchanged. The real interest rate on savings deposits (calculated on the basis of the corresponding year-on-year inflation rate) remained negative during 2006, although slightly smaller (–2.2%, against –2.7% in 2005). This development was due to the upward course of the nominal interest rate on savings deposits, as well as the slight drop in inflation towards the end of 2006. Repo rates also rose significantly (by 112 basis points) and stood at 3.30% in December 2006, recording a small further increase in the first two months of 2007.

The change in the interest rate on overnight deposits in the euro area followed a similar course. As a result, the positive differential between the Greek and the corresponding euro area rate remained at almost the same level in 2006 (22 basis points). The rise in the euro area interest rate was somewhat stronger for deposits with an agreed maturity of up to one year. Hence, the positive differential decreased slightly (December 2006: 20 basis points, December 2005: 24 basis points). In the first two months of 2007, the interest rate differential between Greece and the euro area dropped further in both deposit categories (see Table VI.4A and Table VI.4B). In contrast, the interest rate on new repos in the euro area increased further in 2006 and was higher than the corresponding Greek rate in December.

As regards lending rates, an increase was recorded in most loan categories, as mentioned above (see Chart VI.7), which was generally smaller than the increase in key ECB interest rates (a total of 125 basis points) in 2006. The average interest rate on loans to enterprises recorded the largest rise, which was more than triple that of the average interest rate on loans to households, as stronger competition between banks operating in Greece contributed to moderate increases, even decreases, in interest rates on certain consumer and housing loan categories.

Chart VI.7 Bank interest rates on new loans in Greece

(percentages per annum)



1 Monthly average rate.
2 End-of-month rate.
Source: Bank of Greece.

In particular, the average interest rate on total consumer loans with a defined maturity fell to 7.82% in December 2006, i.e. 44 basis points lower than in December 2005, which reflects the decrease (by 96 basis points) in interest rates on the major category of consumer loans (with a floating or fixed rate of up to one year). In contrast, the interest rate on this loan category in the euro area rose and was 74 basis points higher than the corresponding Greek rate in December 2006. However, the differential between the two rates narrowed in the first two months of 2007. The interest rate on loans without a defined maturity, which include loans through credit cards, increased (by 73 basis points) in 2006, while a smaller increase was recorded in the euro area. Thus, the differential between the

Chart VI.8 Bank interest rates on new loans: differential between Greece and the euro area

(percentage points)

consumer loans with a floating rate or an initial rate fixation of up to one year
consumer loans with an initial rate fixation of over one and up to 5 years
loans (up to €1 million) to non-financial corporations with a floating rate or an initial rate fixation of up to one year
housing loans with a floating rate or an initial rate fixation of up to one year

Sources: Bank of Greece and ECB.

two rates widened further in December 2006 (377 basis points). This is the largest interest rate differential among all loan categories. As noted before, interest rates on loans through credit cards are relatively high, reflecting the higher administrative costs and lower degree of security this loan category entails for banks (February 2007: 14.57%). The interest rate on consumer loans with an initial rate fixation of more than one and up to five years also followed an upward course, rising by 49 basis points. As the corresponding euro area rate fell, its differential vis-á-vis the Greek rate widened in December 2006 (to 285 basis points). In the January-February 2007 period, the interest rate differential between Greece and the euro area decreased in both the above categories of consumer loans.

As regards interest rates on housing loans, the rate on housing loans with an initial rate fixation of more than one and up to five years (a loan category for which borrowers show increasing preference) fell (by 55 basis points), as mentioned above.[20] Owing to this development, the interest rate on this housing loan category fell to a level lower than the corresponding euro area rate (December 2006: a differential of –21 basis points). During the January-February 2007 period, this differential narrowed slightly (see Table VI.5A and VI.5B). The differential had also been negative in December 2006 (–49 basis points) for the equally important category of housing loans with a floating rate or an initial rate fixation of up to one year, as the Greek rate increased less (by 21 basis points) than the euro area rate. In the first two months of 2007, this differential widened further (see Chart VI.8), as the interest rate in Greece kept falling and was the lowest rate in the euro area in February. Developments in interest rates on individual housing loan categories caused the average rate on total housing loans to rise further (by 35 basis points) and stand at 4.26% in December 2006. This rate dropped during the first two months of 2007 (February 2007: 4.09%).

As regards loans to non-financial corporations, the increase in the interest rate on loans without a defined maturity[21] was smaller in Greece

20 The significant reduction in interest rates on this housing loan category, as well as the insecurity felt by borrowers due to possible future rises in interest rates, caused a shift in the preferences of households from loans with a floating rate or an initial rate fixation of up to one year (which made up 90% of housing loans in 2005) towards this category. Its share in total new housing loans therefore reached 42% in the fourth quarter of 2006, from barely 4% in 2005.

21 Note that loans without a defined maturity are granted primarily through credit lines, which represent around one third of the outstanding balance of loans to enterprises.

Table VI.5A Bank interest rates on new loans in the euro area[1] and Greece

(percentages per annum)

	December 2005	February 2007	Change Feb. 2007/ Dec. 2005 (in percentage points)
A. Loans with a floating rate or an initial rate fixation of up to one year[1]			
A.1 Loans up to €1 million to non-financial corporations			
Weighted average interest rate in the euro area	3.99	5.21	1.22
Maximum interest rate	5.73	6.86	1.13
Minimum interest rate	3.53	4.75	1.22
Interest rate in Greece	5.41	6.36	0.95
Interest rate differential between Greece and the euro area	1.42	1.15	–0.27
A.2 Loans of more than €1 million to non-financial corporations			
Weighted average interest rate in the euro area	3.25	4.50	1.25
Maximum interest rate	4.22	5.50	1.28
Minimum interest rate	2.70	4.13	1.43
Interest rate in Greece	3.93	5.01	1.08
Interest rate differential between Greece and the euro area	0.68	0.51	-0.17
A.3 Housing loans			
Weighted average interest rate in the euro area	3.49	4.69	1.20
Maximum interest rate	4.44	6.06	1.62
Minimum interest rate	3.18	3.66	0.48
Interest rate in Greece	3.86	3.66	–0.20
Interest rate differential between Greece and the euro area	0.37	–1.03	–1.40
A.4 Consumer loans			
Weighted average interest rate in the euro area	6.76	7.67	0.91
Maximum interest rate	10.18	10.55	0.37
Minimum interest rate	3.69	4.88	1.19
Interest rate in Greece	7.78	7.53	–0.25
Interest rate differential between Greece and the euro area	1.02	–0.14	–1.16
B. Loans with an initial rate fixation of over one and up to 5 years[1]			
B.1 Housing loans			
Weighted average interest rate in the euro area	3.85	4.66	0.81
Maximum interest rate	7.13	7.63	0.50
Minimum interest rate	2.98	3.75	0.77
Interest rate in Greece	4.92	4.49	–0.43
Interest rate differential between Greece and the euro area	1.07	–0.17	–1.24
B.2 Consumer loans			
Weighted average interest rate in the euro area	6.36	6.87	0.51
Maximum interest rate	8.61	15.86	7.25
Minimum interest rate	4.26	5.27	1.01
Interest rate in Greece	8.44	9.02	0.58
Interest rate differential between Greece and the euro area	2.08	2.15	0.07

1 Monthly average rate.
Sources: ECB and euro area NCBs.

than in the euro area. The differential therefore fell to 155 basis points in December 2006 (from 188 basis points in December 2005) and decreased further in the first two months of 2007. In contrast, the interest rate on loans of more than €1 million recorded the largest increase (123 basis points), while the interest rate on loans of up to €1 million also rose, though the increase was smaller (89 basis points). As the corresponding euro area rates

Table VI.5B Bank interest rates on new loans in euro area countries[1]

	New loans with a floating rate or an initial rate fixation of up to one year[2]								New loans with an initial rate fixation of over one and up to five years[2]			
	To non-financial corporations											
	Loans up to €1 million		Loans over €1 million		Housing loans		Consumer loans		Housing loans		Consumer loans	
	Dec. 2005	Feb. 2007	Dec. 2005	Feb. 2007	Dec. 2005	Feb. 2007	Dec. 2005	Feb. 2007	Dec. 2005	Feb. 2007	Dec. 2005	Feb. 2007
Austria	3.66	4.75	3.13	4.40	3.99	4.98	4.95	6.15	2.98	3.75	4.26	5.78
Belgium	4.02	5.09	2.95	4.22	3.18	4.65	5.98	7.19	3.80	4.70	7.07	7.28
France	3.53	5.06	2.70	4.56	3.37	4.21	4.91	6.98	3.46	4.09	6.33	6.48
Germany	4.57	5.72	3.46	4.70	4.44	5.45	4.85	5.74	4.25	4.98	5.64	5.91
Greece	**5.41**	**6.36**	**3.93**	**5.01**	**3.86**	**3.66**	**7.78**	**7.53**	**4.92**	**4.49**	**8.44**	**9.02**
Ireland	4.52	5.87	4.22	5.50	3.47	4.59	4.96	6.13	...[4]	...[4]	...[4]	...[4]
Spain	3.69	5.00	3.12	4.54	3.29	4.75	8.13	9.18	3.59	5.00	7.57	8.61
Italy	4.07	5.17	3.25	4.13	3.60	4.93	10.18	10.55	3.28	4.55	7.87	8.16
Luxembourg	...[3]	5.13	...[3]	4.66	3.62	4.63	...[3]	...[3]	...[3]	...[3]	5.42	5.27
Netherlands	3.60	4.78	3.63	4.32	3.44	4.69	7.51	9.03	3.85	4.79	...[3]	...[3]
Portugal	5.73	6.86	3.93	4.85	3.50	4.45	8.02	7.87	...[4]	...[4]	8.61	15.86
Slovenia	...[5]	5.60	...[5]	4.62	...[5]	6.06	...[5]	6.78	...[5]	5.74	...[5]	7.53
Finland	3.74	4.95	3.19	4.55	3.25	4.40	3.95	5.26	3.48	4.68	4.52	5.42

1 Despite the efforts to harmonise the methodology for euro area statistics compilation, a considerable product heterogeneity continues to exist with respect to the characteristics and the relative weight of the various instruments in each interest rate category; this partly reflects differences in national conventions and practices, as well as national differences in regulatory and fiscal arrangements (e.g. see ECB, "Differences in MFI interest rates across euro area countries", September 2006, Table 2, which shows that the weight of consumer loans without defined maturity, which include credit cards, is much higher in Greece —53%— compared with the euro area average –15%).
2 Monthly average rate.
3 In these interest rate categories, the volume of loans is very small.
4 No data on the respective interest rates are published in these countries.
5 No data available before December 2006.
Sources: ECB and euro area NCBs.

Table VI.6 Average bank interest rates on loans and deposits in Greece[1]

(percentages per annum)

	Average lending rate	Average deposit rate	Interest rate spread (percentage points)
Dec. 1998	16.21	8.12	8.09
Dec. 1999	14.02	6.98	7.04
Dec. 2000	9.68	4.00	5.68
Dec. 2001	7.26	1.96	5.30
Dec. 2002	6.38	1.64	4.74
Dec. 2003	5.95	1.15	4.80
Dec. 2004	5.98	1.19	4.79
Dec. 2005	5.73	1.28	4.45
Dec. 2006	6.31	1.89	4.42
Jan. 2007	6.35	1.97	4.38
Feb. 2007	6.27	2.00	4.27

1 Since September 2002 banks submit new, more detailed interest rate series on the basis of the single methodology followed by all euro area countries. Interest rate data for the pre-2002 period have been adjusted and re-assessed in order to be comparable with the new data. It should also be noted that the average interest rate on deposits underestimates the cost of money, given that banks, in order to finance their rapid credit expansion, have to raise funds from the interbank market as well, at relatively high interest rates.
Source: Bank of Greece.

increased further, the deviation between Greek and euro area rates decreased during 2006, a development which was also recorded in January and February 2007, suggesting that the gradual convergence of interest rates applies to this loan category as well. The difference between interest rates on loans to small-size and large-size enterprises fell during the previous year in Greece (as in the euro area) and stood at 114 basis points in December (against 58 basis points in the euro area). This difference is larger in Greece, as small-size enterprises are faced with higher risks and, therefore, stricter bank credit criteria.

Big divergences between certain categories of Greek and the corresponding euro area interest rates relate to intrinsic characteristics of the domestic banking system and, to some extent, reflect different national practices (e.g. loans through credit cards account for a large share of consumer loans without a defined maturity in Greece, which is not the case in the euro area). For a detailed analysis of these factors, see Box VI.2.

The differential between the average weighted interest rate on new bank loans and the corresponding rate on new bank deposits, i.e. the interest rate spread, remained almost unchanged during 2006 (December: 4.42%), as the average interest rate on deposits and the average interest rate on loans rose equally in the period under review. In the first two months of 2007, this differential stood at a slightly lower level (February: 4.27%, see Table VI.6). Although the spread fell by a total of 367 basis points between December 1998 and December 2006, it is still higher than in the euro area (December 2006: 2.89%[22]), for reasons explained in Box VI.2.

22 According to Bank of Greece calculations. For corresponding ECB calculations, see "Differences in MFI interest rates across euro area countries", September 2006.

Box VI.2

BANK INTEREST RATE DIFFERENTIALS BETWEEN GREECE AND THE EURO AREA[1]

The Greek economy's nominal convergence process in view of the country's participation in Stage III of EMU, the deregulation of the banking system, and the conditions of monetary stability that Greece benefits from as a member of the euro area, have led to a significant decline of bank interest rates from the relatively high levels recorded in the mid-1990s. However, bank rates in Greece in general continue to stand above euro area averages, while the differential in the case of some banking products is considerable.[2] This box examines some factors that can help explain the differentials observed between Greek bank rates and the corresponding euro area averages.

The international literature (theoretical and empirical) has called attention to a large number of factors that affect the level of interest rates, as well as to the difference between the weighted average interest rate on the total of bank loans and the corresponding interest rate on the total of bank deposits, i.e. the interest rate spread. Among these factors, the competitive conditions prevailing in the banking market are considered to be a crucial parameter, since a potentially increased market power of banks would allow them to obtain higher yields by applying higher interest rate spreads. In this context, the Greek banking system's concentration level,[3] although higher than the euro area average, is significantly lower than in the countries with the highest concentration (Belgium, the Netherlands and Finland). Certainly, the competitive conditions prevailing in a banking market are not necessarily reflected fully in the concentration level that characterises it. Other, equally decisive parameters are the intensity of the threat of new entrants ('contestability') in the market and the availability of non-bank sources of financing and savings options (e.g. capital markets).

The bank intermediation process entails costs for credit institutions, which seek to cover these through —among other things— the interest rate spread. One of these costs is the operating cost, the level of which is expected to affect positively the interest rate spread. Despite its improvement in recent years, the Greek banking system is characterised by the highest operating costs as a percentage of total assets among euro area countries. To some extent, this fact is associated with the small size of the country's banking system, which does not allow banks in Greece to take full advantage of the scale economies that characterise the bank intermediation process.[4] Moreover, in Greece the average level of deposits and loans is relatively low, a fact that implies a larger number of bank transactions for a given level of deposits or loans, and thus leads to higher operating costs.

1 For a review of the relevant literature, as well as a more in depth analysis of the factors that can explain the observed bank interest rate differentials between Greece and the euro area, see S. N. Brissimis and Th. Vlassopoulos, "Determinants of bank interest rates and comparisons between Greece and the euro area", Bank of Greece, *Economic Bulletin,* No. 28, February 2007.

2 Deposit interest rates in Greece are among the highest in the euro area. As regards loan interest rates, the wider differentials appear in some categories of consumer loans, while considerably lower differentials are recorded in housing loans and large loans to enterprises.

3 The concentration level, measured here using the Herfindahl index, indicates the degree to which a small number of participants in a market has a large share in this market, and thus provides evidence of the prevailing competitive conditions.

4 Regardless of operating costs, the relatively small size of Greek banks entails a higher cost of financing from the international money and capital markets.

Bank intermediation also entails credit risk, i.e. the probability of some borrowers defaulting on their payment obligations to their creditors. To compensate for undertaking such risk, banks add to their lending rate a risk premium, the size of which increases proportionately to the credit risk thought to be involved. Credit risk in the Greek banking system, as measured by the percentage of non-performing loans,[5] is considerably higher than in the euro area. Specifically, according to the latest available data, non-performing loans in Greece in September 2006 corresponded to 6.0% of total loans (although this percentage differs across banks). In December 2005, the respective percentage for medium-sized banks in the EU was 2.9%.

An issue associated with credit risk and its effect on bank lending rates is the availability of information required for the assessment by credit institutions of the creditworthiness of prospective borrowers. Access to more complete information allows banks to assess more accurately the credit risk they undertake and price it more appropriately in each case. In Greece, despite the progress recorded in recent years with the initiatives taken by Tiresias SA, the availability of information regarding the financial behaviour of individuals and legal entities still faces considerable limitations (partly linked to questions related to the protection of personal data).

Another parameter associated with the effect of credit risk on bank rates is the percentage of the amount receivable that the bank will finally be able to collect in case a borrower does not repay his/her loan. This percentage is to a great extent related with the institutional framework governing the protection of creditors' rights in each country, as well as with the effectiveness of the judicial system as regards safeguarding these rights. According to the relevant index published by the World Bank,[6] among the euro area countries Greece and Italy are the ones with the weakest legal protection of creditors. At the same time, the Greek judicial system does not appear to be particularly effective in protecting creditors, since the process for enforcing the collateral in case of a borrower's default on his/her payment obligations is particularly protracted and as a rule exceeds two years. In the other euro area countries it takes less time (with the exception of Italy, where five years are usually needed).

The macroeconomic environment may also have an effect on the level of bank rates. Although the existence of a relationship between the interest rate spread and GDP growth has not yet been theoretically or empirically established beyond doubt, it is clear that bank rates are affected by the inflation rate. Specifically, according to the "Fisher effect", for a given real interest rate level the corresponding nominal interest rate will be higher the higher the inflation expected each time. In parallel, the existence of high inflation causes uncertainty, which exacerbates the information asymmetries existing between lenders and borrowers,[7] increasing the interest rate spread. Although the inflation rate in Greece remains higher than in the euro area (1.2 percentage points on average in the period 2001-2006), this differential is not wide enough to be exacerbating information asymmetries to such an extent as to contribute to a higher interest rate spread in Greece.

5 The percentage of non-performing loans refers to the portion of total loans for which borrowers have failed to meet regular payment obligations. Despite its imperfections as a measure of credit risk, this figure is used quite extensively.
6 See http://www.doingbusiness.org/ExploreTopics/GettingCredit/.
7 As a rule, borrowers have more complete information than their creditors regarding their real financial situation and economic prospects and, consequently, regarding their ability to repay their obligations to their creditors.

In addition to the aforementioned economic factors, Greek bank rate differentials over the corresponding euro area bank rates are also affected by technical factors, such as the statistical classification of the various banking products, as well as by differences in the established banking practices. The weighted average lending rate and the weighted average deposit rate —and by extension the interest rate spread— reflect, in addition to the level of interest rates on individual loan and deposit products, the composition of those two groups of products. In more detail, in Greece loans without a defined maturity weigh heavily in the total of consumer loans (December 2006: 44.6%) and they include loans through credit cards, which carry the highest interest rates. In deposits, overnight deposits have a high weight (December 2006: 56.6%) and they include savings deposits, which have a relatively low interest rate. The corresponding percentages in the euro area were considerably lower (13.9% and 44.8%, respectively).

Of course, the composition of loans and deposits does not reflect solely the choices made by bank customers, but is also affected by the availability of the various banking products. In any case, the institutional and regulatory framework governing the operation of the banking system (including tax regulations), as well as factors such as the level of awareness of the bank clientele and its consumer culture also affect the composition of loans and deposits. The effect on the interest rate spread of the different composition of loans and deposits in Greece compared with the euro area is quite significant, given that, if the composition per product that holds for the euro area were to be applied in Greece, the interest rate spread differential in February 2007 would be reduced from 130 to only 54 basis points.

Another determinant that must be taken into account when assessing bank interest rate differentials is that lending rates do not necessarily incorporate the total cost arising for borrowers from their borrowing relationship, since they are often also charged with non-interest fees and expenses, such as loan agreement file expenses. On the other hand, deposit rates do not reflect the total benefits depositors enjoy, since they are also offered a series of follow-on services, such as safekeeping, accounting, payment facilitation, etc. Therefore, bank interest rate differentials to some extent also reflect different pricing practices as regards the incorporation of cost elements in the respective interest rates. At the same time, bank interest rate differentials also reflect different government policies pursued in the euro area countries as regards e.g. the tax treatment of housing loan interest and the supply of a guarantee or interest rate subsidy on housing loans or loans to small and medium-sized enterprises.

In conclusion, the high operating costs that characterise the Greek banking system, the relatively high cost entailed by the credit risk undertaken by credit institutions in Greece, as well as technical factors such as the composition of loans and deposits per product, can explain a considerable part of the differences observed between Greece and the euro area in bank rates and the interest rate spread. However, the possibility that part of these differences may be reflecting the competitive conditions prevailing in the Greek banking system cannot be excluded.

An important determinant of this divergence is the different composition of both deposits and loans in Greece, compared with the euro area. Thus, had the composition of deposits and loans in Greece been the same as in the euro area, the interest rate spread in Greece would have fallen to 3.57% in December 2006 (i.e. it would have been 85 basis points lower) and the difference from that of the euro area would have dropped by more than half (to 68 basis points). Moreover, in 2006 the euro area spread widened by 33 basis points, as the increase in the average lending rate was larger than in the deposit rate, which suggests that Greek interest rates continue to converge towards the corresponding euro area rates.

Additional information on the evolution of bank interest rates and the total indebtedness of enterprises and households is provided by developments in the average interest rates applicable to outstanding balances of loans. The average rate on the outstanding balances of euro-denominated loans (including new loans as well as older ones), which affects the operating income of banks, increased (by 61 basis points) in 2006 and remained almost unchanged in the first two months of 2007. In particular, in 2006, the average interest rate on the outstanding balances of loans to enterprises recorded a stronger increase (86 basis points) than the corresponding rate on loans to households (31 basis points). The interest rate on the most important category of consumer loans (those with a maturity of up to one year) increased more than the interest rate on the most important category of housing loans (those with a maturity of over five years).

VII THE CAPITAL MARKETS

1 THE MARKET FOR GOVERNMENT PAPER

1.1 THE PRIMARY MARKET

The main drivers of developments in the primary market for government paper in 2006 were the decline in the government's net borrowing requirement (for the second consecutive year)[1], the reduced redemptions of securities[2] issued in previous years, the increase in key ECB rates as well as the less favourable conditions that prevailed in the Greek and international bond markets compared with last year. These factors led to a decrease in the value of government paper issued and an increase in corresponding rates[3] from the very low levels of 2005. It should be noted, however, that investors' demand for Greek government paper remained at high levels in 2006 and, compared with the supply of such paper, was among the highest in the euro area.

The nominal value of Greek government securities issued in 2006 fell drastically to €29.0 billion, from €38.1 billion in 2005 (see Table VII.1). These issues concerned mainly bonds (93.1%) with a maturity of 3 to 32 years (no 7-year, 15-year and 20-year bonds were issued), while Treasury bills issued (of 12, 26 and 52 weeks)[4] remained at relatively low levels and accounted for only 6.9% of the value of 2006 issues (see Table VII.1).

The bulk of new paper (76% of its total value) was issued during the first half of the year, due to the need to refinance debt maturing during that period, as well as to the government decision to issue highly liquid benchmark bonds at the beginning of each year, with a maturity of 3, 5 and 10 years.

Table VII.1 Breakdown of Greek government paper issues

(percentages)

Securities	2004	2005	2006
Treasury bills	**5.7**	**5.7**	**6.9**
Bonds	**94.3**	**94.3**	**93.1**
1-year	17.5	–	–
3-year	21.2	19.4	19.1
5-year	30.3	23.9	25.4
7-year	0.2	–	–
10-year	23.7	26.7	29.1
12-year	0.9	9.7	1.9
15-year	–	–	–
20-year	0.7	–	–
23-year	5.5	6.2	8.8
32-year	–	14.0	15.7
Total	**100.0 100.0**	**100.0 100.0**	**100.0 100.0**
Total value (million euro)	**43,361**	**38,117**	**28,955**

Note: By initial (not residual) maturity as regards the re-opening of past issues.
Source: Ministry of Economy and Finance.

Funds raised in the primary market concerned new issues and the reopening of past ones. More specifically, new 5- and 10-year benchmark bonds were issued through syndication, while the new 3-year bond was issued through auction. The liquidity of these issues was supported further with the reopening through auction, while the 32-year bond and the 23-year indexed bond[5] were reopened through syndication. Finally, Treasury bills were issued through auctions.[6]

1 See Chapter VIII.1.
2 In 2006 redemptions of Greek government paper dropped to €16 billion, compared with roughly €21 billion in 2005.
3 Such increases affect not only new paper issued at higher interest rates, but also approximately 20% of government debt, which has been issued at a floating rate.
4 43% of the total value of these issues had a maturity of 12 weeks.
5 This bond, which is indexed to the euro area HICP (except tobacco), has a coupon rate of 2.90% and matures on 25 July 2025. The total amount of the issues of this bond comes to €7.2 billion.
6 Furthermore, the Greek government carried out strategic issues through private placement in order to broaden its investment base.

The nominal value of bonds offered in 2006 reached €27.0 billion, from €35.9 billion in 2005 and €40.9 billion in 2004. Table VII.1 shows that, contrary to 2004, the largest part of the 2005 and 2006 issues (about 56% of the total) concerned long-term bonds (with a maturity of 10 years or more) and the rest concerned short and medium-term bonds (with a maturity of 3 and 5 years). This government decision is explained on account of the low long-term interest rates[7] and the high liquidity conditions prevailing in international bond markets in the past two years. Additionally, the marked flattening of the government bond yield curve[8] towards the end of the year created favourable conditions for the issue of long-term paper.[9] Following these developments, the average weighted maturity of all Greek government securities issued in the year under review was 10.47 years, i.e. almost the same as in 2005, and their average weighted interest rate rose to 3.72% (2005: 3.08%).

Investors' demand for Greek government paper in the primary market remained strong also in 2006. The weighted average coverage ratio came to 4.9 in 2006 and constitutes, as mentioned above, one of the highest in the euro area.[10]

1.2 THE SECONDARY MARKET

In 2006 the Electronic Secondary Securities Market (HDAT) was characterised by higher yields, especially for short- and medium-term paper, and the maintenance of a high level of transactions.

Government bond markets in the euro area demonstrate a high level of integration,[11] thus developments in Greek government bond yields reflect corresponding developments in the euro area. More specifically, after declining to historically low levels in September 2005, Greek government bond yields in HDAT demonstrated a gradual increase up to end-June 2006, when they came to the highest level for the past two years (see Chart VII.1). This development was the result, on the one hand, of optimistic estimates about economic activity in the euro area and, on the other hand, of stronger inflationary pressures mainly due to higher oil prices. Furthermore, the increase in key ECB interest rates during that period further affected short-term paper yields. However, during the second half of the year, yields on medium- and long-term government paper followed a downward course, amid expectations for a slowdown

7 Long-term interest rates had fallen to historically low levels in 2005 and, in 2006, despite their increase, they remained at low levels (see ECB, *Financial Stability Review*, June 2006 and December 2006). Due to this conjuncture, some countries (e.g. France, United Kingdom) issued 40-year and 50-year bonds, in order to secure, for a long period of time, low debt servicing costs.

8 For more details on the Greek government paper yield curve, see Section 1.2 of the present chapter.

9 The first Greek 50-year bond, amounting to €1 billion, was issued in early March 2007 through private placement. It is indexed to euro area HICP except tobacco, has a coupon rate of 2.085% and matures on 25 July 2057.

10 According to Ministry of Economy and Finance data, for most euro area countries this index ranged from 1.2 to 1.5 in 2006.

11 The introduction of the euro and the elimination of the foreign exchange risk has been a catalyst to the convergence of government bond yields in the euro area since 1999. These yields are mainly affected by factors that are common for all countries, although domestic factors (e.g. credit risk, liquidity) still play a role. The degree of integration in the bond market is estimated on the basis of the beta coefficient, which demonstrates the comovement of changes in the yields of the 10-year bond of each euro area country against the corresponding changes of the German 10-year bond. In the case of Greek bonds, their yields started converging towards the German ones after the introduction of the euro in 2001 and, as from mid-2003, the relevant index stands at levels over 0.95 (where 1 corresponds to full market integration). See also ECB, "Indicators of financial integration in the euro area", September 2006.

Chart VII.1 Yield on Greek 10-year government bond and yield differential from the corresponding German bond

Source: Bank of Greece.

in US economic activity,[12] lower inflationary pressures due to the decline in oil prices and lower risk premia[13] that are incorporated in long-term interest rates. The decrease in yields was more pronounced for long-term bonds, while yields on 12-month (52-week) and 3-year paper kept on rising, as the ECB moved to new increases in its key rates during that period. From mid-December 2006 to the first quarter of 2007, Greek government paper yields demonstrated a slight increase.

Despite the reversal of the upward course of yields in the second half of the year, volatility[14] in the bond market remained low in 2006. As was the case also in the euro area bond markets, it was slightly under the average of the past five years.

The yield on the 10-year Greek government bond rose to 4.19% at end-December 2006, i.e. it was 68 basis points higher than at end-2005 (see Chart VII.1). During 2006, the spread between its highest (4.42% on 27 June and 6 July) and its lowest yield (3.48% on 9 January) came to 94 basis points, slightly more than in 2005 (86 basis points). The yield differential between the Greek 10-year bond and the corresponding German bond widened considerably in the first half of 2006, a development which is largely attributable to the different maturity of those two benchmark bonds. In the following months however, it gradually narrowed and came to 27 basis points at end-2006, against 21 basis points in December 2005 (see Chart VII.1).[15]

On the basis of the above developments, the yield curve on Greek government paper at end-December 2006 had shifted upwards compared with end-December 2005. However, the part of the yield curve that corresponds to maturities from 12 months to 3 years was slightly negative, while the positive slope of the part corresponding to maturities of 3 years or more dropped markedly, as the yield differential between the 10-year and the 3-year bond decreased by 29 basis points compared with end-2005. The

12 Developments in the United States strongly affect international bond markets, most probably due to the weight of the US economy in the world economy. According to IMF data, the United States GDP corresponds to 38% of the total GDP of advanced economies.

13 In past years risk premia had dropped to very low levels. See also Bank of Greece, *Monetary Policy 2005-2006,* February 2006, Box II.1 and BIS, *Quarterly Review,* "International banking and financial market developments", September 2006.

14 Volatility in HDAT is measured by the standard deviation of the daily yield on the Greek 10-year benchmark yield.

15 On 18 January 2006, a new Greek benchmark bond was issued, maturing on 20 July 2016, i.e. 6.5 months after the corresponding German benchmark bond. Additionally, on 17 November 2006, a new German benchmark bond was issued, maturing in 4 January 2017. If these two bonds had the same maturity date, their yield differential would be 27 basis points at end-December 2006, compared with 25 basis points at end-December 2005.

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	12-year	15-year	20-year	23-year	32-year
2006	Jan.	2,615.5	0.3	3.3	7.8	0.3	68.3	0.1	8.5	4.2	0.0[4]	7.2
	Feb.	3,245.4	0.1	2.9	6.3	0.1	72.6	–	6.8	5.1	0.1	6.0
	March	2,927.3	0.2	5.0	6.4	–	72.1	0.2	4.8	4.9	0.0[4]	6.4
	Apr.	2,356.8	0.3	5.2	5.9	–	69.6	0.2	5.0	4.9	0.1	8.8
	May	2,322.7	0.5	3.9	8.3	–	70.8	0.0[3]	4.4	3.3	0.1	8.7
	June	2,367.7	0.4	5.1	7.5	–	74.6	0.0[3]	2.9	3.4	0.0[4]	6.1
	July	2,243.9	0.7	5.6	7.1	–	74.6	0.1	4.5	2.1	0.0[4]	5.3
	Aug.	1,953.7	0.0[2]	4.8	8.1	–	75.4	0.2	2.5	3.5	0.1	5.4
	Sept.	2,497.8	0.0[2]	6.6	7.0	–	72.5	0.1	2.9	1.8	0.1	9.0
	Oct.	2,392.8	0.3	5.0	5.8	–	75.0	0.2	3.7	3.9	0.0[4]	6.1
	Nov.	2,934.4	0.7	4.6	7.5	–	74.1	0.0[3]	2.9	3.2	0.0[4]	7.0
	Dec.	2,368.8	0.1	5.0	5.0	–	79.6	0.3	2.9	2.8	0.1	4.2
	Jan.-Dec.	2,518.9	0.3	4.7	6.9	0.0	73.2	0.1	4.4	3.6	0.1	6.7
2007	Jan.	2,923.3	0.1	4.2	7.7	–	72.4	0.8	1.0	4.8	0.0[4]	9.0
	Feb.	2,380.0	0.0[2]	4.4	8.1	–	72.6	0.3	1.5	4.1	0.1	8.9
	March	2,841.1	–	3.4	16.1	–	65.6	0.4	1.6	5.0	0.1	7.8

1 As per initial maturity.
2 The average daily value of transactions in Treasury bills amounted to €0.5 million in August 2006, €1.0 million in September 2006 and €0.3 million in February 2007.
3 The average daily value of transactions in 12-year bonds amounted to €0.2 million in May 2006, €0.7 million in June 2006 and €1.3 million in November 2006.
4 The average daily value of transactions in the 23-year bond amounted to €1.2 million in January 2006, €1.4 million in March 2006, €0.7 million in June 2006, €0.5 million in July 2006, €0.2 million in October 2006 and €0.7 million in November 2006.
Source: Bank of Greece.

flattening of the yield curve is connected, as mentioned above, with the increases in ECB key rates and ensuing expectations for further increases, as well as with investors' estimations for the control of inflation over the medium and the long term through the implementation of the appropriate monetary policy by the ECB.

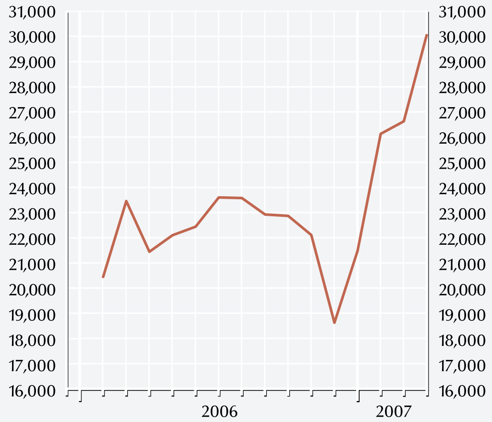
Transactions in the secondary market, despite their slight decline in 2006, stood at high levels. The average daily value of transactions in HDAT and the Book-Entry Securities System[16] of the Bank of Greece was €2.5 billion and €22.1 billion respectively in 2006, from €2.9 billion and €25.8 billion in 2005 (see Charts VII.2A and 2B).[17] Transactions in 10-year bonds absorbed 73% of the total value of transactions (2005: 59%, see Table VII.2). However, the share of other long-term paper (with maturities of 12 years or more) declined from 25%

16 Transactions in the Book-Entry Securities System include not only transactions in HDAT but also over-the-counter transactions between banks and their customers.
17 This decline is also connected with lower foreign investment in Greek government paper in 2006. According to balance of payments statistics data, the net inflow of capital from abroad for investment in such paper came to about €9 billion in 2006, against €21 billion in 2005. This is attributable to the less favourable conditions that prevailed in international bond markets in 2006 compared with 2005, as well as the favourable stock market conditions.

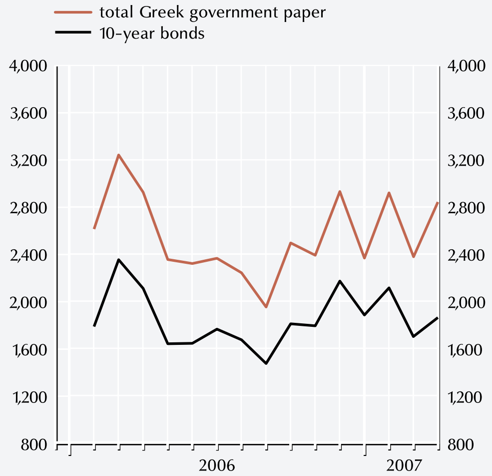
Chart VII.2 Average daily value of transactions

(million euro)

A. In the Book-entry Securities System (SAT)



B. In the Electronic Secondary Market for Securities (HDAT)



Source: Bank of Greece.

in 2005 to 15% in 2006. As a result, the average spread between bid and ask bond prices dropped to 7.4 basis points in December 2006 from 7.9 basis points in December 2005, since this spread is wider for long-term than for short- and medium-term bonds. In the first quarter of 2007, the average daily value of transactions in both HDAT and the Book-Entry Securities System showed an increase (see Chart VII.2A and 2B).

2 THE STOCK MARKET

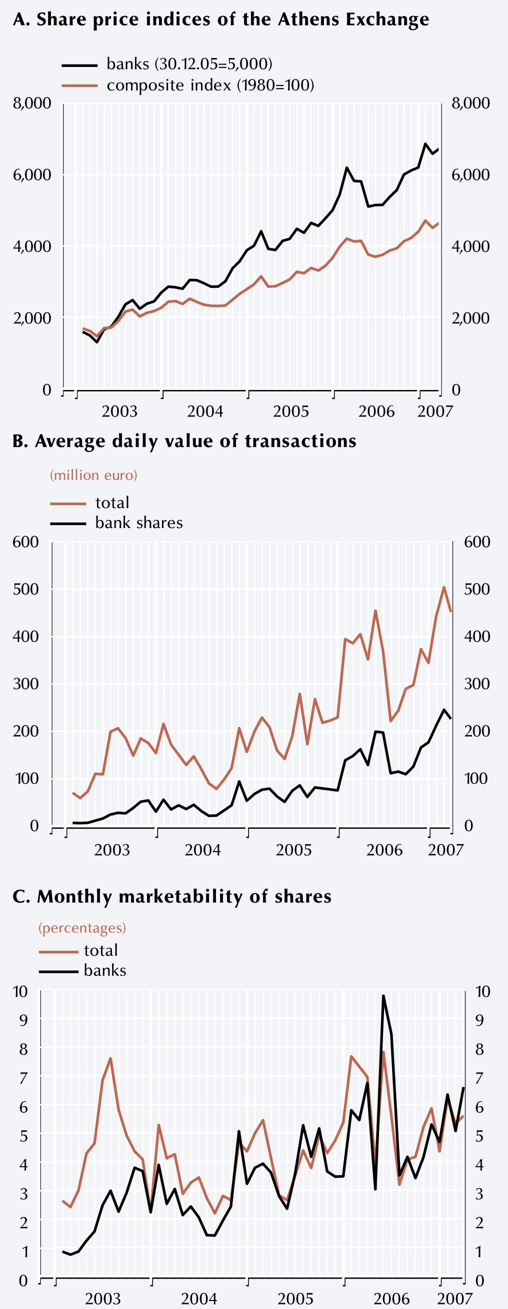
The recovery of the Greek stock market, which had started in 2003, maintained its strong pace during 2006. This is evidenced by the positive performance of the composite price index and the impressive increase in transactions. Additionally, the value of funds raised through the stock market also increased, though this development is almost exclusively attributed to the banking sector.

The Greek stock market was positively affected in 2006 by the favourable environment in euro area stock markets and the high liquidity in international capital markets. However, domestic factors, such as the favourable evolution of macroeconomic aggregates in the past years, the considerable improvement in the profitability[18] of firms listed on the Athens Exchange (Athex) in 2006, the restructuring of firms affiliated with the public sector, as well as important business agreements[19] in 2006, also played a significant role.

Another important development was the successful application of the electronic linking of the stock and the bond markets of the Athens Exchange with those of the Cyprus Exchange, a move that supports liquidity and expands the potential of both stock markets. Furthermore in 2006 the new industry clas-

18 After-tax profits of groups of firms listed on the Athens Exchange rose by about 28% in 2006 compared with 2005.
19 Such agreements concern many sectors, e.g. health, telecommunications and energy, while especially for the banking sector, which is very important in terms of stock market value and transactions, the most significant developments concern the implementation of mergers, the initial public offering of the Postal Savings Bank, the privatisation of Emporiki Bank and the further expansion of Greek commercial banks in the Balkans and, for the first time, in Turkey.

Chart VII.3 Athens Exchange aggregates



Source: Athens Exchange.

sification[20] of firms listed on the Athens Exchange came into effect, while the Capital Market Commission issued a number of decisions[21] aimed at adjusting the operation of the Athens Exchange to the standards applying in developed stock markets and at further enhancing its liquidity.

In greater detail, the composite share price index of the Athens Exchange followed an upward course during the year, except for the May-June period, when most international stock markets showed a considerable decline (see Chart VII.3A). Overall, this index rose by 19.9% from end-December 2005 to end-December 2006, when it came to its five-year peak.[22] The rise in the medium (54.4%) and the small capitalisation (40.5%) share prices outperformed that of the composite index, while the increase in the large capitalisation share prices was somewhat lower (17.7%). Moreover, the rise in the composite index was similar to that of the Dow Jones Euro Stoxx Broad index in the euro area (20.2%),

20 Following a decision taken by the Board of Directors of the Athens Exchange on 24 November 2005, as from 2 January 2006 the industry classification of firms listed on the Athens Exchange follows the Industry Classification Benchmark of FTSE and Dow Jones. According to this benchmark, firms are classified on the basis of the source that generates the largest part of their income, or according to the use of the end-product or the production process used. This change aims at better informing foreign institutional investors and at adjusting the Athens Exchange to the operational standards of international stock markets.

21 Among others, the following Hellenic Capital Markets Committee decisions were adopted: Decision 5/380/4 May 2006 according to which the introduction of a short sale order can take a price equal to that of the last trading of the relevant share in the Athens Exchange; Decision 3/403/8 November 2006 for the establishment of joint investor accounts, which will become effective as from June 2007; and Decision 5/403/8 November 2006 on the expansion of the short sales margin, making stock lending easier for investors, which came into effect at the beginning of 2007. Also, within 2007, the institutional framework for the operation of the semi-regulated market will be completed, while European Commission Directive 2006/73/EC was issued, implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms.

22 This index came to its peak on 21 December 2006 (at 4,395.43 points), while its trough was on 14 June 2006 (3,379.28 points).

Table VII.3 Stock market aggregates

Year	Share price indices[1]: Composite (1980 =100)	Share price indices[1]: Banks (30.12.05 =5,000)	Average daily value of transactions[2] (million euro)	Market capitalisation[1] (million euro): Shares	Market capitalisation[1] (million euro): Loans[3]	Market capitalisation[1] (million euro): Total	Market capitalisation (percentage of GDP): Shares	Market capitalisation (percentage of GDP): Loans	Market capitalisation (percentage of GDP): Total	Funds raised through the Athens Exchange (ATHEX)[4] (million euro): Listed companies	Funds raised through the Athens Exchange (ATHEX)[4] (million euro): New companies	Funds raised through the Athens Exchange (ATHEX)[4] (million euro): Total
2003	2,263.6	2,686.5	141.1	84,547	135,219	219,766	55	88	143	317	61	378
2004	2,786.2	3,877.1	140.8	92,140	157,905	250,045	56	96	151	397	79	476
2005	3,663.9	5,000.0	209.3	123,033	178,925	301,958	69	100	169	2,906	61	2,967
2006	4,394.1	6,194.5	343.3	157,928	191,549	349,477	81	98	179	3,396	86	3,482

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 calculations and (for GDP) Ministry of Economy and Finance.

higher than that of the stock markets in the United States, the United Kingdom and Japan, and ranked eighth among the euro area stock markets. In the first quarter of 2007, the composite index rose by 5.7%, while the Dow Jones Euro Stoxx Broad index by 3.4%.

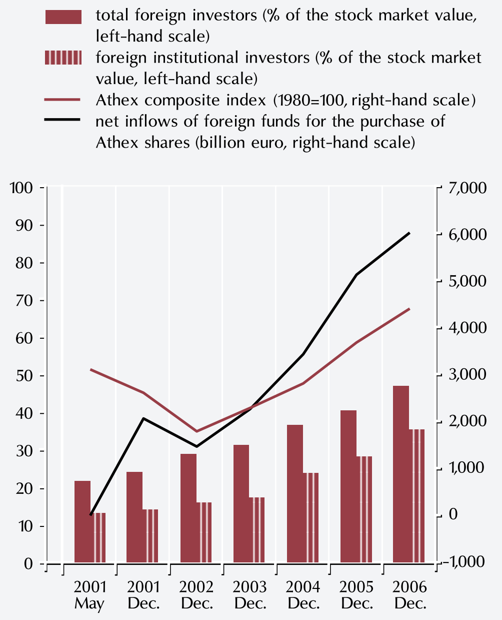
The increase in corporate profits at a rate higher than that of share prices led to a slightly lower P/E ratio at end-2006 compared with end-2005. However, standing at 17.4, this ratio was higher compared with the Dow Jones Euro Stoxx broad index (14).[23] Higher profitability contributed to keeping dividend yields of these indices at satisfactory levels (about 3%).

The average daily value of transactions in shares in the stock market was €343 million in 2006, demonstrating an impressive 64% increase from 2005 (see Chart VII.3B and Table VII.3). Turning to the capitalisation and the sectoral breakdown, transactions in the large capitalisation shares and the banking sector covered 91% and 43% of all transactions respectively. Share marketability[24] was considerably higher, reaching 5.5% in 2006 from 4.3% in 2005 (see Chart VII.3C). Finally, the value of transactions in Greek government and corporate bonds remained almost negligible.[25]

Foreign investors made a significant contribution to the higher value of transactions and marketability in 2006, as they covered about 3/5 of total transactions. Since May 2001, i.e. after the international ranking agency FTSE evaluated and ranked the Greek stock market among the world mature markets, foreign investors have considerably increased their share in the stock market value of firms listed on the Athens Exchange. According to data from the Cen-

23 It should also be noted that, despite the considerable increase in share prices in both indices, the earnings yield, i.e. the reverse of the P/E per share ratio, shows that at end-2006 investment in Greek and European equities was relatively more attractive than investment in bonds.
24 The ratio of the number of traded shares to the total number of listed shares.
25 At end-December 2006 the corporate bonds of only four companies were traded in the stock market.

Chart VII.4 Participation of foreign investors in the Athens Exchange



Sources: Athens Exchange and Bank of Greece.

tral Securities Depository, at end-December 2006 foreign investors[26] held 46.6% of the market capitalisation of the Athens Exchange (2005: 40.3%, see Chart VII.4).[27] This is due to the fact that, according to balance of payments statistics data, net inflows from abroad for investment in shares listed on the Athens Exchange demonstrated a considerable increase at end-2006, coming to €8.1 billion, up from €5.1 billion at end-2005 (see Chart VII.4).

The market value of shares listed on the Athens Exchange was €157,928 million or 81% of GDP at end-2006, compared with €123,033 million or 69% of GDP at end-2005 (see Table VII.3). This mainly reflects the increase in share prices, as the impact of share capital increases and the listing of new shares remained, also in 2006, limited, due to the sluggish raising of funds through the stock market.

In greater detail, funds raised through the Athens Exchange reached €3.5 billion in 2006, i.e. 17.3% more than last year (see Table VII.3), but this increase was almost exclusively attributable to the banking sector.[28] Excluding the banking sector, capital raised through the Athens Exchange declined by 58%. Also, capital raised mainly concerned firms whose shares were already listed on the Athens Exchange, the number of which dropped considerably compared with 2005 (2006: 12 firms, 2005: 23 firms), while only one firm (2005: 6 firms) listed its shares on the Athens Exchange for the first time.

Between end-December 2005 and end-December 2006, the banking sector index rose by 23.9%, slightly more than the composite index, while at end-2006 the banking sector accounted for 40.7% of the total market capitalisation, against 37.3% at end-2005. The average daily value of transactions in bank shares rose impressively by 103% (2006: €148 million, 2005: €73 million), as did the marketability of bank shares (2006: 5.4%, 2005: 3.8%).

The rise in banks'[29] after-tax profits by 15%, which was lower than that of share prices, led

26 64.6% of foreign investors come from EU countries and 18% from the United States.
27 The share of foreign investors was larger in large capitalisation firms (52.3%), while their participation in medium capitalisation firms almost doubled compared with last year, reaching 39.8%. At end-2006, foreign institutional investors held 35.1% of the total stock market capitalisation of the Athens Exchange (2005: 28%).
28 Most of these funds were raised by the National Bank of Greece.
29 Greek commercial banking groups excluding the Postal Savings Bank. See Chapter X for a detailed presentation of the profitability and efficiency of Greek commercial banks.

to an increase in the price to earnings per share (P/E) ratio, which reached 19.7 at end-December 2006, from 18.2 at end-December 2005. However, banks' dividend yield is estimated to have remained at 2005 levels (2.5%).

Turning to the other sectoral share price indices,[30] the health sector demonstrated a remarkable increase (152%), followed by the sector of chemicals (100%) and the sector of financial services (76%). By contrast, share prices in the sectors of oil-gas (-8%) and technology (-1%) dropped.

3 THE MUTUAL FUNDS MARKET

Activity in the mutual funds market decreased considerably in 2006, since the value of their assets fell by €4.1 billion or 15.1% in comparison with 2005, coming to €23.0 billion (see Chart VII.5 and Table VII.4). This development reflects the reduction of the number of mutual fund units in circulation, owing to increased capital outflows (€5.7 billion – see Chart VII.6), which more than offset the rise in unit prices.[31]

The decrease in the value of the assets of bond funds (-55.6%) made a significant contribution to the decrease in the total asset value of mutual funds (see Table VII.4). This development is largely due to the increase in the key ECB rates, which had a negative effect on bond prices, leading to significant outflows from this category (see Chart VII.6). In the balanced

30 See footnote 19 in this chapter.
31 It should be noted that the weighted average yield of equity funds was 22.6%, of balanced funds 9.8%, of funds of funds 3.8%, of money-market funds 2.3% and of bond funds 0.9%.

Table VII.4 Mutual funds: number and assets[1]

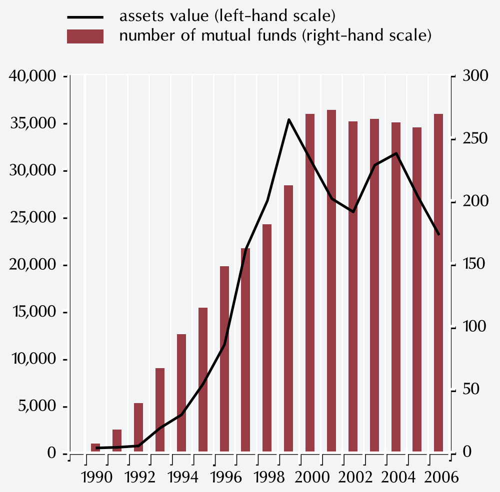
(million euro)

Type of mutual fund	2005 Number	2005 Assets value	2006 Number	2006 Assets value	Percentage change in value compared with previous year	Percentage of total assets 2005	Percentage of total assets 2006
Money-market type	**32**	**4,938**	**30**	**5,894**	**19.4**	**18.2**	**25.7**
Domestic	26	2,664	25	1,408	–47.1	9.8	6.2
Foreign	6	2,274	5	4,486	97.3	8.4	19.5
Bond type	**66**	**13,257**	**66**	**5,881**	**–55.6**	**48.9**	**25.6**
Domestic	32	4,665	31	2,045	–56.2	17.2	8.9
Foreign	34	8,592	35	3,836	–55.4	31.7	16.7
Equity type	**105**	**5,965**	**105**	**6,327**	**6.1**	**22.0**	**27.5**
Domestic	61	4,969	63	5,143	3.5	18.3	22.3
Foreign	44	996	42	1,184	18.9	3.7	5.2
Balanced type	**44**	**2,120**	**46**	**1,918**	**–9.5**	**7.8**	**8.4**
Domestic	26	786	27	881	12.1	2.9	3.9
Foreign	18	1,334	19	1,037	–22.3	4.9	4.5
Funds of Funds	**11**	**809**	**22**	**2,950**	**264.6**	**3.1**	**12.8**
Equity type	6	265	10	593	123.8	1.1	2.6
Balanced type	5	544	9	1,928	254.4	2.1	8.4
Bond type	0	–	3	429	–		1.8
Total	**258**	**27,089**	**269**	**22,970**	**–15.2**	**100.0**	**100.0**

1 At year end. Excluding the two mutual funds managed by "Pension Mutual Fund Management S.A.".
Source: Bank of Greece.

Chart VII.5 Mutual funds: number and assets

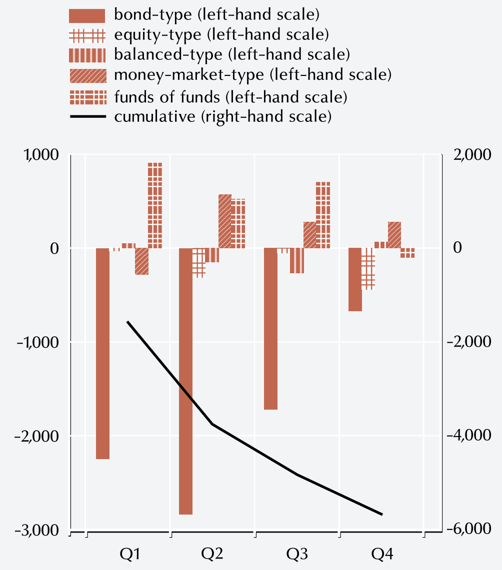
(value in million euro)



Source: Bank of Greece.

Chart VII.6 Mutual fund net inflows (2006)

(million euro)



Source: Association of Greek Institutional Investors.

funds category, the asset value declined (–9.5%) and there were also sales of units, albeit to a limited scale.

By contrast, the assets of the other categories of mutual funds grew, the most significant (264.6%) increase being that in funds of funds (see Table VII.4), which started their operation two years ago. The increase in the assets of money market mutual funds (19.4%) and of equity funds (6.1%) was less pronounced, as investors seem to have preferred to gradually receive parts of their profits, due to the considerable increase in the price of units (see Chart VII.6).

The above developments led to a drop in the share of bond funds in the total value of assets of all mutual funds (2006: 25.6%, 2005: 48.9%), while the share of funds of funds quadrupled (2006: 12.8%, 2005: 3.1% – see Table VII.4). The other categories of mutual funds also increased their shares.[32]

In 2006 demand for mutual funds, with the exception of funds of funds, was mainly met by the sale of shares of mutual funds already operating at end-2005. In greater detail, 13 new mutual funds were launched in 2006 (11 funds of funds and 2 balanced), while 2 money-market funds withdrew from the market. On the basis of these developments, 269 mutual funds were operating in 2006, against 258 in 2005 (see Chart VII.5). Furthermore, a mutual funds management company was split into two, so the total number of these companies rose to 26.

32 The share of money market funds rose to 25.7% in 2006 from 18.2% in 2005, of equity funds to 27.5% from 22% and of balanced funds to 8.4% from 7.8%.

Table VII.5 Portfolio structure of mutual funds[1]

(million euro)

	2005	2006	Change	Percentage change
Domestic investment	**12,834**	**9,360**	**–3,474**	**–27.1**
– Greek government bonds and Treasury bills	3,713	1,709	–2,004	–54.0
– Other bonds	230	154	–76	–33.0
– Shares listed on the Athex	5,024	5,209	185	3.7
– Repos	637	88	–549	–86.2
– Synthetic currency swaps	2,583	1,325	–1,258	–48.7
– Mutual fund shares/units	647	875	228	35.2
– Deposits and cash	87	89	2	2.3
Foreign investment	**13,383**	**13,038**	**–345**	**–2.6**
– Government bonds	883	384	–499	–56.5
– Other bonds	8,999	5,341	–3,658	–40.6
– Shares listed on organised stock markets	1,463	1,483	20	1.4
– Repos	1,278	0	–1,278	–100.0
– Synthetic currency swaps	611	3,831	3,220	527.0
– Mutual fund shares/units	149	1,999	1,850	1,241.6
– Deposits and cash	61	57	–4	–6.6
Other investment	**872**	**572**	**–300**	**–34.4**
Total	**27,089**	**22,970**	**–4,119**	**–15.2**

1 At year-end.
Source: Bank of Greece.

The portfolio of mutual funds in the course of 2006 was characterised by a significant decrease (of €3.5 billion) in domestic investment. In particular, the breakdown of their portfolio shows that investment in foreign and domestic bonds declined (by €4.2 billion and €2.1 billion respectively). Domestic synthetic currency swaps and holdings of repos showed a smaller decrease (of €1.3 billion and €0.6 billion respectively). By contrast, an increase was seen in foreign synthetic currency swaps (€3.2 billion), in foreign mutual funds (€1.8 billion), in domestic mutual funds (€0.2 billion) and in domestic (€0.2 billion) and foreign shares (€0.02 billion – see Table VII.5).

At the institutional level, the Capital Market Commission adopted certain decisions with a view to improving the operation and structure of the Greek mutual funds market as well as to protecting investors. These decisions determine the non-EU markets where mutual funds may invest (Decision 10/372/2006) together with the conditions for the use of financial derivatives and securities chosen by the mutual funds and the requirements for their portfolio risk management (Decision 3/378/2006). Finally, mutual funds which reproduce the composition of stock market indices now constitute a separate category of mutual funds (Decision 4/378/2006).

Contrary to the Greek mutual funds market, the world market maintained its upward course during 2006. The total assets of world mutual funds were €16 trillion at the end of the third quarter of 2006,[33] namely 6% more than at end-2005, while the net inflows that were seen in all individual categories came to €829 billion. Equity funds played a key role in the above developments, as their share in total assets rose to 47% during the period under review. Balanced funds also made a significant contribution, though to a lower degree.

At end-2006 Greek mutual funds accounted for 0.4% of the total assets of the mutual funds of 23 European countries, ranking 17th (with €23 billion).[34] Among European countries, the top three were Luxembourg (€1.7 trillion), France (€1.3 trillion) and the United Kingdom (€635 billion). The three countries with the lowest assets were Hungary (€6.4 billion), the Czech Republic (€5.7 billion) and Slovakia (€3.0 billion).

33 According to data from the European Fund and Asset Management Association (EFAMA). These data concern 42 countries, 23 of which are European. As regards asset structure, 50% concerns the United States and 36% the EU countries.
34 See the previous footnote.

VIII PUBLIC FINANCE

1 THE PUBLIC SECTOR BORROWING REQUIREMENT AND ITS FINANCING

Fiscal policy remained restrictive in 2006[1] and strong efforts were made in order to reduce the fiscal deficit to levels below 3% of GDP. These efforts were successful and, according to the most recent data released[2] to the European Commission, the general government deficit (on a national accounts basis) dropped to 2.6% of GDP in 2006 from 5.5% in 2005 (see Table VIII.1). The containment of the deficit to levels below 3.0% of GDP is in line with the ECOFIN Council decision of 17 February 2005, as well as with the government commitment to correct the excessive deficit by end-2006. Furthermore, this development, combined with the anticipated further decrease in the deficit to 2.4% of GDP in 2007, satisfies the main conditions for Greece's exit from the Excessive Deficit Procedure (EDP).

The considerable reduction in the deficit comes mainly from central government, the deficit of which dropped by 2.4 percentage points to 4.2% of GDP. The contribution of social security organisations,[3] local government and other public entities was also considerable, as their consolidated surplus rose from 1.1% in 2005 to 1.6% of GDP in 2006 (see Table VIII.1).

Several other EU countries saw an improvement in their public finances in 2006, leading to a reduction in the average general government deficit in the euro area (from 2.4% of GDP in 2005 to 1.9% in 2006). Additionally, the cumulative deficit in EU-25 dropped from 2.3% to 2.0%. As was the case in Greece, in most euro area countries the improvement was due to the acceleration of

1 For a detailed presentation of the fiscal policy stance, see Chapter II.4.
2 These data were released on 31 March 2007 in the context of the Excessive Deficit Procedure.
3 According to the Updated Stability and Growth Programme 2006-2009 (p. 11 of the Greek text), the surplus of social security organisations rose by 70.4% mainly due to the establishment of the auxiliary pension fund of bank employees (ETAT). Furthermore, the surplus of other public entities was almost double compared to 2005.

Table VIII.1 General and central government deficits

(percentage of GDP)

	2001	2002	2003	2004	2005	2006*
General government deficit[1] (national accounts data – convergence criterion)	**–4.9**	**–5.2**	**–6.2**	**–7.9**	**–5.5**	**–2.6**
– Central government	–6.6	–7.9	–8.9	–10.3	–6.6	–4.2
– Social security organisations and local government	1.7	2.7	2.7	2.4	1.1	1.6
Central government deficit[2] (administrative data)	**–4.0**	**–3.7**	**–6.3**	**–7.6**	**–6.2**	**–4.3**
Central government deficit[3] (cash basis)	**–5.9**	**–4.9**	**–6.8**	**–9.3**	**–8.0**	**–5.4**

1 Ministry of Economy and Finance data, as submitted to the European Commission (Excessive Deficit Procedure).
2 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 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.

economic growth as well as to other factors which contributed to the positive evolution of revenue.[4]

Better public finances are also reflected in the central government deficit on an administrative basis,[5] which dropped by 1.9 percentage points to 4.3% of GDP (see Table VIII.1). Developments in fiscal aggregates are detailed in Section 2 of the present chapter.

Turning to the central government borrowing requirement, based on central government and OPEKEPE cash flows, it decreased by 2.6 percentage points of GDP (see Table VIII.1). It should be noted that central government data on both an administrative and a cash basis are comparable only to central government aggregates on a national accounts basis, and not to general government data, which include social security organisations and local government. The discrepancy between the central government deficit on a national accounts basis (4.2% of GDP) and the central government borrowing requirement (5.4% of GDP) is mostly due to the fact that a number of central government transactions, which are not taken into consideration in the calculation of the national accounts balance, are included in the calculation of the borrowing requirement on a cash basis. Moreover, while cash data record total cash flows over the year, national accounts data (as per the methodology of the European System of Accounts 1995 – ESA 95) are compiled on an accrual basis, i.e. when a liability arises or an asset is created, regardless of when the relevant amount is actually paid or received. For these reasons, the borrowing requirement is usually different from the respective national accounts figure. In fact, the two items sometimes evolve in the opposite direction.

The central government borrowing requirement

The central government borrowing requirement decreased by 2.6% of GDP, namely from 8.0% in 2005 to 5.4% in 2006 (see Table VIII.2). It should be noted that the borrowing requirement in 2005 was higher due to extraordinary one-off expenditure[6] of €3,641 million or 2.0% of GDP. Without this expenditure, the cash deficit in 2005 would fall to 6.0% of GDP and the decrease in the cash deficit in 2006 would be 0.6% of GDP.

The lower cash deficit concerns primarily the ordinary budget and is due to the positive course of revenue. The public investment budget showed a small improvement, due to increased revenue from EU structural funds, which was higher than what was projected in the budget. At the same time, investment expenditure was €216 million lower than the budgeted amount.

Finally, the decrease in the cash deficit in 2006 is also attributable to the Payment and Control Agency for Guidance and Guarantee Community Aid (OPEKEPE), the balance of which (€1,033 million) was almost triple that of 2005 (€369 million). This development is connected with the change, as from 2006, in the way subsidies are granted to farmers and

4 Higher revenue in the euro area came from the strong profits of sociétés anonymes, the recovery of private consumption, the upward course of European stock markets and, in some countries, the higher real estate prices.
5 State budget data.
6 Such expenditure concerned the settlement of overdue liabilities of public hospitals (€2,586 million) and the increase in the share capital of the Agricultural Bank (€1,055 million), which had not been included in the 2005 deficit on a national accounts basis (see Bank of Greece, *Annual Report* 2005, p. 246).

Table VIII.2 Net borrowing requirement of central government on a cash basis[1, 2, 3]

(million euro)

	2004	2005	2006*
Central government	**15,605**	**14,424**	**10,467**
% of GDP	***9.3***	***8.0***	***5.4***
– State budget	15,377	14,793[7]	11,500[8]
(Ordinary budget)[4]	8,841	10,033	7,020
(Public investment budget)	6,536	4,760	4,480
– OPEKEPE[5, 6]	228	–369	–1,033

1 This table shows 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).
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) from 3 September 2001.
6 The OPEKEPE balance for 2006 is high, because the Ministry of Rural Development concluded a loan of approximately €600 million in December and made advance payments to farmers. This amount will be offset within 2007 by OPEKEPE, when final payment orders to beneficiaries will have been prepared.
7 Including a grant of about €2,586 million to hospitals, expenditure (of €1,055.2 million) for the capital increase of the Agricultural Bank of Greece, as well as proceeds of €1,239.3 million from the sale of 16.4% of OPAP (the Greek soccer pools organisation) shares and €826 million from the sale of 10% of OTE (Hellenic Telecommunications Organisation) shares.
8 Including €149.7 million from EETT revenue settlement, €299.3 million from the decrease in the capital of the Postal Savings Bank, €34 million from the decrease in the capital of the Agricultural Bank, €290 million from additional dividends of the Deposits and Loans Fund, €323 million from the sale of Agricultural Bank shares, €597.4 million from the sale of Postal Savings Bank shares and €364.4 million from the sale of Emporiki Bank shares.
* Provisional data and estimates.
Source: Bank of Greece.

the delay in issuing the final payment orders to beneficiaries (see Table VIII.2).

It should be recalled that the Bank of Greece lacks sufficient data for estimating the cash results of public entities[7] and has therefore stopped calculating the general government borrowing requirement since 2003. The relevant national accounts data are drawn from the special quarterly survey of the NSSG, which collects raw data on the financial results and financial position of such entities.

The central government borrowing requirement, which was 27.4% less than in 2005, was financed in an environment of rising interest rates in the euro area. In this context, the weighted average interest rate on Greek government debt rose to 3.7% in 2006 from 3.1% in 2005.[8]

As was the case in previous years, the financing was largely effected through the issuance of medium and long-term bonds (see Table VIII.3). In 2005 Greece issued for the first time a 30-year bond (maturing in 2037), which was reopened in 2006. By contrast, short-term borrowing (Treasury bills) maintained the downward course seen also in 2005 and dropped further.

The central government borrowing requirement was financed by both domestic and foreign investors. At the same time, central government liabilities to domestic financial institutions declined further. It is worth noting

7 Namely social security organisations, local authorities and other legal persons in public law.
8 It should be clarified that the impact of higher interest rates on interest payments will become apparent from 2007 onwards.

Table VIII.3 Financing of the borrowing requirement of central government

(million euro)

	2004		2005		2006*	
	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total
Greek Treasury bills and government bonds[1,2]	16,829	107.8	15,325	106.2	11,342	108.4
Change in the balances of central government accounts with the banking system[3]	–901	–5.8	–1,224	–8.5	–1,145	–10.9
External borrowing[4]	–323	–2.1	323	2.2	270	2.6
Total	**15,605**	**100.0**	**14,424**	**100.0**	**10,467**	**100.0**

1 Comprising Treasury bills and government bonds issued in Greece, as well as bonds convertible into shares.
2 Comprising bonds issued by the Greek government for debt repayment to the Social Insurance Institute – IKA (Law 2972/2001, article 51). See also footnote 3 in Table VIII.2.
3 Comprising changes in central government's accounts with the Bank of Greece and credit institutions, as well as the change in OPEKEPE's account.
4 Comprising borrowing abroad and securities issuance abroad, as well as the change in government deposits with foreign banks. Excluding non-residents' holdings of bonds issued in Greece.
* Provisional data.
Source: Bank of Greece.

that external borrowing excludes non-residents' holdings of euro-denominated bonds issued in Greece.

2 FISCAL AGGREGATES

2.1 THE STATE BUDGET

The considerable improvement in fiscal aggregates in 2006 came mainly from the state budget,[9] which saw its deficit narrow from €11,317 million or 6.2% of GDP in 2005 to €8,371 million or 4.3% of GDP in 2006 (see Table VIII.9). This improvement was slightly better than projected, as the budget deficit target was set at €8,550 or 4.4% of GDP. It should however be noted that the ordinary budget deficit was €261 million higher than forecast and came to €3,901 million in 2006. This overrun was offset by the public investment budget, the deficit of which was €440 million lower than the budgeted amount.

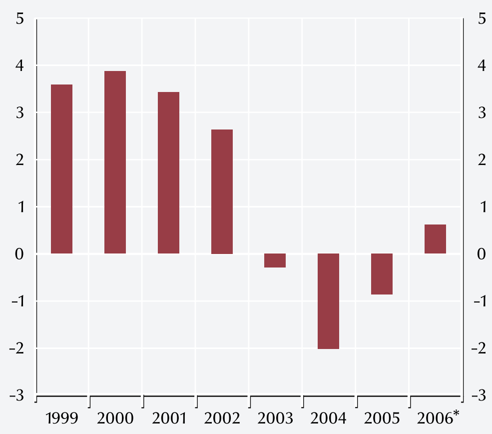
The lower deficit in relation to 2005 is attributable to both the favourable evolution of revenue, which was also supported by extraordinary revenue, and the containment of expenditure within the limits set by the budget. The improvement stems mainly from the ordinary budget, the deficit of which dropped from €6,479 million (or 3.6% of GDP) in 2005 to €3,901 million (or 2.0% of GDP). A smaller adjustment was also seen in the public investment budget, as its deficit fell to 2.3% of GDP in 2006 from 2.7% in 2005. These developments point to the stronger fiscal adjustment efforts in 2006 and the qualitative superiority of the factors that contributed to the decrease in the deficit in 2006, given that the adjustment in 2005 was mainly due to reduced public investment.

The improvement in fiscal aggregates is also reflected in the primary balance of the state budget, which turned from a primary deficit of 0.9% of GDP in 2005 to a primary surplus of 0.6% of GDP in 2006 (see Chart VIII.1 and Table VIII.9).

9 The state budget is drawn up on an administrative basis by the General Accounting Office.

Chart VIII.1 Primary balance of state budget

(percentage of GDP)



* Provisional data.
Source: General Accounting Office.

Revenue

As mentioned above, budget revenue played a key role in fiscal adjustment in 2006. Specifically, ordinary budget revenue rose by 8.8% in 2006 from 6.4% in 2005 and reached €48,685 million (see Table VIII.4). It fell short of the budgeted amount (€48,750 million) by a mere €65 million.

In order to support revenue and prevent a divergence from the target, three sets of measures were adopted during the year – the first in January, the second in July and the third in November 2006. Mainly as a result of these measures, 2006 revenue includes extraordinary receipts[10] of €1,539 million. If these receipts were excluded, the increase in revenue would have been 5.3%. Apart from these measures, the intensification of tax controls during the year also supported the evolution of revenue and this is evidenced in the positive course of revenue from indirect taxes.

Although supported by extraordinary revenue of €766 million,[11] direct tax revenue in 2006 grew by only 1.8% against 11.4% in 2005 (see Table VIII.4). This deceleration has to be attributed to corporate income tax revenue which, despite increased advance payments, was 6.2% less than in 2005. This development was due to the reduction in the tax rate on corporate earnings from 35% to 32% in 2005, to 29% in 2006 and to 25% in 2007. It should be noted that 2006 was the first year the decrease in tax rates was reflected in relevant revenue. The lower tax rates follow a general trend seen in the EU, as tax competition becomes strong. Besides, many neighbouring countries (e.g. Bulgaria, Romania, Turkey and Cyprus) apply corresponding tax rates below 20%. Indeed, at the beginning of the year, Bulgaria further reduced the tax rate on corporate earnings from 15% to 10%.

Receipts from tax on parental donations, gifts and inheritances decreased by 12.8%, even though taxpayers expedited parental donations and gifts in anticipation of the second rise in objective real estate prices in 2007. Lower receipts are partly due to pro-

10 These receipts include revenue from the decrease in the share capital of the Postal Savings Bank (€299 million), the Agricultural Bank (€34 million) and the Deposits and Loans Fund (€290 million) as well as from the Hellenic Telecommunications and Post Commission (€150 million). They also include revenue from the one-off taxation of bank reserves (€316 million) and the higher advance payment of corporate income tax (€450 million). Out of this total, €440 million was projected in the budget, while the rest came from measures taken in the course of the year. It should be noted that these three sets of measures also included permanent changes in taxation, which also increased 2006 revenue.

11 This revenue came from the one-off taxation of bank reserves (€316 million) and the higher advance payment of corporate income tax (€450 million). If these amounts were excluded, direct tax revenue would have risen by 2.4% against 2005 and it would have fallen short of the target by €1,127 million.

Table VIII.4 Ordinary budget revenue[1]

(million euro)

	2003	2004	2005	2006*	Percentage changes 2004/2003	2005/2004	2006*/2005
I. Direct taxes	**15,397**	**16,484**	**18,371**	**18,704**	**7.1**	**11.4**	**1.8**
1. Income tax	**12,141**	**13,307**	**14,166**	**15,006**	**9.6**	**6.5**	**5.9**
– Personal	6,969	7,785	8,292	9,275	11.7	6.5	11.9
– Corporate	4,341	4,724	4,731	4,438	8.8	0.1	–6.2
– Special categories of income tax	831	798	1,143	1,293	–4.0	43.2	13.1
(tax on shipping)	10	9	9	9	–10.0	0.0	0.0
(tax on interest income from bonds, deposits, etc.)	459	436	439	441	–5.0	0.7	0.5
2. Wealth taxes	**436**	**422**	**548**	**464**	**–3.2**	**29.9**	**–15.3**
3. Direct taxes collected on behalf of third parties	**1**	**1**	**2**	**2**	**0.0**	**100.0**	**0.0**
4. Tax arrears	**1,671**	**1,569**	**2,410**	**1,848**	**–6.1**	**53.6**	**–23.3**
5. Extraordinary and other direct taxes	**1,148**	**1,185**	**1,245**	**1,384**	**3.2**	**5.1**	**11.2**
II. Indirect taxes	**21,484**	**23,000**	**23,722**	**26,287**	**7.1**	**3.1**	**10.8**
1. Customs duties and special contributions on imports-exports	**222**	**277**	**260**	**276**	**24.8**	**–6.1**	**6.2**
2. Consumption taxes on imports	**2,257**	**2,624**	**2,661**	**2,922**	**16.3**	**1.4**	**9.8**
– VAT	1,485	1,716	1,771	2,026	15.6	3.2	14.4
– Cars	726	852	833	839	17.4	–2.3	0.7
– Special consumption tax	46	56	58	57	21.7	2.9	–1.0
3. Consumption taxes on domestic products	**16,856**	**18,168**	**18,547**	**20,372**	**7.8**	**2.1**	**9.8**
– Turnover tax	245	269	270	296	9.8	0.3	9.7
– VAT	10,848	12,025	12,360	13,799	10.8	2.8	11.6
– Fuel	2,432	2,457	2,474	2,604	1.0	0.7	5.3
– Tobacco	2,248	2,242	2,257	2,415	–0.3	0.7	7.0
– Road duties	554	693	706	794	25.1	1.8	12.5
– Special levies and contributions on cars	134	82	60	72	–38.8	–27.0	20.2
– Other[2]	395	400	421	391	1.3	5.2	–7.1
4. Transaction taxes	**1,490**	**1,514**	**1,687**	**1,867**	**1.6**	**11.4**	**10.7**
– Capital transfers	816	799	905	1,045	–2.1	13.3	15.5
– Stamp duties	592	624	681	710	5.4	9.1	4.3
– Licence fees for gambling	82	91	101	112	11.0	11.0	10.9
5. Other indirect taxes	**659**	**417**	**567**	**850**	**–36.7**	**36.0**	**49.9**
III. Total tax revenue	**36,881**	**39,484**	**42,093**	**44,991**	**7.1**	**6.6**	**6.9**
IV. Non-tax revenue	**3,000**	**2,571**	**2,667**	**3,694**	**–14.3**	**3.7**	**38.5**
V. Total ordinary budget revenue	**39,881**	**42,055**	**44,760**	**48,685**	**5.5**	**6.4**	**8.8**

1 For comparability purposes, tax refunds have not been deducted from revenue.
2 Including the special consumption tax on domestic products.
* Provisional data.
Source: General Accounting Office.

visions of Law 3427/2005, which are favourable for the tax payers (e.g. quadrupling of the tax-exempt amount), and partly to high revenue in 2005 due to the considerable expediting of gifts and parental donations in view of the first increase in objective real estate prices on 1 January 2006. Revenue from large real property tax (which is aggregated with the previous item under "wealth taxes" in Table VIII.4) decreased by 17.8% relative to 2005, when they had risen by 53.0% because they also included revenue from the one-off taxation of the adjusted value of fixed corporate assets.

Revenue from the collection of direct tax arrears dropped by 23.3% due to the weakening of the positive effect on income from measures adopted in July 2004 (Law 3259/2004) regarding the settlement of pending tax cases.

Receipts from income tax on bonds, deposits etc. rose only marginally, by 0.5% in 2006.

By contrast, personal income tax receipts rose by 11.9% relative to 2005 and overshot the budgeted amount by €415 million. This development is largely attributable to higher revenue (by 13.4%) from tax deduction at source from salaries and pensions. It should be noted that such revenue corresponds to 59% of total revenue from personal income tax.

Turning to indirect taxation, total revenue rose by 10.8% in 2006 against 3.1% in 2005 and came to €26,287 million, thus exceeding the budgeted amount by €1,147 million. This positive development is mainly due to the higher VAT income and, to a lesser degree, to increased revenue from other categories of indirect taxes.

In greater detail, revenue from VAT on imports from non-EU countries rose by 14.4%, against 3.2% in 2005. This acceleration is due to the large increase in the value of imports from non-EU countries and to the increase in VAT rates as from April 2005.[12]

Receipts from VAT on domestic goods and services grew by 11.6% from 2.8% in 2005 and stood at €13,799 million. This development is due to the higher VAT rates, the considerable increase in retail sales, the intensification of tax controls throughout the year and the high world oil prices, together with the increase in the special consumption tax on fuel as from 1 July 2006.[13]

Revenue from car registration fees rose by 0.7% and came to €839 million. This is related to the small increase (of 0.5%) in the number of new passenger cars in 2006.

Revenue from the special consumption tax on liquid fuel stood at €2,604 million, thus rising by 5.3% against a budgeted increase of 15.1%. The increase is attributable to the 5.7% increase in the special consumption tax on liquid fuel (as from 1 July 2006) and to the 1.7% increase in consumption.[14]

Revenue from tobacco tax increased by 7.0% against a budgeted increase of 23.1% and came to €2,415 million. The increase came from the imposition of the "minimum excise duty" on cigarettes in April 2005,[15] and then its increase on 27 July 2006. Furthermore, the tobacco industry raised the retail prices, leading to a further increase in corresponding tax income (the rise in the tax rate in July affected cheap brands only).

Receipts from real estate transfer tax (presented under item "capital transfers" in Table VIII.4) grew by 12.2% to €924 million. This development is related to the increase in objective real estate prices on 1 January 2006 and the acceleration of real estate transfers. It should be noted that demand for real prop-

12 The annual impact of this adjustment was seen for the first time in 2006 revenue.
13 VAT on fuel is imposed on the sum total of the refinery price and the special consumption tax.
14 It concerns total consumption of liquid fuel (gasoline, diesel oil, heating oil etc.).
15 The annual impact of this measure affected the revenue of 2006.

Table VIII.5 Outlays under the ordinary budget and the public investment budget

(million euro)

	2003	2004	2005	2006*	Percentage changes 2004/2003	2005/2004	2006*/2005
I. Outlays under the ordinary budget	**43,116**	**48,288**	**51,239**	**52,586**	**12,0**	**6,1**	**2,6**
1. Personnel outlays	16,526	18,425	19,325	20,474	11.5	4.9	5.9
of which: pensions	(3,523)	(4,065)	(4,211)	(4,577)	(15.4)	(3.6)	(8.7)
2. Interest payments[1]	9,416	9,464	9,774	9,589	0.5	3.3	–1.9
3. Payments to the European Union	1,542	2,030	2,224	2,172	31.6	9.6	–2.3
4. Payment of revenue collected on behalf of third parties	3,512	3,736	4,056	4,076	6.4	8.6	0.5
5. Tax refunds	2,381	2,799	2,554	2,392	17.6	–8.8	–6.3
6. Subsidies to farmers	479	555	634	686	15.9	14.2	8.2
7. Grants	6,862	8,721	9,960	10,619	27.1	14.2	6.6
– social security	(5,070)	(6,306)	(7,441)	(7,661)	(24.4)	(18.0)	(3.0)
– public enterprises	(1,792)	(2,415)	(2,519)	(2,958)	(34.8)	(4.3)	(17.4)
8. Other	2,398	2,558[2]	2,712[3]	2,578	6.7	6.0	–4.9
II. Outlays under the public investment budget	**8,435**	**9,522**	**7,524**	**8,184**	**12.9**	**–21.0**	**8.8**
1. Project implementation	3,222	3,633	...	...	12.8	...	...
2. Grants	5,159	5,821	...	...	12.8	...	...
3. Administration	55	68	...	...	23.6	...	...
III. Total (I+II)	**51,551**	**57,810**	**58,763**	**60,770**	**12.1**	**1.6**	**3.4**
Primary expenditure under the state budget	42,135	48,346	48,989	51,181	14.7	1.3	4.5
Primary expenditure under the ordinary budget	33,700	38,824	41,465	42,997	15.2	6.8	3.7
Amortisation payments	**21,615**	**20,356**	**21,752**	**17,832**	**–5.8**	**6.9**	**–18.0**
Ministry of National Defence programmes for the procurement of military equipment	**987**	**1,792**	**1,394**	**2,067**	**81.6**	**–22.2**	**48.3**

1 Including "other expenditure" for public debt servicing.
2 Including €148 million preparation costs for the 2004 Olympic Games and €333 million for extraordinary subsidies related to the Olympic Games.
3 Including extraordinary payments of €345 million by the Greek State for the settlement of its debt to the Agricultural Bank of Greece and payments of €39 million for the allowance granted retroactively to forest guards following a court decision.
* Provisional data.
Source: General Accounting Office.

erty remained high also in 2006, most probably due to the anticipated further increase in objective prices[16] in 2007, to expectations of higher interest rates on housing loans in 2007 as well as to the fact that newly built real estate is now sold at prices including VAT (but no real estate transfer tax).

Proceeds from tax on stock exchange transactions (which are aggregated with real estate transfer tax in Table VIII.4) rose by 48.8% to €121 million. This increase is due to the considerable rise in share prices and the larger volume of transactions in the Athens Exchange during 2006. A considerable increase, of 49.9%, was also seen in revenue from other indirect taxes.[17]

Finally, non-tax revenue, including extraordinary revenue of €773 million, rose in 2006 by 38.5% to €3,694 million. Apart from extraordinary revenue,[18] receipts from the Deposits and Loans Fund demonstrated a considerable increase (110.9%), as did

16 This increase had already been announced last year.
17 Also including "indirect tax arrears".
18 Explained in detail in footnote 11.

receipts from the Public Petroleum Corporation (122.3%). Furthermore, €48 million were collected from UMTS licences awarded in 2001. Most of this revenue was collected in 2001, but the agreement also specified two instalments of €48 million each (payable in 2005 and in 2006).

Expenditure

Efforts to contain ordinary budget expenditure[19] continued also in 2006. As a result, the rate of increase in expenditure decelerated further to 2.6%, from 6.1% in 2005 and 12.0% in 2004 (see Table VIII.5). Furthermore, ordinary budget expenditure was contained at 26.9% of GDP, from 28.9% in 2005 and 28.7% in 2004. The low rate of increase in expenditure (2.6%), which is considerably lower than the rate of increase in nominal GDP (7.8%), was achieved thanks to the setting of quarterly low "disbursement rates" on budgeted credit and to the close monitoring of disbursements.

Primary expenditure under the ordinary budget (including tax refunds) rose by 3.7% to €42,997 million, against a 6.8% increase in 2005. By contrast, interest payments decreased by 1.9%, about as much as forecast in the budget (a 1.8% decrease). Primary expenditure was €207 million higher than the budgeted amount, while interest payments were €11 million lower than forecast.

19 Including tax refunds.

Box VIII.1

BUDGETING, NUMERICAL FISCAL RULES AND INDEPENDENT ASSESSORS AFFECTING THE FISCAL BALANCE

Considerable efforts have been made all over the world in the past three decades to contain fiscal deficits. In this context, at the late '70s, many efforts to control public expenditure were channelled through the drafting of the budget.[1] These efforts continued also in the '80s, with initiatives and the active participation of OECD.[2] Despite such efforts, in most developed countries public debt kept on rising up to the end of the '80s.

At the beginning of the '90s, the European Union adopted ceilings on the level of general government deficit and debt (as a percentage of GDP). These numerical fiscal rules, which were incorporated in the Maastricht Treaty and the Stability and Growth Pact (SGP), proved quite effective, especially as concerns cutting down on deficits, especially in the period before Stage Three of EMU (i.e. the second half of the '90s). During the same period, studies published by the IMF[3] further supported the view that fiscal adjustment is likely to be more sustainable when it is based on lower primary expen-

1 In particular, the effort, initially seen in the US, to transfer the "zero-based budget" rationale of private enterprises into the state budgets. In Greece, the pilot application of this method in state hospitals and Greek Post in the 1977-79 period brought impressive results, but the programme was terminated for no obvious reasons in 1980.
2 OECD, *The Control and Management of Government Expenditure,* 1987.
3 Premchand, A., *Public Expenditure Management,* IMF, 1993; IMF, *Unproductive Public Expenditures,* IMF Fiscal Affairs Department, 1995; C.J. McDermott and R.F. Wescott, "An Empirical Analysis of Fiscal Adjustments", *IMF Staff Papers,* No. 4, Vol. 43, December 1996; Kopits G. and S. Symansky, *Fiscal Policy Rules,* IMF Occasional Paper 1962, 1998.

diture, in particular personnel outlays and transfer payments. By contrast, in most cases fiscal adjustment is not sustainable if it is achieved through an increase in tax rates and a decrease in interest payments (without a respective decrease in the debt) or a temporary reduction in public investment. For these reasons, it was widely held that the control of public expenditure with the introduction of quantitative restrictions in its level and/or its rate of increase, combined with the improvement in the budgeting process,[4] constitute the best way to achieve sustainable fiscal adjustment.

The widening of deficits in most euro area countries immediately after the introduction of the single currency, a development also attributable to higher "tax competition" in both the EU and worldwide, led to a renewed interest in sustainable fiscal adjustment,[5] which is reflected in the new important provisions of the revised SGP for the sustainability of public finances.

Thus, immediately after the revision of the SGP, the European Commission[6] and many researchers became interested in studying and evaluating the importance of the numerical fiscal rules in achieving a sustainable fiscal position. Such research, which also took into consideration the experience gained by the euro area countries during the first five years of their participation in EMU,[7] showed that quantitative fiscal rules are very important, but they constitute only a part of a greater institutional context, i.e. a set of institutions, rules and independent agencies, which largely determines the fiscal balance in each country.

The new, comprehensive review of the subject distinguishes among three categories of factors that affect the budget balance:

(i) institutions and administrative rules concerning the preparation, drafting and execution of the budget;

(ii) numerical fiscal rules of a permanent character, which usually set ceilings on the level[8] or the rate of increase of an important fiscal variable (e.g. budget deficit, public debt, public expenditures and other fiscal aggregates);

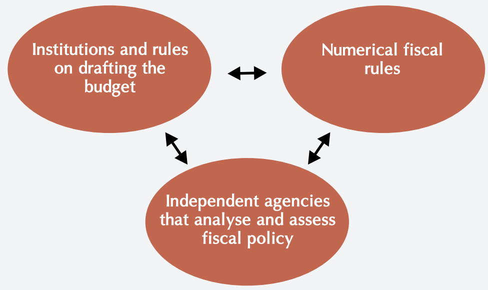
(iii) independent agencies[9] involved in analysing and assessing the fiscal outcome and the fiscal policy pursued, as well as in carrying out macroeconomic forecasts and formulating recommendations.

The first category encompasses all rules and procedures ensuring the principles of budget unity, transparency and reliability. The budget should cover the whole of the general government sector (e.g.

4 The Bank of Greece has repeatedly reported on these rules and the need to adopt them in Greece. See *Annual Report 1999,* p. 31; *Annual Report 2001,* p. 53.; *Annual Report 2003,* pp. 70-71, where the fiscal rules and certain conditions for the effective control of expenditure and fiscal deficits are presented in a comprehensive manner; and *Annual Report 2004,* p. 65.
5 Most EU countries, including Greece, had reduced their deficits through higher tax revenue (and in some cases also with one-off measures), while their interest payments were lowered due to the reduction in interest rates before Stage Three of EMU.
6 European Commission, *Public Finances in EMU-2006*, pp. 122-68. Also, the European Commission held two seminars in Brussels (on 22 September and 24 November 2006) and many presentations in various countries (the presentation in Athens was held on 13 November 2006).
7 This experience mostly relates to the efforts made by these countries during that period to deviate from the fiscal rules laid down in the Maastricht Treaty and the SGP.
8 In absolute terms or as a percentage of GDP.
9 They usually are research centres, institutes, "fiscal councils", etc.

social security organisations, public hospitals, local authorities, special accounts etc.), the various budget aggregates should be clearly defined and their comparability from year to year should be ensured. Furthermore, it has to be clear which agency, entity or person is responsible for possible deviations in the execution of the budget. Measures contributing to the above include: multi-year budgets, the establishment of a system to assess public expenditures in drafting the budget (e.g. zero-based budget or programme-based budget), the timely drafting and presentation of the budget to the Parliament as well as the preparation and publication of reports during the execution of the budget. Furthermore, detailed accounts should be compiled on an annual basis, through which potential changes in the property of general government would be easily traced.[10]

Institutional framework for sound public finances



In the new, comprehensive review of the subject, numerical fiscal rules keep on constituting the core of the necessary institutional framework for monitoring public finances in each country. "Numerical fiscal rules" refer to permanent restraints in fiscal policy expressed as quantitative limits in summary indices (e.g. budget deficit, public debt, level of expenditure and other fiscal aggregates) or in a considerable sub-set of relevant indices (e.g. primary expenditure). These rules usually set ceilings as to the absolute number, the level-to-GDP ratio or the annual rate of increase of the major fiscal variables, such as deficit, expenditure, revenue[11] or public debt.

According to a European Commission survey,[12] the absolute number of numerical rules in force in EU Member States (EU-25) quadrupled[13] between 1990 and 2005. Furthermore, the rules now cover more general government variables than before. The most recent development is the imposition of numerical rules on social security. It should be noted that these rules complement and support the corresponding rules laid down in the Maastricht Treaty and the Stability and Growth Pact.

The data analysis showed that both the introduction of numerical fiscal rules in a country and the widening of their scope of application to a continuously larger part of general government led to a decrease in the cyclically adjusted deficit of the country (or an increase in its surplus). Furthermore, the imposition of numerical fiscal rules on primary expenditure led to a decrease in its ratio to GDP. It should be noted that such rules become more effective when they are supported by relevant laws,[14] when they enjoy wide press coverage and when strong imposition mechanisms are in place.

10 It should be noted that, at times, almost all euro area countries decreased their deficit by converting assets into current budget revenue.
11 The numerical rules for revenue are not very important. In EU countries there exist only five fiscal rules on revenue, three of which refer to the distribution of revenue exceeding the budgeted amount.
12 See footnote 6 of this box.
13 In 1990 there were 16 numerical rules in force, while in 2006 there were 66. Of course this is partly attributable to the EU enlargement. See European Commission, *Public Finances in EMU-2006*, pp. 136-48.
14 Rules included in the Constitution or laws are more effective than those based on political agreements.

The most significant contribution of the Commission study is probably the recognition of the importance of independent agencies which analyse and assess the fiscal policy pursued in each country and formulate recommendations thereon. The more reliable these agencies are, the more they contribute to determining the fiscal outcome. These independent agencies usually monitor, analyse and assess the current economic developments in a country, carry out macroeconomic forecasts and formulate recommendations on fiscal (or economic) policy. The survey data reveal that there exist 23 such entities in the 25 EU countries. Of these, 10 analyse macroeconomic developments and carry out forecasts, the most important being those of the Netherlands, Belgium and Austria. Furthermore, 12 independent agencies carry out and publish forecasts on revenue and expenditure, the most important being those of Germany and the Netherlands. Finally, there exist 17 independent entities which evaluate and analyse fiscal policy issues and formulate relevant proposals.[15]

The study shows that the existence of these independent agencies exerts a generally positive influence on fiscal management and contributes to the achievement of fiscal discipline. The degree of this influence depends on the credibility and the status of the entity, two key features which allow it to influence public dialogue on fiscal issues and to directly participate in the drafting of the budget, while also strengthening its autonomy and independence.

It should be made clear that, although each of these three categories of factors that determine the fiscal outcome is significant per se, their effectiveness is amplified when they all work together. In other words, the institutions and processes employed in drafting the budget, the quantitative fiscal rules and the existence of independent agencies that analyse and evaluate the fiscal developments complement each other, interact and support one another.

Finally it should be noted that the institutions and processes used in drafting the budget in Greece do not yet include a system to assess expenditures and no multi-year budgets are prepared. As regards the quantitative fiscal rules, the ones set out in the SGP are applied, but they are not complemented by national numerical fiscal rules. Furthermore, existing agencies and entities do not fulfil the criterion of independence *stricto senso*, nor the other conditions that would allow them to be included in the third group of factors determining the fiscal outcome.

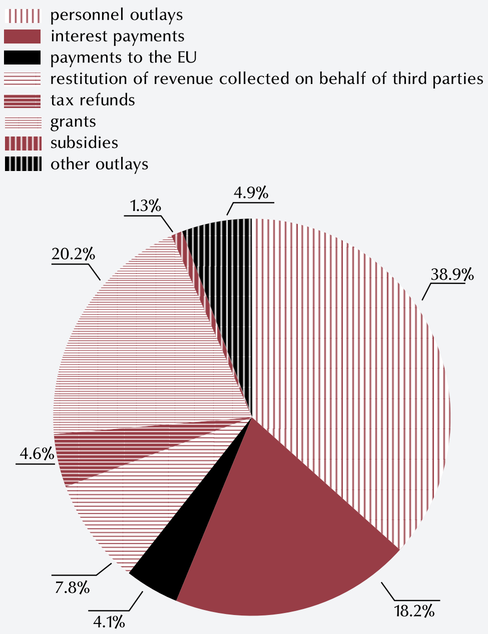
15 Any of these entities may engage in more than one of these tasks.

Due to the tight incomes policy pursued also in 2006, personnel outlays rose by 5.9%, against 4.9% in 2005 and 11.5% in 2004, and totalled €20,474 million. It should be noted that, for the first time in recent years, total personnel outlays were lower than budgeted (see Chart VIII.3), reflecting wage moderation. Despite the lower than budgeted personnel outlays, their share in total expenditure under the ordinary budget rose to 38.9% from 37.7% in 2005, as the rate of increase in total expenditure in 2006 was considerably slower than the rate of increase in personnel outlays (see Chart VIII.2). By contrast, pension expenditure grew by 8.7% and exceeded the budgeted amount by €162 million. This was due to the retirement of a larger than usual number of civil servants.[20]

20 See Hellenic Stability and Growth Programme 2006-2009, p. 20 of the Greek text.

Chart VIII.2 Composition of outlays[1] under the ordinary budget

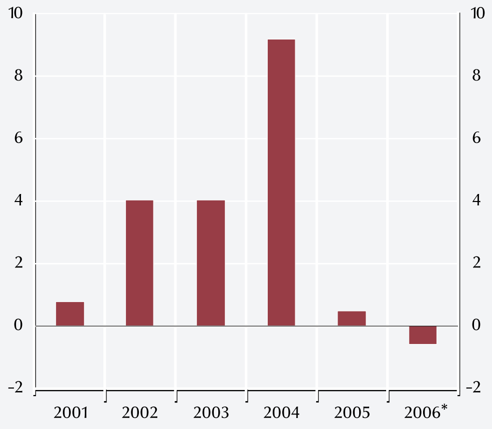
(year 2005*)



1 Excluding amortisation payments.
* Provisional data.
Source: General Accounting Office.

Chart VIII.3 Overrun in personnel outlays as a percentage of the budgeted amount

(percentage of the budgeted personnel outlays)



* Provisional data.
Source: General Accounting Office.

Interest payments were reduced by 1.9% in 2006 and stood at €9,589 million, marginally lower than the budgeted amount (€9,600 million). It should be made clear that the 0.6% increase in interest rates on new government borrowing in 2006 has not affected interest payments for 2006, as almost all new debt consists of long-term fixed-rate paper, but will start affecting them from 2007 onwards. Nevertheless, interest payments will maintain their downward course as a percentage of GDP, as long as the average interest rate on new government borrowing (3.7% in 2006) remains lower than the average interest rate on debt assumed in the past (4.5% at end-2006, see Chart VIII.4). It should also be noted that, according to data released to the European Commission on 31 March 2007, interest rate swaps also contributed to reducing interest expenditure. This reduction is estimated at €564 million or 0.3% of GDP.

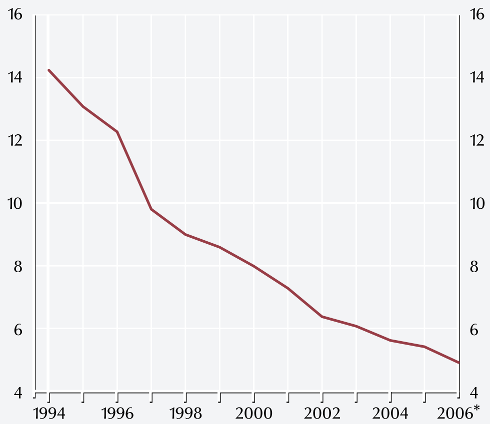
Payments to the EU decreased by 2.3% and came to €2,172 million in 2006, after two years of large increases, which were due to the introduction of a new method for determining Member State contributions to the Community budget.[21]

Restitution of revenue to third parties (mainly municipalities and prefectures) rose by a marginal 0.5% and came to €4.076 million, against an 8.6% increase in 2005.

21 As mentioned in the Introductory Report on the 2005 Budget, a new method was introduced in 2002 to determine "own resources". This method lowers EU receipts from customs duties under the Common Customs Tariff, agricultural levies and VAT-based contributions, but recoups lost revenue by increasing GDP-based contributions. Given that the growth of the Greeк economy has been faster than the Community average during the past few years, this change led to the increase in Greece's payments to the Community Budget up to 2005.

Chart VIII.4 Interest payments[1] on central government debt

(percentage of GDP)



1 On an administrative basis. Including capitalised interest and other debt servicing outlays.
* Provisional data.
Source: General Accounting Office.

Tax refunds fell by 6.3% to €2,392 million. This decrease, for the second year in a row, took place despite the increase in exports and the higher VAT rates. It should however be noted that, despite their decrease compared to last year, tax refunds were €192 million higher than the budgeted amount, i.e. almost equal to the total overrun of budgeted primary expenditure (€196 million).

Outlays for government grants (to social security organisations and public enterprises), which constituted the second largest item of ordinary budget expenditure with a share of 20.2% of the total (see Chart VIII.2), rose by 6.6% against last year, to €10,619 million. The largest increase came from grants to public enterprises (17.4%), while grants to social security organisations showed a small increase.

Finally, "other outlays" dropped by 4.9% in 2006, to €2,578 million. This is attributable to the fact that the corresponding amount of 2005 included an outlay of €345 million for the settlement of a debt to the Agricultural Bank. Adjusted for this amount, "other outlays" rose by 9.0% in 2006.

The public investment budget

Investment spending rose by 8.8% in 2006, to €8,184 million (see Tables VIII.5 and VIII.9). Despite the considerable increase relative to 2005, this amount is €216 million less than the budgeted amount.

By contrast, revenue under the public investment budget (mainly inflows from the EU structural funds) rose by 38.3% to €3,714 million, overshooting the budgeted amount by €224 million.

As a result of these developments, the public investment budget deficit fell to €4,470 million, i.e. it was €440 million less than the budgeted amount and €368 million lower than last year. As a percentage of GDP, the public investment budget deficit came down to 2.3% in 2006, from 2.7% in 2005.

Box VIII.2

PUBLIC-PRIVATE PARTNERSHIPS

1. Introduction

The term Public-Private Partnerships (PPPs) suggests a long-standing relationship (cooperation) between the public and the private sector, with the view to delivering comprehensive public services to citizens. Law 3389/2005 on "Public-Private Partnerships" established the necessary legal framework for PPP agreements in Greece.

In other countries, e.g. the United Kingdom, Ireland, France, Italy, Australia, Canada etc., partnerships between the public and the private sector date back a few decades, they are much more complex and quite wide-spread. In the United Kingdom in particular, such partnerships have existed for the past 25 years. During this period some 650 projects have been implemented, including the construction and operation of schools, hospitals, correction facilities, railroads, court buildings, museums etc.

Through time, the *degree of involvement* and the *assumption of risks* by the private sector have increased in parallel with the provision of comprehensive services to the public.

2. Basic characteristics

The cooperation between the public and the private sector for the delivery of comprehensive public services to citizens has certain basic characteristics:

(i) in principle, the delivery of services implies the execution of a project (e.g. construction of a building, road etc.), but this is not a key determinant of the partnership (since the asset may already exist);

(ii) the design, construction, financing, operation and maintenance usually constitute a whole;

(iii) the constructor, who is also the service provider, finances the investment;

(iv) the payment method (from the State to the private entity) is designed in a way to ensure the continuous and unhindered delivery of high quality services throughout the duration of the agreement;

(v) if the terms and conditions laid down in the contract agreement are not met and the performance of the service provider is not satisfactory, sanctions are imposed (e.g. lower "rent") or the contract is terminated;

The fact that the design, construction, financing and maintenance constitute a whole supplied by the same provider transposes the emphasis from a "lower construction cost" to a "lower total cost" for the delivery of the service (construction, operation, maintenance) throughout the duration of the contract. Empirical studies have shown that this long-term, comprehensive consideration leads to higher quality and lower cost. Therefore, the cost effectiveness is improved.

It should be noted that PPP contract agreements are extremely complex and this complexity may be responsible for a potential failure. Their effectiveness depends on the ability of the public entity to clearly define the project or service it wants to assign. This is the reason why it is generally proposed to implement relatively simple projects or services in the initial phase of a PPP, so as to build on know-how before moving into more complex works or services.

3. Advantages

Due to this long-term consideration and the wider involvement of the private sector, PPPs present many advantages, the most important being the following:

(i) quality improves and the total cost for the delivery of the final service to the citizens comes down, leading to higher cost effectiveness;

(ii) budgeted costs are not exceeded (at least as regards the State);

(iii) there are no delays in completing and delivering the project and, should the opposite occur, the private entity bears the relevant cost; and

(iv) the good operation and maintenance of the asset is guaranteed throughout the duration of the contract agreement.

The full set of advantages can be reaped only if PPPs are not used solely as financing tools. The generalised use of PPPs allows the implementation of more projects and the provision of more services without a direct fiscal burden. However, the advantages are expected to come by the larger participation of the private sector, which is considered to be able to contribute to the introduction of innovation in the design of projects/services. Furthermore, the implementation of PPPs in the provision of services not related with the operation of a project carried out through a PPP will also be beneficial. In particular, services usually delivered by the State (e.g. maintenance of existing infrastructure) could be delivered through PPPs, a fact that will allow the pricing of such services at competitive prices, thus helping drafting more accurate budgets.

4. Risks and how they are faced

There can be many risks in implementing a project. According to a common classification, also adopted by Law 3389/2005, there are three broad categories of risks:

- risks related to delays in the construction, a potential excess of the budgeted cost, technical deficiencies etc.
- risks related to a potential inability to supply the agreed volume or quality of goods or services,
- risks related to a possible deviation of demand from the level envisaged when signing the contract.

PPPs allow the best allocation of risks to the counterparty (public or private entity) that is in the position to handle them in the most effective manner.

5. Fiscal considerations

With the PPPs, part of public investment expenditure is deferred to the future. In other words, instead of paying a considerable amount for the construction of an asset now, a "rent" is paid for a given number of years, beginning when the project is put into operation (or, alternatively, the State does not collect the relevant revenue for that given number of years). At the same time, PPPs facilitate the restructuring of public expenditure, as capital expenditure is reduced (i.e. public investment) and current expenditure is increased (i.e. the payment of “rents”).

In order to reduce public investment expenditure (and thus the budget deficit), the asset should be considered to belong to the private, not the public sector. The question raised in the context of a PPP is whether the assets belong to the public or the private sector. According to a Eurostat decision (Stat/18/2004) the asset is registered to the private sector if it is the one to assume the risk related to construction, good operation or demand.

In principle, the private sector undertakes the two first risks, which are linked with the construction and operation of the project, while the public sector undertakes the risk of a possible deviation of demand from the levels foreseen in the contract agreement. It should be borne in mind that the construction risk also includes the financing of the project, which is guaranteed by the private sector.

As long as the risks are allocated this way, the expenditure for the construction of the asset is registered in the National Accounts as a private (not as a public investment), i.e. without adding any burden to the general government deficit and debt. This feature has made partnerships quite attractive in those EU countries which face fiscal pressures. In the past two years, Germany, Italy, Portugal and Greece (countries with excess public deficit) have demonstrated particular interest in public-private partnerships.

6. PPPs in Greece

From September 2005 until March 2007, 19 proposals for PPPs were lodged pursuant to the provisions of Law 3389/2005, with a total budget of about €2.2 billion. The first tender procedure for the selection of the private entity to undertake the construction and maintenance of six Fire Brigade services and one Fire Brigade station started in March 2007. Furthermore, tender procedures have been announced for the selection of a consultant who will make the necessary arrangements for the selection of private entities for five PPPs.

Finally, it should be noted that three big projects that have been constructed with concession agreements in the past ten years (before the enactment of Law 3389), namely the “Eleftherios Venizelos” airport, the Rion-Antirion bridge and the Attiki Odos, constitute the product of a partnership between the public and the private sector.

2.2 SOCIAL SECURITY AND WELFARE ORGANISATIONS

According to available data,[22] the provisional financial results of the six major social security and welfare organisations[23] deteriorated

22 Introductory Report on the 2007 Budget (Chapter 5) and detailed data from the Ministry of Economy and Finance.

23 Namely the Social Insurance Institute (IKA), the Seamen’s Insurance Fund (NAT-KAAN), the Farmers’ Insurance Fund (OGA), the Greek Manpower Employment Organisation (OAED), the Workers’ Housing Organisation (OEK) and the Workers’ Social Benefits Organisation (OEE).

in 2006 relative to 2005, despite the containment of capital expenditure below the forecast level. The deterioration was due to the operating account deficit, which widened from €5,542 million in 2005 to €6,577 million in 2006 (see Table VIII.6).

Total revenue of these organisations grew by 7.0%, against a 31.0% increase in 2005, reaching €16,994 million. Strong increases were recorded in the receipts of OAED (9.9%), IKA (8.3%) and NAT (5.0%).

Total operating expenditure increased by 10% in 2006 to €23,571 million, overshooting the budgeted amount (€20,855 million). Strong increases were recorded in pension payments by OGA (9.5%), NAT (22.4%) and IKA (8.2%), in housing loans granted by OEK (30.8%) and in unemployment-related expenditure by OAED (12.2%).

Capital account expenditure decreased by 3.0% in 2006 to €289 million. This is attributable to the fact that part of the housing programme that would be implemented by OEK in 2006 was postponed for 2007.

The widening of the operating account deficit, together with the capital account expenditure, caused the total consolidated operating and capital account deficit of the

Table VIII.6 Financial results and financing of social security and welfare organisations[1]

(million euro)

				Budget for	Percentage changes		
	2004	2005	2006*	2007	2005/2004	2006*/2005	2007/2006*
A. Operating account							
1. Revenue	12,125	15,887	16,994	19,019	31.0	7.0	11.9
2. Expenditure	17,601	21,429	23,571	26,493	21.7	10.0	12.4
3. Result (1 – 2)	–5,476	–5,542	–6,577	–7,474			
B. Capital account							
4. Revenue	0	0	0	0			
5. Expenditure	934	298	289	612	–68.1	–3.0	111.8
(Investment)	424	298	289	612	–29.7	–3.0	111.8
(Working capital)							
(Other)	510	–	–	–			
6. Result (4 – 5)	–934	–298	–289	–612			
7. Special resources	510	–	–	–			
Total result (3+6+7)	**–5,900**	**–5,840**	**–6,866**	**–8,086**			
Percentage of GDP	***3.5***	***3.2***	***3.5***	***3.9***			
Financing							
8. Grants	5,300	6,095	6,516	7,462	15.0	6.9	14.5
(Ordinary budget)	5,088	5,923	6,217	7,170	16.4	5.0	15.3
(Public investment budget, EU, etc.)	212	172	299	292	–18.9	73.8	–2.3
9. Depreciation	2	1	3	3	–50.0	200.0	0.0
10. Net borrowing requirement	598	–256	347	621	–142.8	–235.5	79.0
Total financing	**5,900**	**5,840**	**6,866**	**8,086**			
11. Amortisation payments		132	167			26.5	–100.0
12. New suppliers' credit							
13. Gross borrowing requirement (10+11-12)	598	–124	514	621	–120.7	–514.5	20.8

1 Social Insurance Institute (IKA), Seamen's Insurance Fund (NAT-KAAN), Farmers' Insurance Fund (OGA), Manpower Employment Organisation (OAED), Workers' Housing Organisation (OEK) and Workers' Social Benefits Organisation (OEE).
* Estimates.
Source: Ministry of Economy and Finance.

above organisations to rise by €1,026 million, i.e. from €5,840 million in 2005 to €6,866 million in 2006. As a percentage of GDP, this deficit rose to 3.5% in 2006 from 3.2% in 2005.

Of this deficit, 94.9% was financed through grants from the state budget, which were 6.9% higher than last year. Grants from the ordinary budget rose to €6,217 million in 2006 from €5,923 million in 2005, while grants from the investment budget and the EU budget came to €299 million, from €172 million in 2005. Despite increased grants from the state budget, net borrowing reached €347 million in 2006, against a debt repayment of €256 million in 2005.

The above developments point to a gradual worsening of the financial results of the major social security and welfare organisations. More specifically, their total pre-grant deficit rose gradually from 2.7% of GDP in 2003 to 3.5% in 2006. Also, the total deficit is expected to reach 3.9% of GDP in 2007 (see Table VIII.6).

2.3 PUBLIC ENTERPRISES

Law 3429/2005[24] on "Public Enterprises and Organisations – DEKO"[25] radically changed the institutional framework for the operation and the regime for the monitoring and the supervision of public enterprises by the Ministry of Economy and Finance, with a view to reducing the deficits of public enterprises as well as grants extended to them.

In greater detail, all public enterprises listed on the stock exchange, as well as their subsidiaries, are no longer monitored by the Ministry of Economy and Finance. Consequently, the financial results of 19 large public enterprises have been removed from the aggregates shown in Table VIII.7, but data for another 20 public enterprises have been added for the first time.[26] Due to these changes, data for 2005 and 2006 are not comparable with data for 2003 and 2004.

As shown in Table VIII.7, after the exclusion of the large public enterprises, the total turnover from 2005 onwards is about 1/10 of the relevant amount up to 2004. By contrast, for reasons explained below, the total (operating and capital account) deficit does not differ much before and after 2004 (see Table VIII.7).

Total operating revenue rose by 2.8% to €1,459 million, while operating expenditure rose by 7.0% to €2,768 million in 2006. Therefore, the operating deficit for 2006 came to €1,309 million, against €1,168 million in 2005.

Capital account expenditure rose by 13.4% in 2006 to €1,499 million, because of higher needs for working capital. On the other hand, investment outlays dropped by 4.0% against 2005, while a decrease (11.2%) was also registered in receipts from "special

24 For a detailed description of relevant provisions, see Bank of Greece, *Monetary Policy 2005-2006,* February 2006, pp. 137-39.

25 The term DEKO, as used in the new law, no longer has the meaning attributed to it at the beginning of the '80s. In fact, while in the Introductory Report on the Budget from 1982 to 2005 the term "organisations" included social security funds, local authorities, etc., the new law uses the term "organisations" when referring to legal persons in private law which are financed at least to the extent of 50% by the State or legal persons in public law. Furthermore, according to Law 3429/2005, "public enterprises" are only those public enterprises which are not listed on the Athens Exchange; the financial results of these enterprises are affected, either directly or to a significant degree, by the State.

26 Table VIII.7 includes 49 enterprises and "organisations".

Table VIII.7 Financial results and financing of public enterprises

(million euro)

	2003	2004	2005[1]	2006*[1]	Budget for 2007[1]	Percentage changes 2004/2003	2005/2004	2006*/2005	2007/2006*
A. Operating account									
1. Revenue	15,003	17,011	1,419	1,459	1,866	13.4	–	2.8	27.9
2. Expenditure	14,861	16,756	2,587	2,768	3,353	12.8	–	7.0	21.1
3. Result (1 – 2)	142	255	–1,168	–1,309	–1,487				
B. Capital account									
4. Revenue	0	0	0	0	0				
5. Expenditure	3,917	3,918	1,322	1,499	1,431	0.0	–	13.4	–4.5
(Investment)	2,441	2,937	1,017	976	1,264	20.3	–	–4.0	29.5
(Working capital)	134	–234	76	454	129	–274.6	–	497.4	–71.6
(Other)	1,342	1,215	229	69	38	–9.5	–	–69.9	–44.9
6. Result (4 – 5)	–3,917	–3,918	–1,322	–1,499	–1,431				
7. Special resources	1,721[2]	1,564[2]	894	794	471	–9.1	–	–11.2	–40.7
Total result (3+6+7)	**–2,054**	**–2,099**	**–1,596**	**–2,014**	**–2,447**				
Percentage of GDP	***1***	***1.2***	***0.9***	***1.0***	***1.2***				
Total financing									
8. Ordinary budget grants[3]	211	222	154	151	152	5.2	–	–1.9	0.7
9. Depreciation	1,171	986	245	234	252	–15.8	–	–4.5	7.7
10. Net borrowing requirement	672	891	1,197	1,629	2,043	32.6	–	36.1	25.4
Total financing	**2,054**	**2,099**	**1,596**	**2,014**	**2,447**				
11. Amortisation payments[4]	1,312	1,377	696	256	312	5.0	–	–63.2	21.9
12. Repayment of credit[4]	49	51	26	9	11	4.1	–	–65.4	22.2
13. New suppliers' credit	128	49	15	60	5	–61.7	–	300.0	–91.7
14. Gross borrowing requirement (10+11+12–13)	1,905	2,270	1,904	1,834	2,361				

1 According to Law 3429/2005 (Government Gazette 314A/27 December 2005), 20 new public enterprises replaced 19 older ones in the list of public utility companies, which is included in the Introductory Report on the 2007 Budget (p. 131). For this reason, data from 2005 onwards are not comparable with previous data.
2 Advances and participations by Public Power Corporation (DEH) consumers, lump-sum payments by Hellenic Telecommunications Organisation (OTE) subscribers, private sector participation in Water Supply and Sewerage Company (EYDAP) 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 increases, leading to their gradual reclassification as "special resources" instead of "grants".
3 Grants from the ordinary budget to the public enterprises which ran a deficit, minus collection of the surpluses of the other public enterprises.
4 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.

resources", which mainly cover investment outlays (see Table VIII.7).

The total operating and capital account deficit of public enterprises came to €2,104 million in 2006, or 1.0% of GDP, against a €1,596 million deficit in 2005. Most of this (80.9%) was covered by borrowing, 7.5% by grants from the ordinary budget and the remaining by depreciation allowances. It should be noted that net borrowing came to €1,629 million in 2006, from €1,197 million in 2005.

The data show that the deficit stood close to the 2004 levels. This is explained by the fact that the most ailing public enterprises, namely public transport enterprises,[27] which account for 89.1% of the deficit, were not affected by the change in the composition of Table VIII.7. This suggests that all efforts to substantially control the deficit and

27 Mainly OSE (Railway Organisation of Greece), ETHEL (Greek Thermal Buses), HSAP (Athens-Piraeus Electric Railways) and HLPAP (Athens-Piraeus Electric Buses).

reduce the corresponding grants out of the ordinary budget should primarily aim at improving the financial efficiency of public transport enterprises.

Due to the considerable borrowing by public enterprises, the outstanding balance of state-guaranteed loans[28] rose to €17,300 million or 8.9% of GDP in 2006, from 7.8% in 2003. The forfeiture of these guarantees is one of the reasons why progress towards the reduction of public debt is slow.

2.4 PUBLIC DEBT

The considerable fiscal adjustment of 2006 is also reflected in the evolution of public debt, as the ratio of general government debt[29] to GDP fell by 2.9 percentage points to 104.6% of GDP, from 107.5% in 2005 (see Table VIII.8). This reduction was the result of (i) the restrictive fiscal policy, which led to a shift from a primary deficit of 0.4% of GDP in 2005 to a primary surplus of 2.0% of GDP in 2006, and (ii) the combined effect of robust economic activity and low interest rates.

Despite its considerable decrease, public debt remains at very high levels and constitutes one of the most important sources of macroeconomic imbalances, especially in the light of the country's obligation to reduce the debt-to-GDP ratio below 60% and the anticipated (from around 2015 onwards) heavy burden on public finances coming from ageing-related expenditure. The evolution of the debt up to now explains the seriousness of this problem. In the past 14 years, the debt remains at 109% of GDP on average,[30] despite the particularly favourable conditions for its decrease (high primary surpluses, considerable decrease in interest rates up to 2005, high rates of economic growth and privatisation proceeds) between the mid-'90s and 2006.

28 Introductory Report on the 2007 Budget.
29 Consolidated debt of general government, as defined in the Maastricht Treaty.
30 The average for the 1993-2006 period was 109.3% of GDP.

Table VIII.8 Consolidated debt of general government[1]

(million euro)

	2001	2002	2003	2004	2005	2006[2]
Short-term liabilities	2,285	1,398	3,409	2,839	1,346	1,108
– securities	752	982	3,084	2,568	1,156	943
– loans	1,533	416	325	271	190	165
Medium- and long-term liabilities	149,386	156,974	163,860	179,342	192,757	202,498
– securities	125,188	134,040	140,922	156,969	170,863	180,968
– loans	24,198	22,934	22,938	22,373	21,894	21,530
Coin and deposits	198	515	454	521	563	612
Total	**151,869**	**158,887**	**167,723**	**182,702**	**194,666**	**204,218**
percentage of GDP	***114.1***	***110.7***	***107.8***	***108.5***	***107.5***	***104.6***
– domestic debt	143,369	154,190	164,341	180,199	191,919	202,162
(of which: debt to the Bank of Greece)[3]	(10,985)	(9,561)	(9,018)	(8,488)	(7,988)	(7,989)
– external debt	8,500	4,697	3,382	2,503	2,747	2,056

1 According to the definition in the Maastricht Treaty.
2 Provisional data.
3 The marginal increase of the euro-denominated debt to the Bank of Greece in 2006 is due to the conversion into euro of the foreign-currency-denominated debt, which was included in external borrowing. This conversion is also reflected in the substantial decrease of external debt.
Sources: General Accounting Office and Bank of Greece.

It is estimated that the debt-to-GDP ratio will maintain its downward course over the coming years, although significant uncertainties exist. First, according to the Updated Stability and Growth Programme 2006-2009, the primary surpluses anticipated up to 2009 do not suffice[31] for the reduction of public debt to levels below 60% of GDP by 2015. Second, the considerable rise in interest rates over the past 15 months and their potential further increase —underscoring the risks and uncertainty related to the high public debt— will effectively contain the positive impact of low interest rates. Finally, the robust rates of economic activity seen in the past decade cannot be maintained for ever. For these reasons, the European Commission believes that Greece and Portugal will have to be very careful[32] as regards the sustainability of their public finances.

The above show that it is imperative to create large primary surpluses and accelerate the efforts to reduce the debt below 60%[33] of GDP, if possible, within the next ten years.

The systematic efforts made since the late '90s to extend the average maturity of the debt, coupled with the more stable macroeconomic environment due to the participation of Greece in the euro area, led to a considerable increase in long-term debt. In greater detail, while in 1990 about 45% of general government debt consisted of Treasury bills (i.e. securities maturing in up to one year), in 2001 the outstanding amount of total short-term liabilities did not exceed 1.5% of the debt. In 2006, short-term liabilities decreased further to 0.5% of total general government debt, while medium- and long-term liabilities (bonds, loans and coin) accounted for 99.2% (see Table VIII.8).

Apart from average maturity, the negotiability of general government debt has also improved. Specifically, while at end-2001 roughly 83% of the total debt was negotiable, at end-2006 negotiable securities (mostly medium- and long-term bonds) made up 89.1% of the debt.

3 THE BUDGET FOR 2007

3.1 THE STATE BUDGET

The fiscal policy for 2007 aims at further reducing the general government deficit to 2.4% of GDP, from 2.6% in 2006, in order to put an end to the Excessive Deficit Procedure that the Greek economy has been subject to since July 2004.[34] However, this reduction will not come from the state budget, as the Budget for 2007 forecasts that the state budget deficit will be 4.3% of GDP (unchanged from 2006), which corresponds to a general government deficit of 2.4% of GDP[35] (see Table VIII.9).

Given that the state budget deficit remains unchanged, the small decrease in the general government deficit in 2007 (by 0.2% of GDP)

31 According to the Updated Stability and Growth Programme 2006-2009, the largest primary surplus (2.9% of GDP) will be in 2009. Even if the surplus is maintained at this level up to 2015, it will still not be enough for the reduction of the debt below 60% of GDP.
32 It should be noted that, according to the updated Stability and Growth Pact, the debt criterion is taken into consideration in assessing the long-term sustainability of public finances.
33 Though it is theoretically impossible to determine an optional debt-to-GDP ratio, many countries (*including* EU Member States) try to keep their debt below 40% of GDP.
34 For the termination of the Excessive Deficit Procedure, the general government deficit should be lower than 3% of GDP also in 2007.
35 The state budget deficit data are on an administrative basis, while the general government deficit data are on a national accounts basis.

Table VIII.9 Revenue, expenditure and deficit under the state budget

(million euro)

	2003	2004	2005	2006*	Budget for 2007	Percentage changes 2004/03	2005/04	2006*/05	Budget for 2007/06*
Revenue[1]	**41,704**	**44,949**	**47,446**	**52,399**	**55,260**	**7.8**	**5.6**	**10.4**	**5.5**
1. Ordinary budget	39,881	42,055	44,760	48,685	51,370	5.5	6.4	8.8	5.5
Direct taxes	15,397	16,484	18,371	18,704	19,450	7.1	11.4	1.8	4.0
Indirect taxes	21,484	22,999	23,722	26,287	28,580	7.1	3.1	10.8	8.7
Other revenue	3,000	2,571	2,667	3,694	3,340	–14.3	3.7	38.5	–9.6
2. Public investment budget	1,823	2,894	2,686	3,714	3,890	58.7	–7.2	38.3	4.7
Expenditure[1]	**51,551**	**57,810**	**58,764**	**60,770**	**64,310**	**12.1**	**1.7**	**3.4**	**5.8**
1. Ordinary budget	43,116	48,288	51,239[3]	52,586	55,560	12.0	6.1	2.6	5.7
(Interest payments)[2]	(9,416)	(9,464)	(9,774)	(9,589)	–9,750	0.5	3.3	–1.9	1.7
(Ordinary budget primary expenditure)	(33,700)	(38,824)	(41,465)[3]	(42,997)	(45,810)	15.2	6.8	3.7	6.5
2. Public investment budget	8,435	9,522	7,524	8,184	8,750	12.9	–21.0	8.8	6.9
Net deficit (–)/surplus (+)	**–9,847**	**–12,861**	**–11,317**	**–8,371**	**–9,050**				
Percentage of GDP	**–6.3**	**–7.6**	**–6.2**	**–4.3**	**–4.3**				
1. Ordinary budget	–3,235	–6,233	–6,479	–3,901	–4,190				
2. Public investment budget	–6,612	–6,628	–4,838	–4,470	–4,860				
Primary deficit (–)/surplus (+)	**–431**	**–3,397**	**–1,543**	**1,218**	**700**				
Percentage of GDP	**–0.3**	**–2.0**	**–0.9**	**0.6**	**0.3**				
Amortisation payments[2]	21,615	20,356	21,752	17,856	24,247	–5.8	6.9	–17.9	35.8
Ministry of National Defence programmes for the procurement of military equipment[2]	987	1,792	1,400	2,067	1,700	81.6	–21.9	47.6	–17.8
GDP (at current prices)	155,543	168,417	181,088	195,278	209,338	8.3	7.5	7.8	7.2

1 For comparability purposes, tax refunds have been recorded in expenditure and not been deducted from revenue, according to the practice applied by the Ministry of Economy and Finance in the last years.
2 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".
3 Including a grant of €330 million to OTE's personnel insurance fund (TAP-OTE) and a payment of €345 million effected by the Greek State for the settlement of its debt to the Agricultural Bank of Greece. These expenses are not included in the estimates of the Ministry of Economy and Finance for 2006.
* Provisional data.
Source: General Accounting Office.

is expected to come from the higher surplus of social security organisations, local authorities and other entities that are included in general government but not in central government. By contrast, the largest part of the decrease in the deficit last year came from the state budget.

The limited contribution of the state budget to the promotion of fiscal adjustment in 2007 is also seen in the fact that the primary surplus is expected to be half of that in 2006 (2007: 0.3% of GDP, 2006: 0.6% of GDP – see Table VIII.9).

Turning to revenue, the Budget for 2007 anticipates that ordinary budget receipts will increase by 5.5%, from 8.8% in 2006. This deceleration of the rate of increase is due to extraordinary revenue in 2006. If such revenue is not taken into consideration, the rate of increase for 2007 rises to 9.0%. A positive impact on the annual rate of increase in revenue will also come from

(i) increases in the special consumption tax on fuel on 1 July 2006 and 1 January 2007, (ii) the increase in the minimum special consumption tax on cigarettes on 27 July 2006, (iii) the increase in the mobile telephony duties on 1 October 2006, (iv) the new increase in the objective real estate prices in March 2007 and (v) the continuing efforts to curb tax evasion.

By contrast, the cuts in income tax of both natural and legal persons are expected to have a negative bearing on revenue.

Ordinary budget expenditure is expected to increase by 5.7% in 2007, against 2.6% in 2006. This acceleration is attributable to primary expenditure, which is expected to rise by 6.5% (from 3.7% in 2006), and also to interest payments, which will rise by 1.7% in 2007, whereas in 2006 they had decreased by 1.9%. The acceleration of the rate of increase in primary expenditure is mainly attributable to higher social expenditure, in particular that related to the rise in OGA pensions, the increase in EKAS (the Social Solidarity Benefit for Pensioners) and the refund of the LAFKA contributions (the Solidarity Account of Social Security Organisations). Among other categories of primary expenditure, a considerable increase (7.1%) is anticipated in personnel outlays, as well as in civil service pensions (5.1%). By contrast, all other categories of expenses are expected to register limited increases.

As regards Greece's financial transactions with the EU, net receipts rose by a substantial 32.8% in 2006, against a 10.7% decrease in 2005, reaching €4,292 million (see Table VIII.10). This development is mainly attributable to the 18.5% increase in receipts and the 2.3% decrease in payments. Higher receipts come from the Regional Fund and the Cohesion Fund (60.0% and 55.3% increase respectively), as well as the 1.7% higher inflows for farmer subsidisation under the CAP (European Agricultural Guidance and Guarantee Fund – EAGGF, Guarantee Section). The decrease in payments is mainly due to a small increase (0.9%) in contributions on the basis of VAT revenue and the 29.7% lower refunds to the EU from unrealised projects.

For 2007, net inflows are expected to show a small increase (0.5%) to €4,315 million. Receipts from the EU are expected to rise by 2.9% and payments by 7.6%. It should be noted that the calculation of Greece's contribution according to VAT revenue was based on the "old" (not the revised) GDP data; revised data are not used yet (see Table VIII.10).

3.2 THE BUDGETS OF SOCIAL SECURITY AND WELFARE ORGANISATIONS AND OF PUBLIC ENTERPRISES

According to data published in the Introductory Report on the 2007 Budget, although social security organisations are expected to register a higher aggregate surplus, the financial results of the six major social security and welfare organisations discussed here are expected to worsen in 2007. In greater detail, their consolidated operating and capital account deficit is expected to increase by €1,220 million to €8,086 million or 3.9% of GDP (see Table VIII.6). As was the case in previous years, the largest part of the deficit (92.3%) will be covered by increased grants out of the state budget.

Table VIII.10 Greece's financial account with the European Union

(million euro)

	2003	2004	2005	2006*	Budget for 2007	Percentage changes 2004/03	2005/04	2006*/05	Budget for 2007/06*
A. Receipts from the European Union	**4,605**	**5,650**	**5,455**	**6,464**	**6,652**	**22.7**	**–3.5**	**18.5**	**2.9**
1. 10% refund to cover cost of collecting the Union's "own resources"	52	65	67	68	70	25.0	3.1	1.5	2.9
2. Social Fund	584	640	576	552	600	9.6	–10.0	–4.2	8.7
3. EAGGF - Guidance Section	138	296	376	382	401	114.5	27.0	1.6	5.0
4. Regional Fund	945	1,523	1,341	2,146	2,302	61.2	–12.0	60.0	7.3
5. EAGGF - Guarantee Section	2,757	2,737	2,754	2,802	2,821	–0.7	0.6	1.7	0.7
6. Other receipts	18	8	5	10	7	–55.6	–37.5	–	–
7. Cohesion Fund	63	348	311	483	415	452.4	–10.6	55.3	–14.1
8. Receipts from EFTA countries	7	4	3	3	1	–42.9	–25.0	0.0	–66.7
9. Fisheries Fund	41	29	22	18	35	–29.3	–24.1	–18.2	94.4
B. Payments to the European Union	**1,542**	**2,030**	**2,224**	**2,172**	**2,337**	**31.6**	**9.6**	**–2.3**	**7.6**
1. Agricultural levies and duties	15	18	12	12	11	20.0	–33.3	0.0	–8.3
2. Sugar levies	8	7	4	3	4	–12.5	–42.9	–25.0	33.3
3. Customs duties under the Common External Tariffs provision	185	259	250	258	265	40.0	–3.5	3.2	2.7
4. Contribution on the basis of revenue from VAT	541	441	424	467	493	–18.5	–3.9	10.1	5.6
5. Contribution on the basis of GDP	758	1,129	1,211	1,222	1,300	48.9	7.3	0.9	6.4
6. Other contributions	7	15	41	2	14	114.3	–	–95.1	600.0
7. Contribution to the European Development Fund	27	35	33	33	40	29.6	–5.7	0.0	21.2
8. Payments owing to unrealised projects	1	126	249	175	210	–	97.6	–29.7	20.0
Net receipts from the European Union (A-B)	**3,063**	**3,620**	**3,231**	**4,292**	**4,315**	**18.2**	**–10.7**	**32.8**	**0.5**

* Provisional data.
Source: General Accounting Office.

The total consolidated operating and capital account deficit of public enterprises is expected to register a large increase, namely from €2,104 million in 2006 to €2,447 million in 2007. As a percentage of GDP, the deficit is expected to rise to 1.2%, from 1.0% in the previous year (see Table VIII.7).

The operating revenue of public enterprises is forecast to rise by 27.9% in 2007, while operating outlays are expected to increase by 21.1% relative to 2006. Thus, the operating deficit is expected to come to €1,487 million, from €1,309 million in 2006. By contrast, capital account expenditure is projected to decrease by 4.5% to €1,431 million, from €1,499 million in 2006. The above developments, combined with the large decrease (of 40.7%) in special resources, bring the total deficit of public enterprises to €2,447 million or 1.2% of GDP.

Of this deficit, 6.2% is expected to be financed through the ordinary budget, 10.3% through depreciation allowances and 83.5% through net borrowing. Net borrowing is therefore expected to increase further by 25.4%, to €2,043 million.

The steep rise in public enterprise borrowing, which is usually guaranteed by the State, leads to an increase in the outstanding balance of state-guaranteed loans and is an important factor explaining the slow progress in reducing public debt.

APPENDIX TO CHAPTER VIII

TAX POLICY MEASURES

2006 was a year of significant and extensive changes in the tax system. The new regulations, together with those enacted in the past two years, aim at reducing the tax burden from direct taxation, containing tax evasion, harmonising taxation on liquid fuel to EU standards and increasing the competitiveness of the economy. Furthermore, in order to ensure the smooth execution of the budget, without any deviations, and the reduction of the deficit to levels below 3% of GDP, extraordinary measures were taken, which strongly supported 2006 revenue.

As regards corporate income taxation, the tax rates were further cut, from 32% to 29% on 1 January 2006 and from 29% to 25% on 1 January 2007. This last decrease signalled the completion of the reform in corporate income taxation (Law 3296/2004). Also, Law 3453/2006 introduced a rise in the "advance payment" of corporate income tax, from 55% to 65% of the tax due. In particular for banks, the advance payment rose from 60% to 80% of the tax due. In this way, the lower revenue after the decrease in the tax rate (from 35% to 32%) for 2005 profits was offset (for 2006).

The special tax-exempt reserve for corporate investment was abolished by Ministerial Decision 1019/2006[1] for profits accumulated from 2005 onwards.[2] Furthermore, after the intervention of the European Commission, the Ministry of Economy and Finance retrospectively taxed reserves of 2003-04 for those enterprises that had already formed such reserves. In particular, enterprises which closed their balance sheets after 31 December 2004 and formed a tax exempt reserve from the profits of that year were asked to submit a supplementary income statement by March 2006 and pay additional tax for these reserves.

Furthermore, on the basis of Law 3470/2006, the lowering of the corporate tax rates set out in Law 2992/2002 is spread over three years instead of one in the case of mergers or absorptions that take place during the year of completion of such change.

Law 3522/2006 re: "Changes in income tax, simplification of the Accounting Books, Receipts and Invoices Code and other provisions" initiated the lowering of personal income tax. In particular, the tax exempt amount rises from €11,000 to €12,000 for employees and pensioners and from €9,500 to €10,500 for all other tax payers; tax rates are lowered by one percentage point; the 15% rate is abolished and the size of certain brackets is increased. Following these changes, the new income brackets for personal income tax are as follows:

1 Ministry of Economy and Finance.
2 It should be noted that enterprises included in Development Law 3220/2004 may form (between 2004 and 2008) a special tax-exempt reserve for corporate investment amounting up to 35% of total undistributed profits.

Table A Personal income tax for employees and pensioners

Income bracket	Tax rate	Bracket tax	Total income	Total tax
€12,000	0	€0	€12,000	€0
€18,000	29	€5,220	€30,000	€5,220
€45,000	39	€17,550	€75,000	€22,770
>€45,000	40			

Table B Personal income tax for non-employees and non-pensioners

Income bracket	Tax rate	Bracket tax	Total income	Total tax
€10,500	0	€0	€10,500	€0
€1,500	15	€225	€12,000	€225
€18,000	29	€5,220	€30,000	€5,445
€45,000	39	€17,550	€75,000	€22,995
>€45,000	40			

Under the same law, the 5% or 10% discount (without supporting documents) of income from real estate is abolished and is replaced by a decrease of up to 40% with supporting documents. Furthermore, the stamp duty on rents for residential purposes is halved from 3.6% to 1.8%. In all other categories of rent, the stamp duty remains at 3.6%. Furthermore, the exemption of interest income from corporate bonds issued by non-resident enterprises of Greek interests is abolished, and the same applies to the 1.5% reduction due to the timely payment of tax for all tax payers (apart from those whose tax is withheld at source). Besides, if an employee has other sources of income and this income is higher than his/her salary, then he/she is not taxed as an employee. These provisions aim at curtailing the loss of revenue stemming from the change in the tax brackets. It should be noted that, according to a relevant announcement of measures, personal income tax will be lowered again twice, in 2008 and in 2009.

As from 1 January 2007, the tax rate on small enterprises was lowered from 22% to 20%. This reduction completes the tax reform for small enterprises that had started in 2005 (Law 3296/2004). At the same time, the Unique Net Profit Rates, which determine the taxable income of many categories of tax payers, were raised.[3] The higher rates were applied in 2006 for income gained in 2005 and declared in 2006.

As from 1 July 2006 the special consumption tax on liquid fuel was raised by 5.7%.[4] This is the first of a series of increases that will ultimately increase consumption tax on liquid fuel by 20%, thus harmonising it with the levels prevailing in the EU. The second increase, of about 5.8%, became effective on 1 January 2007.

On 1 July 2006 a special consumption tax was imposed[5] on lignite, at 30 cents per gigajoule, according to the relevant EU directive[6] on the taxation of energy products. This tax was abolished in December 2006,[7] since the above directive exempts solid fuel used in the production of electricity.

Law 3492/2006 of 27 July 2006 led to an increase in the "minimum special consumption tax" on cigarettes. According to this law,

3 Minister of Economy and Finance Decisions 1004/2006 and 1035/2006.
4 Law 3483/2006 re: "Amending and supplementing provisions on financial leasing, on public revenue and other provisions".
5 Law 3483/2006.
6 Council Directive 2003/96/EC of 27 October 2003, restructuring the Community framework for the taxation of energy products and electricity.
7 Law 3517/2006 re: "Incorporation of Directive 2005/19/EC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States and other provisions".

the level of the special consumption tax cannot be lower than 75% (against 65% which applied as from April 2005) of the special consumption tax on cigarettes sold at the most preferred price. The same law provided for increases (as from 1 October 2006) in mobile telephony duties, ranging from 36% up to about 127%.

Law 3513/2006 imposed an extraordinary one-off tax on banks' reserves, at rates of 10% and 15%, in order to support 2006 revenue. For this reason, the tax was paid in two instalments, at end-November and at end-December 2006.

A series of decisions by the Minister of Economy and Finance[8] led to higher objective real estate prices. It is estimated that objective prices of properties within the boundaries of the city plan rose by 16% on average and of those outside the boundaries of the city plan by about 37% on average. This is the second increase in objective real estate prices, which was announced at the beginning of the year but finally came into force on 1 March 2007. Higher objective real estate prices lead to a higher tax base for many taxes related with real estate (e.g. real estate transfer tax, parental donation tax, automated overvaluation tax, imputed income from owner-occupied dwelling tax and many other less important taxes and duties) and thus to higher revenue. For this reason, the tax-exempt amount for the purchase of a first residence was raised[9] from 20% to about 22% and for inheritances, gifts and parental donations from 18.8% to about 33.3%.

Law 3522/2006 amended many provisions of the Accounting Books, Receipts and Invoices Code, aiming at its simplification. In this context, the minimum turnover required for bookkeeping purposes was increased by 50%, while the number of books and records that have to be validated by a Local Tax Office was reduced, the subscribers' book was abolished etc. At the same time, the period of limitation is doubled from 5 to 10 years, while the tax authorities may check again self-settled tax cases.

Finally, Ministry of Economy and Finance circulars[10] regulate issues concerning the payment of VAT on new buildings. Also, it is made clear that the tax will be calculated on the basis of either the objective price or the budgeted (or actual) cost of the building, whichever is the higher. Meanwhile, the "minimum construction cost", which affects the budgeted cost of new buildings, is readjusted.

After the increase in objective prices on 1 January 2006, it was decided[11] that the calculation of the tax on large real property will be based on the objective prices applicable in 2005. More recently it was decided[12] that, especially for this tax, objective prices of 2005 will also apply for 2007.

8 Decisions 1033, 1034, 1035, 1036 and 1037 of 27 February 2007.
9 See the law on "Incomes Policy for 2007, tax and other provisions", which was enacted in March 2007.
10 Circulars 1038, 1039, 1048, 1053 and 1054 of 2006.
11 Law 3453/2006 re: "Adjustments to the tax regime of connected enterprises and other provisions".
12 This provision is included in the law on "Incomes Policy for 2007, tax and other provisions", March 2007.

IX BALANCE OF PAYMENTS

1 CURRENT ACCOUNT

In 2005, the current account deficit increased considerably by €9,022 million over 2005 and reached €23,660 million (see Table IX.1), while the combined current account and capital transfers balances showed a deficit of €20,619 million, compared with €12,589 million in 2005.

The widening of the current account deficit is almost equally attributable to exogenous (extraordinary) and endogenous factors. The exogenous or extraordinary factors are the significant rise in the price of crude oil on the world markets in the first few months of the year and the increase in payments for the renewal of Greece's merchant fleet. The endogenous factors are the high growth rate of private consumption, investment recovery, the ongoing decline in price competitiveness and the rise in interest payments, which is mainly due to the high foreign debt of the Greek economy. As a result of endogenous factors, the current account deficit excluding oil and ships widened significantly to €11,508 million, from €7,285 million in 2005. Financing the trade deficit became harder, as both the services and the current transfers surpluses did not change considerably compared with 2005. Specifically, the services surplus decreased marginally, while the current transfers surplus increased only slightly. On account of these developments the current account deficit reached 12.1% of GDP, compared with 8.1% in 2005.

1.1 TRADE BALANCE

About 85% of the increase in the current account deficit reflects the widening of the trade deficit, which increased in 2006 by €7,727 million compared with 2005. The significant widening of the trade deficit in 2006 underlines the negative trend of a lasting economic problem and intensifies the economy's dependence on foreign borrowing. In particular, the trade deficit (excluding oil and ships) increased by €2,928 million to stand at €23.1 billion, thus accounting for 38% of the total increase in the trade deficit. The significant rise in export receipts in 2006 (€1,242 million or 12%), which largely reflects the higher growth rate of total external demand despite the fall in competitiveness, was insufficient to finance the rise (of €4,170 million or 13.6%) in the respective import bill, which —in absolute terms— is still three times higher than export receipts.[1]

The increase in net payments for the purchase of ships contributed considerably to the €2,668 million widening of the trade deficit. Payments for the purchase of ships more than doubled compared with 2005 and reached €5,022 million, their increase thus exceeding by far the rise in the respective receipts. The increase in purchases of ships is necessary in the context of renewing the merchant fleet, which —given the positive medium term outlook for sea transport— creates the necessary conditions for a future rise in receipts from sea

1 According to NSSG data for 2006, the value of exports excluding oil products (but including ships) rose by 13.5%, while the value of imports excluding oil products and ships rose by 9.8%; thus, the trade deficit excluding oil products increased by €1,730 million. The total value of exports increased by 18.2% and that of imports by 15%. It should be recalled that the differences between Bank of Greece and NSSG trade statistics are due to several reasons, the chief one being that the former relate to receipts and payments mainly through the domestic banking system, while the latter are based on customs data (for transactions with non-EU countries) or tax data (INTRASTAT) (for intra-EU transactions) and remain "provisional" for a long time.

Table IX.1 Balance of payments

(million euro)

	January – December		
	2004	2005	2006*
I Current account balance (I.A+I.B+I.C+I.D)	**–10,717.1**	**–14,637.5**	**–23,659.8**
I.A Trade balance (I.A.1 – I.A.2)	**–25,435.8**	**–27,558.9**	**–35,286.3**
Oil trade balance	–4,511.1	–6,629.2	–8,761.3
Non-oil trade balance	–20,924.7	–20,929.7	–26,525.0
Ships balance	135.6	–723.0	–3,390.5
Trade balance excl. fuel and ships	–21.060.3	–20.206.7	–23.134.5
I.A.1 Exports of goods	**12,653.3**	**14,200.9**	**16,154.3**
Fuel	1,544.7	2,257.7	2,939.8
Ships (receipts)	1,291.4	1,602.2	1,631.8
Other goods	9,817.2	10,341.0	11,582.7
I.A.2 Imports of goods	**38,089.0**	**41,759.8**	**51,440.6**
Fuel	6,055.8	8,886.9	11,701.1
Ships (payments)	1,155.8	2,325.2	5,022.3
Other goods	30,877.4	30,547.7	34,717.2
I.B Services balance (I.B.1 – I.B.2)	**15,467.0**	**15,497.1**	**15,337.1**
I.B.1 Receipts	**26,742.5**	**27,359.5**	**28,364.1**
Travel	10,347.8	10,835.5	11,356.7
Transport	13,307.0	13,871.4	14,324.7
Other services	3,087.7	2,652.6	2,682.7
I.B.2 Payments	**11,275.5**	**11,862.4**	**13,027.0**
Travel	2,310.4	2,445.7	2,382.8
Transport	5,728.2	6,237.7	6,991.3
Other services	3,236.9	3,179.0	3,652.9
I.C Income balance (I.C.1 – I.C.2)	**–4,377.4**	**–5,676.1**	**–7,118.8**
I.C.1 Receipts	**2,810.6**	**3,273.5**	**3,626.1**
Wages, salaries	280.0	287.1	318.1
Interest, dividends, profits	2,530.6	2,986.4	3,308.0
I.C.2 Payments	**7,188.0**	**8,949.6**	**10,744.9**
Wages, salaries	188.9	219.8	280.7
Interest, dividends, profits	6,999.1	8,729.8	10,464.2
I.D Current transfers balance (I.D.1–I.D.2)	**3,629.0**	**3,100.4**	**3,408.2**
I.D.1 Receipts	**6,356.0**	**6,876.4**	**6,847.4**
General government (receipts from the EU)	4,080.3	4,615.5	4,462.4
Other sectors (emigrants' remittances etc.)	2,275.7	2,261.0	2,385.0
I.D.2 Payments	**2,727.0**	**3,776.0**	**3,439.2**
General government (mainly payments to the EU)	2,216.8	2,921.4	2,472.7
Other sectors	510.3	854.6	966.5
II Capital transfers balance (II.1–II.2)	**2,386.1**	**2,048.6**	**3,041.3**
II.1 Receipts	**2,618.3**	**2,324.9**	**3,310.7**
General government (mainly receipts from the EU)	2,463.9	2,137.1	3,116.5
Other sectors	154.4	187.8	194.2
II.2 Payments	**232.2**	**276.3**	**269.5**
General government (mainly payments to the EU)	69.8	22.9	32.2
Other sectors	162.4	253.4	237.3
III Current account and capital transfers balance (I+II)	**–8,331.0**	**–12,588.9**	**–20,618.5**
IV Financial account balance (IV.A+IV.B+IV.C+IV.D)	**8,098.0**	**12,606.6**	**20,363.7**
IV.A Direct investment[1]	**863.6**	**–679.0**	**953.8**
By residents abroad	–828.8	–1,166.7	–3,321.6
By non-residents in Greece	1,692.4	487.7	4,275.4
IV.B Portfolio investment[1]	**13,727.5**	**7,322.6**	**8,115.4**
Assets	–11,489.4	–18,459.7	–6,961.2
Liabilities	25,216.9	25,782.3	15,076.6
IV.C Other investment[1]	**–9,104.1**	**5,914.0**	**11,518.5**
Assets	–6,215.7	–6,301.5	–5,851.0
Liabilities	–2,888.4	12,215.5	17,369.5
(General government loans)	–1,027.4	–447.0	–447.7
IV.D Change in reverse assets[2]	**2,611.0**	**49.0**	**–224.0**
V Errors and omissions	**233.0**	**–17.7**	**254.8**
Reserve assets	**1,994.0**	**1,945.0**	**2,169.0**

1 (+) net inflow, (–) net outflow.
2 (+) decrease, (–) increase.
* Provisional data.
Source: Bank of Greece.

Table IX.2 Greece: revised nominal and real effective exchange rate indices (EER)[1]

(average annual levels, percentage changes)

	Nominal EER	Real EER on the basis of relative consumer prices	Real EER on the basis of relative unit labour costs in manufacturing	Real EER on the basis of relative unit labour costs in the whole economy
2001	1.1	1.0	3.4	0.3
2002	1.9	2.8	4.5	3.6
2003	4.5	5.3	7.8	5.2
2004	1.4	2.0	6.1	4.0
2005	–0.7	0.4	5.0	–0.5
2006[2]	0.1	1.0	3.9	1.8
Cumulative percentage change in 2001-2006	**8.4**	**13.0**	**34.7**	**15.2**

1 Revised indices comprise Greece's 28 main trading partners (among them, the other 12 euro area countries, including Slovenia). The weights are calculated on the basis of manufacturing imports and exports (categories 5-8 of the Standardised International Trade Classification – SITC 5-8) during 1999-2001, taking into account competition in third markets.
Sources: – Exchange rates: ECB, euro reference exchange rates.
– CPI: ECB, harmonised CPI where available.
– Unit labour costs in manufacturing and unit labour costs in the whole economy: for Greece: Bank of Greece estimates, for the other countries: ECB.

transport and, thus, a medium term reduction in the current account deficit.

The burdening of the trade balance with the €2,132 million increase in the oil import bill in 2006 was also significant and was due to the rise in world oil prices[2] (in the first seven months of the year) and increased import volume. The net oil import bill corresponds to 25% of the total trade deficit and to 30% of its overall increase. At the same time, oil is an important element of Greece's exports. In 2006, receipts from oil exports amounted to almost 20% of total export receipts excluding ships. Furthermore, they corresponded to 25% of the oil import bill. Exports of oil products refer to processed oil products with considerable value added.[3]

As already mentioned, apart from the increase in payments for oil and ships, the trade deficit widened on account of the decrease in the Greek economy's price competitiveness, given that the growth rate of unit labour costs and consumer prices is outpacing that of other countries (taking also into account the change in the exchange rate – see Table IX.2). The situation is further aggravated by the structural weaknesses of the economy, which are reflected in the composition of external trade in goods and the difference in size between imports and exports. Over a number of years, the value of imports in absolute terms is almost three times that of exports. This stresses on the one hand the limited capabilities in replacing imported products, mainly industrial products, with domestic products and on the other hand the difficulty of exportable products to penetrate the world market (although exports have been expanding in recent years). Furthermore, regarding imported products, the low price elasticity of demand, together with its high income elasticity, is having an adverse effect on cutting down the import bill.

2 Indicatively, the average price of crude oil in euro increased at a rate of 18.6% in 2006.
3 Panhellenic Exporters Association (PSE), "Petroleum: Greece's Trade", *Episimanseis,* Athens, 2006.

Table IX.3 Breakdown of Greece's external trade by geographical area*

A. Exports

	Percentage share in the value of total exports			Percentage change in export value	
	2004	2005	2006	2005/2004	2006/2005
European Union (25)	54.9	53.1	53.7	10.0	19.6
European Union (15)	47.4	45.5	44.5	9.1	15.8
Euro area	37.9	36.9	36.8	10.4	18.1
OECD countries[1]	13.4	13.6	12.0	15.9	4.4
USA	5.3	5.2	4.4	12.8	–1.3
Balkan countries[2]	17.0	14.7	18.1	–1.4	45.1
Bulgaria	6.3	5.8	6.3	4.9	28.7
Romania	3.1	2.9	3.6	6.6	45.8
Commonwealth of Independent States	3.0	2.8	3.5	6.7	47.0
North Africa & Middle East countries[3]	6.5	7.6	8.5	34.2	31.7
China & Southeastern Asia[4]	1.9	2.3	1.9	39.2	–1.4
Other countries	3.4	5.8	2.2	93.0	–54.4
Total	**100.0**	**100.0**	**100.0**	**13.7**	**18.2**

B. Imports

	Percentage share in the value of total imports			Percentage change in import value	
	2004	2005	2006	2005/2004	2006/2005
European Union (25)	57.9	56.2	54.9	0.9	12.2
European Union (15)	55.8	53.9	52.1	0.3	11.2
Euro area	49.2	48.0	46.2	1.3	10.8
OECD countries[1]	16.0	12.5	12.9	–18.8	19.2
USA	4.5	3.4	1.8	–20.7	–40.5
Balkan countries[2]	3.1	3.5	3.9	15.2	28.4
Bulgaria	1.1	1.3	1.5	26.8	31.8
Romania	1.2	1.0	1.0	–13.8	16.3
Commonwealth of Independent States	6.4	9.1	8.9	48.2	12.3
North Africa & Middle East countries[3]	7.9	10.2	10.4	34.6	17.1
China & Southeastern Asia[4]	5.1	5.5	5.0	11.2	3.7
Other countries	3.6	3.1	4.1	–12.2	54.4
Total	**100.0**	**100.0**	**100.0**	**4.0**	**15.0**

1 The OECD Member States (including Turkey) not included in any other category.
2 Albania, Bulgaria, Romania and former Yugoslavia countries (Bosnia-Herzegovina, Croatia, FYROM and Serbia-Montenegro).
3 Greece's major trading partners in North Africa and the Middle East.
4 Greece's major trading partners in Southeastern Asia.
* All the data are provisional.
Source: NSSG.

The increase in Greek exports in the last two years is largely related to the high growth rate of the share of medium- and high-technology products and products of specialised labour.[4] These products are the only ones whose export share in world markets has increased, mainly in EU markets, as well as the markets of third countries.[5] Of course, it should be noted that the share of technology intensive products in total exports remains low compared with the average of the euro area countries: this indicates that the Greek economy has not fully benefited from world demand

4 I. Chalikias, *Changes in the composition of Greek exports in the period 1988-2005* (in Greek), PSE-KEEM, February 2007. See also Bank of Greece, *Annual Report 2005*, April 2006, Box IX.2 ("Review of changes in the structure of Greek external trade"), pp. 285-291.
5 According to the aforementioned recent PSE study, in the period under review the share of technology product exports in total Greek exports quadrupled, while the share of exports of products of specialised labour also increased considerably.

Table IX.4 Breakdown of Greece's external trade by product category (excluding oil and ships)

A. Export receipts

	Percentage share of each product category in total export receipts			Percentage change in export receipts	
	2004	2005	2006*	2005/2004	2006*/2005
Agricultural products	19.5	21.1	19.4	13.8	3.1
Chemicals, plastics	13.4	13.6	13.5	7.3	10.9
Metallurgy[1]	11.0	15.0	17.7	43.6	32.3
Machinery, appliances	6.2	6.4	6.5	9.0	14.1
Means of transport excl. ships	1.5	1.7	2.2	25.4	40.0
Other manufacturing branches[1]	20.0	18.6	15.6	–1.9	–5.8
Unclassified goods[2]	28.5	23.6	25.1	12.9	19.4
Total (excl. oil and ships)	**100.0**	**100.0**	**100.0**	**5.3**	**12.0**

B. Import bill

	Percentage share of each product category in total import bill			Percentage change in import bill	
	2004	2005	2006*	2005/2004	2006*/2005
Agricultural products	14.5	14.2	13.7	–3.4	9.5
Chemicals, plastics	15.2	16.9	15.8	9.8	6.4
Metallurgy[1]	9.5	10.3	11.2	7.0	23.9
Machinery, appliances	20.7	19.2	17.8	–8.2	5.4
Consumer durables	2.9	3.1	2.9	7.5	7.0
Capital goods	13.7	11.6	10.7	–15.9	4.8
Computers	2.0	2.2	2.0	6.0	5.6
Fixed-voice and mobile telephony	2.1	2.3	2.1	6.3	5.8
Means of transport excl. ships	14.5	14.9	15.7	2.1	19.5
Passenger cars	7.8	7.6	7.8	–3.7	16.2
Other manufacturing branches[1]	21.5	23.5	22.1	8.2	6.6
Other goods	0.4	0.2	0.1	–52.6	–22.5
Unclassified goods[2]	3.6	0.7	3.6	–79.9	446.3
Total (excl. oil and ships)	**100.0**	**100.0**	**100.0**	**–1.1**	**13.6**

1 Including raw materials used.
2 Products for which no code number has been reported.
* Provisional data.
Source: Bank of Greece.

developments.[6] At the same time, the share of traditional low-technology and raw-material-intensive exports has decreased. With regard to the geographical composition of Greek exports, a significant change is observed since the mid-1990s, mainly relating to a turn towards Eastern Europe and the Balkans. This development reflects the fact that Greek exporters are familiar with the conditions prevailing in these markets, together with Greece's geographical location (see Table IX.3). Activity in these rapidly developing markets and the increase in world demand are the most important factors which positively affect Greek exports.[7]

According to detailed Bank of Greece data, export receipts increased in most product categories excluding oil and ships (see Table IX.4). The largest contribution came from metallurgy products (including raw materials), which also reflects the rise in world prices. Receipts from transport means exports (excluding ships) also increased con-

6 ECB, MPC Task Force, "Competitiveness and the export performance of the euro area", ECB Occasional Paper, No. 30, June 2005.

7 According to a recent IMF study (IMF, *Greece – Selected Issues,* Chapter I, January 2007) the factors that had a favourable influence on Greek exports in 2000-2005 were (a) the overall rise in global trade and (b) the switch of Greek exports towards the markets of SE Europe.

siderably, mainly on account of re-exports of new cars (which had been imported from the countries where they are produced) to countries in the broader region, as well as exports of used cars. By contrast, a drop was recorded in export receipts from "other manufacturing industries", mainly due to the decrease in textiles and clothing exports.

A more detailed breakdown of exports by industry (which can be based only on NSSG data) confirms that the buoyancy of exports of high-technology and specialised products continued also in 2006. In particular, the growth rate of the value of exports in the "machinery and means of transport" category was 17%, significantly higher than the average growth rate of the same category in the last four years (8%).[8] By contrast, the growth rate of the value of exports in the "chemicals" category fell to 6% in 2006, from much higher levels in 2002-2005.

Regarding the geographical breakdown of exports, according to NSSG data (Table IX.3), the value of exports to the euro area and to the EU-25 increased almost at the same rate as that of the total value of exports. A much faster rate of increase was recorded in the value of exports to the Balkans (mainly Bulgaria and Romania, which are Greece's most important trading partners in the Balkans), Turkey, Eastern Europe, North Africa and the Middle East, thus increasing the share of exports to these countries.

According to detailed Bank of Greece data, in 2006 the import bill for all product categories increased, which is mainly related to the high growth rate of private consumption and the strengthening of investment activity. The higher contribution to this increase came from the "metallurgy" import bill (see Table IX.4), which —as in the case of the respective exports— is also related to the rise in world raw material prices, and from the "means of transport excluding ships" import bill, more than 50% of which refers to passenger cars (partly destined to be re-exported). The geographical composition of imports (see Table IX.3) did not show any significant change in 2006, despite the slight drop in the share of imports from the EU, which account for almost 55% of total imports and for more than 60% of industrial product imports.

1.2 SERVICES BALANCE

The services surplus stood at €15,337 million in 2006, namely it fell by 1.0% compared with 2005. This reflects the fact that the rise in net receipts from travel services was offset by the fall in net receipts from transport services, while net payments for "other" services also increased. The services surplus covered 43.5% of the trade deficit in 2006: this indicates that trade deficit financing is still dependent to a great extent on foreign borrowing.

Specifically, receipts from travel services came to €11,357 million, i.e. they rose by €521 million or 4.8%, while payments fell by €63 million or 2.6% compared with 2005. The rise in travel receipts is exclusively due to the increase in arrivals by 5.8%, while expenditure per arrival (per visitor) and the number of overnight stays per visitor remained virtually unchanged compared with

8 It is noted that the growth rate of the value of exports in this category towards euro area countries was 3.7% and towards Balkan countries 43%.

last year (according to a sample survey conducted on behalf of the Bank of Greece).[9] Total overnight stays increased by 5.7%, while expenditure per overnight stay fell by 1%.

The upward trend in arrivals was maintained partly due to intensive advertising of the Greek tourist product over the last two years. However, the growth rate of travel receipts is below the rate of increase in arrivals, which indicates an inability to attract high-income visitors.

Gross receipts from transport services stood at €14,325 million, i.e. they increased by €453 million compared with 2005. Shipping services account for 93% of these receipts. The rise in receipts is attributed to the increase in the size of the Greek-owned fleet (and thus in the capability to provide transport services) and its quality upgrading through the lowering of the average age of ships (see Box IX.1), which ensures the capability to conclude contracts at higher freight rates than those prevailing in the market.[10] At the same time, however, gross payments for transport services increased by €754 million, €378 million of which resulted from higher payments for the provision of shipping services.[11] Thus, net receipts from transport services fell by about €300 million.

Finally, net payments for other services increased by €444 million to stand at €970 million: this development reflects the rise in payments, while receipts increased only marginally (by 1.1%).

9 This study takes into account the place of residence of visitors, and immigrants who work and live in Greece are excluded from the number of arrivals. This largely accounts for the differences between Bank of Greece and other source data. According to Bank of Greece data, arrivals from EU countries increased by 6.1%, while arrivals from countries outside the EU increased by 5.7%. According to International Tourism Organisation data, in 2006 world arrivals and arrivals in Europe increased by 4.6% and 3.4% respectively, i.e. less than arrivals in Greece.

10 The rise in receipts from shipping services was achieved despite the fact that in 2006 the Baltic Dry Index (BDI) and the Baltic Dirty Tanker Index (BDTI) fell, on average, by 6% and 15% respectively. More specifically, the BDI showed a downward trend at the end of 2005 and at the beginning of 2006, while from the summer of 2006 until the end of the year it increased considerably: in the end, the average level of this index in 2006 was lower than in 2005. The increased demand for iron ore by China played a key role in higher freights from the summer of 2006. The BDTI, with the exception of the summer of 2006, ranged at lower levels compared with 2005. This is related to the limited increase in the demand for crude oil from developed economies (although demand from developing countries in Asia remained strong).

11 Most payments for shipping services are related to services that are associated or complementary to shipping, such as factoring, berthing, hauling etc.

Box IX.1

DEVELOPMENTS IN, AND OUTLOOK FOR, GREEK SHIPPING

1. Introduction

Net receipts from the provision of transport services represent —on average over the past three years— more than 4% of Greek GDP, and almost half of total net receipts from services. Given that the largest share of net receipts comes from the provision of shipping services for the needs of world cross trade, net receipts from Greek transport services, which are almost in their entirety shipping services, correspond to around 75% of total net receipts from transport services in the EU-15 and around half of receipts in the EU as a whole. In 2006 in particular, gross inflows from sea transport came to €13,280

Key economic aggregates related to sea transport

(million euro)

Aggregate	2004	2005	2006
GDP (at current prices)	168,417	181,088	195,213
Trade balance	–25,435.8	–27,558.9	–35,286.3
– *of which: ships (sales less purchases)*	*135.6*	*–723.0*	*–3,390.5*
Services balance	15,467.0	15,497.1	15,337.1
Sea transport receipts	12,404.2	12,953.0	13,280.2
–Annual percentage change	*38.42*	*4.42*	*2.53*
Sea transport payments	4,486.0	4,646.9	5,024.5
– Annual percentage change	*17.50*	*3.59*	*8.13*
Net inflows from sea transport	7,918.3	8,306.1	8,255.7
– Percentage of GDP	*4.70*	*4.59*	*4.23*
– Percentage of the services balance	*51.19*	*53.60*	*53.83*
– Percentage coverage of the trade deficit	*31.13*	*30.14*	*23.40*
Annual percentage change of net inflows from sea transport	53.9	4.9	–0.6

Sources: Bank of Greece and (for GDP) Ministry of Economy and Finance.

million, against corresponding payments of €5,024 million (see table). It is important that, while over the last two years world freight rates were lower than the high levels observed in 2004, gross receipts from the provision of shipping services continued to grow. This is due to both the 19.6% increase (in terms of dead-weight tonnes – dwt) in the transport capacity of the Greek-owned fleet and its qualitative upgrade on account of the fall in ships' average age.

2. Structure of the Greek merchant fleet

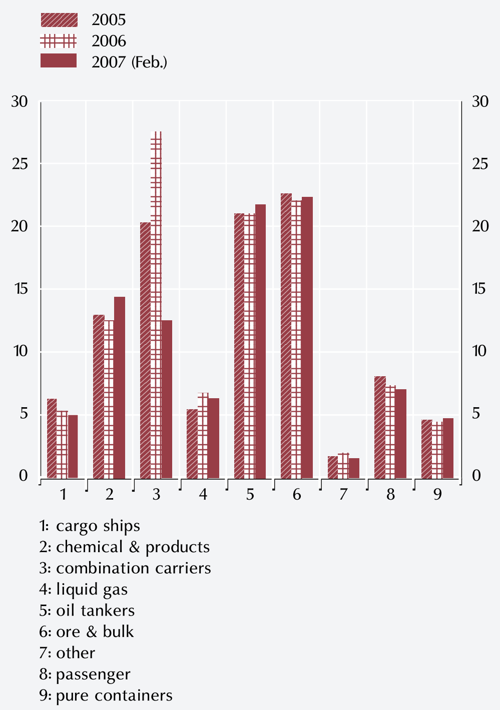
In February 2007, the fleet under Greek management reached 3,699 ships with a total transport capacity of 218 million dwt, which corresponds to 16.5% of the transport capacity of the world fleet.[1] The preference of Greek ship-owners for dry-bulk carriers and tankers is obvious, given that in these two categories the Greek share in the world fleet comes to 22.3% and 21.8% respectively (see Charts A and B). It is worth noting that the average size of ships increased by around 5.5% in 2007, which makes it easier to exploit the economies of scale seen in the shipping sector.

Furthermore, Greek ship-owners are carrying out an extensive programme to renew and expand the existing fleet; in this context, contracts for building 322 new ships (of which 221 tankers and 74 dry-cargo ships) were concluded in 2006, worth a total of $16.6 billion. This strong shipbuilding activity of Greek ship-owners continued in the first quarter of 2007, when orders were placed for 125 ships —mostly dry-bulk ones— worth $6.7 billion.[2]

This renewal programme helped to lower the average age of the fleet. Specifically, the average age of the Greek-owned fleet comes close to 10.1 years, since the average age of dry-cargo ships is 12.2 years and that of tankers 7.4 years.[3] The respective figures for the fleet under the Greek flag are 5.9 years, 7.6 years and 4.8 years: this is indicative of the low age of ships entering the national ship register.

1 According to data of Lloyd's Register-Fairplay, as presented in the *Report* of the London-based Greek Shipping Co-operation Committee – February 2007.
2 According to data from the G. Moundreas company. Indicatively, in early 2007 Greek orders for new ships accounted for 15.2% of world orders in terms of transport capacity, while in 2006 this figure barely exceeded 11%.
3 Weighted average age based on capacity (dwt).

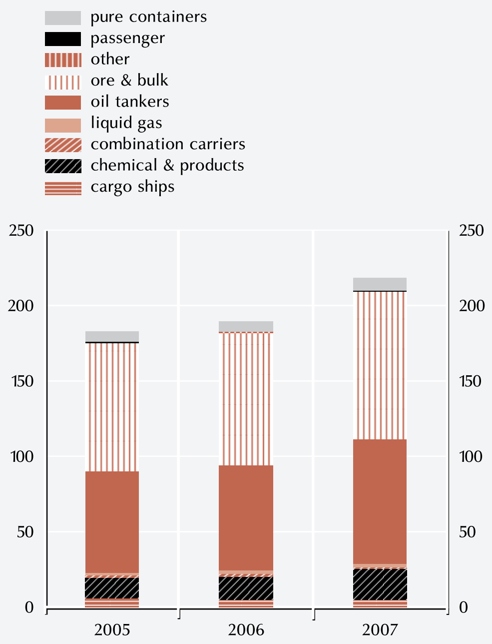
Chart A Greek-owned merchant fleet as a percentage of the world fleet



Source: Lloyd's Register – Fairplay.

Chart B Structure of the Greek-owned merchant fleet

(million dwt)



Source: Lloyd's Register – Fairplay.

The age spread between dry-bulk ships and tankers is mainly due to the tightening of marine environment protection standards in case of accidents on ships carrying oil and/or oil products. Specifically, the requirement to build double-hull vessels and the accelerating phase-out programme for existing single-hull ships has contributed to the faster replacement of older tankers.[4]

It should be noted that the relevant trade balance figures, which reflect the sales and purchases of ships, are compiled only through banks located in Greece; thus, although these figures record the renewal trend of the Greek-owned fleet, they do not reflect, in their entirety, the activities of Greek ship-owners with respect to the purchase and building of ships. This is related to the international character of Greek shipping and its capability to receive financing from both international capital markets and credit institutions outside Greek territory. Given also the productivity increase in maritime credit branches

4 The first action towards establishing the use of double-hull ships for oil transport is related to the Oil Pollution Act 90 that was unilaterally implemented by the USA after the crude oil leak of "Exxon Valdez" in the Alaska sea in 1989. This act required the operation of double-hull ships in USA waters from 2005 and provided for a phase-out programme for existing single-hull ships between 2010 and 2015. Subsequently, the International Maritime Organisation (IMO) imposed, through the MARPOL Convention, the construction of double hulls in ships to be delivered after July 1996. Consequently, single-hull vessels (built before 1996) that would not meet US regulations would continue to provide services in the remaining areas. However, after the "Erika" incident in December 1999 and the "Prestige" incident in November 2002, the EU (Regulation 417/2002, as amended by Regulation 1726/2003) and the IMO established a programme for the gradual implementation of the double-hull requirement and the accelerating phase-out programme for single-hull ships by 2010. It is worth noting that IMO regulations are only applicable in the territory of adhering countries, which contributes to the creation of a two-tier market.

of Greek banks, foreign banks are establishing branches[5] in Greece to service Greek ship-owners. To the extent the interest of the latter in renewing and expanding their fleet remains intact, sales and purchases of ships will continue to contribute significantly to the trade balance in the years to come.

3. Greek shipping and crew composition

Only 25% of the Greek-owned fleet is registered in Greece, while 15% is registered in Panama, 14% in Malta, 10% in Cyprus and 10% in Liberia, mainly on account of the increased cost required for crew composition in ships under the Greek flag. According to a study by the University of Piraeus,[6] the additional annual cost from the use of the Greek flag compared with the use of the so-called "flags of convenience" comes to €265,000-395,000 per ship, depending on her size. Although the strategy followed by shipping companies includes the employment of Greek seamen in high-ranking positions, the required composition of the crew on ships under the national flag implies the employment of Greek seamen also in low-ranking positions, which results in much higher costs compared with the employment of foreign seamen.[7]

In December 2006, the Ministry of Mercantile Marine reduced[8] the mandatory number of Greeks to be employed on ships under the Greek flag.[9] Furthermore, there is no longer any limitation in the positions that need to be held by Greek seamen, with the exception of the master. On account of this regulation, many Greek shipping companies expressed their interest to place under the Greek flag a significant number of existing ships as well as ships under construction.[10] According to NSSG data, in January of this year 8 new ships of an average age of 6 years and 2 ships under construction were registered, while 11 ships of an age exceeding 13 years were written off. Thus, the fleet under the Greek flag was reduced by one ship, but the capacity of the Greek fleet increased by around 400,000 tonnes.

4. Recent developments and outlook

In the summer of 2006, the European Commission published a consultative paper on shipping issues (Green Paper): the consultation will last until June 20, 2007.[11] The aim set by the European Commission with the Green Paper is to enhance the ecological dimensions of shipping policy, taking also into account the stance of the Lisbon Strategy with respect to an environmentally viable economic development. This goal is expected to be achieved both through the protection of EU seas and with the development of high-quality services and products for the world economy. For its part, the shipping com-

5 Indicatively, since 2005 four foreign bank branches or representative offices with significant financing activity towards Greek shipping are already operating in Greece.
6 University of Piraeus and Hellenic Chamber of Shipping, *Investigation and recording of the effect of shipping activity on the Greek economy – sea farers and Greek ship manning costs*, September 2005.
7 According to the aforementioned study by the University of Piraeus, the annual employment cost spread between Greek and foreign seamen in low-ranking positions ranges between €72,000 and €90,000 per ship, depending on her size.
8 Through the amendment of clause 8 of registration approval acts, issued under article 13 of LD 2687/1953.
9 Depending on the size of the ship, the mandatory number of Greeks is 4-6 persons, plus one cadet officer.
10 According to Ministry of Mercantile Marine announcements, a legislative proposal to reduce the social security contributions to the Merchant Seamen's Fund for lower-ranking positions is under way; furthermore, ship-owners will be relieved from the relevant contributions for the employment of Greeks beyond the mandatory number of Greeks in the composition of the crew of ships under the Greek flag.
11 According to data presented in the Green Paper *(Green Paper towards a future Maritime Policy for the Union: A European vision for the oceans and seas)*, around 3-5% of the EU-25 GDP comes from activities related to shipping and the provision of maritime services.

munity on the one hand recognises the effort of the Commission to strengthen EU shipping, but on the other hand expresses its concern regarding the suggested reinforcement of the coordinating role of the EU with respect to the positions of Member States and their uniform representation in international shipping organisations, as well as regarding the potential negative impact of the creation of the Common European Maritime Space.[12]

In 2007, it is expected that the growth of gross receipts from sea transport will continue —albeit at a slower pace— mainly on account of the increase in the transport capacity of the Greek-owned fleet. Specifically, dry-cargo freight rates are estimated to stand at the levels observed in 2006, since the net rise in the provision of sea transport services (after taking into account the delivery of new ships and the scrapping of older ones) will be offset by the rise in demand. However, continued strong demand for iron ore from China remains a key condition. The tanker industry is expected to present a marginal decline in freights in 2007, due to the increase in the world fleet at a rate (6%) that is much higher than the rate of increase in world oil demand.[13] A key aspect regarding the development of tanker freights is the number of ships that will be scrapped in order to strike a balance between the respective supply and demand. Although it is expected that payments for the purchase of ships will remain at high levels over the next five years, the addition to the Greek-owned fleet of the 612 ships that have already been ordered by Greek shipping companies will strengthen the transport surplus in the coming years.

12 Letter by the International Chamber of Shipping (ICS). The arguments of the ICS regarding the Common European Maritime Space are related to the limitations that will possibly be placed by coastal EU countries on ships under non-European flags when providing transport services within the EU. In essence, the concern relates to the possibility of creating a peculiar kind of cabotage, whereby only ships under an EU-country flag will be able to provide transport services within the EU. Today, transport between EU countries is considered international transport and is not subject to any limitations or prohibitions.

13 Since October 2006, OPEC has decided to proceed with two consecutive limitations of its production, while according to the forecasts of the International Energy Agency (IEA) the rate of increase in oil demand will come to 1.8% in 2007 (compared with 1% in 2006).

1.3 INCOME ACCOUNT

The income account deficit widened considerably (by €1,443 million) and came to €7,119 million in 2006. This was due primarily to the rise in interest payments (on account of ongoing external borrowing by Greece and the rise in interest rates in world money markets) and secondarily to the increase in dividends paid to non-residents (on account of higher investments by foreign institutional investors in Greek shares).

1.4 CURRENT TRANSFERS BALANCE

In 2006, the current transfers surplus increased exclusively due to the rise in net current transfers to general government (mainly from the EU), since net receipts by other sectors (mainly emigrants' remittances) remained at the same levels. Current transfers from the EU mainly include receipts from the Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) in the context of the Common Agricultural Policy and receipts from the European Social Fund, while the respective transfers to the EU mainly include Greece's payments to the EU Budget.[12]

12 It should be noted that current transactions on a monthly and annual basis do not only concern direct CAP contributions and regular contributions to the Community Budget, but also other funds, such as temporary transfers between central banks, extraordinary contributions and return of funds to the EU Budget.

2 CAPITAL TRANSFERS BALANCE

The widening of the capital transfers surplus in 2006 reflects the rise in EU transfers to €3.1 billion, from €2.1 billion in 2005, and is mainly due to the higher rate of absorption of resources from the Structural Funds under Community Support Framework III (CSF III).[13] Specifically, from the start of CSF III implementation in 2001 until the end of 2006 Greece had received from the Structural Funds almost €13 billion, out of a total community funding of €22.7 billion. The fact that two years before the final stage of CSF III implementation the overall absorption rate is around 60% of the total community contribution[14] reflects a series of weaknesses that were recorded in 2000-2006 (e.g. regarding the institutional framework for awarding projects and the management and control systems). In order to absorb community funds more rapidly and more fully until the end of 2008, the European Commission, following deliberations with the Greek government,[15] set a number of measures which mainly include the following: (a) revision of certain CSF III programmes, (b) transfer of projects which will not have been completed by 2008 to the 2007-2013 National Strategic Reference Framework (NSRF) and (c) increase in the community funding percentage for CSF III specific projects and programmes, which implies a positive impact on the national budget.[16]

Accordingly, it should be expected that the rate of increase in receipts from the EU under CSF III will accelerate in the coming period.[17] With regard to receipts from EAGGF under the revised CAP (which in Greece is implemented gradually as from 1 January 2006), it is estimated that they will remain at the levels of previous years (around €2.6 billion per annum).[18] Taking also into account Greece's contributions to the EU Budget, in 2007 and 2008 total net transfers from the EU will fluctuate (on an annual basis) around €5 billion, excluding 2007-2013 NSRF advance payments (CSF IV).[19]

As regards the entire fiscal period 2007-2013, Greece has ensured community funding of €24.3 billion (current prices) from the Structural Funds and the Cohesion Fund for the implementation of the National Strategic Reference Framework (CSF IV, 2007-2013).[20] As already mentioned, it seems that subsidisation under the CAP will remain virtually unchanged until 2013.[21]

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13 EU capital transfers mainly include receipts from the Structural Funds —other than the European Social Fund— and the Cohesion Fund under the Community Support Framework.

14 At end-December 2006, the absorption rates on a cash basis for the individual Structural Funds were as follows: European Regional Development Fund (ERDF) 53%, European Social Fund (ESF) 59%, Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) 56%, Financial Instrument for Fisheries Guidance (FIFG) 56%. At end-December 2006, public spending (Community and national) corresponding to contracts signed was close to 90% of total public spending budgeted under the 3rd CSF.

15 See the letter sent on 15 November 2006 by the President of the European Commission Mr. Baroso to the Greek Prime Minister.

16 Bank of Greece, *Monetary Policy 2006-2007*, February 2007, p. 125.

17 According to provisional data, receipts from the Structural Funds and the Cohesion Fund in the first quarter of 2007 reached €2,130 million, compared with €775 million in the same period of 2006.

18 For the CAP revision, see Bank of Greece, *Annual Report 2005* (pp. 301-302), and *Annual Report 2004* (pp. 258-259).

19 According to the relevant regulations, the European Commission will pay to Greece and the other EU Member States a 5% advance of Structural Funds total financing during the 2007-2008 period and 7.5% of the Cohesion Fund total financing during the 2007-2009 period.

20 See European Commission, *The Growth and Jobs Strategy and the Reform of the European Cohesion Policy: Fourth progress report on cohesion,* COM (2006) 281, 12 June 2006, and Ministry of Economy and Finance, *National Reform Plan 2005-2008 – Implementation Report 2006*, October 2006.

21 See statements by Commissioner for Agriculture Ms Marian Fischer Boel during the informal EU Council of Ministers of Agriculture (25 September 2006) and interview with Commissioner Hübner (15 October 2006).

It should be noted that the revision of Greek GDP implies higher contributions to the EU Budget as from 2007,[22] while it will not affect the amounts of transfers from the EU already agreed upon for the period 2007-2013.[23]

3 CURRENT ACCOUNT AND CAPITAL TRANSFERS BALANCE

The combined current account and capital transfers balance (old presentation method) showed a deficit of €20.6 billion in 2006, compared with €12.6 billion in 2005. In particular, total net transfers from the EU (current transfers and capital transfers) rose to €5.1 billion in 2006, compared with €3.8 billion in 2005, which corresponds to 2.6% of GDP and 14.4% of the trade deficit. Specifically, structural resources (receipts from Structural Funds and the Cohesion Fund according to CSFs) falling under Community Support Frameworks came to 1.8% of GDP. The combined current account and capital transfers deficit (old presentation method) reflects the financing volume which needs to result from the financial account.

4 FINANCIAL ACCOUNT

In 2006, net financial inflows came to €20.4 billion or 10.4% of GDP and, together with the capital transfers surplus, provided sufficient funding to offset the current account deficit. Despite the significant recovery of inflows for direct investment, the parallel increase in the same type of investment abroad by Greek residents limited the net inflow for direct investment. This means that the financing of the current account deficit was achieved mainly through the net inflows of the other two categories (portfolio and "other" investment), which, however, mostly represent foreign borrowing.

In more detail, financial investment in 2006, i.e. the sum of direct investment, portfolio investment and "other" investment (which mainly include interbank deposits and repos) recorded a net inflow of €20,588 million, compared with a net inflow of €12,558 million in 2005 (see Table IX.1). This development is primarily due to the net inflow of €11,519 million in "other" investment (compared with a net inflow of €5,914 million in 2005) and €8,115 million in portfolio investment (compared with €7,323 million in 2005) and secondarily to the net inflow of €954 million for direct investment (compared with a net outflow of €679 million in 2005).

4.1 DIRECT INVESTMENT

With regard to direct investment, a significant increase was recorded in both investment in Greece by non-residents and investment abroad by residents, resulting in relatively low levels of net inflows in this category.

More specifically, the net inflow of non-residents' funds for direct investment in Greece

22 The upward revision of the Greek GDP by 25.7% implies an annual increase in the contributions of €450-500 million and a respective burden on the fiscal deficit. The exact amounts and the way and time for the payment of contribution arrears to the EU Budget have not yet been determined.

23 With regard to the contributions from the Cohesion Fund, it should be recalled that Member States with a per capita GDP of less than 90% of the EU average remain eligible. The eligibility of Member States will be re-examined in 2010 on the basis of data regarding the EU-27, and Greece might lose €1.4 billion (of a total provision of €3.3 billion for the whole seven-year period).

Table IX.5 Breakdown of foreign direct investment in Greece by area of origin			
(million euro)			
	2004	2005	2006*
EU (25)	1,357	228	3,994
EU (15)	1,335	189	3,830
Euro area	679	–79	3,092
Other OECD countries[1]	292	138	206.0
Balkan countries[2]	–1	1	2
Middle East, Mediterranean and former USSR[3]	10	3	10
Other countries	35	118	63
Total direct investment by non-residents	**1,692**	**488**	**4,275**

1 Australia, Canada, Iceland, Japan, Korea, Mexico, New Zealand, Norway, Switzerland, Turkey and USA.
2 Albania, Bulgaria, Romania and former Yugoslavia countries (Bosnia-Herzegovina, Croatia, FYROM and Serbia-Montenegro). Bulgaria and Romania joined the EU on 1.1.2007.
3 Greece's major trading partners in the Middle East, the Mediterranean and former USSR countries.
* Provisional data.
Source: Bank of Greece.

came to €4,275 million, which is particularly high compared with the low levels of recent years (e.g. in 2005 inflows of funds for direct investment came to €488 million). This development is largely due to the acquisition (worth €2,090 million) of Emporiki Bank by Crédit Agricole (increase in the participation of the latter in Emporiki Bank's share capital from 8.2% to 72.0%). It is also worth noting the increase in investment abroad by residents, which came to €3,322 million (compared with €1,167 million in 2005). The outflow of €2,154 million for the acquisition of the Turkish Finansbank by the National Bank of Greece contributed to a great extent to this development.

Regarding the geographical distribution of direct investment by non-residents in Greece, these came almost exclusively from EU countries, especially euro area countries, and — to a lesser extent— from the remaining OECD countries (see Table IX.5). Apart from the acquisition of Emporiki Bank, other significant direct investments were also realised in 2006 by non-residents in Greece, most importantly the following: (a) the acquisition, worth €298 million, of Q-Telecommunications SA by the US firm Apax and Texas Pacific (in January), (b) the participation, worth €114 million, of Sara Lee in the capital increase of its subsidiary Sara Lee Hellas (in March), (c) the purchase, for €392 million, by Dubai Financial of 31.5% of the share capital of Marfin Financial Group (in May) and (d) the coverage, worth €203 million, of the share capital increase of Unilever Hellas SA by its parent company, the Dutch Unilever SA (in November). It is also worth noting the inflow of €342 million due to the sale of OTE's stake in the share capital of Armentel (Armenia) to a non-resident company (Vimpel-Communications).

Table IX.6 shows the geographical distribution of direct investment abroad by residents. "Other OECD countries" (including Turkey) absorbed the greatest part of these investments (mainly due to the acquisition of Finansbank), while a significant part was directed towards the Balkans (direct investment in these countries by residents of

Table IX.6 Breakdown of Greek direct investment abroad by area of destination

(million euro)

	2004	2005	2006*
EU (25)	578	409	208
EU (15)	312	102	–330
Euro area	226	72	–18
Other OECD countries[1]	95	35	2,340
Balkan countries[2]	91	560	706
Middle East, Mediterranean and former USSR[3]	23	84	36
Other countries	42	79	32
Total direct investment by residents	**829**	**1,167**	**3,322**

1 Australia, Canada, Iceland, Japan, Korea, Mexico, New Zealand, Norway, Switzerland, Turkey and USA.
2 Albania, Bulgaria, Romania and former Yugoslavia countries (Bosnia-Herzegovina, Croatia, FYROM and Serbia-Montenegro). Bulgaria and Romania joined the EU on 1.1.2007.
3 Greece's major trading partners in the Middle East, the Mediterranean and former USSR countries.
* Provisional data.
Source: Bank of Greece.

Greece increased by 26%). The most important direct investments abroad by residents of Greece are the following: (a) the acquisition, worth €69 million, of an extra stake (20%) in the share capital of the Turkish Intelteck by Intralot (in January), (b) the participation, worth €63 million, of the National Bank of Greece in the share capital increase of Banca Romanesca SA (in January), (c) the completion of the acquisition, worth €77 million, of EFG Eurobank SA Polska in Poland by Eurobank-Ergasias SA (in March), (d) the partial acquisition, worth €93.5 million, of the Serbian Agroindustrijka Komercijalna Banka by the Agricultural Bank (in October), (e) the partial acquisition, worth €36 million, of Mindbank (Romania) also by the Agricultural Bank (in November) and (f) the acquisition, worth €357 million, of the Serbian Vojvodjanska Banka by the National Bank of Greece (in December).

4.2 PORTFOLIO INVESTMENT

Inflows of funds for portfolio investment came to €15.1 billion, showing a decrease relative to 2005 (€25.8 billion). This is mainly due to the decrease in purchases of Greek government bonds by foreign investors (€11.2 billion compared with €20.7 billion in 2005) and, to a lesser extent, to the redemption of short-term Greek government paper amounting to €2.2 billion. By contrast, purchases of shares by foreign investors increased to €6.0 billion (2005: €5.1 billion).

Portfolio investment abroad by residents of Greece also fell considerably to €7.0 billion, compared with €18.5 billion in 2005. Yet again, this was mainly due to the drop in residents' investment in bonds and —to a much lesser extent— in foreign Treasury bills. By contrast, residents' investment in foreign equities rose to €2.3 billion, compared with €1.8 billion in 2005.

The overall downward trend of both foreign and domestic new investment in bonds largely reflects the recovery of world stock markets, particularly in the last months of 2006, the fall in bond prices on account of

Table IX.7 International investment position

(million euro)

	2004	2005*	2006**
1. Direct investment	**–10,785**	**–13,213**	**–16,520**
Abroad by residents	10,125	11,530	14,852
In Greece by non-residents	20,910	24,743	31,372
2. Portfolio investment	**–99,692**	**–112,007**	**–127,551**
Assets	38,665	59,319	67,136
Liabilities	138,357	171,326	194,687
3. Financial derivatives	**603**	**559**	**10**
4. Other investment	**–16,242**	**–26,471**	**–38,111**
Assets	51,375	56,741	62,574
Liabilities	67,617	83,212	100,685
5. Reserve assets[1]	**1,994**	**1,945**	**2,169**
Net international investment position (1+2+3+4+5)	**–124,122**	**–149,187**	**–180,003**
GDP	168,417	181,088	195,213
% of GDP	**–73.7**	**–82.4**	**–92.2**

1 The decrease in reserve assets in 2004 is associated with the restructuring of the Bank of Greece's portfolio.
* Data for 2005 have been revised and thus are not identical to the corresponding data in the previous Annual Report.
** Provisional estimates.
Source: Bank of Greece.

the euro area interest rate upswing, as well as the increased volatility of bond prices.

4.3 OTHER INVESTMENT

The net inflow of funds in the "other" investment category mainly reflects the fact that the inflow of non-residents' funds for investment in deposits and repos in Greece was more than three times as much as the outflow of residents' funds for similar investment abroad. In more detail, non-residents' investment in deposits and repos in Greece came to €17.0 billion, compared with €14.2 billion in 2005, while residents' corresponding investment abroad came to €5.5 billion, compared with €6.3 billion in 2005.

Lastly, Greece's reserve assets, as defined by the European Central Bank, stood at €2.2 billion at the end of 2006, having recorded an increase of €224 million in the course of the year.

5 INTERNATIONAL INVESTMENT POSITION

In 2006, Greece's negative international investment position deteriorated further to €180.1 billion at the end of the year (92.2% of GDP), from €149.2 billion at the end of 2005 (82.4% of GDP – see Table IX.7).

The deterioration of the country's international investment position reflects the negative effect primarily of portfolio investment and, secondarily, of "other" and direct investment. The negative impact of the first two categories is due to the greater increase in liabilities relative to the corresponding increase in assets and, particularly for portfolio investment, it affects considerably the volume of the country's external debt. Finally, the negative effect of foreign direct investment is associated with the significant recovery of non-residents' investment in Greece.

X BANKING SYSTEM AND SUPERVISION

1 INTRODUCTION

Banks' satisfactory profitability and capital adequacy, as well as the improvement in their risk management systems, contributed to the robustness of the banking system also in 2006. Underlying this positive development were high economic and credit growth rates; the satisfactory performance of the stock exchange; Greek commercial banks' income diversification through cross-border expansion; and the containment of operating costs.

The profitability of Greek banks grew for the fourth consecutive year, albeit at a slower rate than in 2005. This rise is largely accounted for by net interest income, which makes up almost 3/4 of Greek banks' total income, as the small narrowing of the net interest rate margin owing to increasing competition was more than offset by strong credit expansion.

Credit expansion to households slowed down in 2006, but remains strong, while credit expansion to firms sped up. At the same time, commission income grew owing to a further rise in retail banking operations, as well as the favourable conjuncture in the stock exchange. Profitability was also boosted by non-recurring profits, such as the sale of participations, but was unfavourably affected by the one-off taxation of banks' reserves, as well as by increased provisioning (impairment losses) for non-performing loans (NPLs) by certain banks. Greek banking groups' after-tax return on equity (ROE) dropped, but remained satisfactory, close to that for EU banking groups,[1] while the continuous expansion of their business and the curtailment of operating costs improved the efficiency ratio.

As regards the quality of the loan portfolio, in 2006 an improvement was observed in the non-performing loans to total loans ratio (NPL ratio) across the loan spectrum, although this ratio remains considerably higher than the average for EU countries. The decline in this ratio is attributable on the one hand to the favourable economic environment and, on the other hand, to increased bad loan write-offs by banks, which took advantage of the supervisory incentives provided by the Bank of Greece. Moreover, the coverage ratio of provisions to NPLs remained at a satisfactory level.

At end-2006, capital adequacy remained above the supervisory minimum (8%) and marginally higher than the average for EU countries, despite the strong increase in risk-weighted assets, which is mainly accounted for by strong credit growth and Greek banks' cross-border expansion. The substantial amount of capital raised by the National Bank of Greece for the implementation of acquisitions abroad[2] kept unchanged the quality of supervisory capital at banking system level, as the share of Tier I capital in total supervisory own funds did not change visibly.

However, it is necessary to underline the main challenges and risks facing the banking system:

First, the effort to successfully adapt to the new supervisory framework ("Basel II"). The Bank of Greece has already carried out pre-

1 In this chapter, comparative data for the EU countries are drawn from the following ECB publications: *EU Banking Sector Stability*, November 2006; *EU Banking Structures,* October 2006; and *Monthly Bulletin*, March 2007.

2 Mainly the Turkish Finansbank and the Serbian Vojvodjanska Banka.

liminary controls in order to verify credit institutions' readiness to implement this framework, and at the same time is preparing the relevant institutional framework.[3] It is estimated that total capital requirements will rise, as the increase owing to the calculation, for the first time, of capital requirements for operational risk will not be offset by the decrease in capital requirements for credit risk.[4]

Second, mounting competition among banks for capturing larger market shares, especially in retail banking, which has led to narrower profit margins and —at least for certain banks— a loosening of credit standards. Signals in this direction include the maintenance of high loan-to-value ratios and the increase in the number of approvals in relation to the number of applications for new consumer loans and credit cards.

Third, the effective management of the risks (credit, operational and country risk) associated with Greek banks' activities abroad, especially in Southeastern Europe countries, where markets are characterised by considerable volatility.

Fourth, correct assessment of the risks arising out of innovative products and investments in products traded on semi-supervised markets (e.g. hedge funds), although these investments currently have a small share in banks' capital requirements.

Fifth, the rise in the loan-to-deposit ratio, which has increased Greek banks' reliance on alternative sources of financing, such as Euro Commercial Paper (ECP) and Euro Medium Term Notes (EMTN), loan securitisation etc. These financial instruments on the one hand provide a costlier source of income and, on the other hand, make Greek banks more vulnerable to fluctuations in the money and capital markets.

These points about risk sources are in line with those made by the International Monetary Fund (IMF),[5] which found that the measures taken by the Bank of Greece, coupled with the profitability, capital adequacy and liquidity levels of the Greek banking system, are satisfactory and ensure its stability.

The Bank of Greece, taking into account continuing credit expansion and the above sources of risk, attaches particular importance to a further improvement in the quality of banks' loan portfolios and an increase in the coverage ratio of provisions to NPLs, so that wide fluctuations in the Capital Adequacy Ratio (CAR) will be avoided, in view of the implementation of the new capital adequacy framework (Basel II), in particular "Pillar 2". Specifically, the Bank of Greece has asked the boards of credit institutions to formulate policies that will lead to a decline in the NPL ratio to 3.5%, while the ratio of net NPLs (i.e. NPLs overdue by more than 90 days minus cumulative provisions) to supervisory capital should not exceed 10%. Moreover, credit institutions' credit policies should include such factors as loan approval rates, credit risk pricing, NPL recovery procedures, loan-loss provisions and write-offs.

The Bank of Greece will adjust the minimum required CAR for each bank, according to Law 2937/2001, as in force from time to

3 See Section 9 of this chapter.
4 See Section 5.1.1 of this chapter.
5 IMF, *Greece – Staff Report for the 2006 Article IV Consultation,* January 2007. For more details, see Bank of Greece, *Monetary Policy 2006-2007*, February 2007, Box III.1.

Table X.1 Banks' balance sheet key aggregates

(percentage changes over previous year)

	All banks		Greek commercial banks	
	2005	2006	2005	2006
Loans	19.1	14.2	18.6	15.1
Deposits	17.3	13.1	14.9	14.6
Deposits and repos	10.2	12.2	13.0	13.6
Own funds	30.8	32.1	39.9	32.8
Total assets	**21.1**	**15.2**	**19.0**	**17.1**

Sources: Bank of Greece and banks' balance sheets.

time, taking into account the measures adopted for credit risk mitigation. However, the supervisory evaluation of risk management for the calculation of the acceptable CAR will not be limited to credit risk, but will cover all the risks assumed (Basel II, Pillar 2).

A relevant issue is the overhaul of the terms of operation and evaluation criteria of credit and financial institutions' internal control systems, notably the upgrading of the risk management, compliance and internal audit functions.[6] Moreover, the Bank of Greece attaches particular importance to the implementation of the new anti-money laundering and counter-terrorist financing (AML/CTF) framework.[7] In the area of transaction transparency, on the one hand it amended the provision on banks' unilateral amendments to conditions of banking contracts with a view to improving customers' information and, on the other hand, it codified the provisions on the processing of private cheques through the banking system.[8]

Finally, the Bank of Greece cooperates closely with the supervisory authorities of the countries where Greek banks have established branches, with a view to ensuring effective supervision at banking group level and crisis management.

2 DEVELOPMENTS IN BANKS' KEY BALANCE SHEET AGGREGATES

In 2006, the favourable macroeconomic environment in Greece contributed to a rise in the key balance sheet aggregates (loans, deposits, own funds, assets) of credit institutions active in the Greek market, despite a small slowdown in the growth rate of these aggregates in comparison with 2005 (see Table X.1). Specifically, in 2006 the assets of the banking system rose by 15.2% to 161.5% of GDP, compared with 151.2% in 2005, which is considerably lower than in the EU (where they have exceeded 300%), reflecting the lower degree of financial intermediation in Greece in comparison with the EU countries' average. This fact, coupled with the size of the Greek market, affects the size of the banks active in Greece, as this is still small by international standards, despite their cross-border expansion. Credit institutions' total loans and the sum of deposits and repos grew slightly slower than assets (by 14.2% and 12.2% respectively). Accounting own funds improved by 32.1%.

6 Bank of Greece Governor's Act 2577/9 March 2006.
7 Law 3424/2005 and Banking and Credit Committee Decision No. 231/4/19 October 2006.
8 Banking and Credit Committee Decisions Nos. 234/20/1 December 2006 and 234/23/11 December 2006 respectively.

Table X.2 Structure of the Greek credit system

A. Market shares (%) in balance sheet key aggregates

	Assets		Loans		Deposits	
	2005	2006	2005	2006	2005	2006
Greek commercial banks	85.1	86.5	86.4	87.1	85.4	86.5
Foreign banks	10.1	10.1	8.8	9.2	9.1	9.3
Cooperative banks	0.8	0.8	1.0	1.1	0.9	0.8
Specialised Credit Institutions[1]	4.0	2.6	3.8	2.6	4.6	3.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

B. Number of banks, branches and employees

	Banks		Branches		Employees	
	2005	2006	2005	2006	2005	2006
Greek commercial banks	21	21	3,035	3,265	53,029	54,998
Foreign banks	22	24	242	260	5,381	5,705
Cooperative banks	16	16	126	108	875	946
Specialised Credit Institutions[1]	2	1	140	4	2,010	444
Total	**61**	**62**	**3,543**	**3,637**	**61,295**	**62,093**

1 Deposits & Loans Fund and Postal Savings Bank. With 136 branches and 1,203 employees, the latter is considered a commercial bank as from 2006.
Source: Bank of Greece.

The aggregates of Greek commercial banks, which have the largest share in the Greek banking system, were slightly better than the corresponding aggregates of banks as a whole (see Table X.1). The aggregates of foreign bank branches rose slower, as their assets increased by 11.5%, and the growth rate of their loans and deposits was even weaker (9.2% and 9.3% respectively). Finally, the assets of the Deposits and Loans Fund dropped by 20.7% as a result of a 21.9% decline in its deposits, while its loan portfolio showed a limited increase (2.6%).

3 BANKING SYSTEM STRUCTURE AND COMPETITIVE CONDITIONS

The structure of the banking system changed little in 2006, since Greek commercial banks continue to be the leading player in the Greek banking system, as their market share in the assets, loans and deposits of the Greek credit system as a whole exceeds 85% (see Table X.2). Foreign bank branches' and co-operative banks' market shares remained virtually unchanged, and the market share of Specialised Credit Institutions shrank, on the one hand because the Postal Savings Bank is now included in Greek commercial banks and, on the other hand, because —as already mentioned— the assets and deposits of the Deposits and Loans Fund declined.

Measured by the market share of the five largest banks, the degree of concentration of the Greek banking system showed a small increase in terms of total assets (2006: 66.4%, 2005: 64.8%) and in terms of deposits, while it declined in terms of loans.[9] Similar conclusions on the degree of concentration of the Greek banking system in comparison

9 The degree of concentration on the basis of deposits and loans was 65.8% and 63.9% respectively in 2006, compared with 65.5% and 66.1% in 2005.

with the European average are reached using the Herfindahl index.[10] This index was 1,117 for Greece in 2006 (1,096 in 2005), compared with averages of 601 and 641 for the EU and the euro area respectively in 2005. Overall, the degree of concentration of the banking system in Greece increased in 2006, as a result of mergers and acquisitions involving small and medium-sized banks. Similar developments in the degree of concentration on the basis of assets are observed in both the euro area (2005: 59.7%, 2004: 58.8%) and the EU (2005: 42.3%, 2004: 40.9%), where small countries generally show a comparatively higher degree of concentration.

It should be noted that in international literature no safe conclusions have been reached regarding the impact of the degree of concentration of a country's banking system on its effectiveness.[11] However, there are cases where a higher degree of concentration is associated with a narrower interest rate margin[12] and, therefore, improved effectiveness.

In 2006 the stake of the Greek State in the Greek banking system shrank considerably, as the share of directly or indirectly state-controlled credit institutions in the banking system's total assets dropped to 15%, from 23% in 2005, as a result of the acquisition of Emporiki Bank by the French Crédit Agricole.

The number of credit institutions active in Greece increased by one, reaching 62 in 2006, as a result of the opening of two new branches of foreign banks and the absorption of a Greek commercial bank by another. The number of bank branches also grew, albeit slower than in previous years (see Table X.2), but branch density relative to population did not change (33 branches per 100,000 inhabitants), being still considerably lower than in the EU (2005: 44). In the EU, the trend towards stronger banking market integration led to a further decline in the number of credit institutions (8,684 in 2005, from 8,836 in 2004), but this was accompanied by a rise in the number of branches (to 201,259 in 2005, from 199,879 in 2004), after a drop for four consecutive years.

The expansion of the branch network in Greece also led to an increase in staff numbers (2006: 62,093, 2005: 61,295). At end-2006 there were 17 employees per branch, which is still considerably higher than in the EU (EU-12: 13, EU-25: 15), but this figure tends to fall in recent years. Finally, banks' assets per employee are considerably lower in Greece than in the EU (Greece: €5.1 million, EU: €9.3 million).

Despite expanding their branch networks, banks continued to develop alternative distribution networks in 2006. The number of automatic teller machines (ATMs) rose by 7% (2006: 6,667, 2005: 6,230) and, at the same time, the operations that can be carried out through ATMs increased. Moreover, banks improved e-banking services, enhanced their cooperation with retail chains (e.g. electronics shops, car agencies etc.) and professional associations (e.g. manufacturers) to

10 The Herfindahl concentration index is calculated as the sum of all banks' squared market shares, ranging from 0 to 10,000. A level lower than 1,000 suggests low concentration, between 1,000 and 1,800 moderate concentration and over 1,800 high concentration.

11 See, by way of illustration, Athanasoglou P., S. Brissimis and M. Delis, "Bank specific, industry specific and macroeconomic determinants of bank profitability", Bank of Greece, *Working Paper Series,* No. 25, June 2005.

12 ECB, *EU Banking Sector Stability,* November 2006.

promote banking products, and increased direct phone and postal sales.

4 GREEK BANKS' PROFITABILITY[13]

In 2006, the growth rate of Greek commercial banks' and banking groups' profitability slowed down in comparison with 2005. Banks' after-tax profits rose by 6% to €1,888 million and groups' after-tax profits increased by 16.6% to €2,720 million. Profitability growth benefited from the favourable economic conjuncture, credit expansion and the containment of operating costs; on the other hand, it was hampered by the narrower interest rate margin, increased provisioning for NPLs, mostly by certain banks, as well as by the one-off taxation of reserves. Moreover, banking groups benefited in particular from the expansion of their business in foreign developing markets, mainly in the Balkans and —for the first time— Turkey, as the share of income from business in these countries in Greek banking groups' total income rose by almost four percentage points in 2006 in comparison with 2005, coming close to 12%.

Greek commercial banks' (and banking groups') financial statements show that operating income grew comparatively faster (banks: 18%, banking groups: 20.6%) than operating costs (banks: 12.4%, banking groups: 15.1% — see Table X.3). Specifically, underlying the increase in banks' and banking groups' operating income in 2006 was mainly higher (by 14.5% and 19.7% respectively) interest income, as banks' credit expansion continued, albeit at a slower pace.[14] In 2006 credit expansion to enterprises sped up, while the rate of credit expansion to households slowed down, but remains comparatively higher. However, the rise in net interest income was somewhat hampered by a faster increase in interest payments than interest receipts, owing to the ECB interest rate hikes and the impact of growing competition on banking services provision; as a result, the ratio of net interest income to assets at both bank and banking group level fell slightly (see Table X.4).

Non-interest income grew (banks: 28.5%, banking groups: 22.9%) stronger than net interest income (see Table X.3). Except for a decline observed in dividend income at bank level, all other income categories improved, notably income from financial operations and the investment portfolio,[15] owing to the strong performance of the stock market and one-off profits from the sale of treasury shares and participations. This development is taken into account by the Bank of Greece in the evaluation of the sustainability of banks' income sources and therefore their credit-risk provisioning capacity, as well as their resilience to money and capital market volatility (indicatively, volatility rose sharply in the May-June 2006 period and in February 2007).

In 2006, small changes were observed in the income structure of both banks and banking groups (see Chart X.1). Net interest income continues to make up the bulk of Greek banks' income (about 3/4), while the share

13 Excluding figures for the Postal Savings Bank, which were not available until the cut-off date.
14 Credit expansion was also strong in the developing markets of Southeastern Europe and Turkey, where Greek banks increased their business.
15 The fact that the rate of increase in this income category was much higher for banks than for banking groups is explained by a bank's sale of a participation to a subsidiary, as the relevant amount is omitted at group level.

Table X.3 Greek commercial banks' and banking groups' income statements for 2006

(percentage changes over 2005)

	Banks	Banking groups
Operating income	**18.0**	**20.6**
Net interest income	14.5	19.7
– *Interest income*	*34.3*	*36.8*
– *Interest expenses*	*60.0*	*61.7*
Net non-interest income	28.5	22.9
– *Net income from commissions*	*12.1*	*20.1*
– *Income from dividends*	*–9.4*	*23.9*
– *Income from financial operations and investment book income*[1]	*146.9*	*49.5*
– *"Other" income*	*11.5*	*13.3*
Operating expenses	**12.4**	**15.1**
Personnel outlays	11.9	14.5
Administrative costs	12.7	12.5
Amortisation	–5.0	6.0
Other expenses	113.9	211.3
Net income	**24.7**	**27.6**
Provisions for non-performing loans	29.3	31.5
Pre-tax profits	**22.3**	**25.9**
Tax	85.7	57.9
After-tax profits	**6.0**	**16.6**

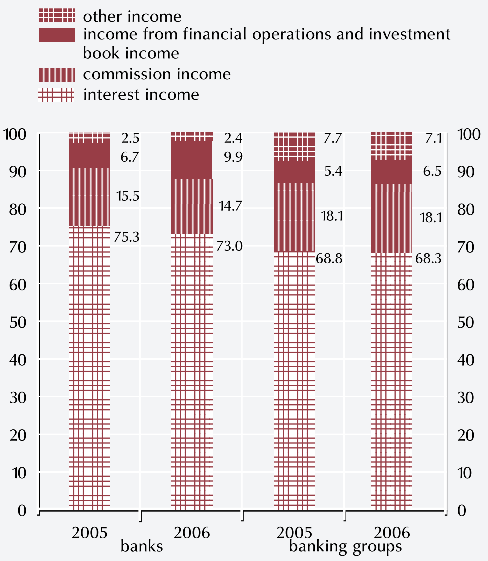
Source: Balance sheets and income statements.

of income from core banking operations (net interest and commission income) in total income narrowed slightly in 2006 in comparison with 2005, but remained at high levels (around 9/10). The share of net interest income for Greek banking groups is relatively higher than for medium-sized banking groups in the EU, while the share of net commission income is lower (EU for 2005: 63.1% and 25% respectively).

Among the other income categories, the share of income from financial operations remained small in 2006, although it increased in relation to 2005; at banking group level, income from insurance business (with a substantial share in "other" income) is relatively large. As regards the income breakdown by activity, retail banking accounts for around 3/5 of total income, business bank-

Chart X.1 Income structure of Greek commercial banks and banking groups

(percentages)



Source: Income statements.

Table X.4 Greek commercial banks' and banking groups' income statements

(percentage of average assets)

	Banks		Banking groups	
	2005	2006	2005	2006
Interest income	4.9	5.7	5.2	5.8
Interest expenses	2.1	2.9	2.1	2.8
Net interest income	2.8	2.7	3.1	3.0
Non-interest income	0.9	1.0	1.4	1.4
Operating expenses	2.0	1.9	2.5	2.4
Net income	1.7	1.8	1.9	2.0
Provisions	0.6	0.6	0.6	0.6
After-tax profits (ROA)	0.9	0.8	1.1	1.0
After-tax profits as a percentage of own funds (ROE)	16.2	12.6	17.0	13.9

Source: Balance sheets and income statements.

ing for 1/5, and investment banking and insurance business for the other 1/5.

Banks and banking groups made successful efforts to curtail their operating costs in 2006, assisted by centralised services management and investment in technology and infrastructures, as was the case for EU banks. Thus, although operating costs increased in relation to 2005, their share in assets showed a small decline (see Table X.4).

Personnel outlays make up the bulk of total costs[16] (banks: 60.1%, banking groups: 58.5%), but have gradually declined as a percentage of assets in recent years (banks: 1.2%, banking groups: 1.4%); nevertheless, they are still considerably higher than for medium-sized banking groups in the EU (2005: 0.8%).

The faster growth of operating income than operating costs helped improve the efficiency ratio (operating costs to operating income) to 52.3% for banks (2005: 54.9%) and 54.2% for banking groups (2005: 56.8%), which compare favourably with the average for medium-sized banking groups in the EU (2005: 58.4%).

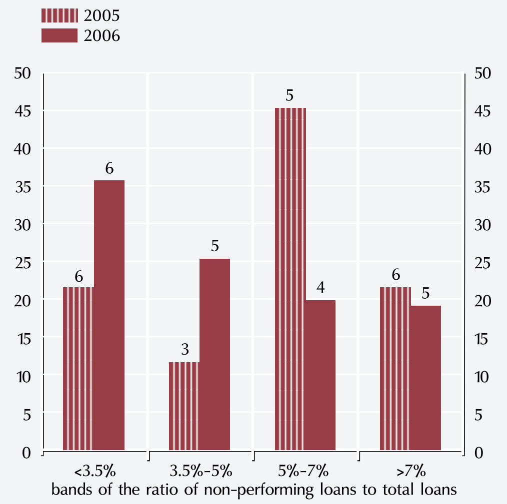
During 2006 loan-loss provisions grew considerably (see Table X.3) as a result of the measures adopted by the Bank of Greece and banks' stronger provisioning policy.[17] However, these provisions as a percentage of average assets did not change in comparison with 2005 (0.6%), still being more than double than for medium-sized banking groups in the EU (2005: 0.23%).

As a result of these developments, pre-tax return on assets (ROA) remained close to the satisfactory levels of 2005 (banks: 1.1%, banking groups: 1.5%). However, in comparison with 2005 pre-tax return on equity (ROE) dropped by around one percentage point for banks (18.3%) and about two and a half percentage points for banking groups (19.4%).

16 Operating costs do not include loan-loss provisions.
17 See Section 5.1.1 of this chapter.

Chart X.2 Distribution of total assets over the non-performing loans ratio bands

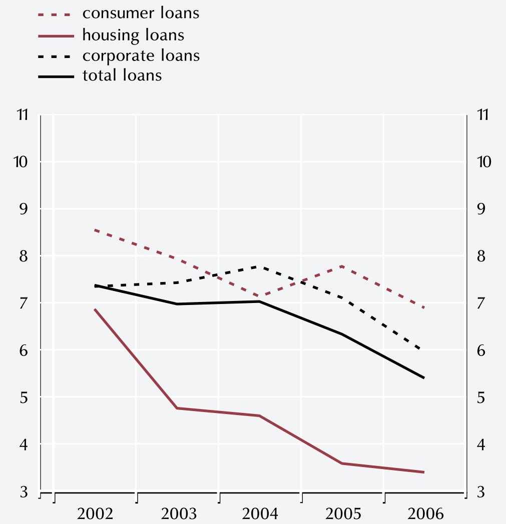
(percentages)



Note: The figures above the bars indicate the corresponding number of banks.
Source: Bank of Greece.

Chart X.3 Non-performing bank loans by category of loan granted by Greek commercial banks

(percentages of total loans by category)



Source: Bank of Greece.

After-tax ROA and ROE stood lower (see Table X.4) as a result of the one-off tax on banks' reserves. Thus, Greek banking groups show higher after-tax ROA than banking groups in the EU (2005: 0.56%), but lower after-tax ROE (EU: 15.3%).[18] But for the impact of the one-off taxation of reserves, Greek banking groups' after-tax ROE (15.4%) would be close to that for banking groups in the EU.

5 BANKING RISKS

5.1 CREDIT RISK

5.1.1 Quality of the loan book and evolution of provisioning

Greek commercial banks' bad loan write-offs (of around €1,452 million) during 2006 and the favourable economic environment helped reduce considerably their NPL ratio (2006: 5.4%, 2005: 6.3%). However, despite improving, this ratio is still much higher than for medium-sized banks in the EU (2005: 2.9%).

In more detail, in 2006 the NPL ratio was below 5% for 11 banks (making up 61% of total assets), compared with nine banks in 2005 (which accounted for 33.2% of total assets – see Chart X.2). At the same time, the percentage of banks with NPL ratios between 5% and 7% declined considerably (2006: 19.8%, 2005: 45.2%). This decrease concerns all loan categories, most notably corporate loans (2006: 6.0%, 2005: 7.1%) and consumer credit (2006: 6.9%, 2005: 7.8%) and, to a lesser extent, housing loans (2006: 3.4%, 2005: 3.6% – Chart X.3).

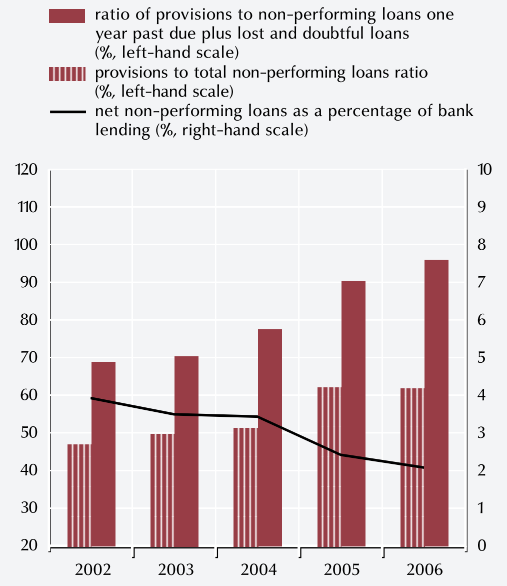
18 It should be noted that, in a sample of 34 large banks in the EU, in the first half of 2006 ROE rose to 21%, from 18% at end-2005, while for around 65% of banking groups in the EU this indicator was over 15% at end-2005.

Banks wrote off bad loans in the context of the implementation of the relevant measures adopted by the Bank of Greece, which provide for write-offs of consumer loans more than one year overdue and corporate loans more than 30 months overdue that are not backed by real estate collaterals. At the same time, the Bank of Greece has already introduced incentives for bad loan write-offs for the years 2006 and 2007, and it should be recalled that as from 1 January 2007 loans more than three years overdue should be covered by special provisions or reserves.[19]

Increased provisioning at banking system level, coupled with strong credit expansion, helped reduce the ratio of net NPLs (i.e. NPLs minus provisions) more than three months overdue to total loans to 2.1% in 2006, from 2.4% in 2005 (see Chart X.4). Moreover, the provisioning coverage of NPLs more than one year overdue rose (2006: 95.9%, 2005: 90.3%), as a result of bad loan write-offs, and the provisioning coverage of NPLs more than three months overdue remained virtually unchanged (2006: 61.6%, 2005: 61.9%).

However, the improvement observed in the quality of banks' portfolios and provisioning policies should not lead to complacency. The NPL ratio remains high, as well as the cost of credit risk, measured by the ratio of the flow of loan-loss provisions (impairment losses) to operating income (Greece, 2006: 14.5%, EU, 2005: 9.2%).[20] In addition, according to the conclusions of the Fifth Quantitative Impact Study – QIS 5,[21] total capital requirements for Greek banks are expected to rise owing to the implementation of the "Basel II" framework. This is so because the maintenance of high NPL ratios and the relatively high probability of default for the per-

Chart X.4 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.

forming loan portfolio will not allow capital requirements for credit risk to fall enough in order to offset the increase due to the imposition of capital requirements for operational risk. This is expected to affect unfavourably the competitiveness of Greek banks vis-à-vis banks of other EU countries, where capital requirements are expected to decrease substantially as a result of the implementation of sophisticated risk measurement methods under the new framework.

This being so, also taking into account continuing strong credit expansion, the Bank of Greece — as already mentioned — considers it essential that banks should further improve

19 Bank of Greece Governor's Act 2565/11 October 2005.
20 Figures at banking group level, in order to be comparable with medium-sized banking groups in the EU.
21 For the QIS 5 results for Greece, see Bank of Greece, *Annual Report 2005,* Athens 2006, Chapter X.6.2.

the quality of their portfolios and increase the coverage ratio of provisions to NPLs, so that wide fluctuations in the CAR will be avoided, in view of the implementation of the new capital adequacy framework (Basel II), in particular "Pillar 2". Specifically, the Bank of Greece has asked credit institutions to formulate policies that will drive the NPL ratio down to 3.5% and the ratio of net NPLs (i.e. NPLs overdue by more than 90 days minus cumulative provisions) to supervisory capital to below 10%. Moreover, credit institutions' credit policies should include such factors as loan approval rates, credit risk pricing, NPL recovery procedures, loan-loss provisions and write-offs.

Moreover, it is necessary for banks to apply a stricter risk management approach and to carry out stress tests, since limited data are available on borrowers' behaviour across the business cycle and on loan recovery in periods where the probability of default is increased.

5.1.2 Credit risk from loans to households

Loans to households account for about 1/2 of banks' total lending to the private sector,[22] and in recent years have been rising faster than corporate loans. Therefore, developments in households' financial condition and banks' credit policies towards households affect considerably the level and nature of the credit risk facing banks.

In 2006, households' total borrowing reached 44% of GDP (2005: 38%),[23] which remains lower than the corresponding euro area average (first half of 2006: 58.3%, 2005: 57%). The outstanding balance of housing loans as a percentage of GDP rose to 29.3% in 2006 (2005: 25.1%), while the outstanding balance of consumer and "other" loans to households reached 14.7% (2005: 12.9%). The rise in household borrowing in an environment of rising interest rates[24] has increased households' debt servicing costs, as a large part of the loans they have obtained carry floating rates. It should be noted, however, that in 2006 the satisfactory growth rate and the decline in the unemployment rate boosted households' disposable income. On the other hand, the difficulty of estimating the impact of a potential economic downturn should not be underestimated, since the liberalised banking system has yet to experience a full business and credit cycle, in particular with respect to household loans.

In addition to higher interest rates, banks' pricing and credit policies also affect considerably household loans' credit risk. Mounting competition among banks to maintain and capture market shares in 2006 squeezed interest rate margins across the household loan spectrum; as a result, these margins converged and, in certain loan categories, are below the average of the euro area countries.[25]

This development is in principle favourable for households, but raises concerns regarding effective debt management by house-

22 Specifically, they make up 51% of credit institutions' loans to domestic corporations and households and 47% of total financing. The difference concerns the corporate bond portfolio held by credit institutions.
23 Excluding the outstanding balance of securitised loans, credit institutions' loans to households stand at 41.1% of GDP (2005: 36.3%), which is lower than the corresponding euro area average (2006: 54.3%, 2005: 52.4%).
24 Between December 2005 and March 2006, the ECB raised the interest rate on the main refinancing operations by 175 basis points, from 2.00% to 3.75%.
25 See Chapter VI.3.

holds with low income and warrants more accurate credit risk pricing, in order to take into account adequately the possibility of an economic slowdown and its impact on households' future debt servicing capacity. This becomes all the more pressing in the light of indications of a relaxation in certain banks' credit policies, as in the second half of 2006 there was an increase in the ratio of approvals to total applications for consumer loans and credit cards in comparison with the first half of 2006 and the end of 2005. Besides, it has been verified that the aforementioned approval ratio and the NPL ratio are highly correlated.[26]

Moreover, with respect to housing loans, the loan-to-value ratio for new business reached a high level. Specifically, for 20% of new mortgage loans (accounting for 29% of new disbursements in 2006) this ratio was over 80%, while for 2% of new mortgage loans (making up 3% of new disbursements) this ratio exceeded 100%. It should be noted that the outstanding balance of housing loans denominated in foreign currency (mostly Swiss francs) rose substantially in 2006: actually it trebled, although it is still 1.7% of the total outstanding balance of housing loans (2005: 0.6%). In addition to credit risk, foreign currency-denominated loans also involve interest rate risk (if they have been obtained at floating rates) and foreign exchange risk, as the amount of instalments depends on the prevailing foreign currency/euro exchange rate.

In conclusion, because the NPL ratio for housing loans remains relatively high[27] and may rise further owing to the ECB interest rate hikes and the gradual slowdown of credit expansion,[28] banks should evaluate more effectively such risk parameters as the narrowing of the spread in this loan category, the high loan-to-collateral ratio for new business and the distribution of products that involve specific risks, such as foreign currency-denominated loans and deferred interest loans.[29]

5.1.3 Corporate loans' credit risk

The growth rate of MFIs' loans to non-financial corporations[30] edged up last year (2006: 12.2%, 2005: 9.8%),[31] and these corporations' total financing by credit institutions, including corporate bond holdings, grew even stronger (15.5%). Nevertheless, the rate of credit expansion to the corporate sector as a whole does not seem to constitute in itself a potential source of additional credit risk for banks. Exposures to corporate borrowers or sectors are discussed below (see Section 5.2). On the other hand, the bearing of the economic robustness and prospects of the domestic corporate sector on banks' credit risk should not be disregarded.

26 This ratio is estimated to be 0.9, subject to limited data availability.

27 According to OECD data, in the 2003-2006 period the NPL ratio for housing loans was below 2% in many countries, such as France, the United States, the United Kingdom and Spain (Girouard Nathalie et al., "Has the rise in debt made households more vulnerable?", OECD, *Economics Department Working Paper* No. 535, January 2007.

28 If borrowers' credit ratings and banks' credit standards and write-off policies remain unchanged, the NPL ratio is also affected by developments in the lending growth rate, i.e. a slowdown in the latter typically pushes up the NPL ratio, despite the increase in the outstanding balance of loans.

29 That is housing loans granted with favourable repayment conditions for an initial period (e.g. loans with a grace period, a low fixed interest rate for a short initial period which becomes a floating rate or a higher fixed rate after the end of this initial period, or loans where principal payments start after a certain initial period, during which only interest is paid).

30 That is excluding other financial institutions and insurance companies.

31 These rates are calculated by taking into account loan write-offs and securitised corporate loans.

The financial condition of non-financial corporations is satisfactory as, according to data compiled on a sample of 472 firms,[32] in 2006 their pre-tax profits grew by 15.9% in comparison with 2005 and their ROE improved (2006: 16.8%, 2005: 15.2%). However, the gearing ratio dropped (2006: 0.84, 2005: 0.91) and the financial costs to gross profits ratio rose (2006: 7.4%, 2005: 5.8%), pointing to a possible increase in credit risk. Nevertheless, underlying the small deterioration in these two ratios are higher lending rates, while the rise in corporations' short-term liabilities is partly accounted for by increased sales. A mixed picture is also given by credit registry data of the Greek credit bureau "Tiresias S.A.", which are associated with banks' credit risk.[33]

The migration matrix data for 2006 imply a deterioration in the financial condition of corporations, as net downgradings account for 6.5% of total ratings, corresponding to 6.1% of the total outstanding balance of corporate loans[34] (it should be noted that these percentages were 8.2% and 5% respectively in 2005). It should be pointed out that the trend towards net downgradings is common across banks, despite quantitative differences.

5.1.4 Credit risk transfer

Credit risk transfer through loan securitisation accelerated further in 2006. Specifically, Greek commercial banks securitised loans of €4,850 million (of which €2,250 million were loans to small firms, securitised for the first time), compared with €2,250 million in 2005 (up 116%). At end-2006, the total stock of securitised loans was €4,643 million for housing loans (8.1% of the total outstanding balance of housing loans), €997 million for credit card loans (3.8% of the total outstanding balance of consumer credit) and €2,864 million for loans to small firms (3% of total financing of corporations by credit institutions).[35] In addition to serving as a credit risk transfer tool, securitisation also improved asset allocation, increased liquidity and served as a source for funding banks' credit expansion, notably to households. Credit risk transfer through loan securitisation may have led banks to relax their credit standards for loans to households, according to international experience.[36]

Credit risk transfer through the use of credit derivatives continued throughout 2006. At end-2006, the total amount invested in credit default swaps and total return swaps[37] in the credit protection market came to €527 million, down 24.2% over 2005, while the corresponding amount for protection selling was €263 million (considerably higher than in 2005, when it was €30 million). Finally, credit institutions' investment in credit-linked notes rose by 63.1% to €56 million in 2006, from €34.3 million in 2005.

32 For a more detailed discussion, see Chapter IV.3.
33 Specifically, in 2006 bankruptcy petitions and the value of court payment orders grew (by 24.8% and 64% respectively), while the value of unpaid cheques declined by 17.9%. These figures are highly volatile and are subject to frequent revisions.
34 Ratings remained unchanged for 75.9% of borrowers, who accounted for 69.4% of the outstanding balance of corporate loans.
35 For revolving credits (i.e. credit card loans and loans to small firms), owing to their nature and according to international practice, the amount transferred to special purpose vehicles (pool) exceeds the amount of the securities issued, so that the pool's value does not fall short of the nominal value of the issue.
36 For example, the impact of loan securitisation on the subprime mortgage market in the United States has attracted the attention of supervisory authorities and international organisations.
37 For definitions of these terms, see Bank of Greece, *Annual Report 2005,* p. 327, footnotes 1 and 2.

5.2 CONCENTRATION RISK

5.2.1 Large exposures to groups or individual firms

Monitoring group- or firm-specific concentration risk is an integral part of credit institutions' risk management systems and is evaluated very carefully by the Bank of Greece, in view of the implementation of the new Capital Adequacy Directive (Basel II – Pillar 2).

Prudential returns on credit institutions' large exposures (i.e. exposures over 10% of their supervisory own funds) at end-2006 show that, at bank level, the aggregate net large exposures of Greek commercial banks to groups or individual corporations rose by 16.8% in comparison with 2005 and reached €28.5 billion, corresponding to 127% of their supervisory own funds (compared with 144.5% in 2005). Furthermore, the distribution of these percentages across individual banks indicates that for about half of credit institutions exposures are within the 100%-200% band, while only one credit institution has large exposures of over 600% of supervisory own funds (the upper limit being 800%).

At banking group level, net exposures rose by 7% in 2006 (2005: 19%) and reached 55.5% of supervisory own funds (2005: 60%). Lower percentages for groups than for banks are justified by the fact that the bulk of groups' large exposures are exposures to their subsidiaries, which are consolidated and therefore are not taken into account. It should be noted that for 80% of banking groups exposures are considerably lower than 100% of supervisory own funds, while only one banking group has net exposures of 330% of supervisory own funds (the upper limit being 800%).

5.2.2 Large exposures to specific sectors

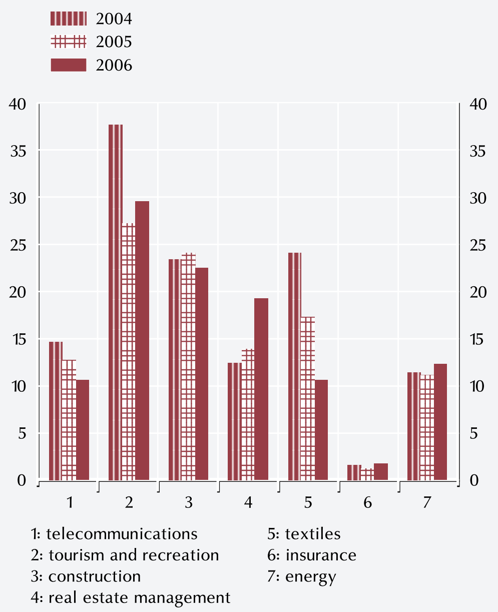
Although no ceilings on sectoral exposures have been imposed, sectoral concentration and the adaptation of exposures to the prevailing conditions should be an integral part of banks' risk management systems.

According to data on loans over €1 million at end-2006, Greek commercial banks' exposures to two sensitive sectors of economic activity (constructions and textiles) declined in 2006, both as a percentage of total exposures (to 4% and 1.9% respectively) and as a percentage of banks' supervisory own funds (see Chart X.5). However, the NPL ratio remains high for both sectors.[38] On the positive side, the NPL ratio for the tourist sector, which has a share of 5.2% in total exposures, dropped (2006: 1.7%, 2005: 3.1%).

In (retail and wholesale) trade, the share in total exposures rose to 22%, from 20.4%, but is not a source of concern, considering the relatively low and declining level of NPLs (2006: 2.3%, 2005: 3.6%). Finally, the share of exposures to the real estate management sector widened considerably (2006: 3.4%, 2005: 2.5%), but the NPL ratio is very low (2006: 0.7%, 2005: 1.5%). Contrary to other countries, the real estate management sector does not seem to be strongly correlated with the constructions

38 The NPL ratio for the textiles sector was 11.6% in 2006, compared with 9.2% in 2005, while it remained at the 2005 level (5.1%) for the constructions sector.

Chart X.5 Exposures of Greek banking groups by sector of economic activity as a percentage of their own funds



Source: Bank of Greece.

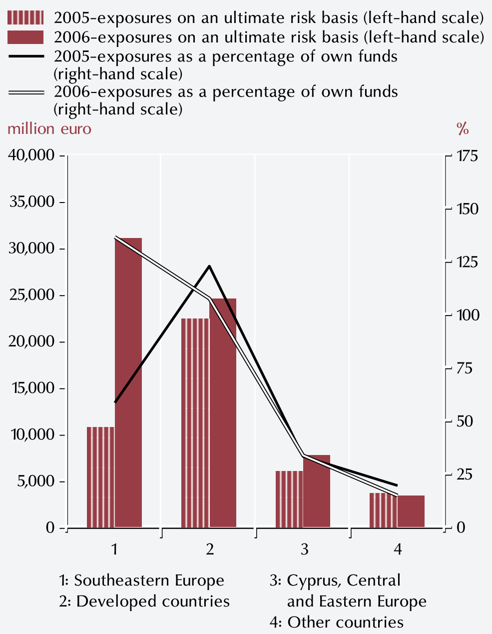
sector, since the former depends on the fluctuations of prices and demand for real estate, while the latter mainly depends on progress in the execution of public infrastructure projects.

5.2.3 Exposures to non-residents

Greek commercial banks' foreign claims on an ultimate risk basis amounted to €66.5 billion at end-2006 (up 56.3% over 2005), accounting for 292% of their supervisory own funds and 22.4% of their assets. Underlying this increase is mainly further expansion of banking groups to Southeastern Europe, notably Turkey. These exposures are broken down as follows: the bulk is on Southeastern Europe, including Turkey (46.6% of total exposures and 136% of banking groups' supervisory own funds), on Developed Countries (36.8% of total exposures) and on Cyprus and Central and Eastern Europe (11.5% of total exposures), and only 5.1% on other geographical regions (see Chart X.6).

Developments in foreign claims are primarily addressed by credit institutions in the context of their risk management and provisioning policies, especially when claims on an ultimate risk basis at country or regional level exceed a reasonable percentage of their supervisory own funds. However, the Bank of Greece has asked internationalised banks to carry out regular stress tests in order to estimate the impact of potential unfavourable developments in the countries where they are active, and cross-check their results with their provisions and the margin provided by the CAR.

Chart X.6 Banks' exposures on an ultimate risk basis and as a percentage of their own funds



Source: Bank of Greece.

5.3 MARKET RISK

The total value of banking groups' trading book as at 31 December 2006 was €18.8 billion (6.8% of their assets), compared with €17.7 billion as at 31 December 2005. The fair value of derivatives on the trading book came to €2.8 billion on 31 December 2006, compared with €2.2 billion on 31 December 2005. The bulk of these products are interest rate and foreign exchange derivatives (80% and 19% respectively), while the share of equity derivatives is very small (1%). The total funds required for covering the domestic banking system's market risk were around €634 million on 31 December 2006, compared with €434 million at end-2005. The share of market-risk-weighted assets in total weighted assets rose to 4.3% at end-2006, from 3.8% at end-2005.

5.3.1 Value-at-risk models

The cumulative potential loss of the trading books of banks that have developed internal value-at-risk (VaR) models recognised by the Bank of Greece dropped to €5.9 million at the end of the year, from €7.3 million at end-2005 (down 18.6%).[39] Underlying this decrease are changes in the structure of portfolios. It should be mentioned that the sharp increase in equity price volatility in May 2006 owing to the strong swings in the stock market had boosted potential loss up to and including July 2006. However, it should be noted that the potential loss of trading books makes up a very small percentage of these banks' own funds; as a result, the share of market risk in total risk is low.

The Bank of Greece considers that, according to the "proportionality to market risk exposure" principle, the application of sophisticated techniques, especially by systemically important banks, and the recognition of their use by the Bank of Greece for supervisory purposes help manage market risks more effectively and form a more accurate picture of the banking system's market risk.

5.3.2 Structured products and hedge funds

During 2006, the market for structured products widened and became more composite, as new products were introduced and the securities traded became more complex. Factors such as the continued narrowing of interest rate margins and excess liquidity worldwide pushed in this direction; moreover, it should not be disregarded that both investors and credit institutions increasingly seek investments with relatively higher yields.

Against this background, Greek credit institutions were active in this market, either as investors on their own behalf or as intermediaries on behalf of their customers; as a result, a large range of products appeared in the banking market. It should be mentioned that, because of the complexity of these products, investors should be very careful and be capable of evaluating the risks assumed; on the other hand, credit institutions should properly inform the investors concerned on both the possible yields and the risks involved.

Credit institutions' investment mainly in hedge fund units and, to a lesser extent, in the capital of hedge fund management com-

39 This loss ranged between €4.5 million and €9.3 million in 2006, with an average of €6.3 million.

panies came to €706 million or 0.27% of their assets in 2006 (2005: 0.04%).

According to the provisions of Bank of Greece Governor's Act 2577/2006, credit institutions should have adequate systems and infrastructure for managing the risks arising out of these investments. The Bank of Greece also raised the coefficients used in the determination of supervisory own funds in relation to such investments, with a view to covering increased risk.

5.4 LIQUIDITY RISK

The Greek banking system fulfils the criteria of adequate liquidity, since the relevant ratios exceed the minimum limits established by Bank of Greece Governor's Act 2560/1 April 2005. Specifically, as at 31 December 2006, the liquid asset ratio and the asset/liability maturity mismatch ratio stood at 25% and 0.14% respectively (31 December 2005: 23% and -2.50% respectively), compared with regulatory minimums of 20% and -20%. The supplementary loan-to-deposit ratio increased to 98.2% on 31 December 2006, from 94.6% on 31 December 2005, and is still considerably lower than the euro area average (2005: 128%).

As already mentioned, these liquidity ratios are on average satisfactory, although for certain (mainly foreign) banks they fall short of the regulatory minimums. However, quantitative ratios do not provide adequate assurance and should be accompanied by proper qualitative risk management measures and stress tests. The Bank of Greece recognises the importance of centralised liquidity management; hence, as far as foreign banks' branches operating in Greece are concerned, the procedure for the abolition, on an ad hoc basis and subject to conditions ensuring equal treatment, of the requirement to comply with these liquidity ratios is in progress.

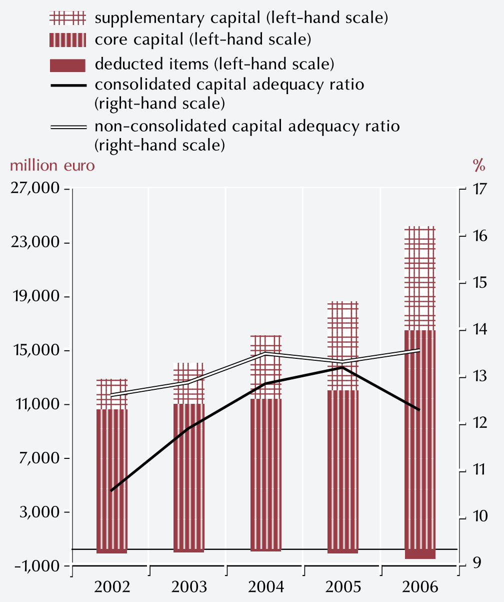
It should be noted, however, that as a result of banks' strong credit expansion in the last decade, competition for raising funds has increased, leading to higher recourse to the interbank market or refinancing by the Eurosystem, as banks increasingly rely on interbank lending and the issuance of bank bonds and other debt securities to finance credit expansion.

6 CAPITAL ADEQUACY

Greek commercial banks' and banking groups' CAR remained satisfactory during 2006, despite a considerable increase in risk-weighted assets. At bank level there was a marginal improvement, while banking groups' considerable cross-border expansion led to a small decline in CARs at group level.

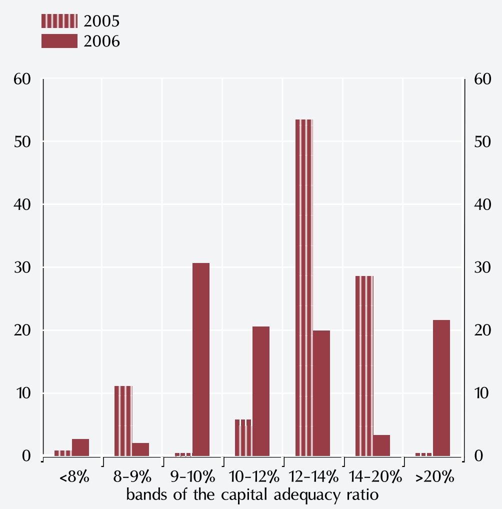
Specifically, at bank level, the CAR and the Tier I ratio came to 13.6% and 9.5% respectively in 2006, improving marginally in comparison with 2005 (CAR: 13.3%, Tier I ratio: 8.7% – see Chart X.7). Thus, the amount of supervisory own funds beyond the supervisory minimum reached around €9 billion, which can serve as a buffer against unexpected losses. Moreover, higher-quality Tier I capital rose by 38.7%, faster than total supervisory own funds (29.4%), mainly as a result of the fact that the National Bank of Greece proceeded to capital increases. As a result, the share of Tier I capital in total supervisory own funds grew (2006: 68.2%,

Chart X.7 Greek commercial banks' capital adequacy and breakdown of supervisory own funds on a non-consolidated basis



Source: Bank of Greece.

Chart X.8 Percentages of weighted assets related to the bands of the capital adequacy ratio



Source: Bank of Greece.

2005: 64.3%), after dropping in the previous years. Higher supervisory own funds more than offset the considerable increase in capital requirements both for credit and market risk (risk-weighted assets rose by 24.6% and 57.8% respectively), boosting marginally the capital adequacy ratios. However, the distribution of CARs across the Greek bank population worsened, as the percentage (on the basis of weighted assets) of banks with a CAR below 10% increased (2006: 35.1%, 2005: 12.3% – see Chart X.8). Underlying this was the fact that the overall improvement came from a rise in the capital and profitability of certain banks only.

At the level of banking groups, the capital adequacy of which is a more representative indicator, both the CAR (2006: 12.2%, 2005: 13.2%) and the Tier I ratio dropped (2006: 9.9%, 2005: 10.9%). However, these ratios are marginally higher than for medium-sized banking groups in the EU (12.2% and 8.5% respectively in 2005); the quality of the capital of Greek banking groups remained unchanged, as the share of Tier I capital in total capital remained the same (2006: 79.1%, 2005: 80.9 %).

The CAR of cooperative banks was 20.1% in 2006, virtually unchanged in comparison with 2005, well above the regulatory minimum (10%).

Finally, the Bank of Greece will adjust the minimum CAR required for each bank,[40] taking into account the measures adopted for mitigating credit risk; it should be pointed out that risk management Supervisory Evaluation for the determination of the accept-

40 Law 2937/2001, as currently in force.

able CAR level will, in addition to credit risk, also cover all risks assumed ("Pillar 2" of the new "Basel II" framework).

7 OTHER SUPERVISORY ISSUES

7.1 TRANSPARENCY OF TRANSACTIONS

The Bank of Greece, with a view to adapting continuously the rules of transaction transparency, supplemented and amended the relevant provisions in December 2006. According to the new provisions (Banking and Credit Committee Decision No. 234/20/11 December 2006), in the event of unilateral amendment to the conditions of contracts, credit institutions must, in addition to providing to the counterparty a thirty-day time limit for accepting or rejecting the new condition, inform customers on an individual, not general (e.g. through the press) basis, in order to enable them to weigh in a timely manner the economic consequences of the relevant change.

Moreover, banks were prohibited from charging inactivity expenses on savings accounts, insofar as they exceed interest and reduce the amount of deposits.

Regarding customers' complaints by transaction category (loans, deposits, investment products, credit cards and other banking operations), according to the data reported to the Bank of Greece, the rate of increase in complaints submitted to banks dropped from 11.8% in 2005 to 5.1% in 2006. Of total complaints submitted, 13.8% concerned loans, 11.5% deposits, 1.2% investment products, 64.8% credit cards and 8.7% other banking operations. A considerable increase was observed in complaints concerning investment services (78.4%), which at least partly seems to be accounted for by the growing supply of composite products on special conditions, the comprehension of which requires customers to be more experienced and familiar with modern banking practices. Hence, the Bank of Greece, in addition to enacting institutional provisions (Bank of Greece Governor's Act 2577/2006, joint decision of the Bank of Greece and the Capital Market Committee on the credentialling of employees offering investment and mixed products), also instructed banks to adapt the information provided, especially with respect to special product categories that have both deposit and investment features.

7.2 INSPECTIONS

7.2.1 On-site inspections abroad (2000-2006)

The Bank of Greece exercises its supervisory powers by evaluating the supervisory data reported to it and by carrying out on-site inspections.

Since 2000, 14 on-site inspections have been conducted in credit institutions established abroad (namely Southeastern Europe) which are subsidiaries or branches of Greek banks, in a total of 27 and 7 respectively.

By these inspections the Bank of Greece seeks to evaluate the effectiveness and adequacy of the parent bank's controls of the Internal Control and Risk Management System of its subsidiaries and branches abroad, regardless of the scope of supervision exercised by the supervisory authorities of the host country. Such inspections focus on the responsibility of the parent bank, under Bank of Greece Governor's

Act 2577/2006, as currently in force, taking into account that the increase in the risks assumed as a result of cross-border expansion through branches or subsidiaries may have a considerable impact on its reputation and overall financial condition.

The results of these inspections were overall satisfactory, showing considerable growth of banks' business in these countries. Weaknesses have been identified in parent banks and the necessary corrective measures have by and large been taken.

The Bank of Greece plans to invigorate on-site inspections, in line with the principle of proportionality to the magnitude and nature of risks in host countries, and further develop its cooperation with these countries' supervisory authorities in specialised supervisory issues.

7.2.2 On-site inspections in Greece

During 2006, the following on-site inspections were carried out in Greece:

- sixty-four (64) inspections of credit and supervised financial institutions to verify compliance with AML procedures;

- twenty-three (23) inspections in collaboration with the Capital Market Committee;

- forty-seven (47) special inspections to investigate eponymous complaints, 43 of which to verify credit institutions' compliance with transaction transparency procedures;

- sixty-nine (69) inspections of the quality and authenticity of the euro banknotes supplied to credit institutions' ATMs; and

- thirty-three (33) inspections concerning the implementation of restrictions imposed on natural and legal persons under European Council regulations.

7.2.3 Complaints in writing

During 2006, the Bank of Greece received 580 complaints in writing within the scope of its authority on transaction transparency and its legal power to control the information on compound interest provided by credit institutions, and in the overall context of its supervisory and regulatory role to safeguard the credibility of the financial system.

Around 23% of total complaints in writing concerned credit card charges, 8% concerned banks' failure to implement provisions on restructuring of compound interest debts, notably delayed or inadequate provision of data or information to debtors, and about 10% surcharges in the event of early payment of floating-rate loans. The rest of the complaints concerned inadequate information prior to the conclusion of contracts or other issues.

Of the complaints examined:

— 78% were dismissed because banks had acted in conformity with the provisions in force;

— 17% were referred to the Banking and Credit Committee to decide whether or not to impose sanctions;

— 5% were archived as they did not concern violations, but requests for arrangements that banks and their counterparties could agree upon at their discretion.

7.3 SANCTIONS

In 2006, the following sanctions were imposed:

(a) on 19 credit institutions, interest-free deposits with the Bank of Greece, totalling €46.8 million, for violations of transaction transparency and AML laws and decisions of the Bank of Greece;

(b) on 5 credit institutions, fines in favour of the Greek State totalling €38,000 for violations of Article 42 of Law 2912/2001 on delayed provision of data and certificates to applying debtors;

(c) on 2 credit institutions, fines in favour of the Greek State totalling €40,000 for faulty implementation of the procedures for controlling the authenticity and quality of euro banknotes;

(d) on 2 financial corporations, fines in favour of the Greek State amounting to €10,000 in each case, for failure to include material information in advertisements and violation of Law 1665/1986 on financial leasing agreements respectively;

(e) on one bank, a fine amounting to €30,000 in favour of the Greek State for violating the Underwriting Regulation.

7.4 PREVENTION AND SUPPRESSION OF MONEY LAUNDERING AND TERRORIST FINANCING

Domestic developments

Bank of Greece Governor's Act 2577/2006 laid down the general principles governing anti-money laundering and counter-terrorist financing (AML/CTF) procedures as an integral part of each credit institution's internal control system. This was followed by Banking and Credit Committee decision 231/4/19.10.2006, which provided specific instructions on the implementation of the aforementioned procedures pursuant to the provisions of Law 3424/2005 and the relevant recommendations of the Financial Action Task Force (FATF) established within the OECD. Specifically, these instructions, in line with the principle of proportionality aforesaid, require in particular credit institutions to evaluate customers and transactions, following a risk-based approach, and conduct customer due diligence. To this end, credit institutions are required, inter alia, to compare, with the help of suitable IT systems, customers' profiles with the operation of their accounts, evaluate divergences and take proper measures. Under the same decision, credit institutions should also identify actual beneficial owners, notably in the case of offshore companies, and terminate the business relationship if the certification conditions are not fulfilled.

EU developments

On 15 December 2005 came into force the new Directive of the European Parliament and the Council (2005/60/EC/26.10.2005), which introduces into Community law new provisions on the basis of FATF's revised AML/CTF recommendations. The EU Member States are required to transpose the new legal framework to domestic law by 15 December 2007. In Greece the transposition procedure has already started, with the participation of the Bank of Greece.

On 15 November 2006 Regulation (EC) 1781/2006 of the European Parliament and the Council was adopted, with effect as from 1 January 2007. This Regulation specifies the information on the payer accompanying fund transfers, depending on whether such transfers are within or outside the EU.

In 2006, FATF started to evaluate the AML/CTF system in place in Greece. This evaluation will be completed in June 2007.

8 DOMESTIC INSTITUTIONAL DEVELOPMENTS

8.1 DECISIONS OF THE BANK OF GREECE AND LEGISLATIVE ARRANGEMENTS

During 2006 and at the beginning of 2007, the Bank of Greece further adapted the rules governing supervised institutions, taking into account the new supervisory requirements of international developments. Specifically:

By Bank of Greece Governor's Act 2577/9 March 2006 and following extensive dialogue with banks, the Bank of Greece overhauled the institutional framework of operational principles and criteria for the evaluation of the organisation of Internal Control Systems of credit and financial institutions and the relevant powers of their management bodies, both on an individual and a group basis. The most important provisions, in view of the implementation of the new capital adequacy framework ("Basel II"), are as follows:

- They seek to strike a balance between the determination of general principles that will be specified by credit institutions themselves and the imposition of specific requirements, mainly on small or medium-sized banks, on the basis of the principle of proportionality and international practices, especially with respect to qualitative criteria of efficiency, such as independence of crucial functions from front line units, conflict of interest prevention and customer service.

- They aim at the upgrading and specialisation of the following functions:

— Risk Management, covering all the risks assumed by a credit institution, including operational risk;

— Compliance (with the applicable legislative and regulatory framework, codes of conduct and the AML/CTF provisions);

— Internal Audit,

with a focus on the control of the above functions' procedures, as well as of the IT and accounting systems and outsourcing procedures.

- The Board of Directors as a whole shall have adequate knowledge and experience in at least the most important risks and activities of the credit institution, so that it can supervise all operations in today's specialised and rapidly changing international environment. According to proportionality criteria, the Board shall be assisted in its work by Audit and Risk Management Committees, to be staffed with Directors.

- Trilateral or bilateral consultations shall be carried out among supervisory authorities, banks and certified public accountants.

• Every credit institution shall establish ethical behaviour rules, to be observed by both employees and management; at the same time, the Act upgrades the importance of the quality of services provided to customers and transaction transparency as an integral part of operational risk.

• The Act lays down the conditions under which credit institutions may outsource their activities, always maintaining the relevant responsibility.

• With a view to adapting to Law 3424/2005, Banking and Credit Committee decision 231/4/19 October 2006 was issued, including instructions on the specialisation of the AML/CTF procedures.

Banking and Credit Committee decision 234/20/11 December 2006 amended provisions of the banking transaction transparency framework.

Banking and Credit Committee decision 234/23/11 December 2006 codified the provisions on the processing of private cheques through the banking system. Specifically, according to the new provisions, the proceeds of the cheque shall be credited to the bearer's account with a value date one working day later at the latest. Moreover, the unpaid cheque sealing notice shall also name the natural persons issuing an unpaid cheque as representatives of legal persons, and shall be addressed by credit institutions to TIRESIAS S.A. on the next working day after the end of the statutory eight-day time limit for presentation of the cheque, provided that the cheque has not been paid. The chequebook shall be removed from the issuer if the total amount of unpaid cheques issued by him within a 12-month period exceeds €1,000 (up from €600).

8.2 PREPARATION FOR THE TRANSPOSITION AND IMPLEMENTATION OF THE NEW SUPERVISORY FRAMEWORK

The law that will transpose to Greek law Directives 2006/48/EC and 2006/49/EC (Basel II) provides as follows:

1. Under three pillars, credit institutions and investment firms are required to:

(a) calculate their supervisory capital requirements according to the relevant standardised or sophisticated approaches;

(b) establish internal procedures as an integral part of the corporate governance framework in order to determine the funds required for covering risks of any nature; and

(c) with a view to enhancing market discipline and transparency, disclose appropriate data and information that enable customers and market participants to compare credit institutions' policies.

2. Likewise, the supervisory authorities (the Bank of Greece and the Capital Market Committee) shall publish data that will allow the parties concerned to compare and evaluate the supervisory measures and methodologies, as well as the overall implementation of Directives 2006/48/EC and 2006/49/EC (Basel II) by the supervisory authorities of the Member States.

3. Supervisory authorities shall evaluate credit institutions' compliance with the above obligations, and a supervisory authority's role

is upgraded, as it is assigned with supervision at group level, both in normal times and in crises that may put at risk the stability of the financial sector in any Member State where subsidiaries of the supervised credit institution are established. To this end, particular importance is attached to cooperation among supervisory authorities both at domestic and cross-border level, as the law expressly provides for the signing of Memoranda of Understanding. The signing of a Memorandum of Understanding between the Bank of Greece and the Capital Market Committee is expected to help minimise overlaps and reduce supervisory costs to the benefit of both supervisory authorities and supervised institutions.

The specialised provisions of the above Directives that cover technical issues under the three Pillars of Basel II will be transposed to Greek law by Acts of the Bank of Greece Governor (in relation to credit institutions) and decisions of the Capital Market Committee (with respect to investment firms).

In addition to transposing the Directives, the new law will replace and amend, in the light of current developments, the provisions in force of the main banking law (2076/1992) and Presidential Decree 267/1995, as well as other obsolete provisions of the banking legislation. The codification of the banking legislation into a single instrument is aimed at facilitating supervisory authorities and supervised institutions, as well as any party concerned; moreover, it has been recommended by the IMF in its assessment of the Greek financial system.

To this end, the draft law proposes the following new provisions:

(a) Credit institutions' capital may also be increased by contribution in kind, provided that the relevant risks are covered from a supervisory point of view.

(b) Bank interest rates (instead of the contractual interest rate applicable so far) shall also apply to loans or other credit extended by investment firms, with a view to ensuring a level playing field.

(c) The Bank of Greece shall evaluate potential shareholders also in proposed acquisitions of stakes in the capital of credit institutions below the currently applicable 10% threshold, with a view to enhancing transparency and better evaluating the appropriateness of persons that can actually exercise material influence, especially in cases of substantial dispersal of a credit institution's shares.

(d) A specific provision prohibits credit institutions from extending credit on privileged conditions to persons closely related with it, which could compromise the credit institution's sound management.

(e) The law addresses the issue of credit institutions carrying out secondary activities other than purely financial ones that enjoy mutual recognition and are freely carried out across the Community.

(f) Criteria are established for both the imposition of sanctions on supervised firms and the disclosure of such sanctions.

(g) The law updates the provision on the immunity of the statutory bodies and employees of the Bank of Greece when they exercise their powers under the law, so that they will carry out their mandate without the threat of ill-founded civil claims. This principle already applies to the employees of the Capital Market Committee and is one of the main principles of the Basel Committee on Banking Supervision.

(h) The law replaces the framework on mortgage bonds with the modern institution of covered bonds.

8.3 OTHER INSTITUTIONAL DEVELOPMENTS

Law 3458/2006 "Reorganisation and winding up of credit institutions" transposed to Greek law Directive 2001/24/EC of the Council and the European Parliament on the reorganisation and winding up of credit institutions. The new law provides that, *inter alia,* the authorities of the home Member State have the power to take measures for the reorganisation or winding up of a credit institution. The law of the home Member State shall apply, and all the measures taken by the competent authorities of the credit institution's home Member State shall be recognised across the Community, so that they will immediately bring about results in all the other Member States where the credit institution has established branches.

On the initiative of the Bank of Greece, Law 3483/2006 "Amendment to, and supplementation of, the provisions on financial leasing, provisions on government revenue and other arrangements" allowed credit institutions domiciled and operating in Greece, in addition to their other activities, to provide also financial leasing services (so far permitted to branches of banks domiciled in the EEA). Moreover, the law allowed (subject to conditions) banks operating as credit cooperatives to carry out transactions with non-members.

Law 3487/2006 transposed to domestic law Directive 2003/51/EC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, providing that credit and financial institutions referred to in paras. 1 and 6 of Article 2 of Law 2076/1992 and having the form of a société anonyme (except for the Bank of Greece) shall prepare their annual financial statements according to the International Accounting Standards.

The joint decision of the Capital Market Committee and the Bank of Greece (Government Gazette 1114/16 August 2006, Issue B) "Credentialling of credit institutions' employees and officers" laid down the Bank of Greece's conditions and procedures for the credentialing of employees and officers of credit institutions that provide investment services, by way of analogy to the provisions on employees of investment firms. This decision is aimed at ensuring uniform qualifications for persons providing investment services, with a view to improving the quality of services, protecting investors and strengthening competition.

Moreover, a Law-Drafting Committee has been established to transpose to Greek law Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments, which sets out, *inter alia*, detailed rules of organisation and behaviour to be observed by both investment firms and credit institutions in providing investment services to their customers, with a view to ensuring high quality in the execution of investor transactions and financial system efficiency.

9 EUROPEAN AND INTERNATIONAL DEVELOPMENTS

9.1 INSTITUTIONAL DEVELOPMENTS AT EU LEVEL

In June 2006, the ECOFIN Council adopted Directives 2006/48/EC and 2006/49/EC amending Directives 2000/12/EC and 93/6/EC respectively and making up the new capital adequacy framework for credit institutions and investment firms on the basis of the "Basel II" rules. The Directives will be available for implementation by the Member States as from 2007 and, in particular with respect to the more sophisticated approaches, as from 2008.

Moreover, in July 2006 the European Commission announced, after consultations with market representatives, the prospective modification of Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, pointing out that this modification should be compatible with the proposed Directive on payment services submitted by the European Commission in December 2005, which has not been adopted yet.

Regarding the revision of Directive 94/19/EC on deposit guarantee schemes, the European Commission announced in November 2006 that there is no urgent need to amend it in order to improve deposit guarantee schemes, in particular with respect to their cross-border operation within the context of single market integration. Possible improvements concerning the actual implementation of the Directive (in particular regarding excluded deposit products, supplementary cover, exchange of information among schemes, risk-based calculations of contributions, improvement of the information provided, as well as the time of compensation) are examined by a Working Group of the European Commission, composed of representatives of the Member States and the European Forum of Deposit Insurers (EFDI). Besides, any modification of the current Directive providing for harmonisation of the way of financing (ex *post* or *ex ante*) and for the possibility of contribution transfers is subject to completion of the ongoing discussions on cross-border crisis management, as both issues have direct bearing on financial stability.

In September 2006, the European Commission published a proposed Directive amending Directives 2006/48/EC, 92/49/EEC, 2002/83/EC, 2005/68/EC and 2006/49/EC. This proposed Directive seeks to enhance the transparency of the procedures applied by Member States' supervisory authorities in the evaluation of proposed mergers and acquisitions in the financial sector, as well as to further harmonise such procedures at EU level, without weakening supervisory powers in this area.

9.2 COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)

CEBS focused on promoting convergence among European supervisors' practices in view of the forthcoming adoption and implementation of the new capital adequacy framework. To this end, CEBS issued ten Guidelines concerning:

(a) outsourcing by credit institutions;

(b) the Application of the Supervisory Review Process, with additional guidelines on stress tests, concentration risk and interest rate risk affecting the investment portfolio;

(c) the Common Reporting Framework to be used by credit institutions when they report their solvency ratio to supervisory authorities and implement the Framework for Consolidated Financial Reporting;

(d) the recognition of External Credit Assessment Institutions;

(e) the cooperation between Consolidating Supervisors and Host Supervisors; and

(f) the validation and assessment of risk management and measurement systems.

Moreover, following a relevant assignment by the European Commission, CEBS provided technical advice on large financial exposures and recorded in detail all the market rules and trends regarding own funds. It also continues to examine the supervisory treatment of risks arising out of credit institutions' activities directly or indirectly linked with commodities. CEBS will continue to deal with various other practical supervisory issues, such as the running of operational networks and the degree of utilisation of the guidelines in everyday supervisory practice.

9.3 INTERNATIONAL DEVELOPMENTS

In October 2006 the new Basel principles were published, concerning the evaluation criteria of banking supervision efficiency and revising the principles applying since 1997. This revision was warranted on the one hand by innovations and developments in financial markets, banking operations and financial instruments and, on the other hand, by the need to take advantage of the experience gained from previous evaluations. Specifically, the revision focuses on effective risk management; corporate governance practices; the need for closer cooperation and exchange of information among supervisors of various sectors of the financial system and countries; and independence, responsibility and transparency in the conduct of supervisors' duties.

Moreover, with a view to strengthening cooperation with the supervisory authorities of third countries, the Bank of Greece signed in 2006 a Memorandum of Understanding with the central bank of the Former Yugoslav Republic of Macedonia (FYROM) and is preparing to sign a Memorandum of Understanding with the central bank of Egypt. The Bank of Greece also participates in the MEDA Programme on Banking Supervision at the central bank of Egypt (in cooperation with the European Central Bank, Banca d' Italia, Banque de France and Deutsche Bundesbank). The object of this programme is to provide technical assistance, mainly through joint working groups in Egypt and visits of Egyptian colleagues to European central banks.

10 PAYMENT SYSTEMS

10.1 THE HERMES PAYMENT SYSTEM

The HERMES real time gross settlement system operated effectively in 2006, contributing positively to the smooth flow of payments and financial stability.

Payment traffic in the HERMES system rose by 8.9% to 1.5 million in volume terms and by 22.3% to €6,873 billion in value terms in com-

Table X.5 Transactions through the HERMES system

Payment orders	Number of transactions			Value of transactions (million euro)		
	2005	2006	% change	2005	2006	% change
1. Domestic	**1,078,621**	**1,194,058**	**10.7**	**3,157,922**	**4,384,691**	**38.8**
– Customer payments	629,437	645,586	2.6	271,949	214,638	–21.1
– Interbank payments	449,184	548,472	22.1	2,885,973	4,170,052	44.5
2. Cross-border	**316,083**	**324,083**	**2.5**	**2,459,569**	**2,488,131**	**1.2**
– Customer payments	181,186	195,983	8.2	12,201	15,581	27.7
– Interbank payments	134,897	128,100	–5.0	2,447,368	2,472,550	1.0
HERMES total	**1,394,704**	**1,518,141**	**8.9**	**5,617,491**	**6,872,822**	**22.3**
TARGET total	**76,150,602**	**83,179,993**	**9.2**	**488,900,500**	**533,541,100**	**9.1**

Sources: Bank of Greece and ECB.

parison with 2005 (see Table X.5). The considerable increase in both volume and, most notably, value terms stemmed mainly from domestic (especially interbank) payments, largely as a result of the change (as from the second half of 2005) in the settlement of transactions through the System for Monitoring Transactions in Book-Entry Securities operated by the Bank of Greece. Specifically, end-of-day netting was replaced with trade-by-trade settlement in real time; as a result, payments increased in both value and volume terms.

Domestic payments grew considerably stronger in value terms than in volume terms; as a result, the average value per transaction rose from €2.9 million in 2005 to €3.7 million in 2006. By contrast, cross-border payments increased only slightly in value terms, actually at a weaker rate than in volume terms. As a result, the average value per transaction showed a small decline, from €7.8 million in 2005 to €7.7 million in 2006.

TARGET[41] transactions grew at a rate slightly over 9% in both volume and value terms in 2006. As the rate of increase in the HERMES transactions in volume terms was similar to that for TARGET transactions, while their growth rate in value terms was clearly higher, the share of the HERMES system in the TARGET system remained unchanged (1.83%) in volume terms and increased slightly in value terms (2006: 1.29%, 2005: 1.15%).

The smooth flow of payments was supported by sufficient intraday liquidity provided by the Bank of Greece. The value of posted collateral was well in excess of the collateral actually used throughout 2006. Specifically, the average daily amount of posted collateral was €2,557 million, while the average value of intraday credit was €879 million, providing an adequate buffer against any credit institutions' increased liquidity needs.

The availability of the HERMES system remained high in 2006, with the average annual availability rate standing at 99.98% (owing to one short failure due to technical reasons, which was addressed promptly), slightly higher than the average annual figure for the TARGET system (99.86%).

41 Trans-European Automated Real-time Gross-settlement Express Transfer system.

10.2 RETAIL PAYMENT SYSTEMS AND PAYMENT INSTRUMENTS

In 2006, the number of cheques processed through the Athens Clearing Office and DIAS S.A. rose by 0.4% to 16.5 million, and their total value increased by 11.3% to €320.5 billion in comparison with 2005. Besides, cheques processed through banks' networks rose by 0.6% in volume terms and 0.9% in value terms.

The volume and value of small-value fund transfer orders through DIASTRANSFER showed a considerable increase (of 48% and 71.6% respectively). This rise mainly stemmed from the processing by the system, as from July 2005, of bulk salary, pension, benefit and dividend payments by agencies and firms.

Direct debit orders processed through the DIASDEBIT system in 2006 rose by 18.3% in volume terms and 20.1% in value terms. This increase is accounted for by new contracts signed with private companies, as well as a considerable increase in the transactions of utilities (such as the Hellenic Telecommunications Organisation).

Box X.1

PAYMENT INSTRUMENTS

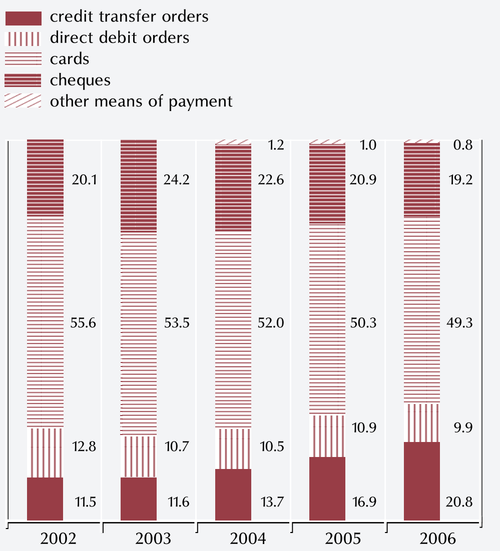
Although cash remains the usual payment instrument, especially in small-value transactions, it is obvious that a substantial amount of payments in the EU Member States is carried out through other, modern instruments. Underlying this development is mainly the fact that they are easy to use, are promoted by credit institutions, can save time and provide safety.

In Greece, other than cash, the main payment instruments are credit transfer orders, direct debit orders, various payment cards and cheques; bills of exchange etc. are of lesser importance. Among them, credit transfers have shown the most considerable increase in recent years, owing to the development of alternative channels, such as telephone banking, internet banking and ATMs, and to their promotion by banks. As a result, credit transfers trebled in volume terms in the last five years.

Overall, developments in the use of various payment instruments (other than cash) in Greece are presented in the chart, which shows clearly that the bulk of payments (about 50%) are carried out through cash. It should be noted that, among the card categories (credit, debit, delayed debit and

Greece: number of transactions by means of payment

(percentages)



Source: Bank of Greece.

prepaid cards), credit cards have by far the largest share in transactions (around 90%). Besides, it is observed that cheques, which are a widespread payment instrument in business and trade in Greece, have in recent years recorded a decline in their share in total transactions,[1] which probably points to a gradual shift to other payment instruments.

In comparison with other countries, in particular those in the euro area and the EU-15 for which sufficient comparative data are available, the volume of transactions per resident in Greece is very small, both as a whole and for the individual payment instruments, most notably direct debits and fund transfers, as clearly shown in the table.

Number of transactions per resident

(annual data, 2005)

	Total*	Credit transfers	Direct debits	Cheques	Cards
Greece	12.8	2.6	1.5	2.5	6.1
Euro area	157.2	47.2	44.9	16.2	45.8
EU-15	170.2	47.8	44.1	18.1	57.6

Note: Interbank payments are not included.
* The total includes "other" means of payment, whose share is very small.
Source: ECB (Blue Book).

Regarding the value of transactions, Greece's share in the total for euro area countries in very low (1.23% in 2005), although Greece's share in the euro area GDP and population is considerably higher (2.26% and 3.54% respectively).

The value of transactions through payment instruments other than cash is 7.2 times the value of GDP in Greece, while in the euro area it is 13.3 times the value of GDP. Moreover, the value of transactions per resident in Greece was €118,000 in 2005, corresponding to about 1/3 of the value of transactions per resident in the euro area.

1 The widening of cheques' share in 2003 is attributable to the fact that, as from that year, they include cheques where the issuing and the paying bank are the same.

10.3 THE TARGET2 PAYMENT SYSTEM

The development of TARGET2, the new trans-European payment system, continues at a fast pace. During 2006, the Eurosystem finalised the specifications of the single shared platform and the participation and pricing scheme for credit institutions and ancillary systems. At the same time, it addressed specialised issues, such as the management of failures and the legal framework for liquidity pooling, and prepared a detailed schedule of the tests and migration to the new system. Central banks have already started testing the TARGET2 single platform, and will be joined by credit institutions as from May 2007. As is known, migration will be gradual. Since everything is going according to schedule, the first group of countries will migrate on 19 November 2007.

For its part, the Bank of Greece continues to prepare for its participation in the TARGET2, at the same time coordinating and assisting the migration of the credit institutions and ancillary systems operating in Greece by continuously briefing them on the project's characteristics and requirements and by monitoring progress in their adaptations. Credit institutions in Greece will be able to control their systems' readiness during the tests, to start in July 2007. Greece is included in the third migration wave (19 May 2008).

APPENDIX TO CHAPTER X

BANK OF GREECE DECISIONS CONCERNING THE ESTABLISHMENT AND OPERATION OF CREDIT INSTITUTIONS AND THE SUPERVISION OF THE FINANCIAL SYSTEM

1 January 2006

The Paris-based Bank Société Générale discontinues the operation of its branch in Greece.

2 January 2006

A branch of the Belgium-based Fortis Bank SA/NV commences its operation in Greece.

4 January 2006

— The merger between the National Bank of Greece and the company "Ethniki Axiopiiseos Akiniton kai Ekmetallefseos Genikon Apothikon SA" is approved.

— "Pireaus Leasing SA" is authorised to operate as a leasing company.

24 January 2006

— Alpha Bank is authorised to establish and operate 30 new branches in Bulgaria and 4 in Albania.

— The National Bank of Greece is authorised to establish and operate 7 new branches in Albania.

— The Bank of Greece withdraws its authorisation for the establishment and operation of a bureau de change by Change Star S.A.

24 February 2006

— The maximum amount that the Agricultural Bank is authorised to invest in shares and mutual fund units is harmonised with that of other credit institutions and raised to 25% from 15% of the bank's own funds.

— The merger between EFG Eurobank Ergasias and Intertrust Mutual Funds Management SA is approved.

9 March 2006

With a view to adapting the principles and criteria that govern credit and financial institutions' internal control systems to supervisory developments, as well as taking into account the need to further specify individual issues, notably relating to risk management and compliance with the institutional and supervisory framework in force, the basic general principles and criteria all credit and financial institutions supervised by the Bank of Greece must comply with are established in order to ensure that these institutions have, on both an individual and a group basis, an effective organisation structure and an adequate Internal Control System, including risk management, internal audit and regulatory compliance.

10 March 2006

— Marquis International S.A. is authorised to operate as a money transfer intermediary.

— EFG Eurobank Ergasias is authorised to acquire 100% of the share capital of "Nacionalna Stedionica Banka", based in Serbia-Montenegro.

27 March 2006

"Geniki Cards and Financial Services SA" is authorised to become a credit company under the name "SFS Hellasfinance SA".

4 April 2006

The absorption of "Ivision – Advanced Systems and Information Services SA" by Pireaus Bank is approved.

13 April 2006

Proton Investment Bank SA is authorised to acquire a qualifying holding of 20% in the share capital of "Aeoliki Portfolio Investment S.A.".

19 April 2006

— "Greek Postal Savings Bank S.A." is authorised to operate in Greece.

— EFG Eurobank Ergasias is authorised to increase its qualifying holding in the share capital of "Dias Portfolio Investment S.A.".

— EFG Eurobank Ergasias is authorised to acquire 100% of the share capital of the Bucharest-based life insurance company under establishment "SC EFG Eurolife Asigurari de Viata S.A.".

8 May 2006

Hellenic Post S.A. is authorised to acquire 10% of the share capital of "Greek Postal Savings Bank S.A."

11 May 2006

— The National Bank of Greece is authorised to acquire the majority of the share capital of the Turkey-based Finansbank AS.

— "Manig Money Services S.A." is authorised to operate in Greece.

30 May 2006

— Pireaus Bank is authorised to acquire the majority of the share capital of its Bucharest-based subsidiary "Pireaus Bank Romania S.A.".

— Laiki Bank (Hellas) S.A. is authorised to acquire 100% of the share capital of "Laiki Leasing S.A.".

15 June 2006

The financing of natural or legal persons who are among the 10 largest shareholders or stake holders in a company, in order to acquire shares or stakes, is allowed provided that with this acquisition the borrower's share in the company's capital is either maintained or increased.

21 June 2006

The National Bank of Greece is authorised to operate 5 new branches in Serbia-Montenegro.

10 July 2006

— IRF European Finance Investment Ltd. is authorised to acquire a qualifying holding of 30% in the share capital of Proton Investment Bank S.A.

— The ceiling on credit institutions' investment in equity and mutual fund units (25% of their own funds) will be calculated on the basis of their net positive position in equity, derivatives on equity and equity-indexed derivatives of their trading portfolios.

— JP Morgan Chase Bank N.A. is authorised to establish and operate a representative office in Greece.

26 July 2006

— The Paris-based Crédit Agricole S.A. is authorised to acquire 100% of the share capital of the Commercial Bank of Greece.

— The Agricultural Bank of Greece is authorised to acquire a qualifying holding up to

57.12% (85% by a later decision) in the share capital of the Romania-based Mindbank S.A.

— Marfin Financial Group S.A. is authorised to acquire a qualifying holding up to 49% of voting rights in Egnatia Bank.

—Société Générale Consumer Finance Holding Hellas SA is authorised to acquire 100% of the share capital of "Cofidis Hellas Finance S.A.".

— EFG Eurobank Ergasias is authorised to acquire the majority of the share capital of the Turkey-based "Tekfenbank AS".

6 September 2006

— The absorption of Omega Bank and of Proton Stock Brokers by Proton Investment Bank is approved. Proton Investment Bank is also authorised to become a member of the Athens Exchange.

— Dubai Financial LLC is authorised to acquire a qualifying holding up to 34% in the share capital of Marfin Financial Group SA and, through it, in the share capital of Marfin Bank, Investment Bank of Greece and Egnatia Bank.

— "EFG Factors S.A." is authorised to operate a branch in Bulgaria.

— EFG Eurobank Ergasias is authorised to acquire the majority of the share capital of the Ukraine-based Bank Universal.

— The Zurich-based I.B.I. Bank AG is authorised to establish and operate a representative office in Greece.

21 September 2006

The Agricultural Bank of Greece is authorised to acquire a qualifying holding in the share capital of the Serbia-based Agroindustrijka Komercijalna Banka-AIK Banka AD.

26 September 2006

Marfin Bank S.A. is authorised to acquire the majority of the share capital of the Investment Bank of Greece.

2 October 2006

A branch of the Austria-based BMW Austria Bank GmbH commences its operation in Greece.

13 October 2006

— The National Bank of Greece is authorised to convert its branch network in Serbia into a subsidiary.

— The operational principles and the evaluation criteria for the structure of credit and financing institutions' internal control systems are specified, with a view to preventing the use of the financial system for money-laundering and terrorism financing.

— The authorisation for the establishment and operation of bureaux de change by "Dias Bureaux de Change S.A." is withdrawn.

— Novabank SA is authorised to amend its Statute and its registered name. The latter becomes "Millenium Bank S.A.".

8 November 2006

The National Bank of Greece is authorised to acquire 100% of the share capital of the Serbia-based "Vojvodjanska Banka AD Novi Sad".

28 November 2006

— EFG Eurobank Ergasias is authorised to acquire 100% of the share capital of the Bulgaria-based "DZI Bank AD".

— Piraeus Bank is authorised to acquire a qualifying holding up to 27% in the share capital of "Trieris Real Estate Ltd.".

— The authorisation for the establishment and operation of bureaux de change by "Karlos Enterprises Bureaux de Change S.A." is withdrawn.

— By virtue of Law 3483/2006, "Pancretan Co-operative Bank" is authorised to conduct transactions with non-members as well.

11 December 2006

— The Cyprus-based Marfin Popular Bank Public Co. Ltd. is authorised to acquire a qualifying holding up to 100% in the share capital of Egnatia Bank S.A., of Marfin Financial Group S.A. and, through the latter, up to 100% of the share capital of Marfin Bank ATE and 91% of the share capital of Investment Bank of Greece S.A.

— The National Bank of Greece is authorised to acquire 100% of the share capital of P&K Investment Services S.A.

— Except for the cases where the manner of application of contractual terms is clearly determined, whenever the contractual terms agreed upon between customers and credit institutions are unilaterally amended by the credit institution, the latter is obliged to inform the counterparty individually. Besides, fees for the lack of transactions will not be applied to savings deposits, to the extent that such fees exceed interest amounts and reduce the outstanding balance of the deposited amount.

— The authorisation for the establishment and operation of bureaux de change by "Eurocambio Bureaux de Change and Tourist Enterprises S.A." is withdrawn.

— "Intel Express Bureaux de Change S.A." is authorised to operate in Greece.

— The terms for keeping sight deposit accounts and for the circulation of cheques through the banking system are amended and codified so as to respond to market conditions and also to allow for their better application by credit institutions and customers.

1 January 2007

The Greek branch of the Italy-based bank "Sanpaolo IMI S.p.A." changes its registered name to "Intesa Sanpaolo S.p.A.".

24 January 2007

"Proton Bank S.A." is authorised to increase its qualifying holding in the share capital of the Cyprus-based Interfund Investments Ltd.

1 February 2007

The branch of the Poland-based Daimler-Chrysler Bank Polska SA commences its operation in Greece.

13 February 2007

The Greek branch of Société Générale, which is under liquidation, is authorised to prolong its administrative, accounting and tax-related operations.

20 February 2007

The framework for the processing and recirculation of euro banknotes by credit institutions and professional cash handlers is determined.

1 March 2007

— Alpha Bank is authorised to acquire: (i) a direct qualifying holding in the share capital of a holding company under establishment and (ii) an indirect qualifying holding in the share capital of the Turkey-based Alternatif Bank S.A., Alternatif Financial Kiralama AS, Alternatif Yatirim AS and Alternatif Yatirim Ortkaligi AS.

— The Russia-based Kedr Close Joint Stock Company Commercial Bank is authorised to establish and operate a branch in Greece.

9 March 2007

Piraeus Bank is authorised to acquire a qualifying holding in the share capital of the insurance company "Europaiki Pisti AEGA".

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 with an agreed maturity (time deposits): 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.

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 government: as defined in the European System of Accounts 1995 (ESA 95), comprises central, state and local government and social security organisations.

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 maturity 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.

MFI net external assets: the external assets of the euro area *MFI* sector (such as gold, banknotes in currencies other than the euro, 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 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.

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 amended and supplemented by 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.

ANNEX

ANNUAL ACCOUNTS FOR THE YEAR 2006

AUDITOR'S REPORT
REPORT OF THE GENERAL COUNCIL

CONTENTS

BALANCE SHEET AS AT 31 DECEMBER 2006
SEVENTY-NINTH YEAR

(in euro)

ASSETS	31.12.2006	31.12.2005
1. Gold and gold receivables	**2,210,725,255**	**1,938,504,319**
2. Claims on non-euro area residents denominated in foreign currency	**486,131,282**	**486,694,896**
2.1 Receivables from the IMF	125,814,163	173,601,402
2.2 Balances with banks and security investments, external loans and other external assets	360,317,119	313,093,494
3. Claims on euro area residents denominated in foreign currency	**553,330,050**	**951,283,800**
3.1 General government	302,662,973	857,695,042
3.2 Other claims	250,667,077	93,588,758
4. Claims on non-euro area residents denominated in euro	**649,303,017**	**1,252,443,482**
4.1 Balances with banks, security investments and loans	649,303,017	1,252,443,482
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	**4,795,146,004**	**2,354,018,096**
5.1 Main refinancing operations	3,083,000,000	1,561,000,000
5.2 Longer-term refinancing operations	1,712,146,004	793,018,096
6. Other claims on euro area credit institutions denominated in euro	**942,132,861**	**1,013,525,131**
7. Securities of euro area residents denominated in euro	**6,298,382,914**	**7,253,276,427**
8. General government debt denominated in euro	**8,744,528,645**	**8,786,178,291**
8.1 Long-term debt	1,385,447,037	1,527,126,785
8.2 Loans for participation in the IMF	718,441,211	761,114,532
8.3 Long-term loans and securities	6,640,640,397	6,497,936,974
9. Intra-Eurosystem claims	**1,453,912,102**	**1,449,244,341**
9.1 Participating interest in the ECB	393,403,998	393,403,998
9.2 Claims equivalent to the transfer of foreign reserves to the ECB	1,055,840,343	1,055,840,343
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 transactions with the ESCB (TARGET)	0	0
9.6 Other claims within the Eurosystem (net)	4,667,761	0
10. Items in course of settlement	**2,039,130**	**1,834,373**
11. Other assets	**8,789,731,911**	**6,462,189,449**
11.1 Coins	41,305,892	34,660,705
11.2 Tangible and intangible fixed assets	755,690,484	758,447,832
11.3 Other financial assets	6,813,977,432	4,619,720,123
11.4 Accruals and prepaid expenses	705,669,379	613,823,872
11.5 Sundry	473,088,724	435,536,917
TOTAL ASSETS	**34,925,363,171**	**31,949,192,605**

OFF-BALANCE-SHEET ITEMS	31.12.2006	31.12.2005
1. Investments in Greek government securities related to the management of the "Common capital of legal persons in public law and social security funds" according to Law 2469/97	18,034,147,613	19,105,547,134
2. Investments in Greek government securities and other securities related to the management and custody of funds of public entities, social security funds and private agents	10,753,664,510	10,430,655,763
3. Other off-balance-sheet items	7,035,832,577	5,256,542,624
TOTAL OFF-BALANCE-SHEET ITEMS	**35,823,644,700**	**34,792,745,521**

Notes:

1. *Under Article 54A of the Bank's Statute, the balance sheet was drawn up in compliance with the accounting rules and techniques determined by the European Central Bank (ECB) and applying to the members of the European System of Central Banks (ESCB).*
2. *The weighted key for subscription of the Bank of Greece to the ECB's capital fully paid up by the 12 national central banks of the Eurosystem is 2.65405%.*
3. *Claims/liabilities denominated in euro or foreign currency are broken down into claims on/liabilities to euro area residents and non-euro area residents.*

(in euro)

LIABILITIES	31.12.2006	31.12.2005
1. Banknotes in circulation	**15,338,479,600**	**13,799,748,640**
2. Liabilities in euro to euro area credit institutions, related to monetary policy operations	**4,529,984,822**	**4,286,009,203**
2.1 Current accounts (including minimum reserves)	4,526,984,822	4,282,809,203
2.2 Deposit facility	3,000,000	3,200,000
3. Other liabilities to euro area credit institutions denominated in euro	**22,195,000**	**27,565,000**
4. Liabilities to other euro area residents denominated in euro	**912,830,809**	**1,106,657,696**
4.1 General government	893,567,625	1,085,934,059
4.2 Other liabilities	19,263,184	20,723,637
5. Liabilities to non-euro area residents denominated in euro	**851,539,789**	**863,282,339**
6. Liabilities to euro area residents denominated in foreign currency	**83,723,120**	**163,530,138**
7. Liabilities to non-euro area residents denominated in foreign currency	**111,747,203**	**109,831,235**
7.1 Deposits and other liabilities	111,747,203	109,831,235
7.2 Liabilities arising from the credit facility under ERM II	0	0
8. Counterpart of special drawing rights allocated by the IMF	**118,206,311**	**125,275,550**
9. Intra-Eurosystem liabilities	**9,752,092,960**	**8,455,940,423**
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	1,568,551,555	1,232,234,040
9.3 Net liabilities related to transactions with the ESCB (TARGET)	8,183,541,405	7,216,770,680
9.4 Other liabilities within the Eurosystem (net)	0	6,935,703
10. Items in course of settlement	**55,474,879**	**48,873,833**
11. Other liabilities	**778,947,772**	**784,830,284**
11.1 Off-balance sheet instruments revaluation differences	0	8,324
11.2 Accruals and income collected in advance	170,041,389	143,172,258
11.3 Sundry	608,906,383	641,649,702
12. Provisions	**1,052,296,846**	**846,722,005**
13. Revaluation accounts	**650,634,500**	**682,695,696**
14. Capital and reserves	**667,209,560**	**648,230,563**
14.1 Capital	88,994,690	88,994,690
14.2 Ordinary reserve	88,994,690	88,994,690
14.3 Extraordinary reserve	19,000,000	–
14.4 Special reserve from the revaluation of land and buildings under Law 3229/2004	470,018,863	470,018,863
14.5 Special reserves	201,317	222,320
TOTAL LIABILITIES	**34,925,363,171**	**31,949,192,605**

4. *Account balances related to monetary policy operations are shown under separate items.*
5. *The value of gold has been calculated on the basis of the euro price of the gold ounce referred to in the ECB's exchange rate list of 29 December 2006 (€482.688 per ounce compared with €434.856 per ounce on 30 December 2005).*
6. *Claims and liabilities in foreign currency have been valued on the basis of the exchange rates referred to in the ECB's exchange rate list of 29 December 2006.*
7. *The value of securities has been calculated on the basis of average prices applying on 29 December 2006, except for the securities included in asset item 11.3 "Other financial assets", which have been valued at cost. This item monitors the investment portfolio of the Bank of Greece, which comprises Greek government securities and government securities issued by other euro area countries; these securities constitute fixed investment to be held by the Bank up to maturity. In financial year 2006, it was decided to reclassify securities totalling €1.6 billion under "securities held to maturity" from the category "trading book" (asset item 7).*
8. *Fixed assets are valued at cost, except land and buildings, which are valued at market prices, determined by independent assessors, less depreciation.*
9. *The depreciation of buildings and banknote production costs is calculated, as of financial year 2005, at a rate of 2.5% and 20%, respectively, according to the estimated useful life of buildings (40 years) and the lifetime of banknotes (5 years on average).*
10. *Out of the profit for financial year 2006, €19 million were allocated to an extraordinary reserve.*
11. *Some items of the balance sheet and the profit and loss account for financial year 2005 have been reclassified so as to be comparable with the corresponding items for financial year 2006.*

PROFIT AND LOSS ACCOUNT FOR THE YEAR 2006

(in euro)

	2006	2005
1. Net interest income	**305,562,534**	**311,925,536**
1.1 Interest income	809,375,938	683,455,834
1.2 Interest expense	–503,813,404	–371,530,298
2. Net result of financial operations, write-downs and risk provisions	**362,192,133**	**133,521,961**
2.1 Realised gains arising from financial operations	362,192,133	155,179,029
2.2 Write-downs on financial assets and positions	–22,939,084	–21,657,068
2.3 Transfer from provisions for foreign exchange rate and price risks	22,939,084	0
3. Net income from fees and commissions	**121,812,074**	**124,906,121**
3.1 Fees and commissions income	122,842,921	125,933,049
3.2 Fees and commissions expense	–1,030,847	–1,026,928
4. Income from equity shares and participating interests	**3,472,030**	**3,476,715**
5. Net result of pooling of monetary income	**4,667,120**	**9,874,431**
6. Other income	**33,147,655**	**27,094,748**
Total net income	**830,853,546**	**610,799,512**
7. Staff costs	**–214,153,481**	**–200,810,488**
7.1 Wages and salaries	–140,052,880	–132,282,005
7.2 Employer's contributions and other levies	–74,100,601	–68,528,483
8. Pensions	**–55,381,266**	**–49,036,451**
9. Administrative and other expenses	**–50,641,472**	**–39,460,857**
10. Depreciation of tangible and intangible fixed assets	**–38,436,988**	**–33,803,564**
11. Provisions	**–227,604,875**	**–59,228,907**
Total expenses	**–586,218,082**	**–382,340,267**
PROFIT FOR THE YEAR	**244,635,464**	**228,459,245**

DISTRIBUTION OF NET PROFIT

(Article 71 of the Statute)

(in euro)

	2006	2005
Dividend €0.67 per share on 15,891,909 shares	10,647,579	10,647,579
Ordinary reserve	0	22,248,671
Extraordinary reserve	19,000,000	0
Additional dividend €2.23 per share on 15,891,909 shares*	35,438,957	27,493,003
Tax payment on dividends (Law 3296/2004, Article 6)	18,824,078	17,948,509
To the Government	160,724,850	150,121,483
	244,635,464	**228,459,245**

** The dividend and the additional dividend for the year 2005 was €2.40 per share.*

Athens, 19 March 2007

THE GOVERNOR

NICHOLAS C. GARGANAS

THE DIRECTOR OF THE ACCOUNTS DEPARTMENT

DIMITRIOS E. MATSIMANIS

To the Shareholders of BANK OF GREECE AE

Report on the Financial Statements

We have audited the accompanying financial statements of BANK OF GREECE AE, which comprise the balance sheet as at December 31, 2006, the income statement, and the statement of profit distribution.

Management's Responsibility for the Financial Statements: Management is responsible for the preparation and fair presentation of these financial statements in accordance with the accounting principles determined by the European Central Bank as they have been adopted by the Bank in Article 54A of its Articles of Association and the Greek Company Law. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility: Our responsibility is to express an opinion on these financial statements based on our audit. Except as discussed in the following paragraph, we conducted our audit in accordance with the Greek Auditing Standards which are based on International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion: The recorded provision for pension and other liabilities to Employee Funds amounts to €909 million, which is not supported by an analysis of the calculation method and, consequently, we could not assess its adequacy. In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to adequacy of the provision for pension and other liabilities to Employee Funds, the financial statements give a true and fair view of the financial position of BANK OF GREECE AE as of December 31, 2006, and of its financial performance for the year then ended in accordance with the accounting principles determined by the European Central Bank as they have been adopted by the Bank in Article 54A of its Articles of Association and the Greek Company Law.

Report on Other Legal and Regulatory Requirements: The content of the General Council report is consistent with the aforementioned financial statements.

Athens, 19 March 2007

The Certified Auditors-Accountants

Christos Glavanis	Despina Xenaki	Ernst & Young (Hellas) A.E.
(Registration No. 10 371)	(Registration No. 14 161)	Certified Auditors Accountants
11th klm National Road Athens-Lamia		(Registration No. 107)
144 51 Metamorphosi Attiki		ERNST & YOUNG

REPORT OF THE GENERAL COUNCIL TO THE GENERAL MEETING OF SHAREHOLDERS

ANNUAL ACCOUNTS OF THE BANK OF GREECE FOR THE YEAR 2006

ACCOUNTING POLICIES

General principles regarding the preparation of the Bank's accounts

The annual accounts of the Bank of Greece, under Article 54A of its Statute, are prepared in accordance with the accounting rules and practices applicable to the European System of Central Banks, as set out by the European Central Bank (ECB) in its Guideline ECB/2002/10 of 5 December 2002.

These rules and practices, although based on internationally accepted accounting policies, have been adjusted to reflect the specific status of the national central banks (NCBs) of the Eurosystem.

Any issues that are not covered by the aforementioned rules or ECB guidelines or are governed by non-mandatory provisions are to be treated either in accordance with the ECB instructions or in accordance with the Bank's Statute and Law 2190/1920 on sociétés anonymes.

Basic accounting principles

The main accounting principles applicable to the Eurosystem (i.e. the ECB and the NCBs of the euro area, including the Bank of Greece) are the following:

- ***Transparency:*** accounting and financial reporting must reflect the Bank's true financial situation.

- ***Prudence:*** Unrealised valuation gains on gold and foreign exchange are not recognised as income in the Profit and Loss Account but are transferred directly to revaluation accounts. By contrast, unrealised valuation losses at the year-end are recognised as expenses and are taken to the Profit and Loss Account.

- ***Post-balance-sheet events:*** Assets and liabilities are adjusted for events that occur between the annual balance sheet date and the date on which the annual accounts are approved, if such events affect the condition of assets or liabilities on the balance sheet date.

- ***Materiality and regularity.***

- ***Going concern basis:*** Accounts are prepared assuming continuity of business.

- ***The accruals principle:*** Income and expenses are recognised in the accounting period in which they are earned or incurred and not according to the period in which they are received or paid.

- ***Consistency and comparability:*** The criteria for balance sheet valuation and income recognition are applied consistently so as to ensure comparability of financial information.

Recording of financial transactions

Transactions in financial assets and liabilities are recognised on the basis of their settlement date.

Balance sheet valuation rules

- Assets and liabilities in foreign currency and gold are converted into euro at the exchange rate prevailing on the balance sheet date, as derived from the ECB's daily quotation of reference exchange rates.

- Income and expenses are converted into euro at the exchange rate prevailing at the trade date.

- No distinction is made between the price and currency revaluation differences for gold. Instead, a single gold valuation is accounted for on the basis of the price in euro per fine ounce of gold, which is derived from the exchange rate of the euro against the US dollar on the balance sheet date.

- The revaluation of foreign exchange assets and liabilities, including on-balance-sheet and off-balance-sheet instruments, is performed on a currency-by-currency basis.

- Marketable debt securities are valued at the mid-market prices prevailing on the Balance Sheet date on a security-by-security basis (by ISIN).

- Debt securities and holdings recorded under asset item 11.3 "Other financial assets" are valued at acquisition cost.

Income recognition

- Realised gains and losses arising from the sale of foreign exchange, gold and securities are taken to the Profit and Loss Account. Such realised gains and losses are calculated by reference to the average cost of the respective asset.

- Unrealised gains (revaluation gains) are not recognised as income but are transferred directly to revaluation accounts.

- Unrealised losses (revaluation losses), to the extent that they exceed previous revaluation gains registered in the corresponding revaluation account, are taken to the Profit and Loss Account at the year-end and are not netted against revaluation gains in subsequent years. Unrealised losses in any one security, currency or in gold are not netted against unrealised gains in other securities, currencies or gold. In the event of an unrealised loss on any item at the year-end, the average cost of that item is reduced to the year-end exchange rate and/or market price.

• Premiums or discounts arising on purchased securities are calculated and presented as part of interest income and are amortised over the remaining life of the assets.

Off-balance sheet instruments

Foreign exchange forward transactions are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses.

Banknotes in circulation

The ECB and the euro area NCBs, which together comprise the Eurosystem, issue euro banknotes.[1]

The ECB has been allocated a share of 8% in the total value of euro banknotes in circulation and the remaining 92% is allocated to the NCBs. The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month according to their banknote allocation keys.[2]

The share of banknotes in circulation that has been allocated to the Bank of Greece is disclosed under the Balance Sheet liability item 1 "Banknotes in circulation".

The difference between the value of euro banknotes allocated to each NCB according to its banknote allocation key and the value of euro banknotes that the NCB actually puts into circulation produces "Intra-Eurosystem claims/liabilities". These interest-bearing claims or liabilities[3] are disclosed under the sub-items "Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem".

For financial years 2002 to 2007, "Intra-Eurosystem balances (claims/liabilities)" that stem from the allocation of euro banknotes are adjusted in order to avoid sharp fluctuation in the monetary income of NCBs relative to previous years.

The amounts of these adjustments were calculated taking into account the differences between the average value of banknotes in circulation of each NCB during the period from 1 July 1999 to 30 June 2001 and the average value of banknotes that would have been allocated to them during the same period in accordance with the ECB's capital key. These amounts will decline gradually and will come to zero by the end of 2007. Income from banknotes will then be allocated in full to the NCBs, in proportion to their share in the subscribed capital of the ECB.

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1 ECB Decisions of 6 December 2001, 18 December 2003 and 22 April 2004 on the issue of euro banknotes.
2 "Banknote allocation key" means the percentages that result from taking into account the ECB's share (8%) in the total euro banknote issue and applying the subsequent capital key to the NCB's share in the total.
3 ECB Decision of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002 (ECB/2001/16, amended by ECB Decision ECB/2003/22 of 18 December 2003).

Interest income and interest expenses on these claims/liabilities, are netted in the ECB accounts and are disclosed in the Profit and Loss Account of each NCB under "Net interest income".

The Governing Council of the ECB has decided that the income from the ECB's share (8%) of the total value of euro banknotes in circulation will be distributed separately to the NCBs in the form of an interim distribution.[4] This income is due in full, unless the ECB's net profit for the year is less that its income earned on euro banknotes in circulation and also subject to any decision of the Governing Council in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes.

For the year 2006, the Governing Council of the ECB decided that the full amount of income earned from the ECB's share of total banknotes in circulation would be retained and used to establish a provision against foreign exchange rate, interest rate and gold price risks.

4 ECB Decision of 17 November 2005 (ECB/2005/11) on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating Member States.

NOTES ON THE BALANCE SHEET

ASSETS

1. Gold and gold receivables

Holdings and receivables in standard gold	31.12.2006	31.12.2005	Change
volume in fine troy ounces (thousands)	*4,580*	*4,458*	*122*
volume in tonnes	*142.5*	*138.7*	*3.8*
value (€ million)	*2,210.7*	*1,938.5*	*272.2*

The amounts reported above comprise the Bank's gold holdings (3,594 thousand oz) and gold receivables from the Greek State (986 thousand) corresponding to Greece's participation in the IMF (the gold component of Greece's quota has been paid by the Bank of Greece on behalf of the Greek State). The largest part of gold holdings is kept in banks abroad.

In 2006 the Bank upgraded gold coins and non-standard gold bars to standard gold bars, totaling 206 thousand oz (6.4 tonnes).

The €122 thousand oz increase in volume stems from gold holdings and reflects the fact that a large part of the gold upgraded consisted in gold coins and non-standard gold bars held by the Bank and previously recorded under asset item 11.5 "Sundry". The €272.2 million increase in value was mainly due to the appreciation of gold.

Gold has been valued at its euro price per fine troy ounce as at year-end according to the ECB's reference exchange rate, i.e. €482.688 on 29 December 2006 compared with €434.856 on 31 December 2005. This price is derived from the USD price of gold quoted on the London market on 29 December 2006 and the euro/USD exchange rate on that same date.

2. Claims on non-euro area residents denominated in foreign currency

This item consists of: receivables from the IMF (in SDRs); balances on correspondent accounts; time deposits with banks abroad; securities holdings; and foreign banknotes held at the Bank's vaults.

2.1 Receivables from the IMF

These arise from Greece's participation in the IMF and include the following:

— the Banks' holdings and deposits in special drawing rights;

— the SDR component of Greece's quota in the IMF. This has been financed by the Bank, which is entrusted with the management of the relevant assets. The euro component of Greece's quota in the IMF, amounting to € 842.8 million, is disclosed under liability item 5 "Liabilities to non-euro area residents denominated in euro". Greece's overall quota amounts to SDR 823 million and must remain unchanged (i.e. the euro component and the SDR component must always add up to SDR 823 million).

Receivables from the IMF (in million)	31.12.2006		31.12.2005		Change	
	SDRs	€	SDRs	€	SDRs	€
Greece's SDR quota	85.2	97.2	117.7	142.4	-32.5	-45.2
SDR holdings	19.6	22.4	20.3	24.6	-0.7	-2.2
Special non-interest-bearing deposit	5.4	6.2	5.4	6.6	0	-0.4
Total	110.2	125.8	143.4	173.6	-33.2	-47.8

The change reported above was due to a shift in the composition of the quota, following a decrease in the SDR component that reflected amounts collected by the Bank from third countries in line with IMF instructions. This necessitated a commensurate increase in the euro component, in order to restore the overall Greek quota at the stable level of SDR 823 million.

Receivables from the IMF were valued at the SDR/euro exchange rate as at 29 December 2006, based on the ECB's reference exchange rates, i.e. 1 SDR = 1.1416 euro, compared with 1 SDR = 1.2099 euro as at 30 December 2005.

2.2 Balances with banks and security investments, external loans and other external assets

This item consists of claims on non-euro area residents denominated in foreign currency, e.g. deposits (mainly time deposits), debt securities and non-euro banknotes.

Asset category	31.12.2006	31.12.2005	Change
	(in € million)		
Deposits with foreign banks (mostly time deposits)	229.3	212.0	17.3
Marketable debt securities (bonds - Treasury bills)	92.3	59.1	33.2
Cash holdings of foreign currency	38.7	42.0	-3.3
Total	**360.3**	**313.1**	**47.2**

The largest part of these assets as at 31 December 2006 is denominated in US dollars amounting to USD 208.1 million (€158.0 million) and in Japanese yen amounting to JPY 21,503 million (€137 million).

3. Claims on euro area residents denominated in foreign currency

This item consists mainly of claims on general government that stem from loans and, to a lesser extent, time deposits with correspondent banks in other euro area countries and holdings of marketable debt securities (bonds).

3.1 Claims on general government

These claims include:

— a long-term loan of GBP 75 million concluded on behalf, of and transferred to, the Greek State on 6 September 1985; the corresponding claim of the Bank on non-euro area banks is disclosed under liability item 7.1 "Deposits and other liabilities";

— loans in SDRs granted to the Greek State to finance its participation in the IMF, relating to the SDR component of Greece's quota;

— loans in USD and gold-linked loans to the Greek State to finance its participation in international organisations; these amounted to €302.7 million as at 31 December 2006, down from €857.7 million one year earlier.

The €555.0 million decrease mainly stems from the redenomination in euro of the long-term USD-linked government bond issue of 31 December 1993 whereby the balance of the account "Foreign exchange valuation differences – Law 1083/80". Redenomination took place on 1 February 2006 following an agreement between the Bank and the Greek State. The outstanding balance of the claim is now disclosed under asset item 8.3 "Long-term loans and securities".

3.2 Other claims

This sub-item primarily consists of time deposits in foreign currency held with euro area correspondent banks and, to a lesser extent, holdings of foreign-currency-denominated bonds issued by euro area residents.

Claims	**31.12.2006**	**31.12.2005**	**Change**
	(in € million)		
Time deposits	243.4	80.7	162.7
Bonds	7.3	12.9	-5.6
Total	**250.7**	**93.6**	**157.1**

The bulk of these claims as at 31 December 2006 is denominated in USD dollars (205.5 million), equivalent to €156.1 million.

4. Claims on non-euro area residents denominated in euro

4.1 Balances with banks, security investment and loans

This item mainly includes time deposits in euro with non-euro area correspondent banks, as well as holdings of euro-denominated bonds issued by non-euro area residents.

Claims	31.12.2006	31.12.2005	Change
	(in € million)		
Time deposits	445.6	620.5	-174.9
Bonds	203.7	210.3	-6.6
Treasury bills	0	421.6	-421.6
Total	**649.3**	**1.252.4**	**-603.1**

The decline was largely due to a substitution of Treasury bills with euro-denominated foreign bonds and commercial paper issued by euro area residents (asset item 7 "Securities of euro area residents denominated in euro").

5. Lending to euro area credit institutions related to monetary policy operations, denominated in euro

This item consists of outstanding balances of lending (provision of liquidity) to credit institutions against collateral of Greek government securities, in the context of the single monetary policy.

Liquidity is chiefly provided through main refinancing operations (with a maturity of one week) and to a lesser extent through longer-term refinancing operations (with a maturity of three months).

— Main refinancing operations (MROs) are liquidity-providing open market operations conducted by the Eurosystem in the form of reverse operations executed through weekly standard tenders with a maturity of one week.

— Longer-term refinancing operations (LTROs) are liquidity-providing open market operations conducted by the Eurosystem in the form of reverse operations executed through monthly standard tenders with a maturity of three months.

Claims	31.12.2006	31.12.2005	Change
	(in € million)		
MROs	3,083.0	1,561.0	1,522.0
LTROs	1,712.1	793.0	919.1
Total	**4,795.1**	**2,354.0**	**2,441.1**

The average outstanding amount of these operations during 2006 was €4,774 million, compared with €2,808 million during 2005.

6. Other claims on euro area credit institutions denominated in euro

These claims mainly relate to time deposits in euro held by the Bank of Greece with correspondent banks in the euro area. They are not connected with monetary policy operations and serve purely investment purposes.

Claims	31.12.2006	31.12.2005	Change
	(in € million)		
Time deposits	857.2	936.6	-79.4
Other claims	84.9	76.9	8.0
Total	**942.1**	**1,013.5**	**-71.4**

7. Securities of euro area residents denominated in euro

This item represents the Bank's marketable portfolio of euro-denominated bonds and Treasury bills issued by euro area residents other than the Greek government. Greek government securities and part of euro-denominated debt securities issued by other euro area residents and held in the Bank's investment portfolio until maturity are disclosed under asset item 11.3 "Other financial assets".

Security type	31.12.2006	31.12.2005	Change
	(in € million)		
Bonds	1,242.2	2,598.9	-1,356.7
Treasury bills	4,677.3	4,654.4	22.9
Commercial paper	378.9	0	378.9
Total	**6,298.4**	**7,253.3**	**-954.9**

The decrease of €954.9 million stemmed from the following:

— the reclassification of bonds and Treasury bills from the "marketable portfolio" to the "investment portfolio" intended to be held until maturity and included in asset item 11.3 "Other financial assets"; and

— new investment, in particular flows into bonds and commercial paper.

8. General government debt denominated in euro

This item consists of long-term loans in euro granted by the Bank to the Greek State. The outstanding balance of these loans was €8,744.5 million as at 31 December 2006, compared with €8,786.2 as at 31 December 2005.

Breakdown by loan category

8.1 Long-term debt

This item represents long-term interest-bearing loans extended to the Greek State up to 31.12.1993:

Outstanding balance as at 31.12.2006	€1,385.4 million
Outstanding balance as at 31.12.2005	€1,527.1 million
Decrease	€141.7 million

The decrease stems from gradual loan repayment.

8.2 Loans for participation in the IMF

These are interest-free loans in euro extended by the Bank to the Greek State for the purpose of financing its euro-denominated participation in the IMF. The amount of this participation, which is deposited by the IMF with the Bank, is disclosed under liability item 5 "Liabilities to non-euro area residents denominated in euro".

Outstanding balance as at 31.12.2006	€718.4 million
Outstanding balance as at 31.12.2005	€761.1 million
Decrease	€42.7 million

The decrease stemmed from revaluation following the appreciation of the euro against the SDR in 2006, as required in accordance with an IMF decision, in the event of any change in the SDR/euro parity. Such revaluation leads to an adjustment of the Bank's relevant claims on the Greek State.

8.3 Long-term loans and securities

This item comprises the long-term amortisation loan and the bond loan, denominated in euro, extended by the Bank of Greece to the Greek government on 31 December 1993, in settlement of the balance of the account "Foreign exchange valuation differences – Law 1083/80".

Outstanding balance as at 31.12.2006	€6,640.6 million
Outstanding balance as at 31.12.2005	€6,497.9 million
Increase	€142.7 million

The increase is due to the redenomination in euro of the USD-linked part of the long-term loan granted to the Greek State on 31 December 1993, formerly disclosed under asset item 3.1 "Claims on general government denominated in foreign currency" Redenomination took place on 1 February 2006 following an agreement between the Bank and the Greek State (outstanding balance of this loan as at 31 December 2006: €503.7 million).

The Greek State paid as appropriate principal instalments and the corresponding interest for the year 2006.

9. Intra-Eurosystem claims

9.1 Participation in the capital and reserve assets of the ECB

In 2006 there was no change in the Bank's shares in the capital and reserve assets of the ECB.

	(%)	*(in € million)*	
ECB's subscribed capital (applying to all 25 EU Member States)		**5,564.7**	
Bank of Greece's key for subscription to the ECB's capital (capital key)	1.8974		
ECB capital paid up by the 12 Eurosystem NCBs		**3,978.2**	
Bank of Greece's subscribed capital key	2.65405		
Bank of Greece's subscribed share of capital			105.6
Bank of Greece's contribution to ECB's reserves			287.8
Bank of Greece's total contribution to ECB's capital and reserves on 31.12.2006			**393.4**

According to article 28 of the Statute of the European System of Central Banks, the national central banks of the ESCB are the sole subscribers to and holders of the capital of the ECB.

The subscription to the ECB's capital is based on a key assigned to each NCB and is equal to the sum of 50% of the share of its respective Member State in the gross domestic product of the European Union and 50% of the share of its respective Member State in the population of the European Union (Article 29.1 of the ESCB Statute). On 31.12.2006, the participation of the Bank of Greece in the ECB capital, together with its contribution to the reserves and the equivalent provisions of the ECB, amounted to €393.4 million.

The share of the Bank of Greece in the ECB's capital is €105.6 million and has been paid up in full. It corresponds to 1.8974% (capital key) of the ECB's total subscribed capital (25 NCBs of the ESCB), which after the adjustments of 2004 amounts to €5,564.7 million and to 2.65405% (weighted capital key) of the capital paid up by the 12 NCBs of the Eurosystem (€3,978.2 million).

The remaining amount (€287.8 million) relates to the Bank's contribution to the reserves and provisions of the ECB. This contribution was paid up upon the entry of the Bank of Greece into the ESCB on 1 January 2001.

Under Article 29.3 of the Statute of the European System of Central Banks, NCBs' keys for subscription to the ECB capital are adjusted every five years after the establishment of the ESCB. Also, according to Article 49.3 of the ESCB Statute, the ECB's subscribed capital is automatically increased when a new Member State joins the EU and its national central bank joins the ESCB.

9.2 Claims equivalent to the transfer of foreign reserves to the ECB

	(%)	*(in € million)*
Total foreign reserve assets transferred to the ECB by the 12 NCBs of the Eurosystem		39,782.3
Bank of Greece's subscribed capital key	2.65405	
Claims of the Bank of Greece on 31.12.2006 arising from the transfer of foreign reserve assets to the ECB		**1,055.8**

These claims stem from the transfer of foreign reserve assets to the ECB, in accordance with the provision of the Accession Agreement (Article 30 of the Statute of the ESCB).

Out of the said foreign reserve assets, determined on the basis of the Bank's share in the paid-up capital of the ECB, 85% were transferred in the form of assets denominated in USD and JPY and 15% in the form of gold.

These claims are expressed in euro, taking into account the exchange rates prevailing at the time of transfer, and are remunerated at the latest available marginal rate for the Eurosystem's MROs (adjusted to reflect a zero return on the gold component).

9.6 Other claims within the Eurosystem (net)

This item, amounting to €4.7 million as at 31 December 2006, corresponds to the balance between the monetary income of €392.0 million accrued to the Bank during 2006 and the monetary income allocated to the Bank according to its share in the subscribed capital of the ECB.

This claim was recorded as prepaid expenses in financial year 2006 and will be collected in January 2007.

10. Items in the course of settlement

These are balances, in the course of settlement, of various intermediate accounts that serve to monitor receivable cheques issued by banks abroad and cheques settled through clearing offices.

Outstanding balance as at 31.12.2006	€2.0 million
Outstanding balance as at 31.12.2005	€1.8 million
Increase	€0.2 million

11. Other assets

11.1 Coins

This item represents the value of coins issued by the 12 euro area countries and held by the Bank of Greece on the Balance Sheet date.

Coins put in circulation by the Bank of Greece are recorded in a special account of the Greek State, reflected in liability item 4.1 “General government”.

Outstanding balance as at 31.12.2006	€41.3 million
Outstanding balance as at 31.12.2005	€34.7 million
Increase	€6.6 million

11.2 Tangible and intangible fixed assets

Fixed assets consist of: real estate (land-buildings and fixtures-buildings under construction), furniture, machinery, electronic equipment, software and the production cost of euro banknotes. Fixed assets other than real estate, which is valued at market prices determined by independent assessors, are valued at acquisition cost. The value of fixed assets as at 31 December 2006 is reported less accumulated depreciation.

Depreciation is calculated on a straight-line basis over the expected lifetime of the asset.

Undepreciated value of fixed assets				
Asset category:	31.12.2006	31.12.2005	Change	Depreciation rate (%)
	(in € million)			
Land	432.1	432.1	0.0	0
Buildings and fixtures	209.6	185.2	24.4	2.5
Buildings under construction	3.2	29.6	-26.4	0
Other equipment	40.3	34.8	5.5	8-24
Capitalised expenses (R&D, software, etc. costs)	6.4	8.9	- 2.5	20-24
Banknote production costs	64.1	67.8	-3.7	20
Total	**755.7**	**758.4**	**-2.7**	

The increase in "Buildings and fixtures" and the corresponding decrease in "Buildings under construction" are mainly due to the fact that the new building of the Bank at Halandri, housing the Cash Handling and Sorting Centre, was put into use in 2006.

11.3 Other financial assets

The largest part of this item represents the Bank's investment portfolio (to be held up to maturity) of Greek government bonds and euro-denominated bonds issued by other euro area governments.

It also includes the Bank's holdings in DIAS Interbanking Systems SA, the Hellenic Deposit Guarantee Fund (TEK), the Hellenic Exchanges Holding SA as well as in the Bank for International Settlements (BIS), denominated in SDRs.

These assets are valued at acquisition cost.

Asset category	31.12.2006	31.12.2005	Change
	(in € million)		
Greek government bonds	3,611.7	3,635.0	-23.3
Government bonds of other euro area countries	3,168.3	954.9	2,213.4
Treasury bills of other euro area countries	5.0	0	5.0
Other participating interests	29.0	29.8	-0.8
Total	**6,814.0**	**4,619.7**	**2,194.3**

The increase recorded for 2006 was due to the reclassification of bonds and Treasury bills totalling €1.6 billion from the Bank's "marketable portfolio" (asset item 7) to its "investment portfolio", as well as to new investment, in particular in bonds issued by other euro area governments.

11.4 Accruals and prepaid expenses

This item includes accrued interest on securities, written-off premia on securities and also interest and other income accrued up to 31 December 2006 and due to be collected in the next financial year, stemming from lending, securities holdings and deposits with banks, as well as from the foreign reserve assets transferred to the ECB. Also included is an amount of €254.2 million, corresponding to the estimated value of drachma banknotes (General Council Decision 3/23.2.2005) which will not be presented for exchange against euro by the deadline of 1 March 2012 and are treated as prepaid expenses for the Bank.

Outstanding balance as at 31.12.2006	€705.7 million
Outstanding balance as at 31.12.2005	€613.8 million
Increase	€91.9 million

The change is mainly due to an increase in accrued interest income from the Bank's loans to the Greek State.

11.5 Sundry

This item primarily consists of balances on the Bank's suspense debit accounts, its remaining holding of non-marketable gold and gold coins, as well as the outstanding balances of loans to the Bank's personnel.

Outstanding balance as at 31.12.2006	€473.1 million
Outstanding balance as at 31.12.2005	€435.5 million
Increase	€37.6 million

This change is mainly attributed to an increase in the balances of suspense debit accounts and of loans to the Bank's personnel, as well as a decrease in the value of non-marketable gold, the most part of which was upgraded to standard gold bars and is now disclosed under asset item 1 "Gold and gold receivables".

LIABILITIES

1. Banknotes in circulation

Outstanding balance as at 31.12.2006	€15,338.5 million
Outstanding balance as at 31.12.2005	€13,799.7 million
Increase	€1,538.8 million

This item consists of the Bank of Greece's share in total euro banknotes in circulation, calculated on the basis of the banknote allocation key (2.4415%) (see "Banknotes in circulation" under "Accounting policies").

During 2006 the average value of banknotes in circulation was €14,099 million, compared with €12,612 million in 2005.

	31.12.2006	31.12.2005	Change
	(in € million)		
Value of euro banknotes that have actually been put into circulation by the Bank	16,907.1	15,032.0	1,875.1
Less:			
– Liability resulting from the ECB's share in the total euro banknote issue (8%)	-1,333.9[5]	-1,200.1	-133.8
– Liability resulting from the allocation of euro banknotes within the Eurosystem	-234.7[5]	-32.2	-202.5
Value of euro banknotes in circulation based on the banknote distribution key of the Bank of Greece	**15,338.5**	**13,799.7**	**1,538.8**

5 Recorded under liability item 9.2 "Net liabilities related to the allocation of euro banknotes within the Eurosystem".

2. Liabilities in euro to euro area credit institutions related to monetary policy operations

2.1 Current accounts (covering the minimum reserve system)

These accounts include credit institutions' reserve holdings with the Bank of Greece, and their balances can also be used for the settlement of interbank payments.

Outstanding balance as at 31.12.2006	€4,527.0 million
Outstanding balance as at 31.12.2005	€4,282.8 million
Increase	€244.2 million

2.2 Deposit facility

This relates to the deposit facility offered by the Eurosystem to credit institutions.

In more detail, it consists of overnight deposits placed by credit institutions with the Bank of Greece at a pre-specified interest rate, in the context of the implementation of the single monetary policy in the euro area.

Outstanding balance as at 31.12.2006	€3.0 million
Outstanding balance as at 31.12.2005	€3.2 million
Decrease	€0.2 million

During 2006, the average balance of the above deposits (current accounts, overnight deposits) was €3,603 million, compared with €3,200 million in 2005.

3. Other liabilities to euro area credit institutions denominated in euro

These are non-interest-bearing, fixed-term deposits by credit institutions as a result of sanctions for infringements of credit rules. On 31 December 2006 these deposits amounted to €22.2 million.

4. Liabilities to other euro area residents denominated in euro

4.1 General government

This item comprises deposits by the Greek State (central government), public entities and the Deposits and Loans Fund.

Outstanding balance as at 31.12.2006	€893.6 million
Outstanding balance as at 31.12.2005	€1,085.9 million
Decrease	€192.3 million

The average balance of these deposits in 2006 amounted to €1,101.8 million, compared with €1,101.5 million in 2004.

4.2 Other liabilities

This sub-item consists of deposits by various entities, most notably by the insurance funds of the Bank's staff.

Outstanding balance as at 31.12.2006	€19.3 million
Outstanding balance as at 31.12.2005	€20.7 million
Decrease	€1.4 million

5. Liabilities to non-euro area residents denominated in euro

Outstanding balance as at 31.12.2006	€851.5 million
Outstanding balance as at 31.12.2005	€863.3 million
Decrease	€11.8 million

The bulk of these liabilities (€842.8 million) consists of deposits in euro held by the IMF with the Bank and corresponds to Greece's euro-denominated participation in the IMF.

The €11.8 million decrease largely stems from this sub-item and reflects a valuation effect due to the appreciation of the euro vis-à-vis the SDR. This decrease more than offset the amounts collected by the Bank from third countries according to IMF instructions (see relevant note on asset item 2.1).

6. Liabilities to euro area residents denominated in foreign currency

These liabilities mainly stem from interest-bearing deposits by public entities, denominated in foreign currency.

Outstanding balance as at 31.12.2006	€83.7 million
Outstanding balance as at 31.12.2005	€163.5 million
Decrease	€79.8 million

The change is due both to a decline in the volume of deposits and to the depreciation of the euro, the most common currency of denomination for these deposits, against the USD.

7. Liabilities to non-euro area residents denominated in foreign currency

7.1 Deposits and other liabilities

The largest component of this sub-item is the long-term loan of GBP 75 million raised on behalf of, and assigned to, the Greek State on 6 September 1985. The corresponding claim on the Greek State is disclosed under asset item 3.1 "General government".

Outstanding balance as at 31.12.2006	€111.7 million
Outstanding balance as at 31.12.2005	€109.8 million
Increase	€1.9 million

8. Counterpart of special drawing rights allocated by the IMF

This item comprises the Bank's liabilities to the IMF, stemming from the cumulative allocation of special drawing rights (SDR 103.5 million) to Greece between 1970 and 1981.

Outstanding balance as at 31.12.2006	€118.2 million
Outstanding balance as at 31.12.2005	€125.3 million
Decrease	€7.1 million

The decrease in the amount of these interest-bearing liabilities, when expressed in euro terms, is solely due to valuation effects, i.e. the appreciation of the euro against the SDR.

9. Intra-Eurosystem liabilities

9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This account shows liabilities that stem from the allocation of euro banknotes within the Eurosystem (see "Banknotes in circulation" under "Accounting Policies").

Outstanding balance as at 31.12.2006	€1,568.5 million
Outstanding balance as at 31.12.2005	€1,232.2 million
Increase	€336.3 million

The balance as at 31 December 2006 is broken down as follows:

— €1,333.9 million refer to the value of euro banknotes issued by the Bank of Greece on behalf of the ECB (8% of the total value of banknotes in circulation are issued on behalf of the ECB). The Bank's share in that amount is calculated in proportion to its share in the subscribed capital of the ECB.

– €234.7 million represent an adjustment to the amount of euro banknotes that the Bank has actually put into circulation. This adjustment is aimed to equalise the bank's share in total euro banknotes in circulation (liability item 1) to its banknote allocation key.

The average balance of these liabilities during 2006 (including the aforementioned adjustment) was €1,265 million, compared with €1,246 million in 2005.

9.3 Net liabilities related to transactions with the ESCB (TARGET)

These are net liabilities to the ECB, stemming from the Bank's cross-border transactions with the other national central banks of the European System of Central Banks and the ECB. These transactions are processed through the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system.

TARGET account, year-end balances

31.12.2001	31.12.2002	31.12.2003	31.12.2004	31.12.2005	31.12.2006
		(in € million)			
8,092.9	17,411.2	15,353.1	6,545.9	7,216.8	8,183.5

TARGET account, year averages

2001	2002	2003	2004	2005	2006
		(in € million)			
7,447.2	13,872.0	16,331.9	13,363.3	12,019.0	11,762.0

The creation of these liabilities in 2001 and their continuous increase through to 2003 reflect outflows of funds from domestic credit institutions to other EU countries. These funds came from the gradual release of credit institutions' reserve holdings (in euro and foreign currency) with the Bank of Greece after Greece joined EMU on 1 January 2001 and became subject to the single monetary policy of the Eurosystem.

That change has had no effect on the Bank's financial results, since the amount of interest paid by the Bank to the ECB in respect of these liabilities has replaced the interest paid until 2001 to domestic credit institutions as remuneration of their reserve holdings.

In the years 2004-2006 these liabilities gradually decreased, while banknotes in circulation increased, reflecting capital inflows aimed to meet credit institutions' increased funding needs in the face of strong demand for credit by households (housing and consumer loans) and non-financial corporations.

9.4 Other liabilities within the Eurosystem (net)

On 31 December 2006 no such liability existed. Instead, a claim of €4.7 million arose from the distribution of monetary income within the Eurosystem for the year 2006, which is disclosed under asset 9.6 "Other claims within the Eurosystem (net)".

The net liability of €6.9 million as at 31 December 2005, which was settled on 31 January 2006, was the net balance of the following claims and liabilities vis-à-vis the ECB:

— a €16.8 million liability relating to the distribution of monetary income from the ECB to the Bank of Greece for the first three quarters of 2005. The distribution was subsequently reversed, following a decision of the Governing Council, in order to establish a provision against foreign exchange rate, interest rate and gold price risks; and

— a claim of €9.9 million corresponding to the Bank's share from the pooling and distribution of monetary income in 2005.

10. Items in course of settlement

This account mainly consists of the float of cheques and payment orders whose settlement is pending, totalling €55.5 million on 31 December 2006 (31 December 2005: €48.9 million).

11. Other liabilities

11.1 Off-balance sheet instruments revaluation differences

On 31 December 2006 there were no open positions in forward transactions. The balance of €8,324 million as at 31 December 2005 had been the net result (gains of €8,324 million) of the end-of-year revaluation of a forward transaction (sale of USD and purchase of euro).

11.2 Accruals and income collected in advance

This sub-item represents write offs/write downs of premiums on securities, interest expenses accrued up to 31 December 2006 and other expenses. Such expenses will be paid within the new financial year and mainly involve tax on interest income from Greek State bonds and various categories of interest payable (on the outstanding balance of the TARGET account, on credit institutions' reserve holdings and on other liabilities).

Outstanding balance as at 31.12.2006	€170.0 million
Outstanding balance as at 31.12.2005	€143.2 million
Increase	€26.8 million

11.3 Sundry

This sub-item comprises: the Bank's liability towards the Greek State regarding Greece's SDR-denominated participation in the IMF (the corresponding claim of the Bank on the IMF is recorded under asset item 2.1 "Receivables from the IMF"); the profit for the year and tax on distributed profits; and balances of suspense credit accounts and other accounts on behalf of third parties.

Also included, as from 2 January 2003, is the equivalent of drachma banknotes not withdrawn from circulation.

Sundry	**31.12.2006**	**31.12.2005**	**Change**
	(in € million)		
Dividends to be distributed	46.1	38.1	8.0
Tax on dividends	18.8	17.9	0.9
Profit to be transferred to the Greek State	160.7	150.1	10.6
Value of drachma banknotes in circulation	256.6	263.3	-6.7
Liability to the Greek State (Greece's SDR-denominated participation in the IMF)	97.2	142.4	-45.2
Other liabilities	29.5	29.8	-0.3
Total	**608.9**	**641.6**	**-32.7**

12. Provisions

Category of provisions	**31.12.2006**	**31.12.2005**	**Change**
	(in € million)		
Provision for future obligations of the Bank to its personnel insurance funds	909.5	705.1	204.4
Provision for general risks under Article 71 of the Statute	25.5	25.7	-0.2
Other provisions for doubtful loans	117.3	115.9	1.4
Total	**1.052.3**	**846.7**	**205.6**

— In financial year 2006 the Bank added an amount of €204.4 million to the provision for future obligations to its personnel insurance funds. This amount represents net profit from swap operations carried out during 2006, following ECB approval.

— The provision of €25.5 million under Article 71 of the Statute is aimed to cover credit risk associated with non-performing loans and the risk of asset depreciation (foreign exchange rate, interest rate and gold price risks).

— The category of "Other provisions for doubtful loans" is aimed to cover special cases of doubtful loans.

13. Revaluation accounts

In accordance with the accounting principles set out by the European Central Bank for the NCBs of the European System of Central Banks, especially the principle of prudence, unrealised valuation gains on gold, financial instruments in foreign currency and securities are not recognised as income in the Profit and Loss Account but are transferred directly to revaluation accounts (functioning as reserves for these particular assets only). By contrast, unrealised valuation losses at year-end are recognised as expenditure and are taken to the Profit and Loss Account.

Valuation at end-2006 produced unrealised gains of €650.6 million (almost exclusively stemming from gold, see breakdown below), which were transferred to the corresponding revaluation accounts, and unrealised losses of €22.9 million, which were taken to the Profit and Loss Account.

Unrealised valuation gains	**31.12.2006**	**31.12.2005**	**Change**
	(in € million)		
– on foreign currency instruments	0.2	46.2	-46.0
– on securities	0.2	0.2	–
– on gold	650.2	636.3	13.9
Total	**650.6**	**682.7**	**32.1**

14. Capital and reserves

On 31 December 2006 the Bank's own funds amounted to €667.2 million against €648.2 million on 31 December 2005.

The change came from the creation of an extraordinary reserve of €19 million, following a transfer from the profits for the financial year 2006.

In more detail, the composition of the Bank's own funds as at 31 December 2006 is as follows:

14.1 Capital

The Bank's capital, following the increases effected by virtue of Legislative Decrees 413/1970 and 889/1971, Laws 542/1977 and 1249/1982, Ministerial Decision E. 2665/1988, Law 2065/1992, Ministerial Decision 1281/30.10.1996 and Cabinet Acts No. 8/4.2.2000, 32/23.5.2002 and 17/4.7.2005, **has reached €88,994,690 divided to 15,891,909 shares of a par value of €5.60 each.**

14.2 Ordinary reserve

The ordinary reserve has become equal to the capital, amounting to €88,994,690.

14.3 Extraordinary reserve

An extraordinary reserve of €19,000,000 was created out of the profit for the year 2006.

14.4 Special reserve from the revaluation of land and buildings under Law 3229/2004

This special reserve was created out of capital gains arising from the restatement of land and buildings at fair (market) value (as determined by an independent real estate assessor), on 31 December 2004, under Article 15 of Law 3229/2004.

Out of these capital gains that totalled €492,267,534, an amount of €22,248,671 was used to establish this special reserve, which thus stood at €470,018,863 on 31 December 2006. Under Law 3229/2004 (Article 15, para. 1), this special reserve may be used by the Bank to offset future valuation losses on its portfolio.

14.5 Special reserves

Special reserves amount to €201,317 and represent the value of fixed assets (mostly buildings) transferred gratis to the Bank.

OFF-BALANCE SHEET (MEMORANDUM) ITEMS

	31.12.2006	31.12.2005	Change
	(in € million)		
– Greek government securities from the management of the "Common fund of public entities and social security organisations" under Law 2469/97	18,034.1	19,105.5	-1,071.4
– Greek government securities and other debt securities from the management and custody of public entities', social security organisations' and private-sector agents' funds	10,753.7	10,430.7	323.0
– Other*	7,035.8	5,256.5	1,779.3
Total	**35,823.6**	**34,792.7**	**1,030.9**

* These include:
– Greek government securities delivered as collateral by the Bank's counterparties in monetary policy operations;
– orders of documentary credits, third-party guarantees of good performance, coins in storage at the Bank, etc.

GENERAL NOTES ON THE PROFIT AND LOSS ACCOUNT FOR 2006

The Bank's net profits in 2006 amounted to €244.6 million, compared with €228.5 million in 2005, thus increasing by 7.10%.

More specifically:

INCOME

- ***The Bank's total net income*** was significantly higher than in the previous financial year (having increased by 36% to €830.9 million, from €610.8 million in 2005).

This result was primarily due to gains arising from financial operations, which amounted to €362.2 million, compared with €155.2 million in 2005.

Of these gains, €204.4 million arose from swap transactions carried out following a prior approval by the ECB in order to increase the special provision for the Bank's future liabilities to its personnel social security funds.

- ***Net interest income*** was slightly lower than in the previous financial year (2006: €305.6 million, 2005: €311.9 million), in spite of higher yields on the Bank's portfolios. This was due to the fact that the ECB increased its minimum bid rate on main refinancing operations to 3.50% in December (from 2.25% in December 2005), which resulted in the substantial increase in the interest paid by the Bank on its share of intra-Eurosystem liabilities. These liabilities have arisen from the conduct of the single monetary policy in the euro area and more specifically from the transfer of excess liquidity from domestic credit institutions to other EU countries (TARGET account).

- ***Other income*** (commissions, participating interests, etc.) came to €163.1 million from €165.4 million in 2005.

It should be noted that this item does not include income arising from the Bank's allotted share in the ECB's income on euro banknotes in circulation and in the ECB's net profits, since the ECB, in 2006 as in previous financial years, retained the full amount of its surplus, including income from its share (8%) in the total value of euro banknotes in circulation issued on its behalf. This surplus was set aside in a provision against future foreign exchange rate, interest rate and gold price risks.

EXPENSES

- ***The Bank's operating expenses excluding provisions*** (staff costs, pensions, administrative and other expenses, depreciation) increased by €35.5 million or 11% (2006: €358.6 million, 2005: €323.1 million).

Operating expenses were substantially affected by:

— the higher expenditure for raw materials required for the Banknote Printing Works' production of new Greek passports and a greater number of banknotes than in 2005 (resulting in a corresponding increase in the Bank's income);

— the increase in compensation payments for staff retirement (217 employees retired in 2006, compared with 95 in 2005);

— the increased depreciation of euro banknote printing costs.

It should be noted that expenditure for wages increased by 4.5%, while total staff costs (wages and salaries, other allowances, employer contributions) rose by 6.6% to €214.1 million, from €200.8 million in 2005. As mentioned above, higher staff costs are attributed to the larger number of employees who retired in 2006 (compensation payments, advance payments, etc.).

• ***Total provisions*** made during financial year 2006 came to €227.6 million, up from €59.2 million in 2005. This substantial increase was due to the Bank's higher provisions (€204.4 million in 2006, compared with €45 million in 2005) for future liabilities to personnel social security funds. This sum of €204.4 million came from gains from swap transactions.

DETAILED INCOME STATEMENT

NET OPERATING INCOME *(in euro)*

	2006	2005
1. NET INTEREST INCOME	**305,562,534**	**311,925,536**
1.1 Interest income	**809,375,938**	**683,455,834**
a. Interest on lending to credit institutions in relation to monetary policy operations	138,824,569	59,583,776
b. Interest on securities and deposits with non-resident credit institutions	241,199,081	212,840,569
c. Remuneration of long-term claims in euro arising from the transfer of foreign exchange reserves to the ECB	25,620,362	18,847,998
d. Interest on long-term claims against the Greek State	241,327,469	222,128,393
I. Interest on long-term loans to the Greek State granted before 31.12.1993	*3,229,033*	*6,244,528*
II. Interest on long-term loans to the Greek State (conversion of debit balances on 31.12.1993)	*49,212,015*	*51,921,472*
III. Interest on long-term bond issue in euro (conversion of debit balances of accounts of foreign exchange valuation differences on 31.12.93)	*58,595,610*	*53,659,424*
IV. Interest on long-term euro-denominated loan (conversion of debit balances of accounts of foreign exchange valuation differences on 31.12.93)	*130,180,741*	*110,219,547*
V. Interest on long-term USD-denominated claims (31.12.93)	*110,070*	*83,422*
e. Interest on deposits and participations in the IMF	3,012,924	6,391,059
f. Interest on Greek government debt securities	156,683,348	161,312,941
g. Interest on loans granted to the personnel of the Bank of Greece	2,678,221	2,325,755
h. Other interest income	29,964	25,343
1.2 Interest expense	**-503,813,404**	**-371,530,298**
a. Interest and expenses on intra-ESCB balances (TARGET)	-333,457,592	-252,143,262
b. Interest on net liabilities related to the allocation of euro banknotes within the Eurosystem	-35,148,573	-26,089,166
c. Interest on banks' deposit accounts in the context of monetary policy operations (including minimum reserves)	-103,044,349	-67,113,649
d. Interest on deposits by the Greek State	-22,263,731	-18,414,751
e. Interest on deposits by public entities in foreign currency	-5,373,361	-4,498,050
f. Interest on the allocation of SDRs	-4,459,584	-3,213,891
g. Other interest expense	-66,214	-57,529
2. NET RESULT OF FINANCIAL OPERATIONS, WRITE-DOWNS AND RISK PROVISIONS	**362,192,133**	**133,521,961**
3. NET INCOME FROM FEES AND COMMISSIONS	**121,812,074**	**124,906,121**
4. INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS	**3,472,030**	**3,476,715**
5. NET RESULT OF POOLING OF MONETARY INCOME	**4,667,120**	**9,874,431**
6. OTHER INCOME	**33,147,655**	**27,094,748**
TOTAL NET INCOME	**830,853,546**	**610,799,512**

NOTES ON NET OPERATING INCOME ACCOUNTS

The Bank's net operating income was considerably higher than in 2005 (it rose by 36% to €830.9 million, from €610.8 million in 2005).

In greater detail:

1. Net interest income

Net interest income (interest income less interest expense) decreased by €6.3 million relative to the previous financial year, to €305.6 million (2005: €311.9 million). This change is due to the larger increase in interest expense (€132.3 million) in relation to interest income (€126 million).

The individual categories of interest are as follows:

1.1 Interest income

Interest income 2006: €809.4 million, 2005: €683.4 million

a) Interest on lending to credit institutions in relation to monetary policy operations

This refers to the financing of domestic credit institutions through open market operations, in the context of the Eurosystem's single monetary policy pursued in the euro area. The largest part relates to main refinancing operations (MROs, with a maturity of 7 days) and the remainder to longer-term refinancing operations (LTROs, with a maturity of 3 months).

In financial year 2006, this category showed a significant increase of €79.2 million, largely because of higher lending (2006 average: €4,774 million, 2005 average: €2,808 million) and higher interest rates. The minimum MRO rate rose by 125 basis points in the course of 2006, to 3.5% in December 2006, from 2.25% in December 2005.

Interest on lending to credit institutions	2006	2005	Change
	(in € million)		
– main refinancing operations	106.5	55.1	51.4
– longer-term refinancing operations	32.3	4.5	27.8
Total	**138.8**	**59.6**	**79.2**

b) Interest on securities and deposits with non-resident credit institutions

This includes interest on securities and deposits, both in euro and in foreign currency, with euro area and non-euro area credit institutions.

Interest by type of asset	2006	2005	Change
	(in € million)		
–on securities	170.8	172.5	-1.7
–on time deposit accounts and current accounts	70.4	40.3	30.1
Total	**241.2**	**212.8**	**28.4**

c) Remuneration of long-term claims arising from the transfer of foreign exchange reserves to the ECB

This refers to interest on the Bank's euro-denominated claim against the ECB with respect to foreign exchange reserves transferred. This claim is remunerated at 85% of the latest marginal MRO rate. In 2006 this interest rose significantly, by €6.8 million against 2005, to €25.6 million (2005: €18.8 million). This increase is exclusively due to higher euro interest rates.

d) Interest on long-term claims against the Greek State

This refers to interest on loans granted by the Bank of Greece to the Greek State until 31 December 1993.

In 2006 it totalled €241.3 million, i.e. €19.2 million more than in 2005. This increase is attributable to the considerably higher euro interest rates, which apply to all loans granted to the Greek State that have resulted from the conversion of debit balances of the "Foreign exchange valuation differences, Law 1083/80" account (12-month Libor and Libid rates). Higher euro interest rates more than offset the lower interest payments by the Greek State due to the gradual repayment of such loans.

e) Interest on deposits and participations in the IMF

This comprises interest on Greece's participation in the IMF and on the Bank's SDR holdings with the IMF. This category of interest income decreased by €3.4 million to €3.0 million in 2006 (2005: €6.4 million).

This change was due to the significant decrease in Greece's participation in the IMF (in SDRs) and the respective increase in Greece's euro-denominated participation.

f) Interest on Greek government debt securities

Interest on the Bank's holdings of Greek government securities dropped by €4.6 million against the previous financial year (2006: €156.7 million, 2005: €161.3 million). The total value of holdings was €3,611.7 million on 31 December 2006, from €3,635.0 million on 31 December 2005.

g) Interest on loans granted to the personnel of the Bank of Greece

Interest on loans (for home purchase or personal loans) granted by the Bank of Greece to members of its staff decreased by €0.4 million (2006: €2.7 million, 2005: €2.3 million).

h) Other interest income

Other interest income totalled €29,964 against €25,343 in 2005.

1.2 Interest expense

Interest expense 2006: €503.8 million, 2005: €371.5 million

a) Interest and expenses on intra-ESCB balances (TARGET)

Interest and expenses on the TARGET account (in € million)

2001	2002	2003	2004	2005	2006
320.9	458.9	384.8	273.4	252.1	333.5

The above interest and expenses are calculated on the basis of the daily balances of the account dedicated to the transactions of the Bank of Greece with the ECB and other ESCB NCBs within the TARGET system.

In the first two years after the Bank joined the ESCB (2001 and 2002), this interest rose significantly, due to the transfer of excess liquidity from domestic credit institutions to other EU countries, while gradual declines were seen from 2003 to 2005. In 2003 the decline was exclusively due to the lower interest rates (marginal MRO rate), as the average annual balance of the account increased.

The declines of 2004 and 2005 reflected lower balances on the TARGET account, in the absence of significant changes in the interest rate over the same period (the interest rate increase of 6 December 2005, from 2% to 2.25% had a negligible impact).

The considerable rise in 2006 is exclusively due to the higher euro rate, as the average balance on the account stood at slightly lower levels (2006: €11.8 million, 2005: 12.0 million).

It should be noted that this interest expense replaced the interest paid by the Bank until 2001 to domestic credit institutions on their required reserve holdings.

b) Interest on net liabilities related to the allocation of euro banknotes within the Eurosystem

This interest expense registered a significant rise of €9 million (2006: €35.1 million, 2005: €26.1 million). By contrast, the average level of these liabilities decreased during 2006 to €1,265 million, against €1,246 million in 2005. The above interest is calculated on the basis of:

— the Bank's liability corresponding to the ECB's share in the euro banknote issue (a share of 8% of the total value of euro banknotes in circulation is allocated to the ECB);

— the intra-Eurosystem claim/liability corresponding to the value of euro banknotes put into circulation by the Bank of Greece, adjusted to ensure that the Bank's share in total euro banknotes in circulation (after the deduction of the 8% share allocated to the ECB) is equal to its banknote allocation key;

- the amount of adjustment. From 2002 to 2007, intra-Eurosystem balances related to the allocation of euro banknotes have been adjusted in order to avoid sharp fluctuations in the monetary income of Eurosystem NCBs (see above Section "Banknotes in circulation" under "Accounting Policies", as well as the note on liability item 9.2).

c) Interest on banks' deposit accounts in the context of monetary policy operations (including minimum reserves)

This mainly concerns interest paid on banks' minimum reserves, in the context of monetary policy in the euro area countries.

This item rose by €35.9 million in 2006 compared with the previous year (2006: € 103.0 million, 2005: €67.1 million), a development which is mainly attributed to the rise in key ECB interest rates (average MRO rate during the reserve maintenance period) and, to a lesser extent, to the increase in the level of reserve holdings (2006: €3,603 million, 2005: €3,200 million).

d) Interest on deposits by the Greek State

Interest on deposits by the Greek State rose by €3.9 million, to €22.3 million (2005: €18.4 million). This is exclusively due to higher interest rates (average rate 2006: 2.83%, 2005: 2.08%), as the average deposit amount registered a small decrease in 2006 (2006: €793,000, 2005: €887,000).

e) Interest on deposits by public entities in foreign currency

This category of interest expense rose by €0.9 million (2006: €5.4 million, 2005: €4.5 million), mainly due to the increase in USD interest rates (the bulk of these deposits is denominated in USD).

f) Interest on the allocation of SDRs

Interest on the Bank's liabilities from the allocation of IMF special drawing rights (SDRs) increased by €1.3 million (2006: €4.5 million, 2005: €3.2 million), due to a rise in SDR interest rates.

g) Other interest expense

This category of interest expense came to €66,214 compared with €57,529 in 2005.

2. Net result of financial operations, write-downs and risk provisions

The net result from financial operations in 2006 increased by €228.7 million to €362.2 million, compared with €133.5 million in 2005.

A detailed breakdown is provided below.

2.1 Realised gains from financial operations	**2006** *(in € million)*	**2005**	**Change**
– transactions in foreign exchange	26.4	81.7	-55.3
– transactions in securities	123.7	69.4	54.3
– transactions in swaps	204.4	0	204.4
– transactions in SDRs	7.7	4.1	3.6
Total	**362.2**	**155.2**	**207**
2.2 Write-downs of financial assets and positions (unrealised losses)			
– from the valuation of foreign exchange	-17.1	-0.5	-16.6
– from the valuation of securities	-5.8	-21.2	15.4
Total	**-22.9**	**-21.7**	**-1.2**
2.3 Transfer from provisions for exchange rate and price fluctuation risks	**22.9**	**0**	**22.9**
Grand total	**362.2**	**133.5**	**228.7**

The significant €228.7 million increase in the net result from financial operations shown in the above table mainly stems from the €204.4 million profit from swap transactions.

The €55.3 million decrease in gains from foreign exchange transactions (2006: €26.4 million, 2005: €81.7 million) was offset by the €54.3 million increase in gains from transactions in securities (2006: €123.7 million, 2005: €69.4 million).

Finally, the 2006 results include unrealised losses of €22.9 million, compared with €21.7 million in 2005, which stemmed from the year-end valuation of foreign exchange and securities and are attributed to the revalution of the euro against the main foreign currencies and to changes in securities prices. These losses were covered by the transfer of an equal amount from the special provision made for this purpose.

3. Net income from fees and commissions

Net income from fees and commissions amounted to €121.8 million, compared with €124.9 million in 2005.

Fees and commissions	2006	2005	Change
	(in € million)		
3.1 Income from fees and commissions			
– from the management of Greek government debt	25.1	32.7	-7.6
– from payments and receipts on behalf of the Greek State	60.9	57.8	3.1
– from the management of the "Common Fund" (surpluses of public entities and social security organisations) under Law 2469/1997	29.6	27.7	1.9
– other	7.2	7.7	-0.5
Total	**122.8**	**125.9**	**-3.1**
3.2 Expenditure for fees and commissions	**-1.0**	**-1.0**	**0**
Grand total	**121.8**	**124.9**	**-3.1**

The €3.1 million overall decrease shown in the table mainly reflects the €7.6 million drop in income from commissions from the management of Greek government debt, due to the reduced volume of new issues in 2006. By contrast, commissions from the management of the "Common Fund" (surpluses of public entities and social security organisations, under Law 2469/1997) and from payments and receipts on behalf of the Greek State increased by €1.9 million and €3.1 million respectively.

4. Income from equity shares and participating interests

Income from equity shares and participating interests in 2006 remained unchanged compared with 2005 (€3.5 million).

This income corresponds to dividends collected in 2005 from the Bank's participating interests in the Bank of International Settlements –BIS (€2.4 million), DIAS Interbank Systems SA (€0.4 million) and Hellenic Exchanges SA (€0.7 million, of which €0.4 million was refund of capital).

2006 was another year in which the ECB retained the full amount of its net profits, including income from its share (8%) in total euro banknotes in circulation, in order to establish a provision against future foreign exchange rate, interest rate and gold price risks.

5. Net result of pooling of monetary income

Monetary income is the income accruing to the national central banks of the euro area in the performance of the Eurosystem's monetary policy function.

The amount of each NCB's monetary income is determined by measuring its actual annual income derived from its assets held against a "liability base".

The liability base consists of the following liability items:

- banknotes in circulation;

- deposit liabilities to euro area credit institutions in euro, related to monetary policy operations;

- net intra-Eurosystem liabilities related to transactions with the ESCB (TARGET); and

- net intra-Eurosystem liabilities related to the allocation of euro banknotes.

Any interest paid by an NCB on items included in the liability base is deducted from the monetary income of that NCB.

The assets that are held against the liability base ("earmarkable assets") are the following:

- loans in euro to euro area credit institutions related to monetary policy operations;

- intra-Eurosystem claims equivalent to the transfer of foreign reserves to the ECB;

- net intra-Eurosystem claims resulting from transactions with the ESCB through TARGET;

- net claims related to the allocation of euro banknotes within the Eurosystem;

- a minimum amount of gold reserves for each NCB, according to its allocation key. Gold is considered to generate no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference is offset by applying to the average annual value of the difference the average rate of return on the earmarkable assets of all Eurosystem NCBs taken together.

At the end of each financial year, the pooled monetary income of the Eurosystem is allocated to the NCBs in proportion to their paid-up shares in the capital of the ECB.

The positive difference (€4.7 million) between the monetary income accrued to the Bank of Greece during 2006 (€392.0 million) and the amount to be allocated to it (€396.7 million) in proportion to its paid-up share in the ECB's capital is the Bank's net monetary income. The level of this difference was also positive in 2005 (€9.9 million).

The above method for allocating Eurosystem monetary income was established by ECB Decision No. 16/2001 and will apply until 2007 (Accounting and Monetary Income Committee–AMICO, 30 June 2004).

6. Other income

Other income increased by €6 million to €33.1 million, compared with €27.1 in 2005.

The most important category under this heading is income from the activities of the Banknote Printing Works (IETA) of the Bank of Greece (about €31 million). A much smaller category comprises income from the sale of useless materials and old equipment, including vehicles, from surpluses at the cashier's, provision of training services, etc.

The observed increase is mainly attributed to the increased IETA revenue from the production of new Greek passports and a greater number of banknotes (276.9 million €10 banknotes were produced in 2006, compared with 174.1 million in 2005).

OPERATING COSTS, DEPRECIATION AND PROVISIONS

	2006	2005
	(in euro)	
STAFF COSTS	**214,153,481**	**200,810,488**
Wages and salaries	140,052,880	132,282,005
– *Basic wages and salaries, benefits*	*128,113,954*	*122,606,661*
– *Other allowances*	*11,938,926*	*9,675,344*
Employer's contributions and other levies	74,100,601	68,528,483
PENSIONS AND BENEFITS	**55,381,266**	**49,036,451**
ADMINISTRATIVE AND OTHER EXPENSES	**50,641,472**	**39,460,857**
DEPRECIATION OF TANGIBLE AND INTANGIBLE FIXED ASSETS	**38,436,988**	**33,803,564**
	358,613,207	**323,111,360**
PROVISIONS	**227,604,875**	**59,228,907**
TOTAL EXPENSES	**586,218,082**	**382,340,267**

NOTES ON EXPENSES ACCOUNTS

Outlays for wages and salaries (basic wages and salaries, benefits) increased by 4.5% (2006: €128.1 million, 2005: €122.6 million). This increase mainly stemmed from the Collective Labour Agreement between Banks and the Greek Federation of Bank Employees (OTOE) for 2006-07.

Outlays for other allowances rose by 23.4% (2006: €11.9 million, 2005: €9.7 million), mainly due to increased compensation payments (217 employees retired in 2006, compared with 95 in 2005).

Employer's contributions and other levies increased by 8.1% (2006: €74.1 million, 2005: €68.5 million).

Outlays for pensions and benefits rose by 12.9% (2006: €55.4 million, 2005: €49.0 million), due to the increased number of retirements.

Administrative and other expenses (including IETA expenditure for raw materials, the cost of building repair and maintenance, procurement of equipment etc.) increased by 28.1% (2006: €50.6 million, 2005: €39.5 million).

This increase mainly reflects the higher expenditure for raw materials required for the Banknote Printing Works' production of new Greek passports and a greater number of banknotes than in 2005, resulting in a corresponding increase in the Bank's income (item 6 in the profit and loss account).

Depreciation increased by €4.6 million (2006: €38.4 million, 2005: €33.8 million), mainly due to the increased outlays for the depreciation of previous years' banknote production costs.

It should be noted that the annual depreciation of the Bank's buildings is calculated at a 2.5% rate on the basis of the estimated lifetime of the buildings (40 years), while the annual depreciation of the banknote production costs is calculated at a rate of 20% over the average lifetime of banknotes (5 years).

Total provisions made in 2006 amounted to €227.6 million, compared with €59.2 million in the previous year. This substantial increase was due to the Bank's higher provisions (€204.4 million in 2006, compared with €45 million in 2005) for future liabilities to personnel social security funds. This sum of €204.4 million came from gains from swap transactions, carried out in 2006 following a prior approval by the ECB.

Breakdown of provisions made in 2006 and 2005	2006	2005
	(in euro)	
– Provision under Article 71 of the Statute	23,000,000	14,000,000
– Provision against future liabilities of the Bank to personnel social security funds	204,375,968	45,000,000
– Other provisions according to decisions of the General Council	228,907	228,907
Total provisions	**227,604,875**	**59,228,907**

NET PROFITS

In 2006 net profits after provisions amounted to €244.6 million, compared with €228.5 million in 2005, i.e. they increased by €16.2 million or 7.10%.

DISTRIBUTION OF NET PROFIT

(Article 71 of the Statute)

The General Council proposes to the General Meeting of Shareholders that the net profit be distributed as follows:

	(in euro)
Dividend on capital, €0.67 per share on 15,891,909 shares (this dividend corresponds to 12% of the share capital)	10,647,579
To the extraordinary reserve	19,000,000
Additional dividend, €2.23 per share on 15,891,909 shares	35,438,957
Tax payment on dividends (Article 6 of Law 3296/2004)	18,824,078
To the Government	160,724,850
Total	**244,635,464**

The General Council proposes to the General Meeting of Shareholders that a total dividend of €2.90 per share be distributed to shareholders. This would be 20.8% higher than the total dividend of €2.40 per share distributed in 2005.

Athens, 19 March 2007

For the General Council
THE CHAIRMAN

NICHOLAS C. GARGANAS
GOVERNOR OF THE BANK OF GREECE